Practice guide

How to handle employee ownership trusts

Speed read

Employee-owned companies can provide a strong foundation for business growth and success. The continued increase in their use as an alternative business structure and to provide succession planning for owners is here to stay. The rules are complex and the long-term operation of employee-owned businesses needs to be managed within the framework of the legislation to ensure the tax reliefs continue to be available. Owners considering transitioning to an employee ownership trust model need to ensure it is culturally right for their business and not purely a way of facilitating an exit on a tax-free basis.

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The rise of the employee ownership trust

The Employee Ownership Association notes in its *Employee Ownership Top 50 2018* report, that the UK's 50 largest employee-owned companies enjoyed combined sales of £19.8bn in 2018, an increase of 6.5% from the previous year, with enhanced productivity of 7.3%. Coupled with strong evidence that employee-owned companies demonstrate lower absenteeism, a happier workforce, higher profitability and more resilience in tough economic times, it is perhaps no surprise that the trend for employee ownership continues apace.

The employee ownership model, which can provide a viable and sustainable long-term structure for a business, typically involves a company becoming controlled by an employee-owned vehicle, such as an employee ownership trust (EOT). EOTs can create an effective means of succession planning and an alternative to the more traditional or conventional exit routes, such as a third-party trade sale, management or private equity backed buy-out. However, whilst the potential tax reliefs available to individuals who dispose of a controlling interest to an EOT can be very appealing, transitioning to an EOT entity can be a seismic cultural shift for a business. The tax drivers need to be carefully balanced against the future financial security and longevity of the business, which in turn may impact on sellers' ability to realise the full value from their shareholding.

With the recent tightening up of the rules on entrepreneurs' relief, the use of EOTs may become more attractive for management shareholders who no longer qualify for entrepreneurs' relief, because their shareholding does not meet the necessary tests.

Owners who decide that the EOT model is right for their business need to be prepared to embark on a 'sale process'. The level of commitment and effort involved in a successful transition to an EOT structure can be as challenging as any third-party transaction, and one which requires careful planning for success.

That said, with proper preparation and employee engagement, the EOT model can help deliver a robust, diverse and employee-centred business structure, whilst affording attractive tax savings.

The EOT structure and tax reliefs overview

The Nuttall Review and FA 2014

Following a government commissioned review of employee ownership (the Nuttall Review), and its wish to promote and introduce more robust and diverse businesses within the economy, FA 2014 introduced the following tax reliefs:

- capital gains tax relief for sellers who dispose of shares constituting a controlling interest to an EOT (TCGA 1992 ss 236H–236U);
- the ability for EOT controlled companies to pay income tax-free bonuses of up to £3,600 per year to employees, subject to certain conditions (ITEPA 2003 ss 312A– 312I); and
- relief from inheritance tax in respect of certain transfers from and into an EOT (IHTA 1984 ss 13A, 28A and 75A).

For both the capital gains tax relief and tax-free bonus arrangements to be available, the following conditions must be satisfied:

The trading requirement (TCGA 1992 s 236I and ITEPA 2003 s 312D): The shares being disposed of to the EOT must be shares in a trading company or the principal company in a trading group. A trading company is one carrying on trading activities, and with activities which do not include, to a substantial extent, non-trading activities (TCGA 1992 s 236I(2) and ITEPA 2003) s 312D(2)). In relation to the income tax relief for bonus payments of up to £3,600 per year, the legislation references a 'member' of a trading group, enabling bonuses to be operated at subsidiary company level.

The all-employee benefit requirement (TCGA 1992 s 236J and ITEPA 2003 s 312E(2)(b)): The terms of the EOT must *not* permit:

- any settled property to be applied other than for the benefit of all eligible employees on the same terms (see the equality requirement below);
- the trustees to apply the settled property by creating a separate trust or by transferring such property to the trustees of another trust (except where such transfer constitutes an 'authorised transfer') (TCGA 1992 s 236J(7));
- the trustees to make loans to beneficiaries; or
- the trustees or any other person to amend the terms of the trust in breach of these requirements.

An eligible employee captures any employee or officeholder of the company or relevant group company who is not an 'excluded participator', as determined in

accordance with TCGA 1992 s 236J(5). Broadly, excluded participators are:

- shareholders who are beneficially entitled to, or have rights to acquire, 5% or more of the company's ordinary share capital, or who would be entitled to 5% or more of its assets on a winding up (5% participators);
- 5% participators in any other close company that has made a disposition to the same EOT (if that disposition would have been a transfer of value had it not been excluded by IHTA 1984 ss 13 or 13A); and
- any person who has been a 5% participator during the ten years ending with the date the first property was comprised in the EOT (or 10 December 2013, if later), or anyone connected with any such person (TCGA 1992 s 286).

