

SHORTS

Employee Ownership Trusts



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1. Introduction —

“Turning workers into owners”

If you are a business owner who is considering their exit strategy, then a sale to an Employee Ownership Trust (“EOT”) is an option you should always consider.

We firmly believe that, for the appropriate set of circumstances, an exit via this route can bring powerful benefits beyond the tax incentives. Depending on your own objectives, an EOT can therefore be an exceptionally effective succession planning tool.

In this guide we will seek to explain both how an EOT works and the pros and cons for the owners, the business and the employees. Perhaps you might conclude that a sale to an EOT is your preferred exit route?

2. —

What is an EOT?

An EOT enables a company to become owned by its employees. A trust is set up by the existing owners of the business for the benefit of all employees. The trust becomes the majority owner of the business, generally as part of an exit or succession planning strategy.



What does the government think of them?

EOTs were established in the Finance Act 2014 to encourage companies to become employee owned.

The government supports them as it would like to see some movement towards a 'John Lewis' economy. The employee 'shared capitalism' model is shown by studies to enhance employee engagement leading to improved productivity and increased job creation and retention.

This ownership model is seen by the government as a counter to short term capitalism, with the enduring ownership structure and tangible employee benefits, resulting in a long-term strategic view and increased business investment, to the benefit of the country.

How does the government encourage it?

- Significant tax incentives for selling owners.
- Annual tax incentives for employees.

3. —

What are the benefits of an EOT?

A sale to an EOT brings benefits to the selling shareholders, the business and the employees:

Top 5 benefits for retiring owners

- Receive full market value for shares.
- Certainty of exit (it will happen in a defined time frame and is not dependent on the whims of trade buyers).
- Zero Capital Gains Tax on business sale.
- Succession can be implemented over a period and previous owner can retain a level of involvement.
- Appeals to altruistic owners and rewards the loyalty of employees who have helped the business succeed.



Top 5 benefits for the business

- Culture and legacy preserved through ownership structure.
- A long-term view on strategy and investment.
- Incentivised employees who are fully motivated.
- Gradual change in leadership with ability to retain shareholders' expertise.
- A more resilient and stronger performing business.

Top 5 benefits for employees

- Opportunity to be part of an employee-owned business that is a fulfilling place to work.
- Directly rewarded for their hard work in developing the business.
- Income tax free annual bonuses.
- There is a real incentive for employees to engage in improving business performance for everyone's benefit.
- Far simpler way for all employees to become owners than via direct share ownership.

4. —

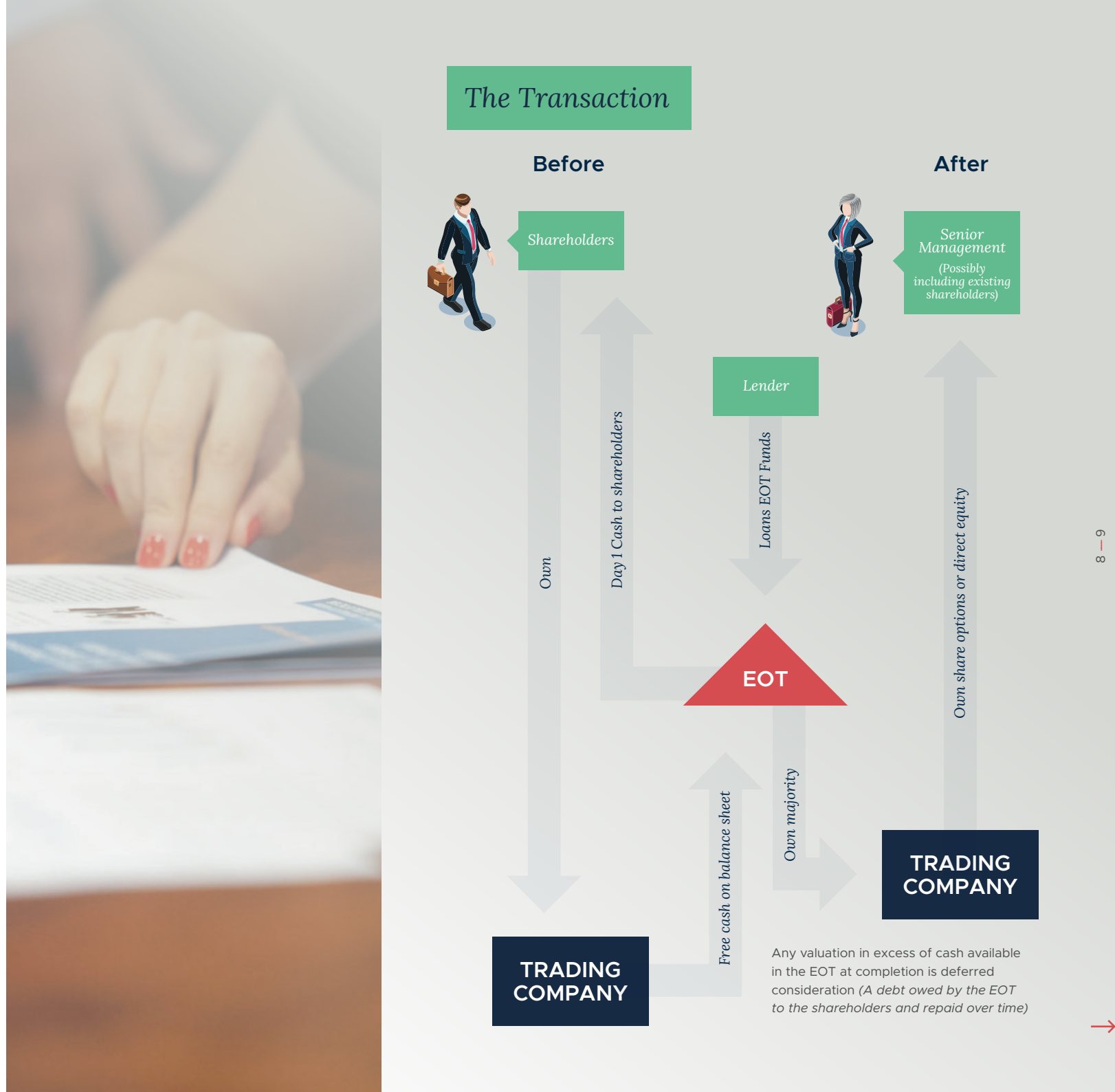
How does it work?

