EMPLOYEE OWNERSHIP TRUSTS & SUCCESSION PLANNING

Article 3

Following the 2008 financial crisis, in the wake of Lehman Brothers collapse, the UK coalition government introduced some little noticed tax legislation aimed at rebalancing the economy. Employee Ownership Trust (EOT) planning was announced as an exit mechanism for business owners wanting to sell shares in trading companies, at full market value and free from tax.

Normally the sale of a trading company's shares triggers a 10% capital gains tax liability on the first £1m of gains, with the excess taxable at 20%. A sale of trading shares to an EOT, however, is an attractive mechanism for exiting a company tax free. A further incentive, aimed at encouraging companies to set up these structures for the long-term benefit of employees, permits the payment of income-tax free bonuses of up to £3,600 to employees on an annual basis. Marketed mainly for their tax benefits, it is important to recognise that the government's main intention behind introducing EOT legislation was to promote employee ownership, enhance productivity and create highly motivated workforces.

Once a qualifying EOT is created, 100% of the shares in the employing company can be acquired. It is also possible to have a hybrid structure whereby the vendor shareholders sell more than 50% of the share capital of the company to the EOT but retain a small shareholding which may be sold in the future. A market value for the shares is determined by an independent valuer before the purchase price is paid by the EOT. This payment is typically financed by a mix of cash already available to the company, third party debt and loan notes. In certain circumstances the trading company can also use existing reserves and future profits to make payments to the EOT, allowing the EOT to pay deferred consideration to the former owners at agreed future dates. Alternatively, the EOT can use third-party debt financing, allowing an initial payment to be made to the vendor shareholders at completion. Once the sale is completed the shares are held by the EOT trustees on trust for the future benefit of all employees.

Using an EOT as a method of sale can provide an alternative to external third-party sales, management buyouts or private equity backed buy-ins, and enables succession planning in family companies where there is nobody in the family who wants to continue the business. It also allows employees to indirectly buy shares in their employing company without having to raise personal finance and allows the current owners to remain as directors of the business after the sale, if desired, and continue to receive market rate remuneration.

Although EOT tax benefits are aimed at companies, it should be possible to transition all businesses to EOT ownership with careful planning. For example, businesses which are run as partnerships could consider incorporating and claiming incorporation relief, so that when the time comes for owners to exit the business the shares in the newly incorporated company could be sold to the EOT.

EOT structures are often seen as 'friendly purchasers' as the acquisition process is generally quicker and carries less uncertainly than a traditional sale of shares to a third party. As is expected, conditions must be fulfilled to secure the tax relief and HMRC will want to feel comfortable that the intention behind setting up the EOT is that it is for the long-term benefit of employees and not simply a 'quick fix' to facilitate a tax-free exit for the current owners who cannot find a suitable third party buyer. Setting up the EOT is a relatively straightforward process, but professional advice should be sought as an incorrectly structured sale of shares to an EOT can have adverse unexpected tax consequences. Care is also required when selecting trustees, as their key role is to hold the Board of Directors to account and to act in the long-term interest of the employees. For this reason, it can be beneficial to include professional advisors and corporate trustees on the Board of Trustees, particularly where the original owner wishes to remain involved in the running of the company.

Although the EOT legislation has been around for almost 8 years now, a recent surge in the number of business owners using EOTs to sell their companies has not gone unnoticed and the percentage of small and medium businesses using the model is gaining momentum. This may have been fuelled by the changes to entrepreneur's relief in 2020 or the more recent rumours of increased capital gains tax rates. All business owners reviewing their succession plans, or seeking to motivate and retain employees, should seek professional advice to determine if an EOT structure suits their exit plans.

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