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Employee Ownership Trust Guide

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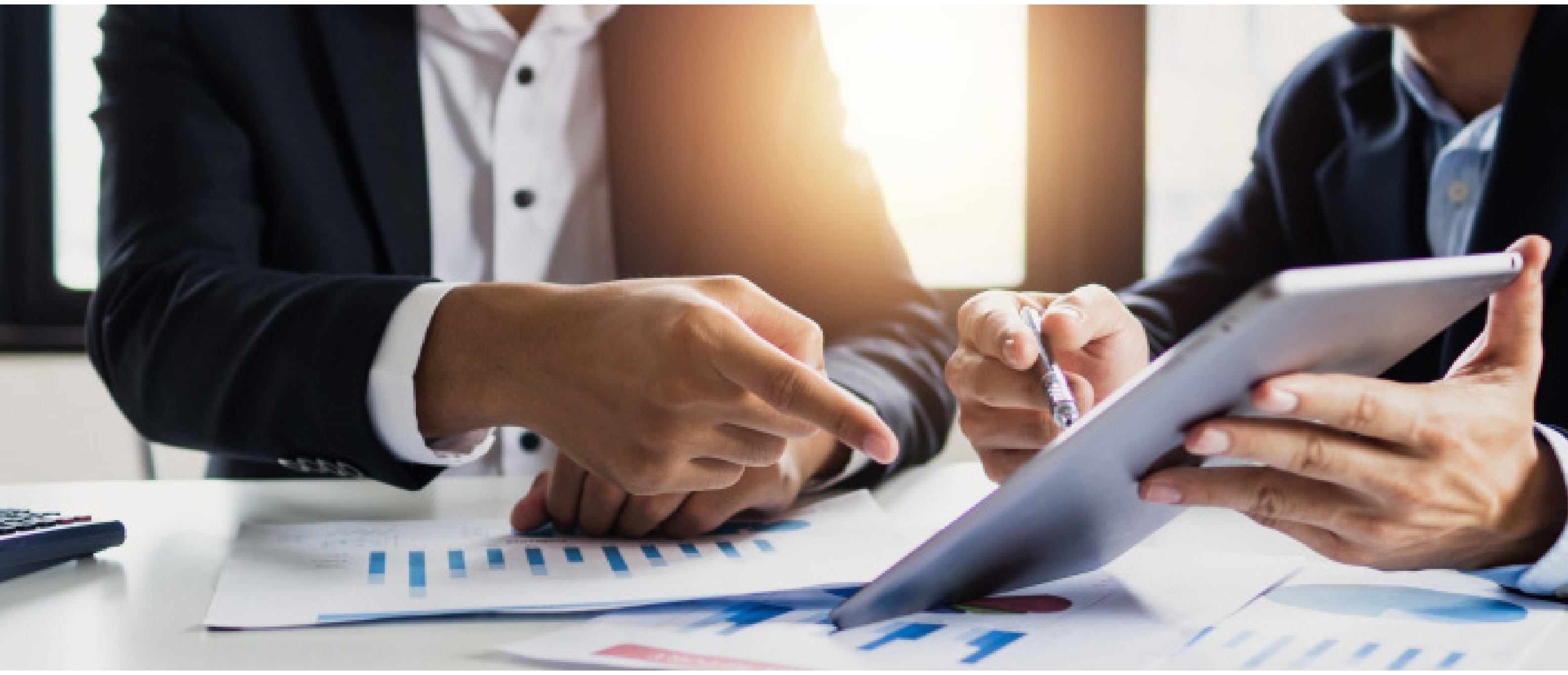

Employee Ownership Trust Guide

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What is Employee Ownership?

There are a range of options when considering the succession of a business. An increasingly popular model is that of employee ownership. Employee ownership, put simply, is where employees have a significant and meaningful share of a company. As a result, employees enjoy greater company engagement alongside a financial stake.

Typically, employee ownership is considered in the following scenarios: at formation, succession, expansion, when delivering a public service and for incentivisation. Employee ownership may be considered by a variety of businesses at different points due to the flexibility and relative attractiveness of the strategy.

Employee ownership is said to benefit employees and companies alike. This may explain why it is the most rapidly growing form of business ownership with companies both large and small, from a diverse range of industry sectors, following suit.

As an established form of business ownership, supported across the political spectrum, employee ownership provides companies with a viable means of innovative succession. The Finance Act 2014 reflected the increased interest and support for employee ownership by providing a tax efficient statutory employee ownership trust (EOT), which we will consider in more detail.

