EMPLOYEE OWNERSHIP TRUSTS
TIME TO EMERGE FROM UNDER THE RADAR

John Dunlop of DAC Beachcroft LLP examines the lifecycle of an employment ownership trust, focusing on the early stages of its inception, where lawyers can bring the most value.

The legislation that created the employee ownership trust (EOT) regime is fast approaching its tenth birthday, so a great deal has been written about them on the technical front.

This article examines the lifecycle of an EOT, focusing on the early stages of its inception as it is at this stage where lawyers can be most valuable. Lawyers always want to boast that they are their clients' trusted adviser and, with this in mind, it is important to make sure that the EOT is on the mental shopping list when speaking to owner-managed businesses that are in the so-called "sweet spot" (*see "The sweet spot" below*).

INCEPTION

While everyone is the product of their own experience, the author has never had a client get in touch and actively request an EOT. By contrast, it is not uncommon for a client to independently decide, with no external guidance, that they want an enterprise management incentive (EMI) share option. Such clients will usually already have a good idea as to what they want from an EMI and will be aware of most of the key tax advantages (*see feature article "Employee share options: the lie of the land", www.practicallaw.com/w-009-5578 and Briefing "EMI options: are problems remediable?", this issue*).

Why is the EOT so unknown?

The reason why EOTs are relatively little known is likely due to their nature (*see box "Structure of an employee ownership trust"*). In practice, an EOT is quite self-contained with no external party being involved and will therefore not bear a sizeable corporate finance fee as, assuming that the trustee directors are similar to the shareholders in the company, no-one would pay an introduction fee to be introduced to themselves.

If this is contrasted with a sale to a private equity house, where there is scope for multiple adviser fees, the total set-up cost of an EOT will usually be far more manageable. It would not be a surprise if the total fees in aggregate of all advisers on an EOT deal were in the region of 5% to 10% of the comparable fees on a sale to a private equity buyer (*see Focus "The rise of employee ownership trusts: a viable alternative?", www.practicallaw.com/w-020-1476*).

The first conversation

If clients are not independently deciding that they want an EOT, how are EOTs ever formed and who is telling clients about EOTs? The conversation with clients usually starts off in one of two ways:

- Client concern over the next business cycle.

- A wish by the client to take money off the table (*see box "Taking money off the table"*).

This article focuses on the first of these issues.

Concern over the next business cycle

The issues that need to be considered can be illustrated by using a hypothetical example of two lawyers, Leigh and Simon, who set up a law firm called Kenilworth Law LLP 20 years ago.

Leigh and Simon always loved the law, advising clients and simply doing a good job but did not enjoy everything that went with working for a big law firm. This is why they set up Kenilworth Law: to get back to simply being lawyers. The early days were hard and they often questioned why they put themselves through it but they promised themselves that Kenilworth Law would be different.

Today, Leigh and Simon are proud of Kenilworth Law; they have a good band of employees who really care about the work they do. It is a niche firm with a loyal client following; meetings are short and to the point. There is a drinks trolley every Friday afternoon, creating a fun atmosphere. Clients pay on time because they appreciate the work done for them and the firm's two mottos are "send the lift back down" and "keep it simple, stupid!".

The business works well but Leigh and Simon are conscious that they will probably only want to work full time for the next five to ten years and start to ask each other "What's next?".

They discuss the options which include:

- A management buyout and a sale to the staff. Simon is not in favour of this, pointing out that the staff would inevitably have to provide significant equity capital and remembering the early days of Kenilworth Law when they both had to remortgage their houses.

- A sale to a competitor but Leigh reminds Simon why they moved from so-called "Big Law" in the first place.

- A sale to private equity, but both agree that is not the right fit.

