Employee Ownership Trust (EOT)

EOTs were borne out of a desire to increase employee ownership of UK businesses. Studies have consistently shown that employee owned businesses perform better, demonstrating greater resilience, innovation and profitability. Employees show greater commitment to, and engagement with, a business when they have a stake in it.

To encourage a move to employee ownership, there are generous tax benefits available for owners who transfer their shares to an EOT. Significantly, such a sale can be made without attracting any charge to capital gains tax.

What are the tax advantages?

- The key advantage for the seller is that there is no capital gains tax on a transfer of shares to an EOT. As long as the EOT acquires a controlling interest in the target company, all sellers that dispose of shares to the EOT in the same tax year qualify for this relief. This includes minority sellers who might not benefit from other available reliefs such as business asset disposal relief (previously known as entrepreneurs' relief).

- The key advantage for the employees of the target company is that they can be paid tax free bonuses of up to £3,600 each per year.

The other advantages

Simply focusing on the tax benefits of selling to an EOT misses the broader advantages such a sale can bring. These include:

- Employee engagement: as noted above, greater employee engagement in the business will reap rewards for all those involved. Benefits include greater commitment, reduced absenteeism, a drive for innovation and increased profitability.

- Friendly-buyer: because a sale to an EOT is essentially an internal transaction, involving no third parties, it is generally viewed as being a "friendly" transaction, which is easier to negotiate. The sale process is often quicker and smoother when compared with a sale to a third party, and the seller can benefit from fewer residual liabilities under a reduced warranty and indemnity package.

- Ready-made exit: a sale to an EOT provides the seller with a ready-made exit from the business. This could be useful where the seller has struggled to find a buyer or where a family business is hampered by succession issues with the next generation being unable or unwilling to takeover. Entrepreneurs who have built up their business from scratch may prefer the idea of transferring ownership to employees rather than selling out to a competitor. It also avoids a founder having to work for a new owner at the end of their career which might happen on an exit to a private equity investor.

- Better return: as the sale proceeds are free from capital gains tax, the seller can receive a higher overall return when compared with a traditional sale. Alternatively, the increased return could allow the seller to offer the shares to the EOT at a discounted price without affecting the seller's overall net proceeds.

- Retained shareholding: provided a "controlling interest" (see below) in the target company is transferred to the EOT, a seller can decide whether to sell all their shares or whether to retain a minority shareholding. By contrast, a trade seller would want to acquire 100% of the target company and any retained holding on a private equity deal would be subject to conditions. This could be useful for a seller who wants to hand over control of the business to its employees but who is not yet ready to fully withdraw from that business.

- Management incentives: it is possible to combine the advantages for a seller of a sale to an EOT with the benefits for second-tier management of a traditional management buyout. Share incentive schemes, either through direct holdings in the target alongside the EOT or via tax efficient share option schemes, mean the next tier of management can receive some of the benefits of a buyout without the restrictions of an external investor protecting their investment.

What are the qualifying conditions which must be met?

In order to benefit from the associated tax reliefs there are a number of qualifying conditions which must be met:

- All employee benefit requirement: all eligible employees should benefit from the EOT. Those who hold or have previously held 5% or more of the target company's shares are not eligible employees. It is also possible to exclude employees with less than 12 months' continuous service.

- Equality requirement: all eligible employees must benefit from the EOT on the same terms. This does not mean that all employees get equal amounts and it is possible to determine the size of awards by reference to remuneration, length of service and hours worked.

- Controlling interest requirement: the EOT must acquire and retain a "controlling interest" in the target company. A "controlling interest" means more than 50% of the ordinary share capital, more than 50% of the voting rights and an entitlement to more than 50% of the profits available for distribution by the company.

- Limited participator requirement: broadly the number of people who are 5% shareholders and officers or employees of the company cannot exceed 2/5ths (40%) of the total number of employees of the company. This could be an issue for a company with a small workforce compared to the number of 5% shareholders who are officers or employees.

- Trading requirement: the target company whose shares are being acquired by the EOT must be a trading company or the holding company of a trading company.

Contact us to arrange a FREE consultation

gtaylor@langdownsdfk.com

+44 (0)23 8061 3000