

BUSINESS TAX

EMPLOYEE OWNERSHIP TRUSTS



Shareholders of trading companies, who wish to share ownership of their companies with their employees, can sell some or all of their shares to employee ownership trusts (EOTs) without incurring a capital gains tax (CGT) liability.

Several conditions must be met by the company and the transferor shareholders in order to qualify for the capital gains tax relief.

There are many potential advantages of EOTs for shareholders, companies and employees.

What is an EOT?

An EOT is a type of employee benefit trust (EBT) designed to enable shareholders of trading companies to transfer controlling interests in their companies to the employees. When the conditions are met, there are tax advantages for both transferring shareholders and eligible employees.

What are the tax benefits of EOTs?

Provided the conditions are met, EOTs offer attractive tax benefits.

Shareholders

The transfer of shares by shareholders into the EOT is free from CGT. This will be of particular interest to shareholders who may not benefit from business asset disposal relief (previously called entrepreneurs' relief) or investors' relief, who would otherwise pay CGT on transfers of their shares at 20%.

There should also usually be 100% relief from inheritance tax which would otherwise apply to transfers of shares.

Employees

The company may pay bonuses of up to £3,600 to each eligible employee per year, free from income tax.

What are the commercial advantages of an EOT?

EOTs provide an alternative succession route to others such as external sales, management buy-outs or intergenerational successions.

They provide the opportunity to generate goodwill from employees, increasing their engagement with businesses and improving recruitment and retention rates.

EOTs also have strong positive connotations for the public and media, thus improving companies' corporate social responsibility profiles.

When implemented carefully and for the right reasons, EOTs have significant benefits for shareholders, employees and all business stakeholders.

What are the qualifying conditions?

In summary, the conditions that must be met are as follows:

- The company must be a trading company or the holding company of a trading group.
- The number of continuing shareholders who are directors or employees and all continuing 5% participators (broadly shareholders) must not exceed 40% of the company or group's total employees. Persons connected with such shareholders are included for the purpose of this 'limited participation' test. The aim of this condition is to ensure there has been a significant change in ownership of the company.
- Trustees must ensure that all property settled into the EOT is for the benefit of all employees on the same terms.
- The transfer must be of at least a 50% controlling interest and this must be retained on an ongoing basis.

- The EOT assets must be applied only for the benefit of all eligible employees, other than 'excluded participators', on equal terms. Eligible employees are those employed by any group member company or the holding company. Distinction may be made between employees on the basis of hours worked, length of service or remuneration. Excluded participators are all 5% or more 'participators', including all such participators in the ten years before the commencement of the EOT.

How is the EOT transfer structured?

The shareholders will sell their shares to the EOT for their open market value. The purchase price for the transfer of shares to an EOT is normally satisfied by a combination of cash (possibly funded with bank debt) and loan notes issued from the trustees to the transferor shareholders.

The deferred consideration is usually satisfied by way of future payments of post-tax profits from the company. It is therefore important that the company must have forecast profits and continue to generate those profits. Proceeds from the future sale of shares may also be used to finance future loan note repayments.

External debt financing may be required if shareholders are seeking an element of immediate cash payment and/or to make future loan note repayments.

Governance

Typically, the trading company will form a subsidiary company to act as trustee of the trust, although it is acceptable to have external professional trustees.

As the EOT rules were introduced to encourage transferring control of a company to employees, some form of employee representation at trustee and main board level should be considered. There are no prescribed rules for this, but the governance arrangements would be for there to be an employee council which would have the ability to appoint one or more directors to both the trustee company and the trading company.

What are the ongoing requirements?

If there are any 'disqualifying events' following the transfer, tax relief may be lost for the transferring shareholder. Disqualifying events include loss of the company's trading status, ceasing to meet the all employee benefit requirement, ceasing to meet the

controlling interest condition and/or failure to meet the 'limited participation' requirement.

As well as the ongoing requirements for tax relief, the trustees must also ensure all trust law and governance requirements are met.

HOW CAN MOORE HELP?

We can provide a full range of services for shareholders considering establishing an EOT, including the following:

- Preliminary restructuring advice where required to fulfil the conditions for an EOT, including incorporation of partnerships or general group restructuring.
- Establishment of the EOT and appointment of trustees.
- Advice on establishment of an employee council.
- Provision of professional share valuation for the transferred interest.
- Share purchase agreement drafting or review.
- Tax advice on whether the qualifying conditions are met.
- Financial modelling at the point of the transfer and for future years over which the deferred consideration to shareholders is due to be repaid.
- Seeking clearance from HMRC that the transactions in securities anti-avoidance legislation should not apply.
- Corporate finance advice on possible part-funding by third-party debt financing.
- Assisting with communications to employees and employee bonus advice.

The above provides a brief summary of EOTs and should not be relied upon without taking further advice. Please get in touch with our team if you would like to discuss aspects of EOTs in greater depth or other related topics.



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