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Consultation: Taxation of Employee Ownership Trusts and Employee Benefit Trusts

Response by the Chartered Institute of Taxation

1 Executive summary

1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000+ members, and extensive volunteer network, in providing our response. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party political organisation.

1.2 We are pleased to see that many of the recommendations we put forward in our 2021 submission '*Autumn Budget 2021 representation on enhancement and anti-abuse measures, funding and other tax issues*[1]' have appeared as proposals within this consultation; as such, we broadly support them. However, it should be ensured that the tax benefits should be used to support the fundamental aims of Employee-Ownership Trusts (EOTs) ie to promote and incentivise genuine employee ownership and engagement without those tax benefits being abused. This would involve having a rigorous set of rules whereby the vendor of the company can enjoy the tax benefits, but at the same not be so prescriptive as to make the establishment and future running of an EOT unnecessarily onerous or commercially unviable.

2 About us

2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities.

2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most

[1] https://www.tax.org.uk/ref833

effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA' and 'CTA(Fellow)' to represent the leading tax qualification.

3 The questions

Question 1: Do you have any comments on the proposal to prohibit former owners and connected persons from retaining control of an EOT-owned company post-sale by appointing themselves in control of the EOT trustee board?

3.1 This was one of the recommendations we made in our 2021 submission and fits in with the presumed intention that the former owners will relinquish control of the entity controlling the company. By ensuring that those same owners (or their associates) do not control the trustee board, this will avoid obvious conflicts of interest and concerns that the trustees cannot act in the interests of their beneficiaries but are merely a vehicle to provide tax free funds to the former owner. Not having the former owner in control of the trustee board is common, but placing it into legislation would hopefully deter anyone minded to abuse the process.

Question 2: Should the government go further and require that the EOT trustee board includes persons drawn from specific groups, such as employees or independent persons? If so, how should these groups be defined?

3.2 We would urge caution with such a proposition, as overly-prescriptive rules could discourage business owners from selling to an EOT, given the potential difficulty of finding people from specific groups. Independent persons, in particular, could be difficult to define or enforce, as people are always going to appoint someone they know (and like), rather than a complete stranger. On that basis, the concept would be effectively unenforceable, anyway. Finding genuinely independent people simply may not be possible or feasible and to deny the benefits of setting up an EOT on that basis alone would harsh. Professional representatives might be too expensive to appeal to some smaller businesses – and many professional trustees are wary of taking on trading enterprises in any event.

3.3 However, while such an approach is not infallible, in principle, we can see some merit in the introduction of criteria of minimum employee involvement (ie of those employees who did not hold a material interest prior to the establishment of the EOT). These employees could be voted onto the board by employees or their representative body (although again we would counsel against being overly prescriptive about the manner of their appointment given the wide range of companies which might use an EOT) and would help ensure that there is genuine employee engagement. By having this criterion as a condition for owners' receiving their CGT relief, and potentially placing a time limit by which independent employee representatives are in place, this may help ensure that the incentives are there for the EOTs to be managed by genuine employees as soon as possible.

Question 3: Do you have any comments on the proposal to require that the trustees of an EOT are UK resident as a single body of persons?

3.4 This too was a source of some discussion within our 2021 submission, which was offshore trusts potentially being used as a vehicle to ensure that the proceeds never suffer UK tax at all. Whilst we acknowledge the high-quality of trustee services available outside the UK, after some discussion we think there is merit in

requiring trustees to be UK resident as a single body, as is now proposed. If particular overseas expertise is required then a non-resident trustee or director of the trustee board can be appointed. but by having qualifying EOTs exclusively onshore, the possibility of abuse of the rules should be removed. Alternatively, thought might be given to deeming EOT trustees to be UK resident, irrespective of where (actually) the trustees for the time being are resident.

3.5 For those existing offshore trustees, if they wish to remain outside the UK for commercial reasons then they should be allowed to do so without any disqualifying event CGT charge for the settlor. However, careful thought should be given to the position of existing offshore trustees and appropriate transitional rules considered.

Question 4: Do you have any comments on the proposal to confirm in legislation the distributions treatment for contributions made by a company to an EOT to repay the former owners for their shares?

3.6 We would support this change ie that contributions made by the company to the EOT trustees in order to repay the former owners for the acquisition cost of the company shares, will not be treated as distributions for the purposes of section 1000 or section 1020; we are unaware of any instances of a company's repayments to their former owners being deemed as a distribution by HMRC, so the need to go through the clearance process seems unnecessary. It would therefore provide clarity to confirm in the legislation that these repayments do not come under the definition of distributions.