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Why choose an Employee Ownership Trust?

Whilst it may not the perfect fit for every company, Employee ownership provides a tailored approach to many companies based on its inherent flexibility. As an exit strategy, employee ownership provides a sustainable pathway whilst also establishing a positive legacy.

When contrasted with other exit strategies, employee ownership can be characterised as a cooperative model which avoids high level disruption. So, whilst trade or equity sales may maximise shareholder value, the employee ownership route can preserve company culture and avoid potential restructuring from a third party.

Additionally, there is an element of control that is connected with an employee ownership transaction. Any number of matters may arise (some may even be completed unconnected to a transaction) that result in a buyer having a change of mind during a transaction process. Employee ownership is a method that reduces such uncertainty over the company's succession process and is centred around employee reward, leadership and innovation.

Further, depending on the chosen structure, employee ownership could benefit both the selling shareholders and on-going employees by way of tax incentives. The different methods of employee ownership are indirect, direct and the hybrid model which are explained in further detail within this guide.

How does Employee Ownership Differ?

Traditional methods of succession differ greatly from that of employee ownership. Selling to a third party often involves marketing the business for sale and divulging otherwise confidential information. Each of which bring their own inherent risks which can be avoided with an employee ownership transaction.

Additionally, employee ownership can be distinguished from a management buy-out as the resulting ownership is not reserved for a sub-section of employees but is inclusive of the workforce in its entirety.

Further, a synergy has been identified between employee ownership and employee participation that is unlike other ownership models. Naturally, a financial stake has proven to have a direct correlation with employee retention and productivity. The incentive being: as the company succeeds, the employees succeed.

Different Models of Employee Ownership

Direct Employee Ownership

Direct employee ownership is relatively self-explanatory and involves employees directly owning shares of the company.

Conventionally, the shares are associated with a share plan in relation to the holding company. Depending on the structure the share plan may have a beneficial tax treatment. There are several share plans that a company may choose to adopt. Examples include a Share Incentive Plan (SIP).

In short, specific employees become owners of a specified number of shares in the company.

Benefits

It is important to note that this model is most suited to companies with a low staff turnover and those that put emphasis on capital growth. In terms of legacy and impact, it may be considered as a more personal investment to staff than other forms of indirect (trust) ownership.

Additionally, there is the possibility of tax breaks for individual employees that have a shareholding thus making the option more attractive and cost effective.

The wider advantages of employee ownership include improvements in staff retention and recruitment, morale, productivity and employee satisfaction.

Indirect Employee Ownership

Indirect employee ownership typically consists of an employee ownership trust. The basis of the trust is that the employees are the beneficiaries. In practical terms, the employees will benefit from the trust holding a majority share rather than the individuals directly owning the shares of the company. Under the Employee Ownership Trust legislation, it is possible for staff to receive tax efficient monetary bonuses.

It should be noted that due to its flexibility, this method of ownership is suited to a wide variety of businesses, both large and small, across many industry sectors.

As part of the legal arrangement the assets of the trust (i.e. the company the employees work for) will be managed with the best interest of the collective employees being a primary objective.

Different Models of Employee Ownership

Benefits

As mentioned above, this model is appropriate for a wide variety of businesses. An advantage of this model is that it is more accessible as employees will automatically be beneficiaries of the trust (subject to a limited number of conditions) rather than having to fund and acquire shares themselves.

The trust is a tangible example of long-term investment in the work force and has been seen to improve staff retention due to the importance of ownership and profit-sharing.

From the company's perspective, this model is relatively "admin light" when it comes to dealing with joiners and leavers and their stake in the company.

Furthermore, legislation permits certain conditions to be implemented in the trust that can help protect the company whilst allowing cash bonus payments for employees.

Hybrid Employee Ownership

The hybrid model combines elements of direct and indirect employee ownership. It offers the opportunity for employees to acquire and own shares individually and also uses employee trusts to maintain a level of collective ownership.

Technically, there is no set amount in terms of how the shareholding should be split between direct employee owners and the trust. However, in practice it is common for the employee trust to own a controlling stake of the company due to tax incentives which are only available if an employee ownership trust has a majority investment.

The employee ownership trust helps protect the long-term intentions of the company to run for the benefit of the employees. Shares held directly by employees allows incentivisation of key individuals and for them to receive dividends.