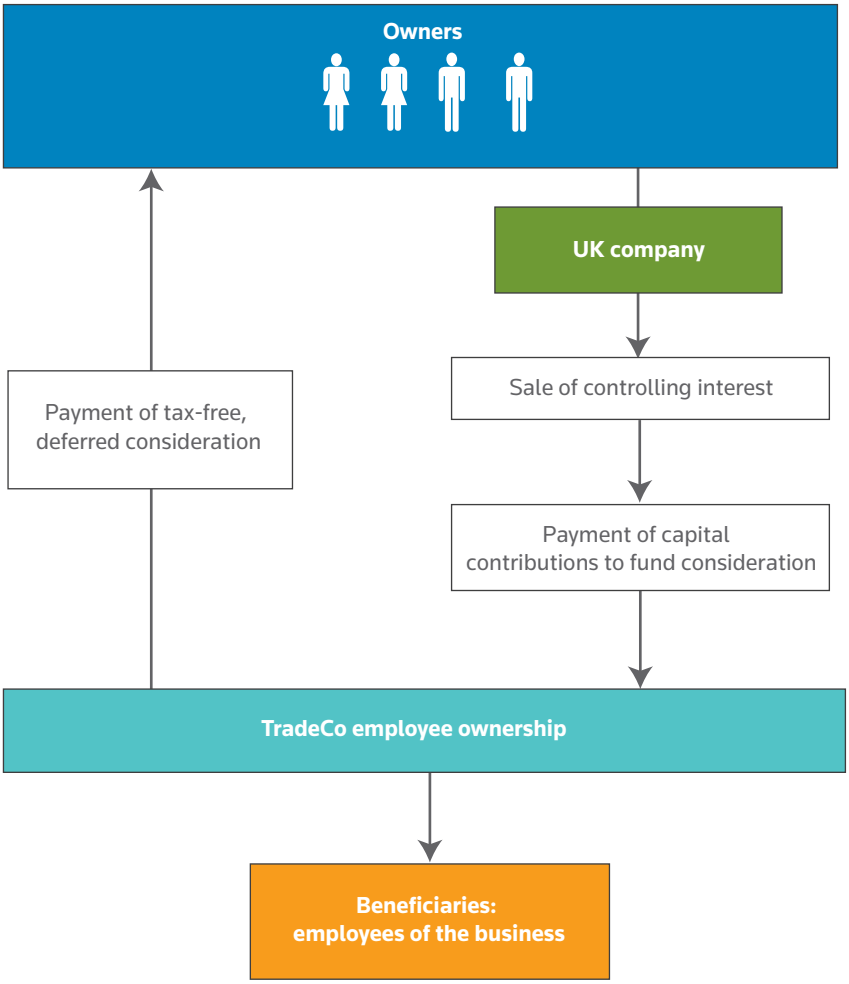
- An initial public offering. However, this is not an option for a firm of this size.

They could just give the firm to the next generation of staff at the firm but this just does not quite sit right with them. For example, they wonder whether their colleagues would maintain the culture and look after Kenilworth Law as they did, or whether their colleagues would just sell the firm after Leigh and Simon had gone. Being selfish, Leigh and Simon question why they should just give away a business that they have worked hard for and risked their houses to make sustainable.

Structure of an employee ownership trust

An employment ownership trust (EOT) is a type of employee benefit trust that is established in order to buy more than 50% of the shares in a trading company, or holding company of a trading group, and hold those shares to provide benefits for the employees of that company or group of companies.

The shareholders sell a controlling interest in the company to the EOT. One of the key benefits of an EOT is that the sale does not trigger a charge to capital gains tax. The company funds the EOT from its future profits. The EOT pays the deferred consideration to the sellers over time, as profits become available.



The chance meeting

This is where a trusted lawyer enters the story. The lawyer will be sitting down, discussing other matters with Leigh and Simon, who will bemoan their lot and resign themselves to continuing as they are forever more. In reality, this is just kicking the can down the road until one day when they no longer want to run Kenilworth Law.

The lawyer suggests an EOT as a solution that solves all of their concerns; that is, retaining a good degree of control, incentivising the staff, and achieving a healthy, phased transition. On top of this, it is also tax free.

Their first instinct will likely be that an EOT is not for them, even though it ticks all of the boxes (*see box "Key advantages of an EOT"*).

Why not an EOT?

At the end of the meeting with their lawyer, Leigh and Simon walk away with lots of new thoughts. But the one thought that keeps coming back to them is that it sounds too good to be true. They ask themselves: "If an EOT is so good, why haven't I heard of it before?".

Time passes because there is no corporate finance house on commission to chase the deal; indeed, this may be the real reason why the EOT is not taken up as much as it could be.

The eager lawyer

It is the author's view that the only way to overcome this stumbling block is for the lawyer to stay in touch with the potential sellers. The more good press coverage that exists for EOTs, the easier this becomes. The difficulty is to make sure that this neither annoys the clients nor crosses the line into financial promotion.

Experience of other countries

It is not just the UK that favours EOTs; they have been in the US for a number of years before the UK adopted the idea. As regards the future, the Canadian Employee Ownership Coalition is urging the Canadian government to create a dedicated employee ownership trust regime that mirrors what has been done in the UK and the US.

THE KICK-OFF MEETING

Six months later, Leigh and Simon come back to see the lawyer. They have been periodically thinking about EOTs and, now that they know about them, have started to see them everywhere and hear about them wherever they go. The EOT is now a constant nagging notion at the back of their brains that they just cannot shake. They come armed with a series of questions, secretly hoping to convince themselves that this is not the right course of action for Kenilworth Law (*see box "Reasons for not setting up an EOT"*).

