Corporate: General Guide to Employee Ownership Trust (EOTs)

Introduction

Employee Ownership Trusts (EOTs) have emerged as a transformative model for business ownership in the UK. For the right business they can offer a unique approach to economic participation and governance, as well as a credible and tax efficient exit route for business owners.

The purpose of this guide is to look at:

- Background to the common structures and models of employee ownership.
- The benefits of the EOT model (for both employers and employees).
- Some emerging trends and developments in relation to EOTs.
- The legal framework for a tax efficient EOT transition.
- An overview of the process of becoming employee owned.
- Some of our top tips for a successful sale to an EOT.

The Current Impact of Employee Ownership in the UK

Evolution of Employee Ownership

Employee ownership has a rich history in the UK and ownership models have evolved over time to accommodate different business needs, workforces and economic circumstances. While basic principles remain consistent, variations have emerged to suit specific requirements.

Whilst this note focuses on EOTs (i.e., "indirect" employee ownership through a trust), common models also include direct ownership and hybrid structures, combining elements of both.

Direct Ownership

This form of employee ownership typically requires the issue of EMI (Enterprise Management Incentives) options or the deployment of a growth share scheme (often a combination of the two).
Under these schemes, the intention is for the employees to acquire shares in the business in their own names. EMI is often the most tax- efficient choice but, regardless of the scheme used, employees will become direct stakeholders in the business. Once they own shares, they can enjoy the benefits of being a shareholder, including access to dividends and participation in exit proceeds upon a sale.

Indirect Ownership

This form of ownership requires the shares to be held "on behalf" of employees and, commonly, a discretionary trust (known as an EOT) will be used.

Often referred to as the "John Lewis" model, the trust holds the shares in the company for the benefit of eligible employees, and the company's profits are paid to the employees by the trust in the form of profit shares or other benefits.

This is, by far, the key form of employee ownership that has seen most recent growth. HMRC received almost 450 applications for EOTs in 2022, compared with under 20 applications five years earlier.

Hybrid Ownership

Indirect ownership via a trust, and direct ownership structures afforded by share schemes, are not mutually exclusive. A business can be held by an EOT while permitting some direct ownership.

This can result from a company transitioning to indirect employee ownership via an EOT setting up a share option scheme, such as an EMI scheme to incentivize management.

It must be remembered that, to avoid clawback of tax reliefs, the EOT must retain a majority stake in the company and not be diluted to less than 50% as a result of shares issued under the scheme.

The choice of structure will depend on factors such as the size and complexity of the business, the preferences of the owner(s), and the objectives of the employee ownership transition.

The evolution of indirect and hybrid ownership EOTs was dramatically altered by changes enacted under the Finance Act 2014 (the "**2014 Legislation**") which introduced significant tax incentives for "qualifying" EOTs (i.e. those that meets the statutory requirements). This included generous capital gains and income tax relief for both sellers and employees, making them a credible option for exit strategy across a wide variety of sectors.

Industries or Sectors where EOTs are most Prevalent

EOTs have been adopted as a business ownership model across a wide range of industries and sectors in the UK, reflecting their broad appeal and effectiveness, including:

1. Manufacturing – manufacturing businesses were early adopters of EOTs, drawn to the model's potential to preserve jobs and maintain the company's craftsmanship and enduring legacy. Employee ownership can also help to foster a sense of pride and commitment among employees, leading to increased productivity, quality and innovation in manufacturing processes.
2. Professional Services – professional services firms, including law firms, accounting firms, and consulting firms, have also begun to embrace EOTs as a way to align the interests of employees with the long-term success of the business. Employee ownership can help to attract and retain top talent in competitive industries, leading to improved client satisfaction and business performance.
3. Technology – technology companies (particularly startups and scale-ups), are increasingly turning to EOTs as a means of rewarding employees for their contributions to the company's growth and success. In the fast-paced world of technology, employee ownership can help to create a culture of collaboration and innovation, driving product development and market expansion.
4. Retail – retail businesses, including both high street stores and online retailers, have found value in EOTs as a way to differentiate themselves in a competitive marketplace. Employee ownership can help to improve customer service and brand loyalty by empowering employees to take ownership of the customer experience.
5. Healthcare – whilst initially a slower adopter, healthcare organisations, including clinics and care homes, are also exploring EOTs as a means of engaging employees in the delivery of high-quality patient care. Employee ownership can help to improve staff morale and reduce staff turnover, leading to better patient outcomes and overall satisfaction.

