

EMPLOYEE OWNERSHIP TRUSTS

Shareholders of trading companies are increasingly considering the possibility of selling some or all of their shares to an Employee Ownership Trust (EOT) which will then hold these shares for the benefit of the company's employees.

When implemented carefully and for the right reasons, selling to an EOT can give rise to significant commercial and tax benefits.

What is an EOT?

An EOT is a type of employee benefit trust. The specific rules relating to EOTs were introduced by the government in 2014 in order to promote indirect employee ownership of trading companies.

Typically, in selling to an EOT, shareholders will sell their shares for their market value. Some or all of the consideration is likely to be deferred and then funded by future profits of the trading company.

Often, where a company is owned by an EOT, some form of employee representation will be put in place. There may, for example, be an "employee council", which might have the ability to appoint one or more directors to the EOT's trustee company and/or the trading company itself.

What commercial benefits come from selling to an EOT?

Some of the key non-tax advantages of selling to an EOT are as follows:

- It can provide a full or partial exit route where a third party sale, a management buy-out, or intergenerational succession may not be appropriate.
- It can generate goodwill from employees – both immediately and in the long term – and so increase their engagement with and commitment to the business.
- EOTs are often viewed positively by customers, the public and the media.

What are the tax benefits of EOTs?

Where certain qualifying conditions are all met, the sale of shares to an EOT will be treated as taking place on a "nil gain/nil loss" basis, meaning it will be free from capital gains tax. Without this treatment, any gain made on the disposal of the shares would be expected to be subject to tax at 20% (or 10% if the disposal qualified for business asset disposal relief or investors' relief).

In addition, companies owned by EOTs may pay bonuses to eligible employees of up to £3,600 per year without income tax (but not without NICs).

What are the main requirements for these tax benefits to be available?

The main requirements that must be met for the sale of shares to an EOT to be free from capital gains tax can be summarised as follows:

- **The trading requirement:** The company whose shares are sold must be a trading company or the holding company of a trading group.
- **The all-employee benefit requirement:** The EOT's assets must be held solely for the benefit of eligible employees on the same terms. Eligible employees are essentially individuals employed by any group member company, except those who have held a greater than 5% shareholding at any time in the last 10 years.
- **The controlling interest requirement:** The EOT must acquire and retain at least a 50% "controlling interest" in the company.
- **The limited participation requirement:** The number of continuing 5%+ shareholders who are directors or employees (and any persons connected with them who are also directors or employees) as a proportion of the group's total number of employees (the "participator fraction") cannot exceed 40%

Where relief is available from capital gains tax, this must be claimed by the individual on their tax return for the year.

Where a "disqualifying event" takes place following a sale to an EOT, capital gains tax implications might arise either in the hands of the seller (if the event takes place in the tax year of the sale or in the following tax year) or in the hands of the EOT (if the disqualifying event takes place subsequently). Disqualifying events broadly encompass ceasing to meet the conditions listed above.

Any future disposal of the shares in the company by the EOT would give rise to capital gains tax in accordance with the usual rules. As the transfer to the EOT will have taken place on a "nil gain/nil loss" basis, the base cost of the shares in the EOT will often be relatively low.



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In order for employees of EOT-owned companies to be paid tax-free bonuses, one of the key conditions is that all employees (except possibly those subject to disciplinary proceedings or without a qualifying employment period) must be eligible to participate in the bonuses on the same terms, with distinctions in the actual amounts received only being possible on the basis of hours worked, length of service, or remuneration. Bonus arrangements will not qualify if some employees receive no bonus, or if the scheme is likely to confer benefit mainly on directors.

How can Moore Kingston Smith help?

We at Moore Kingston Smith offer a full range of services for those considering establishing an EOT, including the following:

- Advice and assistance with any pre-sale restructuring that needs to take place
- Advice in respect of the qualifying conditions for the tax reliefs
- Establishment of the EOT
- Preparation of a valuation report for the shares being transferred
- Preparation of share purchase agreement and other legal documents
- Requesting statutory and non-statutory clearance from HMRC in respect of certain aspects of the tax legislation
- Assisting with communications to employees.

This document provides a brief summary of issues associated with EOTs and should not be relied upon without taking further advice. Please get in touch with our team if you would like to discuss EOTs in greater depth.

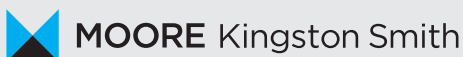
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