Initial steps

- The EOT acquires a controlling stake in the trading business from the current shareholders.
- The price agreed will be market value, based on an independent assessment.

But how does the EOT fund the purchase?

- Any surplus cash on the trading company's balance sheet will be utilised to fund part of the purchase price.
- Funders can then also be approached to loan funds to the EOT (based on the assets and cashflows of the trading business).
- The remainder of the valuation is repaid to the selling shareholders over time (from future profits generated by the trading company). The payment of this deferred consideration is achieved by a contribution from the trading company to the EOT, with the EOT then paying the previous shareholders.



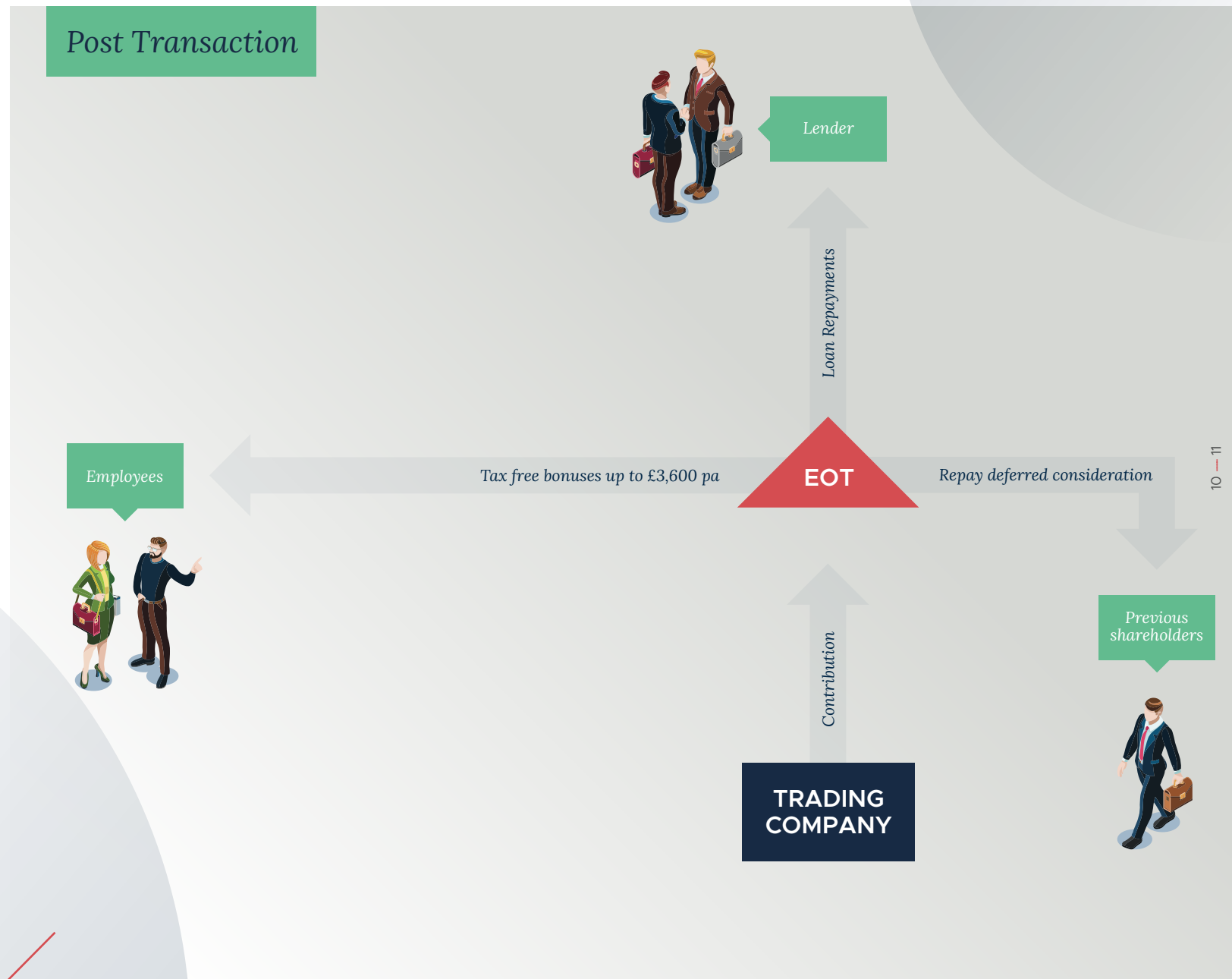
4. How does it work?