In addition to these sectors, EOTs are also becoming prevalent in construction, hospitality, and the creative industries. As awareness of the benefits of employee ownership continues to grow, we can expect to see EOTs gaining traction across a broader range of businesses and sectors in the UK.

So, what is an EOT?

As noted above, an EOT is a form of indirect employee ownership in which a specialised discretionary trust is settled by the target company in order that the trustee/s can hold the company's share capital on behalf of the company's (or its group's) employees. Whilst no individual employee owns legal or beneficial title to shares, this share "ownership" structure fosters a sense of collective ownership and responsibility among employees, aligning their interests with the long- term success of the business.

Increasingly, EOTs are established when business owners wish to sell a company (or group) as an EOT sale can comprise a viable and efficient exit strategy, whilst ensuring the continued independence and success of the business.

TOP TIP

How can a trust, that has just been set up, fund the purchase of the company's shares?

- The purchase price paid by the trustee/s of the EOT to the business owner typically comprises an initial payment (payable on completion of the sale) plus deferred payments (payable over several years).
- The funds for these payments are gifted to the trustee/s by the trading company / group from its existing distributable cash profits (both, at the time of the sale, to finance the initial payment AND from its future distributable profits, to finance the deferred payments).
- Please note that it is possible to accelerate payments with bank finance and many banks have developed internal expertise to understand the ownership structure and risk profile of lending to an EOT-owned company / group.

EOTs are often stated to play a crucial role in promoting “inclusive capitalism” with macro benefits of promoting economic goals of business resilience and long-term growth.

Of course, an employee ownership trust will not be right for every business and detailed analysis of suitability is critical. However, below are some of the key potential benefits often cited for employees and sellers / employers.

Potential Benefits for Employees

EOTs (like most forms of employee ownership) target a range of benefits for employees, including:

1. **Financial Participation:** By becoming indirect “owners” of the company, employees can share in its success, providing a financial stake in its performance.
2. **Enhanced Job Security:** Owning a stake (albeit it, indirectly), fosters a sense of loyalty and commitment among employees and can reduce employee turnover rates and enhance job security. When employees share in the company’s success, it can lead them to greater investment in its long-term viability.
3. **Improved Engagement:** Employees may garner a greater sense of pride and responsibility in their work, which can lead to increased motivation, productivity, and engagement. This heightened sense of ownership can drive innovation and creativity, leading to better business outcomes.
4. **Long-term Benefits:** Unlike traditional ownership models, which may prioritise short-term gains, EOTs are designed to promote sustainable growth and long-term value creation. By aligning the interests of employees with the company’s long-term success, EOTs create stability and resilience.

Potential Benefits for Sellers / Employers

EOTs can also offer significant benefits for business oweners and employers, including:

1. **Tax Advantages:** Selling a business to an EOT can offer significant tax benefits for both seller/s and employees, making it an attractive option for succession planning. EOTs are eligible for Capital Gains Tax relief and employer can pay certain income tax free bonuses to qualifying employees.
2. **Preservation of Legacy**: EOTs provide a succession solution that allows business owners to maintain the company’s independence and preserve its culture and values. Rather than selling to a competitor or a PE firm, business owners can ensure that the company remains true to its founding principles.
3. **Retention of Talent:** Employee ownership can be a powerful tool for attracting and retaining talent, as it offers employees a direct stake in the company’s success. By giving employees a sense of ownership and control over their work, EOTs can help to create a more positive and supportive work environment, leading to higher levels of employee satisfaction and retention.
4. **Increased Resilience:** Employee ownership can enhance a business by fostering a culture of collaboration and innovation. When employees have a stake, they are more likely to go above and beyond to ensure its long-term viability, leading to greater resilience in the face of economic uncertainty and market fluctuations.

