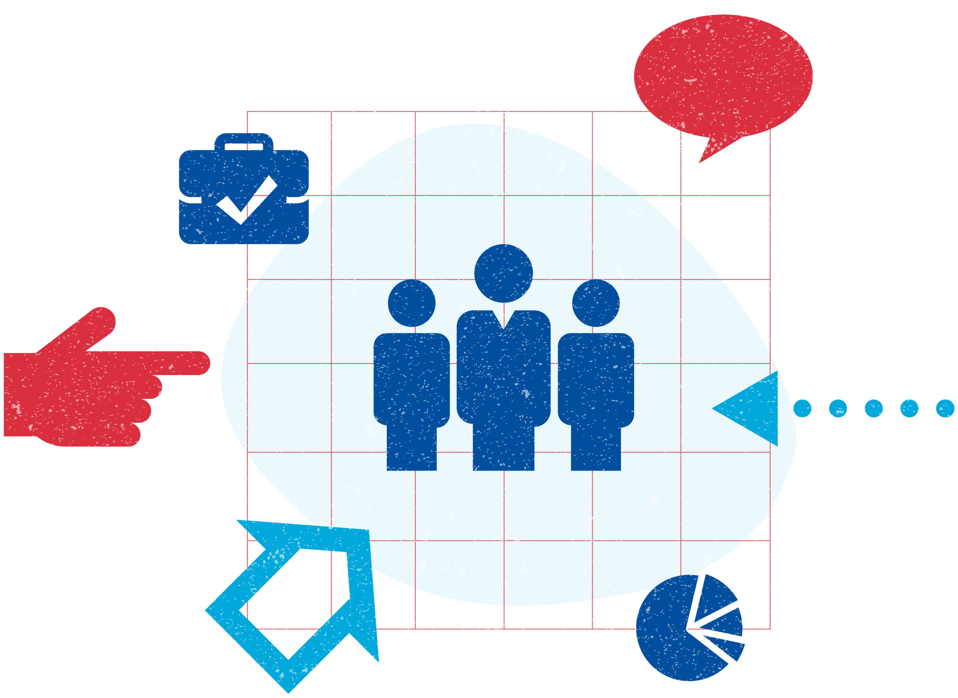
PKF FRANCIS CLARK
Shared Ambition

Employee ownership

A guide to transitioning



Employee ownership trusts

What is an employee ownership trust?

An Employee Ownership Trust (EOT) is a means by which the ownership of a company can be indirectly transitioned to its employees in a tax efficient manner. EOTs were introduced by the government in 2014 to incentivise more shareholders to transition to an employee-ownership model.

An EOT is essentially a particular type of employee benefit trust and must first be set up for the benefit of all qualifying employees. The existing shareholders can then sell a controlling share in the company (anywhere from 51% to 100% of share capital) to the EOT (or its corporate trustee to be precise) in return for payment (the method is dependent on the funds available, as set out on page 7). The EOT thus holds a controlling stake in the company on behalf of its employees.

Provided certain statutory criteria are met, EOTs provide generous tax advantages for both the exiting shareholders and the company itself. A key benefit is that, subject to meeting the criteria before and following the transaction, the exiting shareholders could qualify for an 'exemption' from capital gains tax (CGT) on any gain arising from the disposal of their shares.

Once established, all employees can then benefit from the EOT (based on certain criteria including hours worked, length of service and level of remuneration) as the company profits are gifted up to the EOT.

Why transition to an employee ownership trust?

A transition to employee ownership provides existing shareholders an exit route which yields full market value. However, it is about more than selling the business to a new owner, it can have a transformative impact upon how the business operates, with employees brought into the heart of decision making.

Employee-owned businesses achieve higher productivity, are more resilient to economic downturns and have a more engaged workforces. According to the latest Employee Ownership Top 50 report*, they typically enjoy:

- ***Stronger sales** up 4.3%, compared to a UK average of 1.2%*
- ***Better productivity** up 6.9%, compared to a 1% fall overall*
- ***Lower debt** 66% have no debt*
- ***Growing profits** up 5% on average*

If you're considering employee ownership, you're in good company. Aardman Animations, Riverford Organics, Wildlife World and Lush are among the successful businesses to have embraced this increasingly popular model of ownership.

There are also substantial tax advantages of employee ownership for both exiting owners and employees, not least the chance for a completely tax-free sale.

**Employee Ownership Top 50 report produced by the Employee Ownership Association 2020.*

Why use an EOT?