The equality requirement (TCGA 1992 s 236K and ITEPA 312C(1)(b)): Any application of trust property, or the payment of tax-free bonuses of up to £3,600 per eligible employee per year, must be made on the 'same terms'. However, subject to certain restrictions, it is possible to differentiate individual bonus payments on the basis of remuneration, length of service and hours worked, and to exclude certain employees who have not met a minimum service requirement or are subject to disciplinary proceedings.

The controlling interest requirement (TCGA 1992 ss 236M and 236T): The trustees of the EOT must:

- hold more than 50% of the ordinary share capital of the company;
- have powers of voting on all questions affecting the company which, if exercised, would equal a majority of the votes in the company;
- be entitled to more than 50% of the profits of the company;
- be entitled to more than 50% of the assets of the company on a winding up; and
- there must be no provision in any document that would reduce the trustee's entitlement without their consent.

In addition to the requirements set out above, (which must be met for the period of one year following the disposal for capital gains tax relief to apply), there are two further requirements as set out in TCGA 1992 s 236H(4)(d), (e).

The first is the 'limited participation requirement'. The number of continuing shareholders (and any other 5% participators who are directors, employees or persons connected with them) must not exceed 40% of the total number of employees of the company or group (TCGA 1992 s 236N). The rationale behind the limited participation requirement is to protect against the relief being given in situations where 'individuals who had a substantial shareholding in the company in circumstances where they, along with the other claimants, made up a significant proportion of the business's workforce before and after the creation of the EOT' (CG67856). There is a carve-out where the requirement is not met for a period of no more than six months as a result of events outside the reasonable control of the trustees (TCGA 1992 s 236N(4)).

The second requirement is that no vendor, or any person connected with them, can have claimed relief in any earlier year in relation to any disposal of shares in the same company or any member of the same group (TCGA 1992 s 236H(4)(e)). This is a relevant consideration for vendors considering a whole or partial sale of their holding.

How is the sale of a business to an EOT typically structured?

The EOT will need to be established by the target company. Typically, in order to protect any individuals operating in the capacity of trustee from personal liability, a private company limited by guarantee is used as a corporate trustee of the EOT (trustee). Individuals, including in many cases employees of the target company and its group, are appointed to the board of directors of the trustee company and act as 'trustee directors'.

The trustee will secure funding to purchase (as a minimum) a controlling interest in the target company from the selling shareholders (sellers). Funding can take various forms, ranging from the target company funding the consideration (subject to certain company law factors relating to distributions), to the trustee securing third party debt funding. The sellers, the trustee and typically the target company, will enter into a sale and purchase agreement setting out the terms of the sale transaction.

Following completion, the shares will be held by the trustee on trust for the benefit of the employees of the target company. Often, 100% of the shares in the target company will be sold to the EOT, but it is not uncommon to have a hybrid structure whereby sellers sell a proportion of their shares at completion and retain a holding which may be sold in the future. For the purposes of the 'controlling interest' requirement, this is based on the aggregate of the shares sold by all sellers.

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The sale process

Well advised parties will be aware of what is involved in the sale process. While no two EOT transitions are the same, the decisions, processes and documentation are similar in many ways to more traditional trade sale and purchase transactions.

Whilst in practice many of the interests of parties involved with an EOT transaction are aligned, it will often be appropriate that they each seek independent advice on the proposed transaction, and for vendors to seek advice on their personal tax positions.

Key sale and purchase transaction documents

Heads of terms: The use of a set of heads of terms is advisable. These are not typically legally binding, save in relation to such items as any confidentiality provisions, but allow the parties to consider and negotiate any points of difference prior to professional advisers being instructed to draft the sale and purchase agreement and other supporting legal documentation.

The sale and purchase agreement (SPA): The SPA will form the main agreement between the sellers, the trustee (as purchaser) and the target company, and document the terms on which the sale and purchase of the sellers' shares will occur. It is common practice that

Practical examples

Bonus scheme incorporating the equality requirements

The trustee of Company A's employee trust wishes to make a payment to employees based on an individual's hours worked and their length of service in the previous year. It does so by allocating 'qualifying points' to each eligible employee. They receive 10 qualifying points for each completed year of service and two qualifying points for every £1,000 of gross salary. Each qualifying point is equal to £100 of bonus payment.

An employee who has 10 years' complete service and an annual gross salary of £50,000 would receive a bonus of:

- Service: 10 years x 10 points = 100 points
- Salary: 50 (i.e. £50,000/£1,000) x 2 = 100 points
- Total qualifying points = 200 points

The total bonus amount is £20,000 (being 200 qualifying points x £100). The trustee of the EOT uses the assets of the trust to pay £16,400 of the bonus (which is subject to the deduction of income tax and NICs) and Company A (the employer) pays the balance of £3,600 tax free, but subject to NICs, under the relief rules in ITEPA 2003 Chapter 10A.

