The Personal Tax Planning Review

STATUTORY ESOPS - ARE THEY COMPLETELY USELESS?

Julian Ghosh[1]

No - not completely. The statutory ESOP (within the meaning of FA 1989 Schedule 5) is commonly perceived to be of little value in tax planning. The purpose of this article is to identify a particular area familiar in the commercial world in which ESOPs appear to give rise to a significant tax planning opportunity.

The Commercial Background

Consider a 100% owner/manager of a private company ("the Vendor"), perhaps in his early 50s and planning ahead for retirement. It is not uncommon that he will be faced with a situation where the only suitable purchaser, if not the only purchaser, will be the managers of his company. Furthermore, the managers may well, particularly in the case of small hitherto family companies, only be interested in a purchase of the Vendor's company's shares, rather than an acquisition of a business via their own buy-out vehicle, say a new company. The Vendor may well, in order to make the transaction attractive to the management team, be forced to sell the shares in his company at a discount; the management team will typically require to fund the share acquisition by bank borrowings and will be unable to obtain funding to a level beyond that of the discount price, while to the Vendor a purchaser at a discount is better than no purchaser at all.

---

[1] Julian Ghosh LLB, LLM, Barrister, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ Tel: (071) 242 2744 Fax: (071) 831 8095

Joint Managing Editor of *The Offshore Tax Planning Review*, and also of this *Review*.

I am indebted to Catherine Waring, KPMG Peat Marwick, 1 Puddle Dock, Blackfriars, London EC4V 1PD for invaluable comments and patient assistance with this article; errors and omissions remain mine.

Conventionally, the range of reliefs the Vendor will be offered on disposal of the shares in his company is:

- retirement relief (s.163 and Sch 6, of TCGA 1992 as amended by FA 1994 s.92) allowing a maximum gain of £250,000 to be realised tax free, with half the gain up to £1 million being taxed;

- reinvestment relief, under s.164A-N TCGA 1992, allowing reinvestment into certain types of unquoted company to enable a gain to be rolled over.

Typically, the Vendor faced with the situation described above would be looking to dispose of his shares to employees in two specific contexts:

- It is often the case that a purchaser of a family company will insist, as part of the commercial package it is buying, that key members of the company's personnel are "locked in" to the company prior to the sale. Consequently, the Vendor may often gift a tranche of shares to those employees, not as a beneficent act, but to put the shares into the hands of the employee who would be otherwise be unable to purchase them.

- So far as the sale to the management team itself is concerned, I have already made the point that without a discount to market price, the management may be unwilling or unable to purchase the Vendor's shares, leaving the Vendor with either an unsuitable alternative buyer for his family company or no buyer at all.

The Range of Reliefs

Conventional wisdom dictates that to the extent that the Vendor wishes to extract cash, he can effect a pre-sale dividend strip (now attracting an effective tax charge of 25%) with a consequent ACT charge on the company. The amount which can be extracted by way of this dividend strip may be limited by, amongst other things, the ACT capacity of the company (I do not intend to consider tax planning techniques such as enhanced stock dividends in this article).

On disposal of the shares the Vendor, in sheltering any tax charge, should utilise the maximum amount of retirement relief available.

The Vendor then finds himself turning to reinvestment relief; however this relief has severe restrictions, in particular on the type of asset that the Vendor will be able to roll into (viz, shares in unquoted trading companies) (see TCGA 1992 s.164G).

However, for the Vendor, a desire to lock-in key personnel by gifting them shares and the possibility of an orchestrated and phased sale to the existing management both allow a planning opportunity using an overlooked but valuable roll-over relief

with no limit on quantum and virtually no restriction on the reinvestment asset - the sale to a statutory ESOP introduced in 1990 and now contained in ss.227-236 TCGA 1992.

A gift of shares may give rise to a charge to capital gains tax in the hands of the Vendor and a Schedule E charge in the hands of the recipient. Similarly, a sale of shares to the management team, albeit at a discount, may also give rise to a CGT charge for the Vendor (based on market value) and a Schedule E charge for the management team. Furthermore, as mentioned above, the management team typically has to fund the purchase of the shares through borrowings, often secured by personal guarantees. Thus the management team may well find itself commencing its running of the company's business at a commercial disadvantage.

The purpose of the arrangements described below is to permit the Vendor to escape an immediate charge to CGT in either scenario while simultaneously mitigating a Schedule E tax charge in the hands of personnel obtaining shares in the company; they should also reduce funding costs to the management team.

