Employee Ownership Trusts – Offering a genuine succession alternative

For owners of SME businesses looking to realise the value that they have built up in the Company over many years, there were traditionally two options, a trade sale or a private equity backed MBO. Now, as there becomes a better understanding and more awareness of the benefits, a disposal to an Employee Ownership Trust (EOT) offers a genuine third alternative with certain clear advantages.

The concept of Employee Ownership has been around for decades but is was not until the changes to Capital Gains Tax (CGT) in 2014 that there was a real incentive for owners to dispose of their company to an EOT. This exemption means that the owners of a company that sell their shares to a qualifying EOT will pay no CGT on any gain that they have made on the value of the shares.

With the recent clawing back of the benefits of Entrepreneurs Relief and the current discussions as to whether there could be further increases in CGT to pay for the cost of the Covid-19 pandemic, the possibility of being able to dispose of your company for full value without paying any CGT is very attractive.

There are other non-tax advantages as well which we explore further below.

So how does it work?

The basic idea is as follows:

1) The target company sets up an EOT where the employees of the company are the beneficiaries of that trust;

2) The EOT has either a corporate trustee (which is a company limited by guarantee where the directors are the made up of the sellers, an independent director and an employee director) or multiple trustees who are again made up from the sellers together with an independent trustee and an employee representative;

3) The target company is independently valued;

4) The EOT and the sellers then agree the deal for the payment of the consideration. There is usually a lump sum payment upfront (depending on the free cash that the target company has) with the remainder being paid out over a period of time (usually 5-7 years);

5) The Trust has to acquire at least 50.1% of the ordinary shares in the target company;

6) Once an agreement has been reached between the EOT and the target company, the target company contributes sufficient funds to the EOT to enable it to pay the initial consideration (and the associated professional costs). The deal is then completed and the funds paid to the sellers; and

7) The rest of the consideration remains a debt that the Trust owes to the sellers and as the Company makes profits it then pays further contributions to the Trust to enable it to pay off the outstanding debt to the sellers until the whole of the consideration has been paid.

Advantages of Employee Ownership Trusts

As mentioned above there are various advantages to selling to an EOT:

1) Once you have the independent valuation there is no haggling over price and there is no need for an exhaustive due diligence process;

2) You don't need to search for third party buyers and spend time marketing the business to them;

3) The sellers normally stay involved with the running of the target company, giving employees, suppliers and customers continuity as well as allowing time for junior management to grow their experience before eventually taking over the running of the business;

4) Employees are each entitled to a tax free annual bonus from the target company of up to £3,600; and

5) Studies show that employee owned companies have better staff engagement, higher rates of productivity and greater retention of staff.

Which companies does it suit?

Due to some of the rules regarding EOTs, it doesn't suit all companies. First, there needs to be enough employees so that sellers don't form too large a percentage of the ongoing employee group. If the company only had nine employees and four of these were the sellers, then the company would not qualify for the CGT exemption.

Secondly, the sellers need to be confident that the target company will continue to be profitable. Unless the target company continues to make profits, it will not be able to continue to contribute to the EOT and the outstanding consideration cannot be paid off.

Thirdly, the target company needs to be a trading company or the principal company of a trading group but there are no restrictions upon the sectors that would be suitable for an EOT transaction. Lots of different companies have been sold to an EOT, it has been popular amongst architects' firms and other professional service firms, but it has also been taken up by retailers, agricultural firms and numerous manufacturing businesses.

Conclusion

If you are thinking of selling your company, you really ought to be asking your professional advisers of the possibility of undertaking a disposal to an EOT. In the current climate where trade and private equity buyers will undoubtedly be more cautious and the government could look to further attack the Entrepreneurs Relief regime, a sale to an EOT could offer a viable and very attractive alternative.

At Cripps, we have experience of acting on disposals to EOTs and would happily talk through the possibility with you.

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