Employee ownership trusts: an underused exit for business owners

Large Corporate OMB

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Why more business owners will be turning to employee ownership trusts in the months ahead.

Key Points

What is the issue?

An employee ownership trust is a trust for the benefit of a company's employees (often incorporated as a company limited by guarantee). It acts as the vehicle that purchases a target company from its owners at the outset of the transaction, before then acting as the shareholder of the target post-completion.

What does it mean for me?

Generous tax incentives for business owners selling to an employee ownership trust have led to these trusts rising in popularity.

What can I take away?

There are five main conditions which must be satisfied for a shareholder to be eligible for the tax benefits of selling to an employee ownership trust.

Employee ownership trusts have enjoyed a surge of popularity in the last few years. First introduced by the Finance Act 2014, only 56 were established in the year to September 2020, increasing to 235 the following year and almost 500 the year after that. This is an astonishing rise.

The roster of companies owned by employee ownership trusts now includes Richer Sounds, Go Ape and Aardman Animations, the creators of Wallace and Gromit. This is no surprise, given that they can be a very tax efficient way for shareholders to exit a company, whilst benefiting their employees too. The main legislation covering the taxation of employee ownership trusts is in the Taxation of Capital Gains Act 1992 Part 7 ss 236H to 236U and HMRC's guidance is at bit.ly/409tRsg

What is an employee ownership trust?

An employee ownership trust is a trust for the benefit of a company's employees (often incorporated as a company limited by guarantee). The employee ownership trust acts as the vehicle that purchases a target company from its owners at the outset of the transaction, before then acting as the shareholder of the target post-completion.

In employee ownership trust transactions, the business owners typically sell to the trust for a 'fair' price, as determined with an independent valuation. The consideration for the sale is normally in the form of cash and loan notes, which ultimately derive from the cash generated by the target company.

Where to begin?

There are five main conditions which must be satisfied for a shareholder to be eligible for the tax benefits of selling to an employee ownership trust:

1. The target must be a trading company or the holding company of a trading group.
2. The target must have a minimum proportion of employees who are not the owners or connected persons (such as spouses).
3. The trustee of the employee ownership trust must hold a controlling interest in the target. This means that it should hold more than 50% of the company's ordinary share capital, hold the majority of the voting rights in the company and be entitled to more than 50% of the profits, among other requirements.
4. The employee ownership trust must be established for the benefit of all employees on the same terms, though the amounts paid to employees can vary by reference to remuneration, length of service or hours worked.
5. The selling shareholder must be an individual (not a corporate or institution) and have UK tax residency status.

The process of this sale typically takes between three to five months to complete. This involves getting the company valued, getting clearance from HMRC, drafting the sale documentation and setting up the employee ownership trust structure. The sale documentation is similar in many ways to that of a normal sale but tends to be shorter and with fewer warranties. Additional documents, such as a trust deed, are needed but these are rarely heavily negotiated.

Employee ownership trusts can even be combined with an enterprise management incentive scheme, which can be a particularly helpful way of keeping the management incentivised while a lot of the cash generated by the business is being used to pay the purchase price to the owner.

Employee ownership trusts on the rise

There is a clear reason for employee ownership trusts rising in popularity: the generous tax incentives for business owners selling to an employee ownership trust. The main tax advantages are relief from capital gains tax on all of the gain arising from a sale to an employee ownership trust. The relief is given by treating the sale as a no gain, no loss transaction – which means that the trust acquires the business at the seller's tax base cost.

This compares very favourably to the 20% capital gains tax rate that would otherwise be payable (or 10% if business asset disposal relief is available, capped at the first £1 million of gain). There is also a limited exemption from income tax on bonus payments of up to £3,600 per year for the target's employees. During the current economic climate, it is unsurprising that these tax advantages are catching the eyes of business owners.

There are also significant non-tax related advantages to owners exiting to an employee ownership trust. Many owners like the idea of passing the benefit of their business to its employees, who are often the ones who have contributed to the value in the business in the first place.

The sale process can also be simpler than on a trade sale. HMRC clearance is required and there is some work establishing the employee ownership trust structure; however, a lot of time and expense is saved by not having to find an external buyer. Minimal due diligence is required by the buying entity, there is relatively little negotiation of deal terms, and the risk of a failed sale is low.

Finally, the exiting shareholder can stay in the management of the business post-completion. It is not uncommon for a seller to stay on as a director of the target and wind down their day-to-day involvement with the business over a number of years as their loan notes are redeemed.

From an employee's perspective, in addition to the tax advantage mentioned above, the main advantage of the arrangement is that the business will be run for their benefit and they get to share in the profits generated. This is often very attractive compared to the potential upheaval that can follow trade sales.

Disqualifying events

A claim may not be made and relief previously given will be withdrawn if certain events occur in the tax year next following the year of disposal. Those are known as 'disqualifying events' and they occur when:

- the target company ceases to meet the 'trading requirement';
- the employee ownership trust ceases to meet the 'all-employee benefit requirement';
- the employee ownership trust ceases to meet the 'controlling interest requirement';
- the 'participator fraction' exceeds two-fifths; or

- the trustees act in a way which the trusts, as required by the 'all-employee benefit requirement', do not permit.

Where the disqualifying event takes place at a later date, i.e. after the next tax year following the disposal to the trust, the trustees are treated as making a disposal and immediate reacquisition of the ordinary share capital of the target company, potentially triggering gains.

The risks to be aware of

From an owner's perspective, a key disadvantage of this route is that they will often have to wait a number of years to be paid out (frequently five years or more). This is often because the target is unlikely to be able to fund the full purchase price upfront from its own resources and it is currently uncommon for lenders to finance the gap.

This is especially an issue for targets that do not consistently throw off cash, or whose value is a high multiple of earnings. The delay that may be encountered is food for thought but, as many private merger and acquisition transactions have a sizeable part of the purchase price deferred or subject to earn-outs, the benefits will often outweigh this.

Another consideration is how the employee ownership trust route may also close off strategic buyers, who may be willing to pay a premium to the 'fair value' (e.g. for special synergies between the buyer and the target).

For employees, the time taken to pay the business owner out may be frustrating. While the purchase price is outstanding, the bulk of the profits generated by the business will go to paying off the owner, rather than to the employees. It is, however, possible to mitigate this downside by permitting some of the business's profits to go to the employees, even if some of the purchase price is outstanding.

Although there are a few disadvantages to this process, it is not surprising that employee ownership trusts have surged in popularity. Business owners get a tax-advantaged sale (with less deal risk and due diligence stress) that also gives something back to their employees and often keeps management disruption to a minimum.