Arrangements Using an ESOP

I. A statutory ESOP (hereinafter termed "the trust") is established by the Vendor's company. It is not the purpose of this article to set out all of the requirements for such a trust to come within the definition of Schedule 5 of FA 1989 (as amended by FA 1994 s.102 and Sch 13) although those conditions which the trust must satisfy and which are commonly perceived to make the use of ESOPs unattractive as tax planning vehicles will be considered below.

II. The trust is funded by the company to a level equivalent to a specified proportion of the value of its own shares. Let us suppose that each share is worth £10 and the company funds the trust to the extent of £3 per share. No IHT charge will arise by reason of IHT Act 1984 s.94 due to the employee trust exemption contained in s.13(1). The statutory ESOP clearly falls within the IHT definition "of an employee trust" contained in s.86(1). The company obtains a corporation tax deduction (as a trading deduction or a management expense, depending on the type of company which has made the payment) (FA 1989 s.67(1)(d)). Thus the cost to the company (and the Vendor) of funding the trust is reduced to the extent that the company obtains relief for payments made into the trust.

III. The trust purchases the shares in the company. In the case of the Vendor wishing to lock-in key personnel as soon as possible, this would be done a year before the personnel are to receive these shares due to the requirements of TCGA 1992 s.227(4) which are discussed below. In the case of an MBO, the trust could purchase the shares a year before the projected MBO day.

IV. The difference between the monies used to fund the trust (£3 in this example) and the value of the shares being settled (£10) can be funded by debt. Borrowing could come from the company but, more simply, from the Vendor leaving the purchase price outstanding on loan account.

The funding of the trust by the company is patently financial assistance in terms of CA 1985 s.151. While one would seek to make use of the employee trust exception in s.153(4) (financial assistance to fund an "Employee Trust" permitted) it is worth noting a slight mismatch in the definitions of an ESOP (an "employee share ownership trust") for tax purposes in FA 1989 Schedule 5 paragraph 4 and an "employee trust" for company law purposes in s.153(4) CA 1985. The former provisions require all employees *and* directors of the company to be beneficiaries of the trust, for that trust to qualify as a statutory ESOP. Section 153(4) of CA 1985, however, confines its definition of an employee trust to a trust where *only* employees (and former employees) are beneficiaries. Thus a statutory ESOP established by a company whose directors are not employees would technically fall foul of the financial assistance provisions on the arrangements described in this article.

However, for private companies, it is equally worth noting that financial assistance is permitted in any circumstance provided that the company has sufficient positive distributable reserves to fund the financial assistance (CA 1985 s.155(2)), subject to the procedural requirements in ss.156-158 having been met.

V. After holding the shares for a year (the trust must hold at least 10% of the shares for this period - see s.227(4) TCGA 1992) the trust could sell the shares to the employees for a specified price at least equivalent to the debt element of the purchase price paid by the trust, or perhaps slightly more.

From the point of view of the Vendor, the shares, on being sold to the trust, are transferred on a no gain no loss basis (TCGA 1992 s.229). Thereafter, the gain may be "rolled-over" into any chargeable asset whatsoever selected by the Vendor (with minor exceptions, including shares or securities of the same company or group); s.227(5)). The reinvestment must be made within six months, compared to the more usual three year period contained in most roll-over provisions; however, the generous flexibility of the ESOP roll-over should mean that the shorter six month period does not present a problem. The flexibility of the ESOP roll-over provisions compare favourably to those governing reinvestment relief, since this latter relief prohibits reinvestment into non-trading companies or assets directly.

> The trust, on selling the shares to the employees at a discount, will suffer a CGT charge at 35% on any difference between the trustees' indexed base cost and the market value of the shares as at the date of sale to the employees. This is unlikely to be a significant charge, since the charge will be predicated on the appreciation of the shares in the period between acquisition from the company and sale to the employees, especially if the "earn out" formula discussed below is employed in relation the period for which the trust holds the shares.

It will not have escaped the reader's notice that the extent to which the trust has been funded to purchase the shares has been financed by the Vendor's company's business. The Vendor was, of course, prior to effecting any of these arrangements, entitled to all of the profits of this business. Why then should the Vendor's company fund the trust at all? The short answer is that the funding element (£3 per share) is quite simply a disguised form of the discount which the Vendor typically gives in any case to an MBO team to which he wants to sell (see above).