The limited participation requirement

The limited participation requirement at any relevant time for the purposes of the legislation is calculated by using the formula: NP/NE.

NP is the sum of:

a) the number of persons who are both participators in the company and employees of, or office holders in, the company; and
b) the number of other persons who are both employees of, or office holders in, the company (or any members of its group) and connected with anyone in (a).

NE is the number of persons employed by the company (or any members of its group).

Monty and his sister Maisy each owned half of the ordinary shares in the capital of Company B. They both sold all of their ordinary shares to a newly formed EOT on 21 December 2018. On 21 December 2017, Company B employed 24 people (including Monty and his two children, Maisy and her two children, Monty's wife and Maisy's mother). The participator fraction on 21 December 2018 was 8/24. Three employees who were unconnected with the family resigned and ceased employment with effect from 30 January 2019. The participator fraction rose to 8/21.

On 1 March 2019, Maisy's husband joined the business. The participator fraction therefore increased to 9/22 and exceeded the 2/5 participator fraction, creating a disqualifying event for the EOT. No other employees were recruited for a period of 12 months. Even though the event was beyond the trustee's reasonable control, as the limited participation requirement was not met within a six month period, the relief from the disqualifying event in TCGA 1992 s 236N(4) does not apply.

Disqualifying event

Company C was established in 1995 when four individual shareholders subscribed for 100 ordinary shares each at a price of £10 per ordinary share. The shareholders in Company C each sold their entire holding to a newly established EOT in June 2018 for a total of £10m. The EOT met the qualifying conditions and the vendors claimed relief from capital gains tax at the end of the 2018/19 tax year. In January 2021, the trustee of the EOT breaches the all-employee benefit requirement by making a loan to various beneficiaries from the EOT's assets.

A disqualifying event occurs for the purposes of TCGA 1992 s 236P, and the trustees are deemed to dispose of the shares on which the EOT conditions were met and relief claimed (i.e. 100% of the ordinary shares in Company C) and reacquire them at market value of £12m.

a purchaser's legal adviser will draft the first version of the SPA. However, in the context of an EOT transaction, it is more common for the target company's legal adviser to produce a fair and reasonable draft for the other interested parties to consider. The complexity of the SPA will depend on the nature and circumstances of the particular EOT transaction, but is likely to cover the following key items:

- title and capacity covenants to be given by the sellers, including confirmation that there will be no ability to disclose against such covenants;
- the consideration to be paid to the sellers and how any deferred consideration is to be funded, the timing and amounts of any such deferred payments and the consequences of default;
- whether there are to be any conditions precedent to the transaction completing. This might include, for example, any regulatory approval to the change of control of the target company and the mechanics to deal with a split exchange and completion;
- trading warranties to be given for the benefit of the EOT. It is likely that fewer warranties will be given when compared to a more traditional trade sale, but the giving of warranties still has an important part to play in an EOT transaction;
- the limitation of liability in respect of any warranty protection being given;
- any indemnity protection;
- if there is more than one seller, whether obligations are to be given on a joint and several basis (or otherwise); and
- relevant waivers of any pre-emption rights.

The disclosure letter: To the extent that trading warranties are to be given by the sellers, they will need to be given the opportunity to disclose relevant information against the warranties and this is typically done through the means of a disclosure letter.

Other key documentation

In addition to the key sale and purchase documents, the target company and the trustee will enter into a trust deed and rules governing the operation of the EOT which satisfy the requirements of TCGA 1992 ss 236H–236U and ITEPA 2003 ss 312B–312C. The trust deed and rules will also typically satisfy the Companies Act 2006 (CA 2006) s 1166 definition of an 'employees' share scheme'. This is usually important in the context of a general employee benefit trust set up to support employee share scheme arrangements, as it will enable the trust to benefit from the exemptions from the CA 2006 rules on statutory pre-emption and some of the requirements of the Financial Services and Markets Act 2000. However, for the definition to be satisfied, the EOT must exclude officeholders who are not employees from the class of beneficiaries. This is permitted by TCGA 1992 s 236K(1)(d).

Companies will often adopt or amend their articles of association to ensure they provide a constitution commensurate with an EOT structure. Where any minority shareholdings remain following a transfer of a controlling interest in the target company to the EOT, parties will also often enter into a shareholders' agreement to regulate their relationship.

