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Growing popularity of employee ownership trusts

Employee ownership trusts offer business owners both a tax-efficient exit and a succession plan to protect a company's unique culture.

A sizeable cut in a popular capital gains tax (CGT) relief implemented last year is encouraging more business owners looking for a tax-efficient exit strategy to consider the potential advantages of employee ownership trusts (EOTs).

EOTs have already found favour with UK entrepreneurs – Aardman Animation, the studio behind Wallace and Gromit, is just one of the estimated several hundred companies to have transferred control to EOTs in recent years.

However, EOTs have moved further into the spotlight after changes brought in last year to entrepreneurs' relief (ER) – now rebranded as business asset disposal relief (BADR). Effective from 11 March 2020, a new lifetime limit on gains eligible for BADR, which offers a 10% rate of CGT instead of the usual 20% for higher-rate taxpayers, is now £1 million instead of £10 million.

Tax-free sale of shares

First introduced in 2014 to encourage employee-owned companies, EOTs allow business owners to sell their company or a controlling number of company shares to an EOT without paying any capital gains tax. However, as with all share transfers over a certain value, stamp duty is payable on the transfer of shares.

Another key feature of EOTs for owners to consider is that the sale price is often not all paid upfront, instead some part of it will be repaid through the company's trading profits in the years that follow.

For many entrepreneurs without family members to pass their business on to, the EOT option of selling to employees who helped build the business is a succession plan that ensures the company retains its independence and the unique culture that made it a success in the first place.

In addition, former owners and directors who want to continue to contribute to the company's future can choose to keep a small number of shares and remain in situ post-sale, while still receiving market-competitive remuneration packages.

For employees, one of the main benefits of EOTs is that their shares in the company can be paid for from profits the company generates over a number of years, meaning they can buy the business without the burden of personal debt. In addition, genuine bonuses of up to £3,600 a year paid to employees of a company owned by an EOT can be exempt from income tax.

Greater commitment and loyalty

Not only will employees avoid the upheaval that often follows a business sale by taking the EOT route, but employee ownership is generally considered to lead to greater commitment to the business, with increased staff loyalty and lower staff turnover. These are benefits that can only strengthen a company's chances of success – even in the face of challenges like the ongoing Covid-19 pandemic.

One possible hurdle is that an EOT may need to borrow some money to fund the purchase of a controlling majority of shares. However, lenders are becoming increasingly familiar with this approach.

Retaining senior management can help to ensure the best chance of a smooth handover of day-to-day control, but it should be remembered that under EOT rules they will not be allowed to have substantial shareholdings in their own right.

And finally, an EOT is no guarantee that a company will succeed – management by employees brings changes that may require significant readjustment and EOT companies still need investment to fund working capital and growth.

If you want to discuss EOTs or other exit planning strategies, please get in touch with your usual Shipleys contact. Further details of the tax benefits of EOTs are available at *https://tinyurl.com/yu6pfej6*