Direct and indirect ownership are used co-operatively in the hybrid model. The trust can be used to purchase directly owned shares from employees (e.g. on retirement) and then hold them for the benefit of the wider workforce.

Benefits

By adapting an amalgamation of direct and indirect ownership, the hybrid model combines the benefits of the two models and can be said to minimise the disadvantages associated with using only one.

More specifically, the hybrid model encourages the inclusivity of wide-spread employee ownership whilst also facilitating specific incentivisation for key employees. By arranging the shareholdings in this way, employees can ensure that the interests of all employees are met whilst also having the opportunity to actively participate and influence the company.

In financial terms, indirect employee owners can still benefit from limited bonus payments that are free from income tax by way of the EOT and direct employee owners can potentially enjoy capital growth and dividends.

In financial terms, employees can benefit from bonus payments that are free from income tax by way of the EOT and receive dividends by way of direct employee ownership.

What is an Employee Ownership Trust?

An employee ownership trust is a trust that enables a company to be owned on behalf of its employees as beneficiaries of the trust.To reiterate, EOT's do not involve direct individual shareholding and instead shares are held in trust for the benefit of and on behalf of all employees.

As a statutory trust, an EOT is a government supported approach that provides a tax-efficient method to facilitate employee ownership. As discussed in 'indirect employee ownership' the statutory trust allows employees to benefit as a collective rather than on an individual basis. To provide the widest benefits, the EOT must have a controlling share in the company.

Under the Finance Act 2014, employees of companies which are majority EOT owned can receive limited cash bonus payments avoiding typical tax implications. With reference to the government consultation 2013 'Supporting the employee-ownership sector' tax reliefs were provided to 'promote awareness of the sector and increase the attractiveness of indirect employee ownership structures' for businesses.

It may be helpful to think of an EOT as a passive investor, the reason being is that existing frameworks, management and operations can remain unhindered despite the transfer of ownership.

The structure of the EOT is flexible and can be tailored. Characteristically, an EOT, like other trusts, will have a panel of trustees. Employee engagement can be demonstrated as the trust panel may consist of employees from various departments and seniority, ensuring that the trust is for the benefit of all employees. Profits accrued by the EOT will be distributed amongst the employee beneficiaries.

Over time, it is hoped that the rising number of EOT businesses will help deliver a broader distribution of economic wealth.

Tax Reliefs

To promote the use of indirect employee ownership and EOT's tax reliefs were introduced as follows:

• Capital gains tax relief for those gains generated by the selling shareholders on the disposal of a controlling interest of a qualifying company to an EOT.

• An income tax exemption on up to £3,600 of annual cash bonus payments received by employees of the EOT owned company. However, the bonuses do remain subject to national insurance contributions.

• An exemption on any relevant inheritance tax charges attached to the transfer of value by a company to an EOT may apply.

• A corporation tax deduction for the benefit of employers on the bonus payments to employees.

It must be noted that the detailed tax exemptions are subject to qualifying conditions.

Employee Ownership Trust Criteria

Qualifying Criteria

Qualifying criteria are used to ensure that businesses are engaging with and promoting the principles of good employee ownership. The qualifying criteria aim to minimise the abuse of the reliefs detailed above.

The conditions are construed broadly to allow businesses to transition and benefit from the government initiative.

To benefit from the reliefs a company must comply with the following criteria:
• The company must be a trading company or the holding company of a trading group.
• The trustees must have a controlling interest in the company following the transaction, meaning that the majority of shares and voting rights must be held by the trustees on behalf of the employee beneficiaries.
• The controlling interest must apply to share capital as well as voting rights and assets.

All eligible employees should benefit on equal terms under the trust arrangements, although some exceptions will apply.

Shareholders and former shareholders and their families are not normally able to benefit under the terms of the trust.

The qualifying criteria should be satisfied before a company can claim or benefit from the relevant tax reliefs. Legislation provides additional measures that are to be met in order for a company to qualify and expert advice should be sought.

Disqualifying Criteria

Having met the qualifying criteria, a subsequent disqualifying event may revoke the tax exemptions.

Examples of disqualifying events include:
• The company is no longer trading or fails to meet the relevant trading requirements.
• The trust no longer has a controlling interest of the share capital, meaning that the shareholding held by the EOT is below 50%.
• The trust or trustee panel fail to treat all eligible employees equally (subject to restrictions and conditions).
• The proportion of employees who are defined as participators exceeds two-fifths.

It is important to be aware of disqualifying events.

