Oury Clark Quick Guides:

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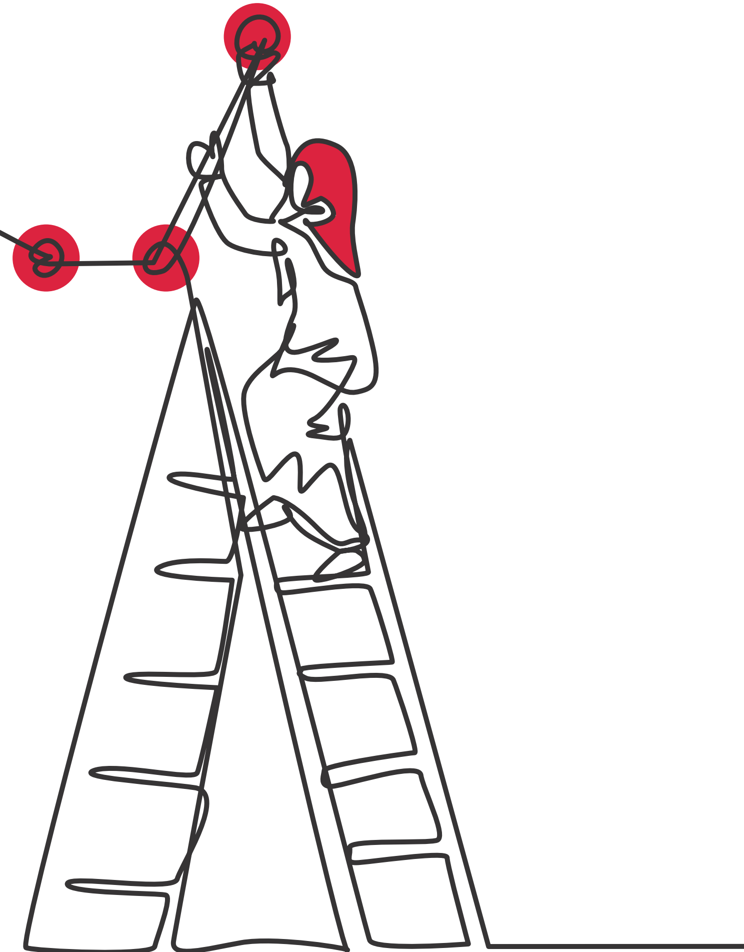
Employee Ownership Trusts



Tax: A22

How does it work?

An EOT is set up with at least one trustee. The shareholders of the company sell more than 50% of the current share capital to the EOT under a share purchase agreement. The purchase price is left outstanding as a debt owed by the EOT to the vendor shareholders. The company uses its future profit to make payments to the EOT which in turn pays down the debt to the vendor. There can be a third-party financing arrangement should the vendor require the proceeds earlier than the company can create profits.

For the vendor to receive their full consideration, the company must remain profitable as it is these future profits which are used to repay the vendor's debt.

Advantages

- No capital gains tax payable by the vendor which can save tax at 20%.
- Enables succession where no external purchasers can be found by providing an immediate purchaser.
- Employee ownership promotes employee engagement in the business and encourages the workforce to take a more active role in ensuring the success of the company. This method of employee ownership means that the employees do not have to find the cash themselves to make the purchase.
- The company controlled by the EOT can pay tax-free (but not NI free) bonuses to their employees of £3,600 per annum.
- The current owners can remain as directors and receive a market rate remuneration after the share sale.
- It allows a more 'seamless' change of ownership without external influences, pressures or indemnities etc.

Concerns

The shares held by the employee benefit trust will be held by trustees acting for the employees. The selection of trustees may well be difficult, as one would be seeking those who are fully aware of their duties. While directors of the underlying company can act as trustees it is advisable to keep director

trusteeships to a minimum to avoid conflicts of interest. Trustees' obligations are prescribed by law and to a considerable extent, require the trustees to act cautiously, which may mean that they are disinclined to allow the company to borrow to any great extent and there may be other occasions when their obligations override what would be seen as normal commercial behaviour. Trustees are also exposed to personal liability, which again acts as a natural inhibitor as to their appetite for risk.

Conditions

- The company needs to be a trading company or the holding company of a trading group.
- All employees must be able to benefit from the EOT.
- The distribution of EOT property must be provided on the same terms to all beneficiaries (although the £ amounts can vary).
- Shareholder employees who own 5% or more of the share capital (or are entitled to purchase 5% or more) now, or in the last 10 years, cannot benefit from the EOT. Neither can anyone 'connected' to the shareholder employees who fall in this category.
- The EOT must hold more than 50% of the ordinary share capital for the remainder of the tax year of purchase. The EOT must not have held a controlling interest in the company prior to the tax year of purchase.
- Particularly relevant to companies with a small workforce – the number of continuing shareholders must not exceed 40% of the total number of employees of the company or group.

Disqualifying events

If any disqualifying events occur in the tax year the EOT acquires the shares, or the following tax year then the capital gains tax advantages for the vendor will be withdrawn and capital gain tax will be payable. If any disqualifying events occur after this period then there will be a deemed disposal resulting in CGT payable by the EOT trustees. Avoiding UK CGT in this situation could be possible by ensuring the EOT is not UK tax resident by appointing professional overseas trustees.

The trustees would normally be able to control whether a disqualifying event occurred or not. The following are disqualifying events:

- The company no longer meets the trading requirement.
- The EOT does not meet the all-employee benefit requirement.
- The EOT does not meet the controlling interest requirement i.e. it's shareholding slips below 50%.
- The number of continuing shareholders exceeds 40% of the total number of employees.

Employee bonus scheme

All eligible employees must be able to benefit from the scheme and distributions from the scheme must be made on the same terms to all beneficiaries. However, the £ amount of any distribution can change depending on the following factors: length of service, hours worked and remuneration level. For example, you could set a bonus of £100 per year worked.

Per tax year a £3,600 bonus can be paid from the company controlled by the EOT to the EOT beneficiary free of income tax, although NIC would still be payable. Any bonus paid in excess of £3,600 would be subject to the usual payroll taxes.

Other considerations

It would be advisable to seek a professional share valuation ahead of such a transaction as there is no mechanism to agree a valuation with HMRC for this purpose.

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Disclaimer: This note does not contain a full statement of the law and it does not constitute legal advice. Please contact us if you have any questions about the information set out above.

IHT planning should be carried out along side the transaction for the vendor as they would be selling an asset which would likely qualify for 100% Business Property Relief for cash and/or a loan balance which would not qualify for the relief.

The EOT is considered independent for the purposes of most share incentive schemes for example EMI schemes and SIPs.

It is also possible for businesses held by partnerships to be sold to an EOT in a process that involves the partnership incorporating prior to the sale to the EOT.