



TAXATION OF EMPLOYEE OWNERSHIP TRUSTS AND EMPLOYEE BENEFIT TRUSTS

Issued 27 September 2023

ICAEW welcomes the opportunity to comment on the consultation “Taxation of Employee Ownership Trusts and Employee Benefit Trusts” published by HMRC on 18 July 2023, a copy of which is available from this [link](#).

For questions on this response please contact our Tax team at taxfac@icaew.com quoting REP 96/23.

This response of 27 September 2023 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW’s membership. The Tax Faculty’s work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty’s Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

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KEY POINTS

1. We support measures which help companies qualifying under the employee ownership trust (EOT) rules to be managed in the interests of their employees.
2. We therefore agree with the proposed prescribed tests for trustees but have concerns that some companies may miss out if they temporarily fail to meet these tests.
3. We therefore recommend that a grace period is introduced alongside this so that the trust has a year from the date it fails to meet the relevant test to become compliant before any tax repercussion occur.
4. We are also highly supportive of the changes to prevent income tax and corporation tax charges arising in relation to any funds made available to the trust to acquire the company's shares. Ideally, this should be achieved through changes to the relevant legislation to provide certainty of treatment.
5. We believe that more could be done to shift the tax benefits derived from the EOT model from the former owners to employees. This could be achieved by:
 - a. uplifting the tax-free bonus amount of £3,600 by inflation so that it remains of the same value in real terms as it did in 2014; and
 - b. a tax exemption on transfer of benefits from the trust to the beneficiaries on disposal of company shares if those shares were held for at least 6 – 10 years.
6. We also propose a small change to the transactions in securities rules to prevent these from applying in the event of a sale of shares from the original owners to the EOT at an undervalue.
7. We have not received any input from members on the questions relating to employee benefit trusts so we have not answered these questions.

ANSWERS TO SPECIFIC QUESTIONS

EMPLOYEE OWNERSHIP TRUSTS: TRUSTEE ISSUES

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?

8. We support any initiative that ensures that the trustees have the benefits of company employees at the forefront of their minds. We agree that requiring more than half of the trustees to not be former owners of the company (or persons connected with them) would go some way to achieving this.
9. From the perspective of simplicity and consistency we agree that the definition of connected persons at s286 (2) TCGA 1992 should be used. However, we can envisage scenarios where former owners might get around this by appointing friends and other people they know that do not fall within the definition of connected persons. Therefore, this requirement would not be infallible.
10. It would be necessary to consider whether grandfathering rules are required, such as to deal with existing trusts where the majority of trustees are former owners and connected persons, or to deal with situations where an existing trustee needs to retire or dies and this then means that the trust fails to meet this test. In both cases, we suggest that the trust is given a grace period (of up to a year) in which to become compliant. This would prevent an immediate capital gains tax charge applying in cases where the trustees have the intention of complying but need to make arrangements to ensure this.

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?

11. While we support initiatives to promote employee representation amongst the trustees, we are concerned that placing a statutory restriction on the status of trustees could cause some genuine arrangements to fail to qualify. We also consider that trustees should ideally have some form of experience or expertise that ensures that they will carry out their duties diligently and professionally, but it is difficult to know how this could be enforced or defined. Perhaps including guidance in HMRC's manuals on what it would expect from trustees is sufficient.

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?

12. For the purpose of preventing tax avoidance, we agree with the proposal that the trust should be UK resident. We would just re-emphasise the need for grandfathering rules where a pre-existing trust is non-resident or there is a change in the make-up of the trustees that causes the trust to become non-resident. A suitable grace period would be required to bring the trust back into compliance.
13. Although this might sound like a long time, volunteers we have spoken to have suggested that a 12 month period would not be unrealistic, given how long it can take for correspondence with offshore trustees to be dealt with. We consider that if the company shares held by the EOT are sold during this grace period, the capital gains tax advantage exemption on the sale of the shares to the EOT should be withdrawn retrospectively.

EMPLOYEE OWNERSHIP TRUSTS: FUNDING ISSUES

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?

14. We are highly supportive of the distribution treatment being confirmed in legislation. We are pleased to see that associated costs will also be included within this treatment and we have some additional suggested categories that HMRC may wish to include:
 - Transaction costs: the trustees are the purchasers in the transactions and should normally be apportioned an appropriate proportion of the legal fees.
 - 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: if professional trustees are appointed, they will expect to be paid a reasonable stipend for their work.

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?

15. We understand the cost and time that HMRC spends on issuing these clearances and agree that could be better spent on other activities. However, we would appreciate some other mechanism to give businesses assurance that s464A does not apply in these cases. This could be:
 - a. specifically carving EOT arrangements out of s464A; or
 - b. perhaps more realistically, confirming HMRC's position on the application of s464A in such cases in its manuals.

EMPLOYEE OWNERSHIP TRUSTS: INCOME TAX BONUS ISSUES

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?

16. We appreciate the difficulties the rules create as they are currently drafted. We support the removal of the requirement for directors to be entitled to bonuses if this solves the problem.
17. We would also like to take this opportunity to argue that the £3,600 bonus limit should be lifted, given that it has remained the same since the regime was introduced in 2014. The recent rate of inflation and cost-of-living crisis means that this is worth considerably less now in real terms. We suggest that the limit should be uplifted for RPI changes since 2014 and then indexed to inflation each year (potentially rounded to a sensible round number each year).

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

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

Transactions in securities

18. We believe that a change should be made to the transactions in securities rules to exempt sales at an undervalue to the trustees from falling within these rules.
19. The transactions in securities provisions carve out situations where there is a “fundamental change in ownership” of a close company as set out in s686 ITA 2007. Broadly speaking, this is where the original shareholders, taken together with their associates or persons under their control, do not hold more than 25% of either:
 - the ordinary share capital, or
 - the entitlement to profits as a result of holding shares, or
 - voting rights as a result of holding sharesin the close company following the transaction.
20. This should exempt most transactions at market value where the majority control of a company passes to new owners. However, there can be a problem where the vendors (the trust settlors) are treated as associated with the purchasers (the trustees). In such cases, a fundamental change in ownership is deemed not to have taken place because the transaction has taken place between associates.
21. This association point is not an issue when the shares are sold at market value but this is rarely the case with EOTs where the shares are often sold at an under value.
22. We therefore recommend that the definition of associates for these purposes is amended so that the settlor and trustees of an EOT are not treated as associated when the shares are sold at under value.

Capital gains tax exemption for employees

23. Although the EOT rules were introduced primarily for the benefit of employees of relevant companies, in reality it is usually the vendors that gain the most financial benefit. There can be quite considerable inequity between the CGT savings achieved by the vendors and the

tax-free bonuses granted to employees and this will continue to be the case even if the bonus threshold is increased in accordance with our response to question 6.

24. To address this, we suggest that if after a set period (say 6 – 10 years) there is sale of shares by the trustees, the trustees pay CGT on the proceeds but there is no further tax on those proceeds when distributed to the beneficiaries. This would help to:
- a. remove double taxation;
 - b. reward employees in a way that looks much more like a benefit of ownership; and
 - c. encourage longer term holding by an EOT, because the trustees of an EOT will be looking out for the interests of the employees.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <https://goo.gl/x6UjJ5>).