The sweet spot

An EOT works best when there is a small cohort of people who currently control, and have consistently controlled, the business. This tends to be a business where at least 50% to 75% is owned and controlled by around no more than half a dozen people.

In terms of valuation, there is no inherent financial cap in the Taxation of Chargeable Gains Act 1992 but, in practice, it would be rare to see an EOT where the valuation of the business was more than £50 million.

Key to the success of an EOT is a good second tier of management who, in time, will be able to step up to run the business but they need a few years of transition time before doing so.

Can an EOT be an LLP?

An EOT cannot simply own a limited liability partnership (LLP) if the owners want the tax advantages but it is a relatively straightforward preliminary matter to transfer the business of an LLP into a company, with the members of the LLP becoming shareholders in the new company. Technically, this is an incorporation and there are various reliefs in the tax code which, assuming that the conditions are satisfied, mean that there is no tax liability at this stage.

The capital gains tax (CGT) conditions are that:

- The whole of the partnership business is transferred to a company as a going concern.

Taking money off the table

Employee ownership trusts (EOTs) can prove an attractive model to clients who wish to take money off the table. Aside from an EOT, this would normally be achieved when the owners of shares in a private company sell some of their shares to new investors in order to obtain liquidity and de-risk their personal financial exposure in the company.

This can be demonstrated by using a hypothetical example of two clients, Ian and Alex, who started their business from scratch. Their business is called Warwick Innovations Limited and is a technology company that has grown exponentially in recent years. It came up with a tech solution that lots of people in the sector want but Ian and Alex are cautious. Their concerns centre on what would happen to the company if their employees left and they or someone else came up with a better or cheaper idea. All of the employees have restrictive covenants in their employment contracts. However, Ian and Alex have been advised that because these are in the employment contract they have to be tightly drawn. Ian and Alex meet with their legal adviser as they want to take some money off the table to de-risk it. They discuss the following options:

- A buyback of shares. Although this is an interesting avenue to consider, it needs distributable profits and, in any event, will result in a large income tax bill so is not much better than a simple dividend.
- A sale to a holding company, partly for shares and partly for cash. In theory, this is great but HM Revenue & Customs' (HMRC) anti-avoidance powers in connection with the transactions in securities rules make it look less attractive: HMRC would probably ask why the company did not simply declare dividends over time.
- An EOT.
- A partial sale to a venture capitalist.

Ian and Alex decide to sell 51% to an EOT based on a modest price but with heavy reliance on an anti-embarrassment provision (*see "Share price" in the main text*). They are happy that this balances their key concerns, which are to:

- Take money off the table, tax free.
- Motivate and retain their staff.
- Protect themselves should an offer be made for Warwick Innovations that is many times higher than the price paid by the EOT shortly after the sale to the EOT.

- All of the assets, other than cash, are transferred.
- The business is exchanged wholly or partly for shares (*section 162, Taxation of Chargeable Gains Act 1992*) (TCGA).

VAT should not be a problem in such a scenario because this should be a transfer of a business as a going concern, which means that it is outside the scope of VAT. However, the buying company must register for VAT.

An LLP of this type will rarely have land other than, for example, a lease of office space at market rent so there should not be any stamp duty land tax.

In a straightforward incorporation there would not be any income tax charge, assuming that all of the members of the LLP sell their interest for market value.

Qualifying businesses

The business needs to be a trading company so, for example, it would be hard for a company owning a series of let properties to qualify. A classic law firm should be fine.

The key issue is in connection with the number of employees. There is a formula in section 236N of the TCGA which is referred to as the "participator fraction" but a simple rule of thumb is that if the company has more than three times as many employees who do not hold shares as shareholders then it should be fine.

Value of the business

There is no magic answer to valuing the business; a consideration of all of the classic valuation models is required. A whole article could be written on the subject but, in practice, the most appropriate methodology for an EOT business that is in steady state (that is, not a hockey stick profit forecast) will be a profits multiple valuation.

Various accountancy firms produce valuation reports every quarter based on the deals that they have been able to track down, showing the average number by which earnings before interest, tax, depreciation and amortisation (EBITDA) must be multiplied to get to a valuation of the business in question.

For trade buyers, this multiple has been hovering around ten over the last few years but it is an average for all sectors and sizes. Generally, the final valuation report tends to discount the multiple down by a couple of percentage points, so that a typical range is six to eight.

