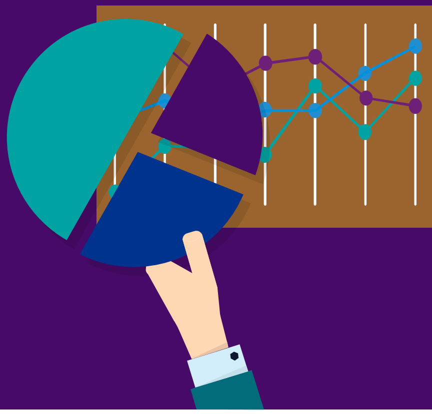
Employee Ownership Trusts



For some owner managed businesses, an Employee Ownership Trust (EOT) can be an attractive means to facilitate efficient and sustainable ownership succession.

When should an EOT be considered?

An EOT is one of a range of choices that might be considered as part of business ownership succession planning. We encourage clients to explore how this route differs from other choices (typically trade sale or private equity investor sale) to help make an informed choice about the route that is best fit for their objectives and circumstances. Making use of an EOT does not necessarily preclude a third party sale at a more distant future date but can provide a framework for continued independence for those companies who wish that.

What is an EOT and how does it work?

Employee ownership is a form of business ownership that can work for different sized private companies across any industry sector. Employee ownership has long been recognised as a way to provide employees with a significant and meaningful stake in their employer organisation. Finance Act 2014 increased support for this by introducing a new form of tax advantaged statutory trust, the EOT.

A business seeking to transition a controlling (more than 50%) ownership to an EOT can consider three methods:

Indirect employee ownership

The indirect ownership EOT model means the employees do not own shares in their employer company directly, instead they are beneficiaries of the trust which owns the controlling shareholding.

Prior to October 2014 there was no tax efficiency in relation to cash bonus payments distributed to employees from the trust, but with effect from then it is possible for tax –free (NIC still applies) bonuses of up to £3,600 per person per annum to be paid.

This method of ownership is suited to businesses with higher staff turnover and a larger number of employees who desire tax-efficient profit-share.

Direct employee ownership

This model allows for direct ownership of shares by employees, typically in conjunction with a statutory tax advantaged share plan over shares in the ultimate parent company. Which choice of share plan is used will depend on a number of factors.

Employees might purchase shares or be gifted shares under a Share Incentive Plan (SIP), potentially tax-free.

Employees might be awarded tax-advantaged share options, the exercise of which might be tied to time vesting (encouraging retention) and/or performance metrics (rewarding business growth – often needed to ensure on-going commercial success and to help fund the EOT pay-outs in future.)

If the value of the business increases, tax-efficient gains can subsequently be realised on the disposal of shares to the EOT. The EOT can provide internal liquidity.

Hybrid Model

This method is a combination of trust ownership and employee direct share ownership. Typically the retiring vendors sell their share interests to the EOT when it is first established and then over time some of this interest is transferred to employees.

The hybrid model suits businesses where the emerging new managers desire a real ownership stake in the business but there is a desire by original founders to preserve independent control of the business. Often some form of performance contingent direct share ownership is required to help support attainment of future financial performance to facilitate the funding of the EOT, the purchase of shares from retiring founders and the delivery of value to EOT beneficiaries, whilst also meeting business operating costs (including any debt servicing).

What are the tax advantages?

Capital Gains Tax and Inheritance Tax Exemptions for EOT founding seller(s)

From 6 April 2014 an individual disposing of their qualifying shares (or a collection of individuals together disposing of a controlling stake in the same tax year) to an EOT will be treated as making the gain at nil gain nil loss. Consequently, no capital gains tax arises.

This is clearly attractive, particularly if Entrepreneurs' Relief would not be available on any alternative sale of the shares. However this is rarely the main motivation for using an EOT.

To qualify for this exemption the EOT must hold a controlling interest (more than 50%) that was not present at the start of the year. Additionally, the taxpayer must not have made a disposal of shares using this relief in a previous tax year. There are other legislative criteria to be met also and a transaction in securities clearance will usually be submitted to HMRC.

In addition to the capital gains tax exemption these vendor shareholders also benefit from an inheritance tax exemption regarding their transfer of shares to the EOT.

Tax- free bonus payments

Bonuses of up to £3,600 per employee per annum can be distributed as tax-free profit-share by the EOT. (Note National Insurance still applies.)

Enterprise Management Incentive (EMI) and SIP for direct employee ownership

EMI potentially allows participants to acquire shares free from income tax charge and to benefit from Entrepreneurs' Relief and therefore capital gains at the reduced rate of 10% when shares are sold.

SIP provides for a choice of four different share awards (Free Shares, Partnership Shares, Matching Shares and Dividend Shares) which facilitate equity awards of up to £9,000 per employee per annum, potentially tax free from award to share sale, if qualifying conditions are met.

Benefits of employee ownership?

Tax reliefs are not the only driving force behind the increasing use of EOTs. Increased employee engagement from direct or indirect ownership also supports:

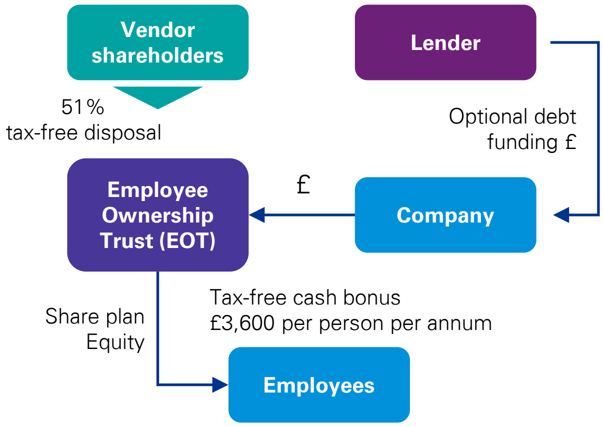
- Higher productivity and innovation;
- Better financial performance;
- Lower absenteeism;
- Higher employee commitment;
- Higher resistance to market volatility; and
- Lower staff turnover.

Independent research, for example the employee ownership index, shows that a combination of shared ownership and employee participation can deliver strong business performance.

Additional points to consider

The following, non-exhaustive list, are further points to consider and we would normally recommend an initial succession strategy review as a first step in the process to flesh these matters out further:

- What are your commercial priorities and values that will help determine the succession planning choice for your business? (To help navigate between different potential exit routes available)
- What percentage of the company's shares are to be sold into trust and what amount, if any, is to be made available for direct employee ownership?
- What value do the founder shares currently have? Has this been independently assessed?
- Can the eligibility criteria be met having regard to facts? (International subsidiaries and/or low participator: employee ratio can be problematic.)
- How will the purchase of shares from vendors be financed and over what timeframe? If by debt then what is the remaining management team's appetite and ability for debt servicing? Are the remaining management able to drive sustained improved financial performance to fund business operations and EOT activity?
- What governance structure will manage operational control of the business going forwards? (Choice of trustees and whether or not to have an Employees' Council/employee representative on board.) Are there trade unions to consult?



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