How the Employee Ownership Trust Offers the Ideal Exit Strategy at Zero Tax

David Craddock is a recognised authority in the UK and worldwide on employee share schemes and the author of Tolley's Guide to Employee Share Schemes. In this article, David identifies the role that the Employee Ownership Trust (EOT) can fulfil in facilitating the ideal tax-efficient and cost-effective exit strategy as an alternative to a trade sale or an initial public offering.

The Latest Triumph for Employee Ownership

The initiative to introduce the EOT through Schedule 37 of Finance Act 2014 emerged from the Coalition Government as the single most significant triumph in the development of employee ownership since Enterprise Management Incentives (EMI) and the Share Incentive Plan (SIP) were introduced by New Labour in 2000. Unlike EMI and the SIP, which deliver direct employee share ownership to individual employees, the EOT offers indirect employee share ownership. The unique feature of the EOT is that the sponsoring company's shares are held in a discretionary trust as a collective arrangement for the long-term benefit of the company's total workforce in stabilising the company's ownership structure and securing its independence.

Although different in kind from EMI and the SIP, either of these two scheme arrangements can, if the company so chooses, operate alongside the EOT and offer direct employee share ownership to complement the collective ownership by the EOT. Notably, the grant of EMI options to senior employees, properly implemented and communicated, can act as a motivational empowerment for executives, thereby ensuring that the shareholder succession is matched by a management succession that is so essential for a successful exit. Nevertheless, the EOT can operate without any accompanying tax-advantaged (tax-approved) employee share schemes, and still offer, courtesy of its own 2014 legislation, if the company so decrees, tax-free bonuses to its employees.

Ironically, although the word ***employee*** precedes the words ***ownership trust***, the introduction of the EOT is not conditional upon offering any form of specific employee financial benefit. In its most basic form, by allowing the sale of a controlling interest to the trust, the selling shareholders enter a transaction with the trustees at a zero capital gains tax rate. The economics reasoning behind the legislation is that the sale of its shares to the trust secures the independence of the company in perpetuity. Any sale to a third-party acquirer - which often results in redundancies through reorganisation and economies of scale - is therefore, forestalled. This preserves not only jobs but also the company's culture that has evolved over many years, and its contribution to the community in which the company is based. Operating in this dynamic, therefore, the EOT is pro-business, pro-employee, and pro-community with an accent on giving the company a safe and secure business environment in which to grow and flourish with its own business identity. ▶

The Headline Capital Gains Tax Exemption: ZERO Tax Charge for the Selling Shareholders

The EOT provisions of Schedule 37 of Finance Act 2014 are effective from 6th April, 2014 through insertions into the Taxation of Chargeable Gains Act 1992 (TCGA 1992) and the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003).

Under Section 236M, TCGA 1992, the Controlling Interest Requirement secures a complete exemption from capital gains tax for the seller of the shares for the sale of the 51% (or more, up to 100%) controlling share interest to the EOT in a defined single tax year. This exemption is available for persons who are not companies. Provided the statutory requirements are met, notably that the shares are in a trading company or the parent company of a trading group, then the capital gains tax exemption is available to an unlimited extent. The fact that the exemption is unlimited is a particularly attractive feature, even if the seller has access to Business Asset Disposal Relief, for the simple reason that the sale of shares to the EOT attracts zero capital gains tax on an unlimited amount of value.

The tax-efficiency of the EOT for the selling shareholders is underlined by the fact that the legislation also states that the sale of qualifying shares to the EOT does not in any circumstances constitute a chargeable transfer for inheritance tax purposes, provided the conditions for the introduction of the EOT are met. Furthermore, a contribution of cash by a close company to an EOT to fund the trustees for the purchase of the shares is not a transfer of value for inheritance tax purposes either. Additionally, with the EOT existing as a discretionary trust for the benefit of the company's employees, the trust is exempt from the 10-year inheritance tax charges and exit charges on distribution.