Indeed, if the company has been in the habit of giving performance-related bonuses to the management team, then instead of paying these bonuses for (say) five years before the projected MBO date, these bonuses could instead be used to effectively fund the trust; thus, to the extent that the trust is funded by monies which would otherwise have been paid as bonus, neither the company nor the Vendor suffers a cash disadvantage; this is quite apart from the cost of funding the trust having been reduced by the corporation tax relief obtained for the payment by the company to the trustees. I say "effectively fund the trust" since the trust must spend any monies it receives from the company within the "relevant period" of nine months from the date of receipt for the company to obtain a deduction (FA 1989 s.67(5)). However, the company could simply refrain from paying bonuses, for, say five years prior to the commencement of the relevant period (with a consequent NIC saving to the company). The company could fund the trust nine months prior to the date on which the trust acquires the shares and receive a corporation tax deduction at that time.

Several points must be made here: firstly, from the point of view of the company, it may be less advantageous to fund the trust in this manner and take a large corporation tax deduction in the accounting period falling nine months before the trust purchases the shares; there may be insufficient profits in the current period to fully utilise the resultant loss which (in the case of a trading loss) would then have to be carried back or forward with inevitably less flexibility than a current year loss. Excess management expenses cannot, of course, be carried back at all. It may be that the company would prefer to fund the trust on a rolling basis (so that the trust would have to buy - and fund - the shares on the same basis) from year to year to maximise the use of the deduction. The matter must be resolved by matching the tax planning interests of the company against the commercial realities faced by the trust (which must find finance on this year to year basis),

with the ultimate goal of the Vendor to effect a tax efficient sale to the management holding the balance.

Secondly, the transfer of the bonuses from the pockets of the employees to the trust must, as a matter of the realities of industrial relations, usually be agreed with those employees whose bonuses are to be used to fund the trust. The trustees clearly cannot *guarantee* these employees that they will be able to eventually buy the shares at a discount; to do so would be a breach of trust, since the shares must be held by the trust for the benefit of all employees (see below), not just the management team. However, there is no reason why the trustees should not point out to the management team that once the trust comes to sell the shares at a discount it is unlikely that employees other than the management team would wish to purchase them.

Furthermore, to make this arrangement attractive from the point of view of the employees to whom the Vendor wishes to sell the shares, the monies used to fund the trust in this way must slightly exceed the level of bonuses which would otherwise have been paid.

It may be that the Vendor does not wish to miss out on any appreciation in value of the shares in the period that the trust holds the shares. This can easily be dealt with by funding the trust on an "earn out" formula whereby to the extent that the shares increase in value the trust must fund this increase in value in relation to its purchase of the shares by borrowings. The trust deed, in imposing this requirement, must ensure that the provisions of FA 1989 Schedule 5 paragraph 7(4) (the trust must not pay a price exceeding the market value of the shares) are not breached. The purchase price (which reflects the full value of the shares as at the date of acquisition by the trust) together with the undertaking of the trust as to the earn-out formula clearly represents an arm's length market price at the purchase date.

A number of further conditions imposed by FA 1989 Schedule 5 in relation to a trust which is to fall within its terms must be considered.

(a) The trust must offer the shares it holds to all of the employees and directors of the company (Schedule 5, paragraph 4(2)) on similar terms (paragraph 9(2)). This is not as inimical to using the trust as an aid to an MBO as is commonly supposed. The trust need not distribute shares to employees free. It could require that employees pay for their shares, at a discount to market value. To the extent that the trust was funded by debt (having left the balance of the purchase price for the shares outstanding) the trustees would require employees to pay for the shares at least to the extent of the debt element in order to be able to distribute the shares.

With private company shares, where there is no ready market (the trust need not be used to provide one), it might well be considered unlikely that the majority of employees would wish to take the shareholdings, where they must finance the purchase themselves (rather than receiving an offer of free shares which it must be supposed most employees would take up) and also face a tax charge on the discount element.

(b) The Vendor's CGT relief is liable to clawback (with no time limit) if there is a "chargeable event" in relation to the trustees (TCGA 1992 s.232; FA 1989 s.69); e.g., the trustees distribute shares otherwise than in accordance with the Finance Act 1989 conditions. This would deny relief to the Vendor by reference to the action of the trustees after the Vendor has parted with control over the shares.

However, because the trust deed will be set up to reflect the restrictions of FA 1989, any "chargeable event" is likely also to be a breach of trust. It is not a common concern on setting up a trust that the trustees may transfer away assets in breach of trust, nor that they may operate the trust in such a way as to frustrate the tax planning surrounding its establishment. These concerns must therefore stem from the lack of control over the appointment of trustees, because trustees must in large measure be elected by, or on behalf of, all the employees (Schedule 5 paragraph 3 FA 1989).