Emerging Trends and Developments in EOTs

EOTs have been evolving continuously since their introduction, and new structures are emerging to meet the changing needs of businesses and employees.

In addition to hybrid ownership, some of the new trends gaining popularity in the realm of EOTs include:

1. Sector-Specific EOTs

   These are EOTs tailored to a particular sector's needs. For example, EOTs focused on healthcare, technology, and renewables. These EOTs may offer specialised benefits or resources to support businesses within their industry, such as training programs, networking opportunities, or access to sector-specific expertise.

2. Community-Owned EOTs

   There is also growing interest in community-owned EOTs, where the trust holds a stake in the company on behalf of not only the employees but also other stakeholders, such as customers, suppliers, or local residents. Community-owned EOTs aim to create a more inclusive and sustainable form of ownership that benefits the broader community, not just the employees and shareholders.

3. Digital Platforms for EOTs

   With the rise of technology, we're seeing the emergence of digital platforms and tools designed to facilitate the management of EOTs. These platforms streamline the process of administering an EOT, making it more accessible and cost-effective. In order to meet the individual needs of each business and ensure a successful transition, online document generation has a long way to go, but these platforms can be useful for ongoing compliance and employee communication.

4. International Expansion of EOTs

   While EOTs have primarily been associated with UK-based businesses, there's increasing interest in their adoption on an international scale. Businesses in other countries are exploring the feasibility of implementing EOTs as a way to promote employee ownership and engagement. This trend reflects the growing recognition of the benefits of employee ownership worldwide and the potential for EOTs to serve as a model for sustainable business ownership.

5. Expansion of Government Support

   One upcoming development is the expansion of government support for EOTs. The UK government has shown increasing interest in promoting employee ownership as part of its broader agenda to support inclusive capitalism and sustainable business practices. We may see new initiatives or incentives introduced to encourage businesses to adopt EOTs, such as additional tax incentives, funding programs, or educational campaigns.

Consultation

In mid-2023, the UK Government announced a consultation to look at a number of developments to the legislation governing EOTs, including:

- Preventing sellers from controlling the EOT post-sale. Most advisors (including Morr & Co) already recommend against this, as it contradicts the spirit of the 2014 Legislation and an EOT transition should involve a meaningful change for employees.
- Requiring corporate trustees to be UK resident to prevent the use of offshore trustees as part of wider Capital Gains Tax avoidance (i.e., a charge to CGT on a sale by the EOT or other disqualifying event).
- Reducing the need for non-statutory clearance by putting HMRC's practice not to tax gifts made to an EOT on a clear statutory footing.

Navigating the Legal Landscape of Employee Ownership Trusts (EOTs) in the UK

Below we look at the legislative framework governing the creation on an indirect EOT under the 2014 Legislation, including a broad explanation of the process involved, the tax benefits they offer, and the qualifying criteria. We also include some key tips and pitfalls to consider when establishing an EOT.

TECHNICAL TIP

Legislative Framework

The legal foundation for a tax efficient sale to an EOT is primarily found in the Finance Act 2014, which introduced specific rules relating to qualifying disposals to EOTs. These rules are contained in sections 236H to 236U of the Act.

Other legislation and regulations, such as the Companies Act 2006, trust law and related tax acts, will also apply, depending on the specific circumstances of the EOT.

To comply with the Finance Act 2014, the EOT must be a discretionary trust established for the benefit of "all" eligible employees of a qualifying company or group.

Core requirement also include that the trust holds a "controlling interest" in the company's ordinary share capital, and the company must be a "trading" company (or the parent company of a trading group).

Process for Transitioning to an EOT

The process of creating and selling to an EOT in a manner that complies with the 2014 Legislation involves several steps, which may vary, depending on the specific circumstances of the company / group and the trust. However, the key steps typically include:

Step 1: Eligibility Assessment

- Determine whether the company / group meets the criteria for establishing an EOT under the rules, including being a trading company (or the principal company of a qualifying group) and having eligible employees.
- As the transition will involve a transfer of the ownership of the company / group, it is also necessary to ensure that this "change of control" will not cause the company / group to lose any key trading benefits (including customer / supplier contracts or certifications) and that all consents (such as lender consents) are obtained.