What about the Employees?

- An EOT must be for the benefit of all employees.
- All employees can receive tax free annual bonuses (based on set criteria) up to £3,600 pa.
- Once the previous shareholders have been fully repaid, all the employees receive the full economic benefits that would normally accrue to the shareholders in a private company via membership of the EOT.
- New employees automatically join the EOT whilst leavers automatically cease to be EOT members. This ensures a simple and enduring ownership structure.

...and senior management?

- To ensure senior management, remain fairly rewarded for their contribution and therefore motivated, it is sometimes desirable for senior management to have additional benefits above those from their membership of the EOT.
- Senior management can therefore be given direct minority equity stakes or share options to ensure they are appropriately incentivised.



4. *How does it work?*

Who runs the business afterwards?

- The EOT will be run by the trustees, and the trustees will generally include employee representative(s), selling shareholder(s) and perhaps independent trustees. Their role is to ensure the trust's assets (principally the trading business) are well managed and the trust runs in accordance with the trust's rules.
- It is not the trustees' role to run the trading company. This is the job of the senior management of the trading business and there is no reason why selling shareholders should not remain involved – indeed it is often encouraged to ensure the trading business continues to run smoothly, protecting the asset for the trust.
- In this way the retiring owner can gradually transition away from the business, ensuring the business continues to trade well and giving an enhanced period for leadership succession to be implemented.
- The retiring shareholder can (if desired) retain a minority shareholding in the business. This can be purchased by the company or the EOT at a later date.



5. —

What are the Tax benefits of selling to an EOT?

Tax reliefs available

In order to encourage the move to employee ownership the government has introduced significant tax benefits for a sale to an EOT:

- **Capital Gains Tax (CGT) exemption** – there is a total exemption from CGT where a shareholder sells their shares in a trading company to an EOT, which results in the EOT having a controlling interest in the company (more than 50%).
- **Income Tax relief** – where the company is controlled by a qualifying EOT, tax-free annual bonuses of up to £3,600 can be paid to all qualifying employees.
- **Inheritance Tax (IHT) relief** – provided the relevant requirements are met, the transfer of shares to the EOT by the vendor will be an exempt transfer for IHT. The EOT may also benefit from relief from IHT principal charges and exit charges.

Assuming the conditions are met the sale at market value of a controlling interest in a trading business to an EOT is therefore tax free for the retiring owner. If it is the most appropriate route, it is therefore the most tax efficient way to sell your business.

Qualifying conditions

In order to qualify for the tax benefits, the following conditions need to be met:

- A. Trading** – The company must be a trading company or be the holding company of a trading group.
- B. All employees** – The EOT must be for the benefit of ALL employees (providing they are not, and have not been within 10 years before the sale, 5% participators in the company).
- C. Control** – The EOT must control the company following the acquisition (i.e. hold more than 50% of the share capital).
- D. Limited participation** – Shareholders with more than a 5% personal interest in the company, who are also employees / Directors, must not make up more than 40% of the total employees of the company.
- E. Equality** – The EOT must benefit the employees on principally equal terms (However, relative remuneration, hours worked or years' service can be applied to differentiate between employees).

