

# Management Buyouts through Employee Share Schemes

David Craddock is a recognised authority in the UK and worldwide on employee share schemes. In his book, *The Tolley's Guide to Employee Share Schemes*, David shares his expertise drawn from over 30 years as a practitioner in the subject, expounding on the multiple ways in which businesses can find solutions through employee share schemes to the challenges that they face. This article addresses specifically how the management buyout initiative can be enhanced with tax-efficiencies and cost-effectiveness through the introduction of employee share schemes, supported by an employee share trust arrangement.

## LOUIS KELSO, PENINSULA NEWSPAPERS AND THE ESOP CONCEPT

The modern day embrace of employee share schemes was in fact born in a management buyout initiative. This historical narrative goes back to 1956 when Louis Kelso, an economist and lawyer based in San Francisco, applied his ESOP concept to provide a solution for a company seeking to introduce a management buyout. The case involved the payment of all the profits of the company into the trust for a period of some five to seven years. The company was a successful Californian newspaper company, Peninsula Newspapers, based in Palo Alto, California, whose founder and sole shareholder had decided to retire. However, this owner did not want to sell the company to one of the large predator newspaper chains. Instead, he wanted to offer the business to his employees. The problem that Louis Kelso's solution addressed was that the

employees, despite their willingness to buy the company, did not have the cash to enter into the transaction. The sole shareholder, though, had to prepare for his retirement and so was not, therefore, in a position to gift the business to his employees. The challenge was to resolve this apparent dilemma.

It was to provide an answer to this conundrum that Louis Kelso was consulted. He duly obliged by introducing the ESOP concept – a trust mechanism in which the trust holds the company's shares and receives company profits for the express purpose of enabling the trust to pay the existing owner for the shares. The ESOP concept was subsequently imported into the UK during the 1980s and given a powerful UK application and perspective, harnessing the opportunities afforded by the employee share trust when coupled with bona fide employee share schemes to facilitate company share ownership by employees, whether on an all-employee basis or for a selected group of executives. So, you can see that if that selected group of executives is the management buyout team then the ESOP concept is tailor-made to facilitating a highly tax-efficient and cost-effective management buyout.

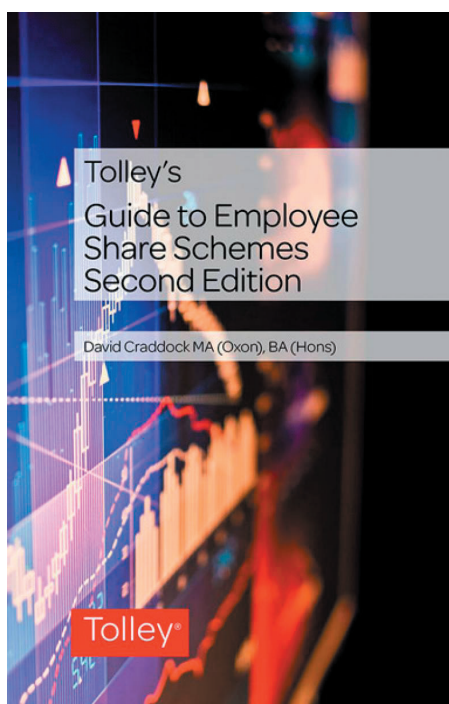
## THE BASIS FOR EMPLOYEE SHARE SCHEMES AS THE MBO SOLUTION

The reality is that although the management buyout initiative is a frequent and regular feature of corporate life, many director shareholders, outgoing and incoming, and their advisers, are unaware of the tax-efficiencies that can be built into the arrangement through the introduction of employee share schemes. At the time of the management buyout, the need to secure cost-efficiencies is paramount. With often a requirement from the banks for incoming shareholders to mortgage their private residences and the banks seeking to maximize their return from

interest payments it is ironical that minimal attention is given to the tax-efficiencies that can be obtained through incorporating a constructive understanding of employee share schemes into the model for the management buyout process.

If the management buyout involves the outright sale of all the shares in one single transaction (rather than a series of piecemeal transactions) then the substance to the capital nature of the transaction emanates from a fundamental change in ownership and, under Section 686, Income Tax Act 2007, these circumstances are excluded from the Transactions in Securities legislation. The point is that in the management buyout scenario that is based on a single transaction there is no retaining interest intended within the planning arrangements.

