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Tax considerations in an employee buy-out

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Also available in Welsh. Also available in large print format.

Introduction

Employee buyouts normally involve a business owner selling their shareholding in the Company to the employees via an employee trust. There are also a small number of occasions where an owner decides to 'gift' their shares to an employee trust for no financial consideration.

As a business owner there are some key tax implications that need to be considered when contemplating selling or gifting shares as part of an employee buyout.

Capital Gains Tax

The primary tax liability associated with the sale of a business or assets is Capital Gains Tax (CGT) and this is charged on chargeable gains that arise on the disposal of capital assets that occur in any fiscal year (ending on April 5th).

If a business owner sells their shares, or makes a transfer by way of gift, these transactions will be treated as a disposal for CGT purposes. CGT is due on the actual gain that a business owner makes as a result of the disposal, not necessarily on the full amount of money they receive as consideration for their shares/ assets. Therefore the actual chargeable gain is usually equal to the sales proceeds less the acquisition cost of the relevant shares/asset.

Each individual has annual CGT allowance of £11,000 (2014/15 allowance) meaning that any gains below this allowance will not be subject to CGT and any gains above this allowance will be taxed on the difference between the £11,000 annual allowance and any gain in excess of this.

Where a business owner sells, or gifts, shares/assets the rate of CGT payable allowing for their GCT allowance, but ignoring entrepreneur's relief, will be as follows:

a. If the individual pays higher rate income tax (£31,866 + 2014/15) in the relevant tax year the individual will pay Capital Gains Tax (CGT) at the rate of 28% on chargeable gains for that fiscal year.

b. If the individual pays basic rate income tax, but the aggregate of the individuals income and chargeable gain exceed the basic income tax threshold (£31,866 for 2014/15), then the amount of the chargeable gains that accrue to the individual in that fiscal year above the income tax threshold are charged at 28% and the amount of the gains below the threshold are charged at 18%.

c. If the individuals aggregate of income and chargeable gains in a fiscal year do not exceed the basic rate tax threshold (£31,866 2014/15) the chargeable gains are taxed at 18%.

Business owners may be able to reduce the amount of their CGT bill if they are eligible to claim Entrepreneurs Relief.

Entrepreneurs Relief

Entrepreneurs' relief (ER) can reduce the tax rate to 10% on qualifying gains up to a lifetime limit of £10 million. However, there are certain conditions that must be met (see below).

Individuals and Trustees qualify for ER, but Companies which are selling shares e.g. in the sale of a subsidiary by a holding Company, do NOT qualify for ER.

Any company with significant (roughly at least 20%) non-trading activities, during the 12 months leading up to a disposal, will not qualify as a trading company.

To qualify for ER a business owner needs to have satisfied all of the criteria below throughout the 12 month period immediately prior to the disposal:

a. The seller must have held at least 5% of the ordinary share capital of the Company, carrying at least 5% of the voting rights in the Company;

b. The Company must be a stand alone trading Company, or the holding Company of a trading group;

c. The seller must be an officer or employee of the Company being sold or, in the case of a sale of a group, one of the companies in the group;

d. The seller must have owned the shares at least one year before the disposal.

Tax incentives for employee ownerships

The Finance Act 2014 introduced a relief from capital gains tax (CGT) on gains derived from the disposal of at least 51% of the total shares in a trading company (or in a holding company of a trading group) to a qualifying 'Employee Ownership Trust' (EOT).

To qualify for the relief owners must satisfy the following criteria:

a. The company whose shares are disposed of must be a trading company, or the parent company of a trading group;

b. The trust which acquires the shares must operate for the benefit all employees;

c. The trust must have a controlling interest in the company at the end of the tax year, which it did not have at the start of that year;

d. Certain participators must be excluded from being beneficiaries of the trust; and

e. The claimant must not previously have qualified for relief on the same company's shares.

Assuming that all of these criteria are met the owner(s) would be deemed as making neither a capital gain nor loss on the disposal of their shares and will not be subject to capital gains tax on the proceeds from the disposal.

Buyout scenario examples

Below we have outlined some of the key considerations for a business owner in the most common employee buyout scenarios. By way of example we have based the sale scenarios as relating to a fictitious company.

Star Engineering Ltd is a manufacturing Company, based in Bangor, has 50 employees and manufactures wind turbine components.

Steve Watson is the Managing Director and owns 10,000 £1 Ordinary Shares and wholly owns the Company after acquiring the business for £200,000 in 2005 where he has been MD since.

Steve now wishes to retire from the business and has agreed to sell his entire shareholding to an employee benefit trust for a total consideration of £1,000,000.

Steve's probable options are as follows.