Unlike Business Asset Disposal Relief (formerly Entrepreneurs' Relief) there is no minimum qualifying period of ownership, or percentage holding, for a shareholder to qualify for the CGT exemption on a sale of share to an EOT.

6. —

Is an EOT the right exit strategy for you?

A sale to an EOT should be considered carefully as part of a review of your exit planning options. The sale of an owner managed business is often an emotional as well as financial decision, and factors other than just valuation and tax are important.

The EOT checklist below sets out, in our experience, the key areas of focus for an owner manager in a sale of a business, and the pros and cons for each in a sale to an EOT:

Key Area	Pros of an EOT	Cons of an EOT	How important is this area to you? (rate on a scale of 1-5)
Valuation	Full and fair market value based on independent valuation.	Price is certain but could be lower than that offered by a strategic trade buyer (if you can find them). Note though that exceptional prices from strategic buyers are relatively rare and apply to businesses with unique selling points.	
Legacy	Very appealing if you are keen for the business to continue 'as is' and you want to protect your legacy. The business can continue to run as before with a smooth transition from your direct ownership. Altruistic owners can feel very positive about giving back to their employees.	None	
Tax	Zero tax for selling shareholders. Ongoing tax savings for employees.	None. The most tax efficient route possible for a selling shareholder. No disadvantages for employees.	

Key Area	Pros of an EOT	Cons of an EOT	How important is this area to you? (rate on a scale of 1-5)
Structure	Ability to shape the deal to some extent (in line with meeting EOT qualifying conditions) to meet your objectives. Can retain minority shareholder and give direct shares or share options to key management.	Day 1 cash is restricted by cash and reserves on the balance sheet, and funds that can be raised from banks by the EOT. Deferred consideration generally makes up the remainder of the consideration and is paid over several years.	
Employees	Hugely beneficial route for the employees who become part of a shared ownership structure that they directly benefit from. The potential threat of redundancies from a trade buyer looking to cut costs is removed.	Generally none, but do need to ensure that over time (through promotion or recruitment) there is a credible team that can run the business successfully once the owner fully retires.	
Confidentiality	No need to market the business for sale. Transaction can remain confidential until well progressed and then employees can be introduced to the process.	None	
Certainty	An EOT will happen if the owner manager is content with the valuation and structure. Once this has been agreed it is merely procedural to implement the new structure with very little prospect of difficulties given the EOT trustees are minded to complete the transaction for the benefits it brings to the employees. It removes the need to find a purchaser and the potential for a late withdrawal or price renegotiation by a trade buyer.	None	



7. —

How we can help?

A sale to an EOT represents a highly significant point in the lifecycle of an owner managed business. We therefore consider it so much more than just a tax exercise. It is a project that requires a holistic approach that takes into account not just the immediate transaction but ensures a successful future for the business and a well-planned transition to retirement for the previous shareholders.

We are here to guide you through the process:

- Initial review of your personal and business objectives, advising you on the relative merits of an EOT compared to a trade sale or management buy out.
- Feasibility study to give you clarity on likely valuation range and the timing of cash receipts.
- Advise on structure including the implications of retained shareholdings, minority share holdings/share options for senior management and the terms of the deferred consideration.
- Ensuring debt and deferred consideration repayments are structured to ensure the future working capital and investment requirements of the business can be met, enabling the business to flourish post transaction.



Our services include:

- Advice regarding the funding arrangements and the tax implications of these. Including the use of loans and deferred consideration.
- Project managing fund raising exercise with our contacts to increase day 1 cash consideration if desired.
- Providing the shareholders, company, and EOT with tax advice.
- Assisting with tax clearance applications to H M Revenue & Customs (HMRC) and liaising with them where required.
- We will also work closely with your solicitors in the preparation of the EOT trust deed, SPA and associated legal documents.
- Project management to legal completion.
- Assistance with presentations to Employees regarding the EOT process and structure, if required.
- Provide professional trustee services in respect of the EOT, if required.
- Undertaking annual reviews of the structure to ensure that it continues to meet all the relevant conditions.
- Review of post transaction objectives for the shareholders by our private client team. Combining investment and tax advice, the role of our private client team is to ensure there is a clear, tax efficient post transaction plan in place to meet yours and your families' future financial requirements.

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