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Employee Ownership Trusts

- Plan for business succession
- Reward your hard-working staff

Where a trade sale is not on the horizon and the management team cannot raise funds for a management buyout (MBO), business owners can be faced with difficulty when planning for their own exit and the succession of the business. An Employee Ownership Trust ("EOT") can provide a unique, tax-efficient solution to this problem.

An EOT can acquire from 51% to 100% of the shares in the business, for the benefit of the employees. The shares are then held 'on trust' for the employees: they do not hold shares directly, but indirectly via the all-employee trust.

EOTs are popular due to their ability to align the goals of the employees with the business. In addition to the significant tax advantages, this tool is proven to encourage employee engagement and improve retention.

Some of the benefits are as follows:

- A market for shares can be created where this would otherwise not exist.
- There is no Capital Gains Tax (CGT) to pay for the selling shareholders when they sell their shares to the trust. Now that Business Asset Disposal Relief (previously Entrepreneurs' Relief) has been reduced to a lifetime limit of £1m, this can make a significant difference.
- Shareholders and employees can continue to work in the business following the sale.

- Finance can be sought from third party providers, which will allow the selling shareholders to extract their value over time.

- Tax-free bonuses of up to £3,600 per year can be paid to employees (National Insurance Contributions still apply).

- Research shows that employee-owned companies perform better, retain staff for longer and have lower levels of absenteeism than other companies.

Employee Ownership Trusts in Action
The Employee Ownership Trust model was based around the John Lewis Partnership's long-running and successful business ownership model, whereby its employees (referred to within the company as Partners) hold shares in the business. These shares are held collectively in an employee ownership trust by the John Lewis Partnership; this means that shares cannot be sold by any individual Partner, but each Partner will receive economic benefits based upon their ownership of the shares. Most notably, this benefit will be by way of a yearly profit share -the amount varies from year to year, but this will usually be around 10 to 20% of the partners' yearly earnings. Find out more here.

To qualify for the Employee Ownership Trust ("EOT") tax benefits the following criteria must be met:

1. The company must be a trading company or the main company of a trading group.
2. The EOT must acquire and maintain a controlling interest in the company (i.e. at least 51% of the shares).
3. All employees must benefit on the same terms.
4. Continuing shareholders and other 5% participators who are directors or employees (and any persons connected with them) must not make up more than 40% of the employees of the company or group.
5. Sellers must not have claimed relief in a previous year in respect of shares in the same company or a member of the same group of companies.

What to look out for

If any of the following occur in the first year following the tax year in which the EOT structure was created, the CGT relief is withdrawn:

- The company no longer meets the trading requirement.
- The EOT no longer meets the all-employee benefit requirement.
- The EOT no longer holds a controlling interest in the company.
- The participator fraction exceeds 2/5.
- The trustees act in a way which infringes the all-employee benefit requirement.

Where these events occur at a later date, a tax charge may arise on the trustees. For this reason, an overseas trustee is often used.

If you have any questions about EOTs and how to go about setting one up, please contact us at info@farringfordlegal.co.uk.

Farringford Legal Limited
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