100% of Steve's shares sold to an employee benefit trust for cash on completion

In this instance Steve is selling his entire shareholding and will receive consideration of £1,000,000 at the date of completion. Steve's sale of shares will be treated as a disposal of a capital asset. However, as Steve is selling 100% of the total issued shares of Star he will qualify for the Employee Ownership capital gains relief. Therefore the transaction will be treated as generating neither a capital gain or loss and Steve will not pay CGT on the sale proceeds.

100% of Steve's shares sold to an employee benefit trust with deferred consideration

In this instance Steve is selling his entire shareholding and will receive a proportion of the consideration, for example £500,000 at the date of completion and the remainder will be deferred and paid over the following 5 years.

Even though Steve is only receiving a proportion of the consideration on completion Steve is still treated as though he has disposed of all of his shares. However, as Steve is selling 100% of the total issued shares of Star he will qualify for the Employee Ownership capital gains relief. Therefore the transaction will be treated as generating neither a capital gain or loss and Steve will not pay CGT on the sale proceeds either on completion or when paid as part of the deferral agreement.

51% of Steve's shares sold to an employee benefit trust for cash on completion

In this instance Steve is selling 51% of the total issued shares of Star and will receive consideration of £510,000 at the date of completion. Steve's sale of shares will be treated as a disposal of a capital asset. However, as Steve is selling a controlling interest (over 51% of the total issued shares of Star) he will qualify for the Employee Ownership capital gains relief. Therefore the transaction will be deemed as generating neither a capital gain or loss and Steve will not pay CGT on the sale proceeds.

Steve will still own 49% of Star's issued shares and when he comes to sell these he would need to determine whether he pays CGT at 28%, 18% or whether he qualifies for ER and can pay CGT at 10%.

Steve will not qualify for the Employee Ownership capital gains relief unless he sells the 49% within the same tax year as the original sale of his 51%.

51% of Steve's shares sold to an employee benefit trust for cash on completion

In this instance Steve is selling 51% of the total issued shares of Star and will receive, for example £260,000 on the date of completion with the outstanding £250,000 deferred and paid over the following 5 years.

Even though Steve is only receiving a proportion of the consideration on completion Steve is still treated as though he has disposed of all of his shares. However, as Steve is selling a controlling interest (over 51% of the total issued shares of Star) he will qualify for the Employee Ownership capital gains relief. Therefore the transaction will be deemed as generating neither a capital gain or loss and Steve will not pay CGT on the sale proceeds at completion or when paid through the deferral agreement.

Steve will still own 49% of Star's issued shares and when he comes to sell these he would need to determine whether he pays CGT at 28%, 18% or whether he qualifies for ER and can pay CGT at 10%.

Steve will not qualify for the Employee Ownership capital gains relief unless he sells the 49% within the same tax year as the original sale of his 51%.

In all of the examples above it is assumed that the Employee Benefit Trust (as a qualifying Employee Ownership Trust) acquires the controlling interest in Star in accordance with the Employee Ownership capital gains relief criteria. Therefore although Steve might be waiting for payment for his shares, the ownership of these shares has passed to the Employee Benefit Trust.

Phased sale of shares using an option agreement

It might not possible, or desired, for the employees or an employee benefit trust to acquire a controlling interest in Star. For instance, Steve may not be willing to accept deferred consideration and may require that his shares are only sold when they can be paid for. As a result it may well be sensible to consider some alternative methods of structuring a sale over time.

It might be possible to structure the transaction with a cross option agreement so that Steve can sell his shares in tranches in the following way:

1. Steve agrees to sell his shares in three tranches over 4 years with the first payment on completion, second payment at the end of year 2 and the last payment at the end of year 4.

2. Steve agrees to sell 33.3% of his shares for £333,333 and a share purchase agreement is put in place. Steve acquired his shares for £200,000 so the base cost of 33.3% of his shares will be £66,666. This sale of shares, will be treated as a disposal of a capital asset and will be liable for CGT on the gain of £255667 (£266,667 gain less his annual CGT allowance of £11,000).

   As Steve has held the shares for more than 12 months and is a director at the time of the share purchase agreement he qualifies for ER and the CGT will be reduced to a flat rate of 10% on the £255,667. As the EBT isn't acquiring a controlling stake this transaction will not qualify for the Employee Ownership capital gains relief.

   An option agreement is put in place relating to the other two tranches of 33.3% of Steve's shares. This option agreement allows the Employee Benefit Trust, or Steve, to exercise the option and trigger an additional sale of Steve's shares at a future date.

   Although an option agreement is in place that would allow for the purchase of all of Steve's shares there is no guarantee that the EBT or Steve will ever exercise these options and therefore there is no guarantee a sale of shares to the EBT will take place and therefore no disposal of a capital asset on which CGT would be due.