3.7 The proposed exemption also covers payments of Stamp Duty and interest. We would suggest that the spirit of the proposal is that the exemption should apply to the reimbursement of other costs legitimately incurred by the trustees in acquiring the company. We have in mind the following:

- Transaction costs: the trustees are the buyers in the transactions and would have either incurred professional fees or an appropriate proportion of such fees will have been allocated to them. This should include fees for valuations, tax advice, legal advice, accountancy advice etc.
- Financing costs: where transactions are financed by external borrowings, the lenders may impose arrangement charges and other costs related to taking out a loan.
- Professional fees: there are likely to be ongoing costs for trustees that will need to be covered, too, such as the fees for professional trustees, accountancy and tax advice for annual tax returns and other compliance costs.

Question 5: Do you have any comments on the proposal that HMRC stops giving clearances on the application of section 464A of the Corporation Tax Act 2010 to the establishment of EOTs?

3.8 Yes, we would welcome such a change, provided that the legislation is clarified to make it clear that payments made into EOTs do not fall foul of s.464A. HMRC's guidance can and should also be updated, though as we say our preference is for the legislation to be clear on the point as well as the guidance.

3.9 We would suggest that clearance applications under s.701 ITA 2007 also come under this initiative. These too are rarely refused and the establishment of EOTs will not involve the mischief for which s.698 ITA 2007 is intended. In many cases, more than 75% of the shares will be sold at market value, meaning there is a fundamental change in ownership, thus placing the transaction outside of the Transaction in Securities (TiS) rules. In some cases, the fundamental change in ownership exemption may not apply due to the settlor and trustees being associates of one another. We have suggested that this provision be changed and have made further points in this area in our answer to question 8.

Question 6: Should the EOT bonus rules be eased so that tax-free bonuses can be awarded to employees without directors necessarily also having to be included, and would this undermine protections which ensure that bonus payments are not abused or weighted towards some employees?

Question 7: Do the EOT bonus rules create any other unintended consequences or challenges in administering the tax-free bonus payments?

3.10 With respect to the bonuses and addressing these questions together:

We have no particular issue with directors'/office holders' being excluded from receiving the bonus; in many instances, directors will often waive their bonus in any event. Their having to waive these bonuses, whilst not a particularly onerous administrative task, is necessary because of the existing equality criterion. Amending this to allow exclusion of office holders would therefore seem to be the more suitable default. As the consultation document points out, there may be companies/groups who exceed the 40% threshold simply because they are a smaller businesses with few employees with office holders making up more than 40% of the workforce. Taking directors/office holders out of the equation altogether would be a welcome simplification.

3.11 The other comments we would like to point out are: first, that the £3,600 level should be increased. It has been at this level since 2014 and would be at £4,735[2] today if inflation were fully taken into account year on year; we would therefore recommend that the £3,600 be increased to reflect the reality of being frozen for 9 years, particularly as inflation has been historically high over the last year. Second, (and particularly if the £3,600 were not to be increased), we would recommend that thought be given to the corresponding employer and employee national insurance contributions (NIC) attached to this bonus also being made exempt. Whilst we appreciate it was a matter of compromise at the time, it does seem an anomaly to exempt the bonus from income tax but not NIC. It would clearly be a greater incentive for both employees and the company to receive a fully tax-exempt bonus. It would also simplify administration.

3.12 ***Question 8: In addition to the reforms proposed at Chapters 4 to 6, do you have any views on ways the EOT tax regimes could be reformed to better support employee ownership?***

3.13 Further to question 5, whereas a market value sale of shares may well be outside the scope of the transactions in securities rules, if there has been an undervalue disposal, the former owner (as settlor) will be associated with the trustees, and thus ineligible for the fundamental change of ownership exemption. This would necessitate a clearance application for an innocuous transaction of establishing an EOT. We would urge the definition of 'associate' to be amended (at least for these purposes) so the settlor and trustees are not associated when shares are sold at an undervalue to an EOT. It would make more sense for EOTs to be expressly excluded from the TiS legislation for any contributions from the settlor, as well as s.464A.

3.14 However, we acknowledge that in order to combat potential abuse of EOT there needs to be some checks to ensure that the conditions are met. It might be preferable, rather than having a single initial clearance, for a simple continuous reporting regime, with an initial registration followed by annual/regular returns along the lines of the Employment-Related Securities regime. A simple registration confirming that the criteria have been met (or will be met within the 60/90 days (or so) to allow employee representatives to be elected), and then confirmation statements each year confirming that those conditions are still being met would likely be of minimal administrative burden for trustees and their agents. More importantly, however, it would be a

[2] According to Bank of England inflation calculator [Inflation calculator | Bank of England]

very useful tool in combatting abuse and ensuring that the benefits and concept of an EOT are maintained after the former owner's initial disposal and their benefitting from the CGT relief.