The Income Tax Exemption for Qualifying Bonus Payments to Employees

Chapter 10A within Part 4 of ITEPA 2003, introduced as a new EOT insertion, is devoted to the rules for the tax-free status which accord to qualifying bonus payments to employees. The tax-free status is given as an exemption from income tax for up to £3,600 for each employee in any given tax year, operated for all employees on a same-terms basis. The income-tax-free payments remain subject to National Insurance Contributions although a corporation tax deduction is available in the same way as for payments that are normal taxable emoluments paid outside the context of the EOT. Although it is the establishment of the EOT that provides the opportunity for the company to introduce qualifying bonus payments, it is the company that pays the qualifying bonus payments to the employees and not the EOT trustees.

The Deferred Consideration

The Sale and Purchase Agreement for the sale of the shares is between the existing shareholders and the EOT trustees acting on behalf of the EOT. Although the company is not a party to this agreement, it is the company that funds the EOT through an arrangement that must be non-binding in order to ensure that monies received by the EOT from the company are not subject to income tax.

The whole of the sale proceeds, linked to the whole company value, will be paid to the existing shareholders immediately following the sale if the EOT has the available funds, albeit supplied by the company. Alternatively, though, the sale proceeds may be paid as a series of deferred consideration payments over whatever time-period is manageable for the company to fund the EOT. Given that the deferred consideration does not have to appear on the balance sheet, the creditworthy status of the company is protected in the eyes of the business community. This piecemeal payment profile is an appealing feature for a company that, at the actual date of the sale transaction, does not have the full amount of the available cash to fund the EOT.

The deferred consideration approach does, of course, require the company to fund the EOT from future earnings. The departing shareholders will usually, therefore, want to remain as directors, whether remunerated or otherwise, until such time as the deferred consideration has been paid. Indeed, they may well remain after that date, often with the role of mentor to the successor management of the company. Furthermore, they can be appointed as directors of the trustee company and play a significant role in the developing nature of the new arrangements in which the company is now operating.

The EOT Implementation

The whole process can be undertaken and completed in a short time span, typically over four to six weeks, and executed under the safe protection of

sound legislative principles. Remember that a key advantage of the EOT as the chosen exit strategy is that the time and costs normally associated with a trade sale in dealing with the acquiring company's lawyers are not incurred. The company directors, working with their advisers, are in control throughout the process and all professional fees are corporation tax deductible.

The implementation should be supported by communications with employees to enable them to see the benefits and opportunities of the company being controlled into the future by an EOT. The tax-free bonuses can be offered as a particularly attractive feature to the employees. However, the companies that prosper most after becoming EOT-owned are those that properly embrace the collective ownership concept of a trust owning the shares for the benefit of the employees and, in that spirit, choose to invest in their human resources activities (training programmes, career development, etc.) in support of the achievement of their strategic objectives.

Since 2014, some 500 companies have taken the EOT route to a company sale. The ownership by the EOT of the shares of the company in perpetuity stabilizes the independence of the company and reinforces the employees' confidence of continuing employment. In a consultation on exit, as well as discussing the advantages of the EOT, discussion should also be given to the ***Employee Share Trust*** ("EST") which allows a more gradual sale approach over several years. The capital gains tax rate for the sale of shares to the EST (as distinct from the EOT) is the Business Asset Disposal Relief rate of 10%. As another possibility, the company owners may prefer a model that allows them to maintain ownership into retirement while taking substantial dividend payments on their shares.

David Craddock has been advising on employee share schemes and employee share trust arrangements for over 35 years. He advises on every aspect of the implementation process, working personally with the client at each stage, and offering solutions and expertise in all the technical questions that require clarification during the consultation. As an expert share valuer, David is the Technical Secretary and Advisor to the Share Valuation Worked Examples Group that meets quarterly with HMRC. He is also a member of the Steering Committee of The ESOP Centre, Economics Policy Adviser to The Employee Shares Policy Forum and the Educational Director of The ESOP Institute.

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