It should also be noted in FA 1989, that it is possible for a minority of trustees to have a material interest (per Schedule 5 paragraph 16) in the company and, of a minimum of three trustees, it is possible for one to be the proprietor of the company (see the terms of FA 1989 Schedule 5 paragraph 3(3)(e)). The trustees must be elected at the outset (paragraph 3(3)(f)). If the sole shareholder stands for election, then, in the unlikely event that he is not elected, no harm is done. He still owns the company, and the trust will find that it receives little further contribution from the company, and is unable to fulfil its object of buying the shares.

Incidentally, where a Vendor wishes to take advantage of both retirement relief and the roll-over relief stemming from the sale of the shares to the trust, timing will be important. If the Vendor is just coming to the requisite age for retirement relief, he can sell the shares to the trust, claiming roll-over relief as described above, before he becomes eligible for retirement relief. If he has already reached the age for retirement relief, the sale to the management, on which retirement relief will be claimed, must take place first. If it does not, retirement and roll-over relief will both be available on the sale to a trust, and relief will be wasted (see

Stephen Allcock in PTPR, Issue 1, Volume 2 for further analysis of this point).

The Vendor need not, of course, sell all of the shares to the management team at a discount via the trust. The above arrangements permit the Vendor to sell so many of the shares at a reduced price as his commercial requirements dictate and sell the remaining shares at full value.

So much for the Vendor. What of the personnel to whom the shares are to be sold? An initial point is that employees who wish to take up the offer to purchase shares from the trust are more likely to be incentivised to boost the value of these shares on the current arrangements, where any excess of the purchase price paid by the employer over the debt element of the price paid by the trust goes into the trust, rather than if the whole of that excess finds its way into the hands of the Vendor. Furthermore, since the employees who take up the offer to purchase the shares of the trust are required to pay for them, the Schedule E tax charge will only be levied on the discount element. This point is of course quite independent from any use of the trust as the vehicle which initially purchases the shares; the Vendor could quite easily have sold the shares direct to the employees at the discount price. However, a further point is that it is also possible for the trust to distribute cash to the beneficiaries, and some element of the payment made into the trust by the company together with the purchase price and any interest of the shares paid by the employees to the trust again (to the extent that this exceeds the debt element for the price paid for the shares by the trust itself) could be used to make a payment to the employees to meet this tax charge.

There is another reason why having an all-employee ESOP should not disrupt a sale to management. Often in an MBO 10% of shares would be set aside for an all-employee trust, and the take up of shares from the ESOP by staff other than the management could be seen as satisfying the requirement for a small percentage holding to be set aside for staff. The FA 1994 (see s102) measures extending the period for which the trustees are permitted to retain the shareholding to 20 years would also enable the trust to be used more tax efficiently for this purpose. Once the MBO has taken place, the new management team could, if desired, set up an approved profit sharing trust to acquire any residual shares in the trust for all employees in the tax efficient manner for those employees.

Incidentally, it may be that the Vendor retains a tranche of shares with voting rights of more than 25% (say, to be able to block a special resolution) which the MBO team could have the opportunity of purchasing at a specified or formula value at the date of the Vendor's death. This value may well be under the market value of the shares at that date. A tax free transfer to the MBO team could, if the shares are unquoted, be achieved at that time by virtue of the CGT uplift on death per TCGA 1992 s.62 and the (currently) 100% business property relief for IHT purposes available under s.105(1)(bb) of IHTA 1984.

Conclusion

Statutory ESOPs are not completely useless. Remember that the Vendor is faced with a situation where a purchaser wishes to buy his business in the form of the shares of his company but will only buy these shares at a discount to market value. In this specific but familiar situation, the arrangements described above allow the Vendor to afford the required discount at a reduced cost to the company (and therefore to him) due to the corporation tax relief given under FA 1989 s.67, while simultaneously rolling his gain over in a most flexible way. In the meantime, the employees' funding costs are also reduced. Indeed, the effective use of an ESOP as a vehicle in which shares are passed to employees (either being those who the Vendor wishes to lock-in to his company or the management team) resurrects the role of a trust as an entity via which assets are passed to the next generation, this generation being the company's employees constituting the management team rather than the Vendor's family. The above arrangement is commercially advantageous to both Vendor and employees, albeit in a particular (but, it must be repeated, not uncommon) commercial circumstance as well as presenting a tax planning opportunity to use a hitherto largely ignored statutory relief.