If a disqualifying event happens within the same tax year or the tax year following the disposal, a vendor's entitlement to capital gains relief will be revoked. Subsequently, responsibility falls on the trustees of the EOT.

What are the Benefits of an Employee Ownership Trust?

Commercial Benefits

- Flexible and applicable to a range of companies.
- Straight forward framework to maintain.
- Positive impact on innovation, productivity, sustainability and resilience.
- Supported across the political spectrum.
- Aligns the interests of the company with the shareholders' interests.
- Allows a transitional pathway for existing shareholders.
- Keeps option of third-party sale open at a later date if desired.
- In the absence of a third-party investor a company can rely on the EOT as an effective exit strategy.
- Leaves a positive legacy.
- Allows shareholders to transition in a streamlined manner over time.
- Owners can continue involvement up to 49% if they see fit.
- Management incentives can continue to be encouraged via the use of direct share ownership.
- Performance growth enhancing share value.
- Cooperative model of transfer avoiding high level disruption.
- Commercial advantage of personal leadership and altruism.
- Contributes to longevity of a company.
- Enhanced resilience during economic uncertainty
- Flexible on number of shares to keep or sell.

Tax Benefits

- Capital gains tax exemption on disposal of a controlling interest to an EOT, subject to conditions.
- Income tax exemption on annual bonuses paid of up to £3,600 made for the benefit of all employees.
- Can be funded out of company profits without adverse tax charges.

Employee Benefits

- EOTs are inclusive of the whole employee base.
- Profit can be shared amongst the entire workforce.
- Possibility of up to £3,600 annual, income tax free bonus per employee.
- Increased satisfaction within employee roles.
- Positive impact on employee engagement.
- Rise in employee retention.
- Strengthened company ethos.
- Higher staff morale.
- Key differentiator in recruitment of prospective employees.
- Lower absenteeism amongst existing employees.
- Lower staff turnover due to investment in employees and their opportunities.
- Increased job security for employees.
- Employees share in any future sale proceeds
- of the company.
- Commitment to the company is strengthened.

Employee Ownership Trust - Funding the Transaction

In order to set up an employee ownership trust, external funding may be required. That funding, together with any surplus cash in the company, can be used to acquire and transfer the shares from the existing shareholders to the EOT for the benefit of the employees.

There are different ways to raise funds for the creation of an EOT, a common example being that the shares are funded through deferred consideration, paid for out of future earnings, usually over a number of years. Alternatively, an external loan may be sourced to help the EOT fund the purchase of the company and sometimes a combination of these options may be utilised.

Whatever funding arrangements are implemented, retaining as much flexibility on the timing of future repayments is imperative. This helps ensure that the cash flow of the company is not unduly pressured should future performance vary from initial expectations.

Hawsons we're with you

Hawsons Corporate Finance is a dedicated team of experienced corporate finance specialists who provide lead advisory, valuation, finance raising, taxation services to clients establishing ownership structures using an Employee Ownership Trust.

Hawsons Corporate Finance are highly experienced and qualified to advise on whether an EOT transaction makes sense for you and your business.

We can advise on and project manage the whole process from tax advice, valuation of the business, sourcing funders, through to legal completion of the sale.

Get in touch

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Our Process

Suitability

We always commence by spending time with you to discuss a variety of options and ensure that you're well informed on their respective merits. That way, you can make a considered decision on the best route forwards.

Valuation

Our experienced corporate finance team can prepare a valuation report for the company, offering reassurance to both parties (the exiting shareholders and the prospective employee owners) that the business is being sold to the EOT at a fair market price.

Sourcing Finance

It is likely that the trust will not have the funds to complete the deal without external finance. We can assist by introducing specialist lenders, and offering support and advice throughout the process to ensure a successful outcome.

EOT Design and Tax Structuring

We can assist in the deal structure and the design of the EOT alongside your solicitors, ensuring that there is full transparency from the outset with regards to consideration received by the exiting shareholders and the timing of payments. We always advocate obtaining HMRC clearance for the transaction which we can also co-ordinate.

Oversight & Communication

We will offer support and guidance throughout the entire process, and will assist in communicating plans to current employees at the appropriate time(s).

As one of the leading firms of accountants in Sheffield, Doncaster and Northampton we can help you. We believe in long-term client relationships and understand the importance of meeting to establish a strong working relationship. This is why we offer all new clients a free initial meeting which will enable you to have a discussion about you and your business.

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