Step 2: Establishing the Trust

- Create the trust deed, setting the terms and conditions of the EOT, including identifying the beneficiaries, the powers of the trustees and the purpose of the trust. In order to provide limited liability and ease of change, the trustee will often be a sole "corporate" trustee, governed by trustee directors.
- Appoint trustees (or trustee directors, if using a sole corporate trustee) to manage the trust on behalf of the beneficiaries, ensuring they have the necessary skills and experience to fulfil their duties effectively.
- If the trust is using a professional trustee (director) as one of its number, it is important to ensure that any agreement with the individual (including the terms, conditions and costs of appointment) are agreed well in advance.

Step 3: Transferring Shares

- Transfer a controlling interest in the company's ordinary share capital to the EOT via a sale of the shares held by the existing owner(s) of the company.
- A third-party valuation must be obtained, and the transfer will require an arm's length sale agreement. This will often include warranties (albeit less onerous than on a trade or PE sale), along with deferred consideration payable to the sellers in the form of loan notes, redeemable from the company's / group's ongoing profits.

Step 4: Compliance

- Apply for statutory tax clearance from HMRC under the "Transactions in Securities" legislation. This will not "bless" the EOT transition (in so far as compliance with the 2014 Legislation) but HMRC will confirm that it will not seek to tax the sellers under certain anti-avoidance legislation. In short this gives comfort that HMRC will (in so far as the content of the application is accurate) view the transition as bona fides and not a mechanism for the sellers to extract cash on which dividend or income tax should otherwise be payable.
- Although not strictly necessary, some tax advisors also apply for non-statutory clearance. This is to confirm that gifts from the company / group to the trust (to fund the purchase price and ongoing profit shares) will not be taxed. It is, nevertheless, HMRC's custom and practice not to do so.
- Crucially, the sale must comply with the conditions of the 2014 Legislation as a "qualifying" transfer. It is imperative that the conditions are met and continue to be met. It is also important that the transaction, along with the ongoing management of the trust, ensures that the trustees (or trustee directors) are able to properly discharge their fiduciary duties. Equally important is compliance with all other legal and regulatory requirements that govern EOTs, including company and trust law, filing obligations (Companies House and the Trust Registration Service at HMRC), reporting requirements, and proper ongoing administration of the trust.

Tax Benefits of Creating an EOT

As referred to above, establishing and selling to an EOT in accordance with the rules enacted under the 2014 Legislation can offer various tax benefits for both the seller/s, the company and its employees. Some key tax advantages include:

Capital Gains Tax (CGT) Relief:

Often considered the headline saving, sellers who make a qualifying transfer of a controlling interest in a company to an EOT can benefit from **full capital gains tax relief** on the sale proceeds. Please note that the tax charge will be re- animated if, later, any of the required conditions fail to be met. This includes the EOT selling the company / group. The responsibility for any re-animated tax charge is dependent on the timing of the disqualification.

In short, so long as the conditions continue to be met during the tax year in which the sale is made, the "relief" can be claimed by the former business owner/s. If a condition ceases to be met in the tax year that follows, it can be clawed back. Thereafter, if a condition ceases to be met, the trustee/s become responsible for the charge to tax, inhering the base cost of the business owner/s from the original transaction. If the disqualification is not a sale by the EOT, a sale (at such base cost) and buyback by the trust will be "deemed" to have occurred with tax being charged on the gain.

Income Tax Exemptions:

Employees may receive tax-exempt bonuses from their employing company (up to £3,600 per year,), without incurring income tax liabilities. National insurance is still payable.

Corporation Tax Deduction:

The employing company is eligible for a corporation tax deduction when bonuses eligible for an income tax exemption are paid to employees.

Inheritance Tax (IHT) Exemptions:

Inheritance tax should not arise on gifts or sales (at an undervalue) to EOTs and trustees of EOTs are exempt from IHT charges that may otherwise apply (e.g., the 6% inheritance tax charge that may arise on each 10-year anniversary of the settlement of the trust).