3. On the option exercise date 2 years after the original sale of shares the option is exercised by either the EBT or Steve and there is a new sale of one half of Steve's remaining shares. This will be treated as a disposable of a capital asset and the gain would normally be subject to CGT, but this transaction will result in the EBT acquiring a controlling stake in Star (33.3+33.3=66.6%) will qualify for the Employee Ownership capital gains relief and therefore no CGT will be payable on the sale proceeds.

4. On the option exercise date 4 years after the original sale of shares the option is exercised by either the EBT or Steve and there is a new sale of Steve's remaining shares. This will again be treated as a disposable of a capital asset and the gain will be subject to CGT and possibly ER.

There are some important factors to consider though. Throughout the option agreement period there could be a change in legislation and this could have an adverse impact if for instance CGT rates increase,

or ER is reduced or removed. Assuming that Entrepreneurs Relief is still available throughout the option period Steve would still have to be either an employee or director of the business at this point to qualify (Non-Executive Directors and Company Secretaries count as officers) and comply with the other ER criteria highlighted above.

Gifting shares to an employee benefit trust

In the examples above Steve has agreed to sell his shares to the employees. However, there are occasions when a business owner decides that they want to gift either a controlling interest or all of their shares to an employee trust and there are tax implications that should be considered.

A gift of shares will usually constitute a transfer of value for inheritance tax purposes. However, if Steve has owned the shares for at least two years (continuously) his shares will qualify for business property relief under S.104 of the Inheritance Tax Act 1984. As his shares are in an unquoted company, the effect of this is that the value of the transfer will be treated as nil and no inheritance tax will be payable on it as a result. Further to this, if Steve were to gift 51%+ of his shares it is likely (subject to him meeting other relevant conditions) that the transfer would be completely exempt under S.28 of the Inheritance Tax Act 1984.

From a CGT point of view, the gift of the shares will constitute a disposal for CGT purposes. As the disposal is a gift, any gain will be calculated by reference to the market value of the shares. However, as the disposal would either be a chargeable event for Inheritance Tax purposes (even though it is subject to 100% relief as explained above) or completely exempt (by S.28 IHT Act) it would be eligible for Hold-Over Relief (under S.260 and/or S.165 of the Taxation of Chargeable Gains Act 1992). The effect of this on Steve is that he will be treated as making a disposal equal to his original acquisition cost of the shares and there will be no gain or loss. The effect of this on the EBT acquiring the shares will be that it is treated as acquiring the shares at Steve's original acquisition cost with the effect being that the gain is "held-over" the shares transferred to the EBT. In effect this means that should the EBT sell these shares in the future and this disposal result in a chargeable gain the acquisition cost of the shares would be the same price paid by Steve in 2005 when he acquired the shares.

Corporation Tax reliefs associated with a HMRC approved Share Incentive Plan

In addition to selling shares to an employee benefit trust it might also be possible for Steve to sell some of his shares to a Share Incentive Plan (SIP) established by the principal Company (in this example Star Engineering Ltd). Detailed information on the benefits of using a SIP can be found in the Wales Co-operative Centre Guide to Incentivised Share Schemes).

A SIP is another type of employee trust, managed by either individual or corporate trustees, used to encourage employees to become direct shareholders in the Company they work for in a tax advantaged manner.

In addition to the benefits for those employees who participate in the SIP there are also some benefits for the principal Company that operates the plan. The costs of establishing and running a SIP such as fees, professional management fees, and stamp duty are deductible against the employer’s taxable profit as a Corporation Tax relief.

Additionally, the value of any shares that are appropriated to employees in trust is also available as a deduction against an employer’s taxable profit. This tax relief is normally allowed in the tax year during which the appropriation takes place.

If during any 12 month period, the trustees of a SIP acquired 10%, or more, of the principal Company’s share capital from Steve then Corporation Tax relief on the entire value of these shares could be taken in

the first tax year even if these shares are not appropriated to eligible employees within the same tax year.

It is quite possible that the shares acquired by the Trustees of the SIP could take several years to be appropriated and this relief mechanism recognises this fact. However, this benefit will wholly or partly unwind if 30% of these shares are not appropriated within 5 years, or all within 10 years.

Further Information

The guide has been produced for the Social Business Wales project. Social Business Wales is funded by the European Regional Development Fund and Welsh Government. It is delivered by the Wales Co-operative Centre and is part of the Business Wales service.

Social Business Wales aims to support social businesses with aspirations to grow. For further assistance, please contact:

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Or visit the online toolkit http://businesswales.gov.wales/socialbusinesswales/

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