What, though, where the management buyout is based on a series of piecemeal transactions? The solution is predicated upon the fact that the transaction for the sale of the shares is for the genuine commercial reasons of establishing and operating bona fide employee share scheme arrangements as the basis for a management buyout, which is itself adjudged by the directors as the best and only means of ensuring the future growth and development of the business under new management. In this context, the commercial test of intention works as a counter argument to tax avoidance in framing the HMRC clearance application under Section 701, Income Tax Act 2007 and Section 748, Corporation Tax Act 2010 for Transactions in Securities. The argument for the clearance is that the securities transaction is to facilitate a bona fide employee share scheme in that the company has purposely resolved to establish a bona fide employee share scheme for its own merits and in wishing to avoid dilution



has chosen to facilitate the scheme through the use of an employee share trust for the recycling of existing shares.

Further reinforcement to the argument for genuine commercial reasons is the contention that in the current circumstances, however defined, no alternative exit opportunities are available for the outgoing shareholders and that in facilitating shareholder succession the linkage to the bona fide employee share scheme is secure. An overriding argument is that the planning arrangements are designed to protect and enhance shareholder value, both in the short-term and in the long-term, as the approach adopted to secure the future of the company and the livelihood of the employees.

#### THE TAX-EFFICIENCIES FOR ALL PARTIES

The great news is that the tax-efficiencies are available for all parties to the transaction!

##### 1. For the outgoing shareholders

The sale of shares to the employee share trust by the outgoing shareholders can be organised as a capital gains tax transaction, with the HMRC tax clearance obtained as necessary. The trust is identified as a third party and the outgoing shareholders are eligible to claim entrepreneurs' relief with capital gains tax limited to 10% on the gain, provided the individuals meet the statutory conditions for entrepreneurs' relief.

##### 2. For the incoming shareholders

For the incoming shareholder managers, provided the company is a qualifying company, Enterprise Management Incentives, as the most tax-efficient of the tax-advantaged (previously known as "tax-approved") schemes, will have a contribution to make as will the tax-advantaged discretionary Company Share Option Plan. The use of the tax-advantaged

### "...AND THE TAX-ADVANTAGED ALL-EMPLOYEE SHARE INCENTIVE PLAN CAN BRING THE WIDER EMPLOYEE WORKFORCE INTO THE MOTIVATION FOR GROWTH WITH A CONTRIBUTION."

all-employee Savings-Related Share Option Scheme and the tax-advantaged all-employee Share Incentive Plan can bring the wider employee workforce into the motivation for growth with a contribution, usually comparatively minor but sometimes substantial, from them to the overall buyout funding requirement. With the tax-advantaged schemes also comes the advantage of a pre-transactional check from HMRC on valuation.

##### 3. For the employee share trust

The employee share trust will typically be resident offshore with a recognised trust administrator in the Channel Islands (Jersey or Guernsey) which has the advantage of offering tax-efficiencies while at the same time being subject to regulation which for the management buyout team gives the security and peace of mind that are so essential. The tax-efficiencies lie in the absence of any tax charge on the trust on sales or gifts or on any transfer of shares whatsoever from the trust to the incoming shareholders. This is because the trust is not resident in the UK for tax purposes and there is no capital tax regime in the Channel Islands.

Interestingly, when exploration is given to the employee share scheme arrangements that are not tax-advantaged schemes it is often the case that these schemes



can deliver tax advantages that are as beneficial as the tax-advantaged schemes and sometimes even more beneficial than the tax-advantaged schemes and allow the involvement of higher percentages of shares. Courtesy of ITEPA 2003 the UK now has the full armoury of tax elections, notional loan arrangements and structures involving restricted securities, all of which can be combined with share reclassifications and possibly new classes of shares as necessary, to construct the tax-efficient infrastructure on a bespoke basis to service the management buyout needs. Furthermore, Companies Act 2006 abolishes the prohibition on loans to directors; instead, for director loans there is a shareholder approval regime that facilitates significant opportunities for share loan schemes that have the potential in certain circumstances to make a management buyout possible where otherwise the possibility could easily fade away into the realm of the pipe dream.

So you can see that with careful planning, the constructive use of the Taxes Acts, the Companies Acts and Trust Law, both from the UK and the Channel Islands, can deliver the management buyout in a highly tax-efficient form using employee share scheme arrangements.

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**David Craddock Consultancy Services**

**Specialist in Employee Share Ownership and Reward Management**

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