In the case of Kenilworth Law, by the time that Kenilworth Law LLP has been converted into Kenilworth Law Limited, Leigh and Simon calculate EBITDA of £1 million which, assuming that there is little in the way of interest costs, depreciation or amortisation, gives a post-tax profit of £750,000. An eight times multiple of EBITDA therefore gives a valuation of £8 million. It is unlikely to be relevant with a recently converted LLP but, generally, the valuer should also check if there is any surplus cash, which would add to the market value.

One potential trap to watch out for is if the key partners are only on modest salaries. For a true valuation, representative salaries for their new role as employees must be factored in but this does not need to include the money that they take as owners of the business; that is, their true dividends.

KEY CONSIDERATIONS

The EOT is a creature of paper so while there are some fundamental technical questions to address in the EOT trust deed, the core document is the sale and purchase agreement (SPA) whereby Leigh and Simon sell their shares in Kenilworth Law to the trustees of the EOT on its behalf.

Share price

It is vitally important that the EOT does not overpay for the shares for two key reasons:

- The trustees of the EOT would be in breach of their trustee duties if they overpaid.
- It is likely that an overpayment would give rise to an employment-related securities charge; that is, an income tax charge on the amount above the market value.

In the author's opinion, an EOT should not be used as a planned staging post for an onward sale by the EOT to a third party but a situation could arise in which an offer is received that is too good to turn down. In addition to the tax implications, Leigh and Simon need to consider how they would feel if they were to sell the company to an EOT, for example, for £8 million and, shortly after, the trustees of the EOT were to sell it on for, say, £25 million. This emotion is classically described as one of embarrassment and this is addressed by an anti-embarrassment provision.

Key advantages of an EOT

When the owners of a business set up an employee ownership trust (EOT), the EOT buys more than 50% of the shares in the business, with the price most commonly left outstanding to be paid from future profits. The sellers become the trustees of the EOT and can remain as the directors of the business while it transitions to the next generation within the firm. Done properly, an EOT should motivate staff by showing them that they have a real stake in the business. In addition, other advantages include:

- The owners can sell their business to an entity of which they remain in charge.
- The owners can receive full value, funded by what would have been dividends.
- The owners can kickstart the process by using retained earnings.
- The staff will feel motivated because it tracks the John Lewis model of the business being owned by staff.
- The EOT model works well for any employee-centric business, regardless as to whether it is currently a partnership or a company.
- Staff can be paid annual bonuses of up to £3,600 per person per year free of tax.
- EOTs are government approved and promoted.
- The money paid to the current owners is tax free.

This provision works by the EOT agreeing to pay a percentage of the uplift if the embarrassing onward sale happens quickly. It is important to consider whether the existence of the anti-embarrassment provision breaches the requirement to not sell for more than the market value. In addition, the provision must not last forever; three or four years is probably about right, with the percentage reducing over time. It is hard to structure the anti-embarrassment payment to be tax free.

Regulatory and other conditions

The EOT will need to register with HM Revenue & Customs (HMRC) as a trust.

As Kenilworth Law is a law firm, the Solicitors Regulation Authority (SRA) will need to be involved but, in the author's experience, if the firm engages with the SRA early in the process and brings it along on the journey, it can be surprisingly helpful.

A couple of tax clearances are needed but these are normally in the straightforward, rather than tricky, camp. The first is that this is not a transaction in securities and the second is that the company, Kenilworth Law Limited in this example scenario, can pass the after-corporation tax profits to the EOT by way of capital contribution to pay down the share consideration without the EOT having to pay any further tax. Once the consideration has been paid off, the EOT should expect to pay tax on any money that it receives.

HMRC's practice on these clearances evolves with time but currently, it wants to know that the consideration is not more than the market value. There seems to be a growing tendency towards HMRC insisting that the controlling minds of the company being sold (Leigh and Simon in this example) are not the sole trustees. It is possible to have an employee representative at the trustee level.

The author's view is that it is better to progress towards adding an employee trustee over time rather than introducing such a person at the outset, in part to reflect that this is an evolutionary change rather than an overnight revolution. A trusted adviser, or perhaps former employee, is therefore commonly added as an additional trustee.

Trust company

In practice, Leigh, Simon and the independent trustee will not want to be trustees in their own name, not least because they have to act unanimously and there is the thorny question of trustee liability. It is better to form a new company to be the trustee, of which they are directors and equal owners. A search of Companies House will show that it returns the maximum return results of 1,000 companies with the name EOT in their name, compared to just 73 in 2019.

The articles of association of this new trust company need to be carefully drafted to make sure that, when each director trustee resigns or stops being a director trustee, their share or membership interest passes to their replacement. This is an area that takes careful thought, although the clients are likely to be utterly uninterested by these nuances.