Advantages for existing shareholders

- *Employees can indirectly buy the company from its shareholders without them having to use their own funds - thereby creating an immediate purchaser and addressing succession issues*
- *Shareholders can sell their shares for full market value (note - an independent valuation will be required)*
- *A tax-free sale. Provided the relevant conditions are met, no capital gains, income or inheritance tax liabilities should arise on the disposal of a controlling interest in a company to an EOT (or on the subsequent receipt of the purchase price by the former shareholders)*
- *Not all shareholders are required to sell their shares to the EOT*
- *The directors can remain in situ post-disposal and can continue to receive market-competitive remuneration packages*
- *The process doesn't include external parties therefore the EOT is generally seen as a 'friendlier purchaser' which allows the owners to set the pace of the transaction with potentially lower fees*

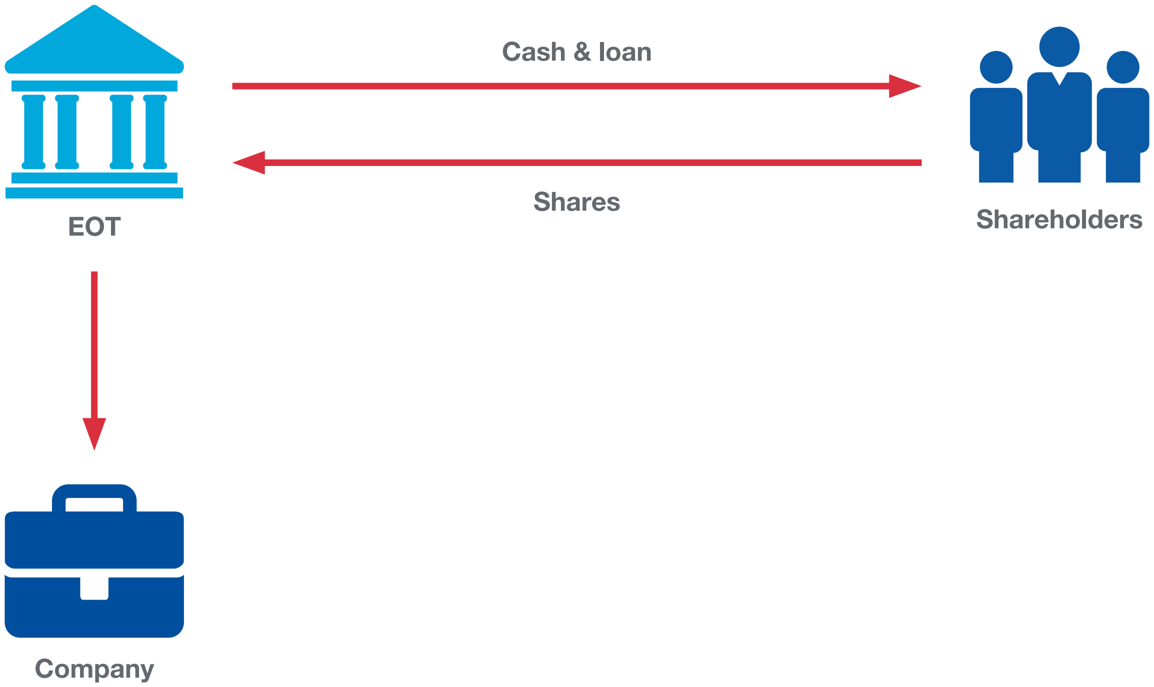
Advantages for the company and its employees

- *A transition to an EOT is about more than selling the business to a new owner, it can have a transformative impact upon how the business operates, with employees brought into the heart of decision making*
- *Companies controlled by EOTs are able to pay tax free cash bonuses to their employees of up to £3,600 per employee per year (but not NIC free)*

What does it typically look like?

Sale of company

- *A special type of trust (the “EOT”) is set up by the Company*
- *This will buy the shares in the company from the existing shareholders, the consideration payable for this purchase will be cash and a loan*
- *The cash will come from initial funds settled to the trust by the company*
- *The loan will be repaid from contributions to be made by the company to the trust out of future profits*



Tax relief requirements

HMRC can be approached for pre-transaction clearances to ensure that the anticipated taxreliefs are obtained. There are 5 key requirements which are broadly set out below:

1. *The trading requirement*
   - *Does not, to a substantial extent, carry out non trading activities*
2. *The all employee benefit requirement*
   - *Must be for the benefit of **all** eligible employees of a company or group on the same terms*
3. *The controlling interest requirement*
   - *More than 50% of the ordinary share capital*
   - *Hold a majority of the voting rights*
   - *More than 50% of profits available for distribution*
   - *More than 50% of the assets available to equity holders on a winding up*
   - *Trustee consent needed for any reduction in its entitlement*
4. *The limited participation requirement*
   - *The exiting shareholder’s continued interest has to be limited*
   - *This can mean the company must have a minimum number of employees who are not ex shareholders*
5. *The no related disposal requirement*
   - *This limits the relief available to all connected claimants on disposals of shares in a particular company (or companies in the same group) to a single tax year*

Planning for the transition

Implementing an EOT is about more than just the tax and legal documents, although these are essential. Moving to an employee ownership model can be transformational, with a shared ethos that can be different from the traditional corporate model, putting employees at the heart of the business.