3.15 As well as tackling potential abuse, our main concern is to ensure the EOTs fulfil the original intention and sentiment, which is employee ownership and engagement. The main benefit, at the moment, lies with the former owner who may qualify for CGT relief on the creation of the settlement, whereas the only benefit for employees is the £3,600 tax-free bonus. If employees receive any additional benefit from the company, often in the event of company shares being sold and the proceeds distributed, the trustees will pay CGT with employees' being taxed on that same amount as earnings. This double taxation element sits uneasily with the concept of employees owning the business, showing instead that it's merely indirect ownership. If such proceeds were distributed to employees in their original capital form, so EOTs were treated as transparent for CGT purposes with the beneficiaries to be assessed on the sale (with credit for tax paid by the trustees), it would be more akin to direct ownership. In the absence of this, a substantial increase in the employee bonus, plus NIC exemption, would give the employees (at least) the impression of having a genuine stake in the success of the underlying company; otherwise, the current bonus comes across as more of a token gesture of ownership. However, we also acknowledge that having a double tax charge may serve a wider benefit in that it encourages trustees to retain the EOT model in the longer term, rather than using it as a vehicle as an intermediate step before third-party sale. Whilst incidents of double taxation are always something we are keen to point out, our overriding concern in this instance is to ensure that EOTs are utilised as trading vehicles to maximise employee involvement in the long term – not as a means to facilitate third-party sales of the business.

3.16 As mentioned above, it may be that a former owner needs to put further shares into the EOT. We would suggest that the CGT relief should be extended to subsequent settlements, rather than just the initial sale. If the incentive is in place for the former owner to settle shares into an EOT, then the CGT relief should apply to all transfers following the initial controlling stake.

3.17 To encourage former owners to transfer further shares to the EOT, consideration should be given to extending the CGT relief and provide full inheritance tax (IHT) exemption to situations where the former owners make further transfers of shares to the EOT (if the transfer is at an undervalue), provided the trustees own more than 50% of the shares at the time of the transfer and there hasn't been a disqualifying event. The IHT exemption should also apply to later waivers of any deferred consideration owed by the trustees. If these changes are not made, the former owners may be disincentivised from adding further value or selling their remaining shareholding, which appears to go against the policy intention. It is unclear why a decision to sell to an EOT has to be made within a year to get the CGT benefits. A wording similar to that in s28 IHTA could be adopted. Once the trust has a controlling shareholding, further sales can be protected from CGT.

3.18 Whilst the trust itself is exempt from IHT, as is the initial transfer from the former owner, any subsequent undervalue sales or the writing off of any debt would presumably be a chargeable transfer. As with the CGT relief, the IHT exemption should be extended to all transfers of value from the settlor, not just the initial one.

Question 9: Do you have comments on the proposal to confirm the government's position by making it explicit in legislation that the restrictions on connected persons benefiting from an EBT must apply for the lifetime of the trust?

3.19 We support this proposal which puts beyond doubt the position supported in the Court of Appeal decisions in *Barker v Baxendale Walker Solicitors* [2017] EWCA Civ 2056 and *Bhaur v Equity First Trustees (Nevis) Limited* [2023] EWCA Civ 534.

3.20 However, there are two points here. The first is that s28 and s13 IHTA should explicitly deal with the ambiguity identified in Barker v Baxendale Walker: namely if a person is connected with a participator while alive, that connection should not cease on the participator's death so that even after death the connected person cannot receive a payment that is not income in form- s28(6). The trust deeds seen for Employee Benefit Trusts (EBTs) too often simply recite s28(4) and it is left unclear what the draftsman intends leading to arguments with HMRC.

3.21 The second point is more difficult and is not covered by the *Barker* decision. The question is whether persons who were never connected to the participator while the participator was alive but would have been connected had they been in existence before the participator died (eg because they were grandchildren born after the participator's death or the wife of a son who married after the participator's death) should also be excluded. This would discourage EBTs being used in respect of companies such as property investment companies for the long term benefit of future born grandchildren. For some families they see EBTs as a useful money box to hold the company shares indefinitely in an IHT free vehicle. If the aim of the EBT is to incentivise employees rather than family members one option is to exclude all family members from any benefit even in income form and therefore all future born grandchildren and remoter issue from benefiting except in income form as set out in s28(6) IHTA. If a grandchild married an employee the spouse would not be excluded. The definition would simply deal with the participator's family and exclude him and his spouse and all issue (rather like the TCGA 1992 sch 5 legislation except omitting spouses that are employees). Only then could the exemptions in s28 and s13 IHTA (and equivalent in CGT legislation) be available.

Question 10: Do you have any comments on the proposal to only allow the IHT exemption where the shares have been held for two years prior to settlement into an EBT?