TOP TIP: Transitioning into an EOT

First and foremost, to benefit from tax reliefs under the 2014 legislation, the transition must meet the qualifying criteria under s.236. We mentioned above that the target company must be **trading** (or the principal company of a trading group) and the EOT must benefit **all employees** (save for limited and prescriptive exclusions) and hold a **controlling interest** in the target. In addition to this, the number of continuing shareholders (and any other 5% participators) who are directors or employees of the company / group (and persons connected with them) **must not exceed 40%** of the total number of employees of the company / group (this is the fourth key condition and known as the Limited Participator Condition).

Failure to meet these criteria could result in the disqualification of the EOT from the tax benefits.

- Consider **employee engagement and communication** as this is an essential element for EOT success. Involve and enthuse employees in the process from the outset and ensure they understand the benefits of employee ownership. For smaller businesses it won't be feasible to create an employee council but processes for meaningful engagement are still critical.
- Consider an **insurance product** over the lives of the seller/s to whom deferred consideration is due (in respect of which such seller/s are named beneficiary/ies). This is to assist with tax liabilities on inherited deferred payment rights, but careful drafting will be required in the sale documents to ensure that this provides an effective solution.
- Be careful to ensure that **trustees' / directors' duties** can be complied with under the terms of the transaction. For example, it will be inconsistent with the duties of the trustees / directors to pay more than a market valuation for the company (as this would require them to provide a benefit to someone other than eligible beneficiaries of the trust). Similarly, the documentation must be carefully drafted to ensure that the trustees / directors are not obliged to pay deferred consideration if they do not have the resources (as this is dependent on gifts from the profits of the trading company / group).
- Give careful consideration to the **availability of distributable reserves** when gifting funds to the EOT to pay the purchase price.

  The concept of distributable reserves applies to a company (not a group) and loans to a holding company do not improve its available reserves, nor can the lending company consider such funding a loan if there is no real prospect of a non-trading holding company making repayment. Compliance with company law is critical.
- If the seller/s receive a substantial amount of the purchase price as deferred consideration (often loan notes) think carefully about what **seller protections** are reasonable to afford to them whilst this is outstanding. Careful consideration must be given to this to ensure that any company / group matters over which a seller has a "veto", or which are otherwise reserved for the sellers to decide, must not inhibit the EOT obtaining or retaining a controlling interest.
- Consider the **choice of trustee / directors** for the EOT carefully. It is usually advisable that these comprise a representative balance that enhances decision making and supervision. It's not unusual for the board to include a mix of: (i) a professional or independent trustee / director; (ii) an employee representative trustee / director; and (iii) a representative from the board of the company (or, whilst deferred consideration is outstanding, the seller/s). These individuals must act independently and without conflict but, collectively, the perspective they bring helps ensure balanced governance.
- Once the EOT is established, ensure **ongoing compliance** with all legal and regulatory requirements, including filing obligations, reporting requirements, and trustee responsibilities. Failure to comply could result in penalties or disqualification from tax benefits.
- Establishing an EOT involves complex legal, financial, and tax considerations. **Seek professional advice** from solicitors, accountants, and other professionals with experience in EOTs to ensure compliance with all legal and regulatory requirements.

Conclusion

Employee Ownership Trusts (EOTs) have evolved significantly in recent years, becoming increasingly prevalent across various industries and sectors in the UK. Their flexible structures and tax advantages make them an attractive option for business owners looking to transition ownership to their employees in a tax-efficient manner while ensuring the continued success and independence of the company.

As businesses across the UK seek to navigate the challenges of succession planning and long-term sustainability, EOTs offer a compelling solution that empowers both employees and employers alike. With the right support and guidance, EOTs have the potential to reshape the UK business landscape for the better, fostering a culture of shared ownership and collaboration that drives long-term growth and prosperity.

Establishing an EOT does, however, involve navigating a complex legal and regulatory landscape, including compliance with relevant tax, company law and trust legislation. By following the correct process, understanding the tax benefits, and ensuring eligibility and compliance, businesses can successfully create an EOT that benefits both the company and its employees. It's essential to seek professional advice and carefully consider all legal, financial, and tax implications to avoid potential pitfalls and ensure the long-term success of the EOT.

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