Valuation of the target company

There are a number of considerations when determining the price payable by the EOT for the target company. In one respect, it is a bargain at arm's length between the parties. However, given the 'internal' nature of the transaction, it will be important for the trustee to be able to demonstrate that it is not paying an 'over value' for the shares. Fundamentally, the trustee must act in the best interests of its beneficiaries and demonstrate it is paying a 'fair price'. Similarly, where the EOT is funded by the

target company by way of gift, the directors must be clear they are discharging their statutory and fiduciary duties to the company and its shareholders when entering into commitments to fund the consideration.

EOT disposals are not exempt from the anti-avoidance provisions in ITEPA 2003. It will therefore be important to ensure that no charge under ITEPA 2003 Part 7 Chapter 3D (securities disposed of for more than market value) could arise for sellers who are employees or officeholders. Given there is no mechanism to agree a valuation for these purposes with HMRC prior to the transaction, it is usually in the best interests of all the parties to seek independent valuation advice.

Change of control provisions

The target company may be party to contractual arrangements with third parties which contain change of control provisions. These can include property leases, supply agreements and banking arrangements. In order to maintain an orderly transaction timetable, the target company should undertake a due diligence exercise to address any obligations under these contracts.

Employee engagement

It is an important decision for sellers to determine when in the sale process to engage with employees about the proposed sale. Many owners will have well developed employee engagement strategies in place, and regularly communicate with staff about the direction and performance of the business. One of the keys to success in employee-owned companies is ensuring that the employees feel an ownership culture. The timing will also be important if employee representatives are to be appointed to the board of directors of the target company and/or the trustee, or an employee council is to be formed.

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Governance

As the directors of the target company must operate in the best interest of its shareholder (being the EOT), careful consideration needs to be given to the ongoing governance of both the target company and the EOT, particularly where any seller is, or continues to be, a director of the target company following completion of the transaction. Given the relation between the EOT and the target company and the potential for conflicts of interest arising, the constitution of the board of directors of the target company and that of the trustee must be carefully thought through.

The appointment of non-executive directors can assist with the management of the inherent conflicts of interest that can arise, as can the use of an employee council or appointment of employee representatives to the board of directors of the target company and/or the corporate trustee of the EOT.

Depending on the size of the target company, the implementation of a 'formal' employee council may not be feasible, but the adoption of a policy of how employees are to be represented, appointed (e.g. by ballot) and consulted on an ongoing basis is advisable. In addition, the trust deed and the relevant constitutional documents (e.g. articles of association) should be constructed to ensure that potential conflicts of interest are mitigated (e.g. specifying that quorum requirements must include the employee representative).

Other tax considerations

Disguised remuneration

There is no carve-out for the activities of an EOT from ITEPA 2003 Part 7A. This anti-avoidance legislation was introduced to prevent the use of trusts and other third-party arrangements to benefit employees in a way that avoids income tax or NICs. The legislation is broadly drafted and imposes an immediate tax charge (payable through pay as you earn (PAYE), with NICs also due) when a third party enters into certain arrangements designed to reward employees. Care needs to be taken when establishing the EOT and entering into the sale transaction to ensure that no inadvertent charges under ITEPA 2003 Part 7A arise.

Traps for the unwary

If a 'disqualifying event' occurs in the year following the tax year in which the disposal to the EOT occurs, any claim for capital gains tax relief by the sellers is revoked and no further claim may be made.

The following are disqualifying events:

- the company ceases to meet the trading requirement;
- the EOT ceases to meet the all-employee benefit requirement;
- the EOT ceases to meet the controlling interest requirement;
- the limited participation requirement is breached;
- the participator fraction exceeds 2/5; or
- the trustees act in a way which infringes the all-employee benefit requirement.

It is therefore key that sellers have certain protections against breaches in the first year post-completion.

However, of perhaps more long-term significance is that where a disqualifying event arises after the end of the first tax year after the capital gains tax relief is claimed by the sellers, there is a deemed disposal and reacquisition of all the shares held by the trustee in respect of which relief was claimed. This causes a capital gains tax charge on the market value of the shares less the seller's original base cost. In many cases, this will be a 'dry' tax charge, since many of the disqualifying events are not associated with the sale of any shares by the trustee. It is extremely important therefore that the company is operated (including any tax-free bonus schemes) on a permanent basis in a way which avoids a disqualifying event occurring. Given the significance of this risk, some companies give consideration to the use of an offshore EOT.

The future for EOTs

On current trends, it is fair to assume that the use and role of EOTs for succession planning and as an alternative to more traditional exit routes will continue to gain traction. However, sellers and target companies need to ensure that transitioning to an EOT model is culturally right for them and is not simply a way of facilitating an exit for sellers on a tax-free basis. Any perceived abuse of the reliefs associated with the EOT model through sellers acting in this way is likely to attract the attention of HMRC. ■