EQUITY INCENTIVES LIMITED

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Employee benefit trusts

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What is an EBT?

An employee benefit trust (EBT) is, in broad terms, a discretionary trust for the benefit of employees. A trust is a legal arrangement by which one person owns assets on behalf of somebody else. The most common examples are pension funds, charities and family trusts. There are different types of EBT and, confusingly, different names for an EBT. An EBT can also be referred to as:

- an employee share ownership plan (or ESOP)
- an employee share trust
- a case law employee trust

A basic discretionary EBT has a set of trustees and a set of beneficiaries. The beneficiaries will be the employees (and, usually, the former employees) of a company (or a group of companies). The trustees will generally be chosen by the company and will tend to be either a professional trustee company or directors of the company appointed as trustees. Increasingly, staff as a whole may have a say in choosing the trustees. The trustees decide who should be given shares (or cash), how many shares a person should be given and when they should be given them. They may decide that it is in the best interests of the employees that the shares are held in the trust for the long term and not distributed. They may hold shares only for a short time before passing them out to some or all employees.

The different types of EBT include some types of trust which have been set up under specific pieces of legislation and which bring specific tax reliefs. The main current example is the approved share incentive plan (or SIP). Other types (under old law) include:

- the qualifying employee share ownership trust (or QUEST)
- the approved profit sharing schemes (known as a PST or profit sharing trust)

Why do I need an EBT?

An EBT can be used for a variety of purposes.

Market maker in an internal market

One of the commonest uses for an EBT is where an unquoted company wishes to create some liquidity to make share ownership more meaningful for its employees.

Employees wishing to sell can offer their shares to the trust which can be funded either by other employees wishing to buy shares, or by the company. The company can fund the EBT either by way of loan or by a gift and this enables shares to be recycled for employees.

Warehouse for shares

Alternatively, a company may choose to park a number of shares in the safe and stable hands of an employee trust. This can act well as a communication tool and has been successfully used to capture value for employees which will be distributed on an exit but avoids widespread individual employee shareholdings.

Increasing productivity

Research suggests that giving employees a “collective voice” through an arrangement such as an EBT helps achieve improved corporate outcomes, such as increased productivity.

Providing an exit

EBTs have been used to provide an exit route for founder or family shareholders. This can be particularly useful where the company wishes to maintain its independence, or its independence. A trade sale may not be attractive and a flotation may not be achievable in the short to medium term. A buy-out by an EBT can offer an attractive alternative.

An EBT can be financed directly by the company or by a third party loan (although the liability may well fall on the company to repay this loan). The EBT can then purchase shares from shareholders. The shareholders may well benefit from attractive rates of capital gains tax if they benefit fully from taper relief.

Mechanism for employee share plans

Another use for an EBT is as a mechanism for employee share plans. A quoted company may choose to set up an EBT to buy shares on the market for use in its employee share plans. This is particularly useful where the company is approaching the dilution limits which govern the number of new issue shares that can be used for employee share plans.

In a private company, an EBT may be used to buy shares from shareholders who want an exit or from employees who leave the company in order to create a pool of shares for use in a share plan.

In either type of company, an EBT can be used to grant options and may be needed if the company wants to give away free shares.

A permanent owner of a business

An EBT can also be used to own shares in a trading company indefinitely (an EBT usually has a life of 80 years). This provides staff with a permanent stake in the business and through the trustees a voice in the direction of the business. In some cases, the EBT may be the only shareholder. The John Lewis Partnership is the best-known UK example of a business wholly owned by the trustees of EBTs. There are many others.

How do I set up an EBT?

An EBT can be established quite easily. The basic steps are:

- draw up a trust deed which sets out how trustees are appointed, who the beneficiaries are and what the trustees can do with the shares they own on behalf of those beneficiaries
- decide who the trustees will be, usually either a professional company or individuals appointed by the board
- trusts can have a "corporate trustee", a company of which the individual trustees are directors to give them some limited liability
- the trustees and the company sign the trust deed
- the company then gives a small initial gift to the trust (say £100)

What is the tax treatment of an EBT?

An EBT is highly flexible but the trust itself does not currently benefit from any income tax or capital gains tax advantages (unless it is a tax advantaged EBT such as a SIP).

The EBT will pay income tax on any income it receives (such as dividends) and may pay capital gains tax if it makes a profit on any shares it holds.

There are tax reliefs (from capital gains tax and inheritance tax) in relation to certain gifts of shares or sales of shares at an under-value to an EBT, which may encourage existing shareholders to set up an EBT. An EBT does have a favourable inheritance tax status. Unlike other discretionary trusts there is no ten-yearly tax charge.

Who are we?

Equity Incentives has substantial experience in all aspects of employee benefits, including equity incentives. As a member of the HM Treasury advisory group, our managing director, Graeme Nuttall, helped HM Revenue and Customs develop and introduce the tax advantaged share incentive plan (or SIP) and the enterprise management incentives arrangement. He also drafted the Employees' Share Schemes Bill, a successful private member's bill enacted as The Employees Share Schemes Act 2002 that increased the tax effectiveness and democracy of SIPs.

THE EUROPEAN LEGAL ALLIANCE

Through the European Legal Alliance and other strategic relationships, we advise on implementing share plans in Europe and worldwide.

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