We can offer our experience on the implementation of these projects and work with you to understand some of the ramifications for both the business and its people.

Essential tax and financial steps

In our experience, all clients going through an EOT transition should:

1. *Ensure that the tax structure is right and tax clearances are obtained*

2. *Obtain a formal valuation report to support the price paid as being market value (this will be a key consideration for both parties and for the tax position)*

3. *Get the right legal documentation in place*

We would be pleased to provide advice on tax and valuation. Your lawyers will ensure the right legal documents in place and we would typically recommend we review the final draft to ensure they meet the tax conditions.

Additional financial and deal structuring advice

An additional area of assistance we would particularly recommend is financial analysis and deal structuring support, to help design a reasonable and affordable payment plan, protecting the vendors position.

Deal structuring

Deal structuring and funding

A key part of the deal for both parties is how to fund the arrangement. If the full purchase price cannot currently be met out of the company's cash reserves the question arises of funding the balance.

At its most simplistic, the balance can be left outstanding as debt and paid out of future profits, in which case questions such as the length of time and interest chargeable need to be addressed.

It may also be in the shareholders' interests to investigate whether a larger upfront payment can be made by involving third party funders, as this would reduce the risk.

If desired, we can support you through this decision-making process. We can assist with finding and negotiating with third party funders, considering the financial projections and working with you on the deal structuring to ensure that the external debt funded element is affordable for the company going forward.

Ways we can help

Essential steps

- ***Pre transaction steps:*** *Identify any pre-transaction tax restructuring or actions that may be required, for example dealing with any shareholder/ director loans in place*
- ***Valuation:*** *Preparation of an initial independent commercial valuation report of the business (assuming 100% of the issued shares are acquired) by our experts in the corporate finance team for feasibility planning purposes*
- ***Tax structure paper:*** *Provision of a tax paper outlining the structure of the transaction, the tax implications, and the practical aspects of any loan notes or preference shares such as interest/dividend rates and withholding taxes*
- ***Tax clearances:*** *Drafting and submitting a statutory tax clearance to confirm the UK tax treatment of the transaction and that HMRC will not seek to apply anti-avoidance legislation. If required, this may also include drafting and submitting a non-statutory tax clearance to confirm the UK tax status of any payments from the company to the EOT with HMRC*
- ***Documentation:*** *Discussions with lawyers and review of legal documents for tax purposes to confirm that the structure is being implemented as anticipated to ensure that the tax legislative requirements are met*

Additional support

- ***Financial analysis and deal structuring:*** *We would be pleased to provide additional transaction and structuring advice/ support. We would discuss fees separately as the time involved would depend upon the nature and extent of the work*

Other support we offer

Implementation

We can offer assistance around the implementation process, for example, with explaining employee ownership to the management team. It is also prudent to prepare the management team and the employees for the cultural changes the transition would bring. We can offer suggestions and guidance on where to find and access further employee support and training.

Ongoing support

After the transaction we would be happy to provide ongoing assistance, for example with the employee communication, ongoing governance, maintenance, tax compliance and support services.

Trustee independent advice

Please note, whilst we would (if instructed) endeavour to recommend a deal structure that we believe to be commercially workable for both parties, as there is the potential for a conflict of interest, we would not be in a position to offer commercial advice to the Trustee where we have advised the seller on the structure of the transaction.

Post deal management incentivisation

Shares in the EOT are used to benefit all employees equally, so an EOT is not suitable for making individual awards to the management, therefore, their incentivisation would have to be considered carefully to ensure that they are properly motivated.

We have extensive experience with management share plans and other incentive and reward arrangements so can help you consider other reward structures for the management team.

Contact

Here at PKF Francis Clark we have a dedicated specialist reward team with many years of experience in designing the right solution for your business with many years experience advising on employee ownership arrangements.

John Endacott
Partner, Head of Tax

john.endacott@pkf-francisclark.co.uk
01392 667000

Damian Lannon
Corporate Tax Partner

damian.lannon@pkf-francisclark.co.uk
01392 667000

Nicola Manclark
Tax Partner

nicola.manclark@pkf-francisclark.co.uk
0117 403 9807

Lisa Whitbread
Corporate Tax Partner

lisa.whitbread@pkf-francisclark.co.uk
01392 663600

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Bristol
0117 403 9800

Exeter
01392 667000

Plymouth
01752 301010

Poole
01202 663600

Salisbury
01722 337661

Southampton
02380 012890

Taunton
01823 275925

Torquay
01803 320100

Truro
01872 276477