TAX POSITION

A sale to an EOT is routinely described as being tax free but, technically, section 236H and the following sections of the TCGA provide that the sale to an EOT, subject to two key points, takes place at such a price as gives rise to neither a gain nor a loss for Leigh and Simon, being the price that they originally paid.

Typically, this will be something like £100 or £1,000. The key is that the sellers make the relevant claim in their tax return. The euphoria of the sale can mean that clients often overlook this. The author has therefore taken up the practice of sending a follow-up letter the following 6th April to remind them of the importance of this claim.

The claim is made in the tax return. Section 236Q of the TCGA details the specific disclosure information that must be given in the return. Information must be provided to identify the EOT, the name of the EOT, its registered office address, and the date of the disposal and the number of shares disposed of.

For some reason, the government chose not to grant an exemption to EOTs from stamp duty so stamp duty at 0.5% is payable by the EOT on the acquisition of the shares in the company.

Staff bonuses

An EOT-owned company can pay bonuses to staff of up to £3,600 per person per year tax free. This bonus is tax free but employer's and employees' national insurance contributions are payable on this. There should be a formal written bonus scheme but this can be extremely short form.

Potential tax traps

If the EOT sells down shares or otherwise stops having a controlling interest, this gives rise to a taxable event. If this loss of control happens in the tax year of sale or the year immediately following, the sellers (in this

Reasons for not setting up an EOT

Knowing why shareholders do not want to set up an employee ownership trust can be as useful as knowing why they do. Reasons for not setting one up may include that:

- The company is wholly owned by companies rather than individuals.
- The company is targeting a listing on a stock exchange.
- The company is too big in terms of valuation.
- The company has an ever-changing shareholder base, giving rise to fears over intergenerational fairness.
- The business is on a rapidly increasing profit trajectory.
- The shareholders would not want the employees to benefit if, for example, the company was sold on in five years for a large profit.
- A private equity or trade buyer is waiting in the wings and either the shareholders do not want to wait for the money or a merger with a larger buyer would provide significant synergies, with perhaps the buyer providing business-critical advice that cannot be sourced elsewhere.

example, Leigh and Simon) have to revisit their tax return and pay CGT based on the consideration. After that point has elapsed, this tax on the difference between Leigh and Simon's base cost for their shares and the onward sale price is a liability of the EOT.

This is one reason that the more than 1,000 EOT trust companies at Companies House is not a true representation of the number of EOT trust companies in existence, the Channel Islands being a popular place to host the trust company. This seems ripe for change and the Chartered Institute of Taxation has lobbied for this tax shuffle to be addressed. The author is surprised that this was not addressed in the Spring Budget 2023.

HOW THE STORY ENDS

Before they were told about an EOT, Leigh and Simon were planning on simply passing the LLP down to the firm's next generation in five years' time but were troubled by the fact that they were giving it away for free.

In the end, they decide to sell 80% of Kenilworth Law to the EOT for six times the maintainable EBITDA, but with an anti-embarrassment provision. With a £1 million EBITDA, which equates to £750,000 profits after tax, they sell for £4.8 million (£1 million x 80% x 6 = £4.8 million). The six times multiple is at the bottom of the range to reflect the fact that Leigh and Simon are retaining a minority interest and benefit from anti-embarrassment protection, and to feel confident that the EOT is not overpaying.

Leigh, Simon and the EOT enter into a shareholders' agreement to ensure that their position as minority shareholders is protected. The drafting of the shareholders' agreement, which to a degree, goes hand in hand with the SPA, is key. The SPA needs to include appropriate warranties and indemnities. While this could be protected by warranty and indemnity (W&I) insurance, given the slow drip feed of the payment profile, it is rare for W&I insurance to be necessary in an EOT scenario (*see feature article "Warranty and indemnity insurance: a global reach", www.practicallaw.com/7-534-6007*).

Over the next six years, the sellers start to wind down, going from six or seven days a week to three or four days a week. At the end of the six years, because of growth in the business, their whole consideration has been paid off by the EOT. They each keep 10% of the business, in large part because of their emotional attachment to it.

First Leigh and then, a few years later, Simon step down as trustee directors, handing the business over to the firm's next generation, with employee representation at the trustee level.

They look back and feel pleased with their choices. Instead of paying nearly £2 million of income tax on their dividends, they have received six years' worth of profits tax free. Assuming that they were additional rate taxpayers, they would have paid income tax at approximately 40% on the £4.8 million of dividends that would otherwise have been paid.

The firm is going from strength to strength and they are happy that they have secured the business for the future. The trust expires in 125 years but that, they decide, is someone else's problem.

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