MOORE Kingston Smith

Employee ownership trust

Shareholders of trading companies are increasingly considering the possibility of selling some or all of their shares to an employee ownership trust (EOT) which then holds these shares for the benefit of the company's employees. With the increase in CGT rates announced in the 2024 Budget and further increases on the horizon from 6 April 2025, EOT's are likely to become an even more popular choice for business owners considering exit options.

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 to promote indirect employee ownership of trading companies.

In selling to an EOT, shareholders 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 is put in place. There may be, for example, 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 provides a full or partial exit route where a third-party sale, a management buy-out or intergenerational succession may not be appropriate.
- It generates goodwill from employees – both immediately and in the long term – thus increasing 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 all certain qualifying conditions are met, the sale of shares to an EOT is treated as taking place on a "nil gain/nil loss" basis, meaning it is free from capital gains tax. Without this treatment, any gain made on the disposal of the shares would be subject to tax at 24% (or 10% increasing to 14% from 6 April 2025 and 18% from 6 April 2026, if the disposal qualified for business asset disposal relief or investors' relief).

Additionally, 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 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 are 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 individuals employed by any group member company, except those who have held a greater than 5% shareholding at any time in the last ten years.

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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%.

For EOTs established on or after 30 October 2024, the following three additional requirements must be met.

Trustee independence requirement: Less than 50% of the trustees – or in the case of a corporate trustee, less than 50% of the directors – must be individuals who are not excluded participators (broadly individuals who have or had a 5% or more shareholding in the company and a right to at least 5% of the assets of the company available for distribution on a winding-up) or persons connected with them, and, excluded participators must not have control of the EOT.

UK resident requirement: The trustees of the EOT must be UK-resident at the time of the disposal (and at all times subsequently). It is not possible to establish non-UK resident EOT's to avoid CGT on a subsequent sale of the shares by the EOT.

Consideration requirement: The trustees need to demonstrate they have taken all reasonable steps to ensure the consideration paid for the acquisition of the shares in the company does not exceed market value. If any part of the payment is delayed, any interest payable on that deferred payment must not exceed a reasonable commercial rate. Currently, there is no guidance on what HMRC considers "reasonable". However, any valuation reports should be commissioned by and addressed to the trustees.

Where relief is available from capital gains tax, it must be claimed by the individual on their tax return for the year, with enhanced disclosure requirements applying for claims made on or after 6 April 2025.

Where a "disqualifying event" takes place following a sale to an EOT, capital gains tax implications might arise. This might be either in the hands of the seller (if the event takes place in the tax year of the sale or in the following four tax years) 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 gives rise to capital gains tax in accordance with the usual rules. As the transfer to the EOT took place on a "nil gain/nil loss" basis, the base cost of the shares in the EOT is often relatively low.

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. Since 30 October 2024, it is possible to exclude directors from the bonus arrangements without breaching this all-employee participation condition. Bonus arrangements do not qualify if some employees receive no bonus or if the scheme is likely to confer benefit mainly on directors.

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How can Moore Kingston Smith help?

At Moore Kingston Smith, we offer a full range of services for those considering establishing an EOT, including:

- advice and assistance with any necessary pre-sale restructuring;
- advice on qualifying conditions for tax reliefs;
- establishing the EOT;
- preparing a valuation report for the shares being transferred;
- preparing share purchase agreement and other legal documents;
- requesting statutory and non-statutory clearance from HMRC regarding certain aspects of the tax legislation;
- assisting with communications to employees.

This document is a summary of issues associated with EOTs and should not be relied on 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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