3.22 Whilst this would bring the IHT relief provisions in line with those for BPR (and prevent the potential exploitation of BPR by a company which would not qualify for that relief) there may be commercially-sound reasons for allowing immediate relief; for example, a sole trader may wish to incorporate and pass the business into an EBT as prelude to their retirement. It would seem rather harsh, in such circumstances, to make the owner remain in service for a further two years after incorporation, rather than establish the EBT as an integral part of their retirement and benefit accordingly. A fairer option might therefore be to make this change subject to a 'motive defence' whereby the existence of a genuine commercial reason could allow shares held for less than two years to benefit from the IHT provisions. We accept that recent GAAR decisions have countenanced an EBT set up on death with cash and some 'employees' with the aim of providing long term benefits for grandchildren etc after the participator's death (and they would not be excluded if s28 is simply amended to make the Barker decision clearer as the grandchild is not connected to the participator if born after death - unless our further suggestion to exclude all family members is adopted).

3.23 On balance though we do not support the two year restriction if the restrictions suggested in questions 9 and 11 are adopted. Much of the more abusive planning is done around property investment companies which are long standing. Restricting the class of beneficiaries in the way suggested above and below will prevent shell companies being set up with cash and a couple of family members as employees in the manner seen in certain GAAR cases.

Question 11: Do you have any comments on the proposal that no more than 25% of employees who are able to receive income payments should be connected to the participator in order for the EBT to benefit from favourable tax treatment?

3.24 It seems a little inconsistent that participators of EOTs are required to have an independent controlling criterion of no more than 50%, yet EBTs are not subject to this criterion and still qualify for IHT relief. The proposal for 25% seems a little arbitrary and incongruous when compared to the EOT regime.

3.25 This proposal needs some careful thought. We understand the reason for the suggestion that no more than 25% of employees who are eligible to receive payments should be participators or connected to the participator at the date of transfer. However, we do not see how this will prevent abuse as it would still be possible for the majority of any income to be paid to those employees in the future. All it would do is say that 25% of the employees only can be related to the participator but a relief that gives exemption on the initial transfer can't proscribe that such EBTs can never actually pay more than 25% of their income to the participators in the future as it would have to be monitored on an ongoing basis. The exemption would be permanently conditional.

3.26 Short of amending s86 IHTA to provide that EBTs can never pay more than 25% of their income each year to the Prohibited Class (ie participators and their family members) it is not possible to stop all the value being diverted to family members in the future albeit in income form. If s86 is amended, existing EBTs would need to be given a transitional period to amend their constitution or wind up.

3.27 We assume that the purpose behind this proposal is that the government does not want EBTs to operate like a family trust avoiding ten-year charges and paying value out in income form? If that is the current policy position, either s86 IHTA needs to be amended or the government would need to prohibit participators and their family members from benefitting at all.

3.28 However, our view is that there should, as a matter of policy, be no objection to the ability to make income distributions to participators and their family members . Presumably, when s28 IHTA was introduced, it was thought that the payment of income tax on benefits received by such persons was a suitable price to pay for the IHT exemption on the transfer into the EBT and the ongoing IHT reliefs as well as CGT exemption. We cannot see any reason why this policy position should have changed. The real mischief is the perceived ability to make capital distributions to family members after the participator's death on a tax-free basis. This will however no longer be possible assuming the change mentioned in Q9 is made.

Question 12: In addition to the reforms proposed at Chapter 7, do you have any views on ways the tax treatment of EBTs could be enhanced?

3.29 Enhancement of the tax treatment would presumably be alluding to tax benefits and incentives of establishing an EBT – currently it is only the participator who obtains any potential benefit through the IHT reliefs if they settle shares therein, there is no benefit to the employees despite the name.

3.30 We would suggest two changes for consideration. The first is that thought could be given to providing that EBTs must be UK resident (for similar reasons to EOTs). As with EOTs, there are good commercial reasons why a EBT may be placed offshore, but nonetheless the shares can be transferred in at cost which effectively gives a tax free break to offshore EBTs. It also makes compliance and accountability to UK employees that much harder.

3.31 The second relates to HMRC's interpretation of s86(3) IHTA which can create a problem where the body carrying on the undertaking for the purposes of s86(3) is say company A which is sold to company B. Company A's employees and business may be moved to Company B or another subsidiary and Company A wound up. HMRC consider that an EBT then ceases to qualify for IHT purposes under s86. HMRC interpret s86(3) to mean that if there are no longer any employees because company A does not exist, the class in s86(1) does not

currently comprise all or most of the persons employed by company A concerned. As long as there is one employee or officer there then they accept it can qualify. While we do not agree with HMRC's interpretation we think that the position should be amended if HMRC do take this view. Why should a very large IHT charge be imposed under s72 IHTA simply because the employees have retired or been moved to another company due to a sale outside their control? The trust should still be able to benefit former employees and hold and invest the proceeds accordingly in an IHT free environment. If the proceeds are paid out in a manner that is not subject to income tax then they will suffer IHT then anyway.

4 Acknowledgement of submission

4.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation

27 September 2023