Employee Ownership Trusts – a quiet revolution?

Employment Tax Tax voice

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William Franklin makes the case

Has a quiet revolution begun that could transform British Capitalism over the next twenty years?

Some little noticed legislation (which was introduced in 2014 in that years Finance Act) is providing retiring entrepreneurs with a new exit route and new opportunities for succession planning. It allows them, over time, to receive much of the value of the business they created while ensuring the business retains its independence after their retirement, and protects employees who helped build the business from the upheavals that so often follow a change in ownership.

Traditionally, in the UK, this has been difficult to achieve because of a combination of cultural, class, and tax reasons. The most common solution has been the family company, but successful continuation of businesses through inter-generational transfers is much less common in the UK than in other parts of Europe, particularly Germany, Switzerland and Northern Italy where family owned businesses with deep roots in their local areas dominate the economy.

Our “Mittelstand” (as such companies are usually collectively referred to in Germany) is relatively weak in the UK, as the prevailing business culture is to sell companies to an outsider if “the price is right”. The result is that businesses are often sold to a much larger group or a private equity buyer who has little interest or understanding in the culture of the business that has allowed it to succeed and has little incentive to retain the business in the local area in which it grew. In the UK there is also a very active mergers and acquisitions industry comprising lawyers, accountants and financiers which encourage owners to sell their companies to a third party and lose their independence. The widespread use of share based employee share incentives, where these only give value to the employee on an exit, reinforces this culture.

But selling out in this way can be the right and necessary thing to do. Only with fresh external capital can a rapidly growing business achieve its potential. Without the incentive of realising a large gain through a possible sale to a third party many entrepreneurs would not take the risks of setting up new businesses.

But for a significant minority of entrepreneurs who are approaching retirement and want the business they created to remain independent and are content to be patient in realising value the new route of selling their company to an EOT offers a new and exciting opportunity.
Before Finance Act 2014, any entrepreneur who wanted to sell their company to a trust that would hold the shares in the company collectively for the long term benefits of employees (along the lines of John Lewis) faced the daunting barrier of a “dry” tax charge when they transferred ownership to a trust.

A trust can only pay the seller out of cash that the company generates over a number of years but capital gains tax is payable on the price paid by the selling entrepreneur at the time of the sale, even though the seller wouldn’t yet have been paid in full or maybe at all, and might never be paid if the company is unable to provide the EOT with sufficient cash from its future profits.

So the change in FA 2014, which means that if control of a company is sold to an EOT the sale is tax free (apart from stamp duty) and there is no “dry” tax on the seller, was a game changer.

For entrepreneurs who wish to retire but allow their employees who helped them build the business succeed to indirect ownership of the business a sale to an EOT is a way of achieving this without burdening the employees with personal debt to fund the buyout. The stresses of a sale to a third party purchaser for the vendor are also avoided, and a tax-free sale achieved providing there is a transfer of ownership and control to an EOT.

The EOT legislation is quite flexible. It recognises that each company is unique and there will inevitably have to be an evolutionary journey towards a full employee ownership culture and employee management style which the sale to the EOT is only a stage. But EOT owned companies are not panaceas. They still require cash to fund the working capital needs of the business and the growth, and some will fail after conversion to EOT ownership. But in time an Employee as well as a family owned British Mittelstand may emerge which could have profound and long lasting consequences for the entire British economy.