SOPHER+CO

EMPLOYEE OWNERSHIP TRUSTS

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With the anticipated increase in the rate of Capital Gains Tax that has yet to materialise but is still on the horizon, there has been a rise in shareholders looking for exit options from their companies. For those looking to sell, Employee Ownership Trusts ("EOTs") are proving to be a popular choice, rather than standard trade, selling to a third party or the purchase of own shares.

This is for numerous reasons, including:

(i) allowing shareholders and the directors to execute a quick and painless transition of the company to the employees, via an employee ownership trust, which allows management to focus on running the business rather than becoming involved in the sale negotiations;

(ii) the shareholders can plan in advance as to when and how the transition occurs;

(iii) allowing shareholders to receive full value for their business without the need for earn-outs;

(iv) utilising the power of employee-ownership to engage and motivate the workforce to improve business performance;

(v) allowing shareholders to claim 100% exemption from Capital Gains Tax on the disposal.

If you own a trading company, you can now sell some, or all, of your shares to an EOT (subject to satisfying certain conditions) for full market value without incurring any Capital Gains tax liability in a way which also benefits your employees.

EOTs are a special form of employee benefit trusts introduced as part of the government strategy to encourage employee ownership for the company they work for and came into effect from 6 April 2014. Probably the most famous example of an EOT is the John Lewis partnership. EOTs provide a tax efficient route for succession of the management of a company and can also provide certain tax advantages for the employees. However, in order to qualify for the tax incentives, the employee ownership needs to be structured in a particular way.

The tax breaks are aimed at Limited companies but there is no reason why businesses that are held by a partnership or other business models could not be incorporated first so that when the time comes for exit, the shareholders (former partners) can sell their shares to an EOT. Although EOTs can work at every stage in the business life cycle, it is easiest to implement if the business is in a good financial position, and the company has a history of maintaining its profitability and is likely to continue to grow.

Selling to an EOT seems particularly well suited to people-orientated businesses such as professional services firms which have a strong culture and where much of the value of business lies with their employees/partners.

Key Implementation Steps for Selling to an EOT

These are the following key steps:

1. A qualifying EOT will be established with a company (or corporate trustee) of the EOT (the Trustee Company).
2. The shareholders sell their shares to the Trustee Company under a share purchase agreement. The EOT must purchase sufficient shares to have a controlling interest in the company. The shareholders and the Trustee Company will jointly engage a share valuation expert to value the company: the Trustee Company will use this value as the basis for ascertaining the purchase price. On the sale of the shares, the purchase price will create a debt owed by the Trustee Company to the shareholders which will be left outstanding. The trustees must hold more than 50% of the ordinary share capital and more than 50% of the voting power and be entitled, on winding up of the company to more than 50% of the assets.
3. The company will make contributions to the EOT from their trading profits. The EOT will use these contributions to repay the outstanding purchase price that it owes to the shareholders.

Key Advantages of Selling to an EOT

For shareholders, there are many advantages, for example:

- The EOT is generally seen as a “friendlier purchaser” meaning the sale process can be quicker and may have lower fees.
- By allowing employees to indirectly buy the company from its shareholders without them having to use their own funds, EOTs create an immediate purchaser and can address succession issues.
- Shareholders can receive full market value for their shares (an independent valuation will be required).
- No capital gains, income or inheritance tax liabilities should arise on the disposal of a controlling interest in a company to an EOT (or on the subsequent receipt of the purchase price by the former shareholders).
- After the disposal, the directors can remain in their pre-disposal positions within the company, whilst continuing to receive market-competitive remuneration packages.
- It is also not a requirement for all shareholders to sell their shares to the EOT, but as mentioned above, the EOT must control more than 50% of the company.

Advantages for the Company & Employees

As all employees will become beneficiaries of the EOT, they acquire an indirect stake in the company. There are substantial practical benefits associated with ownership via an EOT, such as:

- The staff have the opportunity to be involved in all aspects of how the company is run, encouraging greater employee engagement and commitment.
- A reduction in absenteeism which will have positive impact on the finances and ensures economic resilience.
- Recognition of the contribution that employees have made to the success of the business.
- Preservation of the culture of the firm and how business is carried out, which maintains the valuable relationships with customers.
- EMI Schemes for key employees can continue to be used with EOTs.

Companies controlled by EOTs are also able to pay tax-free cash bonuses to their employees of up to £3,600 per employee per year. It should not form part of their regular salary or wages and must be paid to all employees under the same terms. The cash bonus is exempt from income tax but remains liable to National Insurance Contributions.

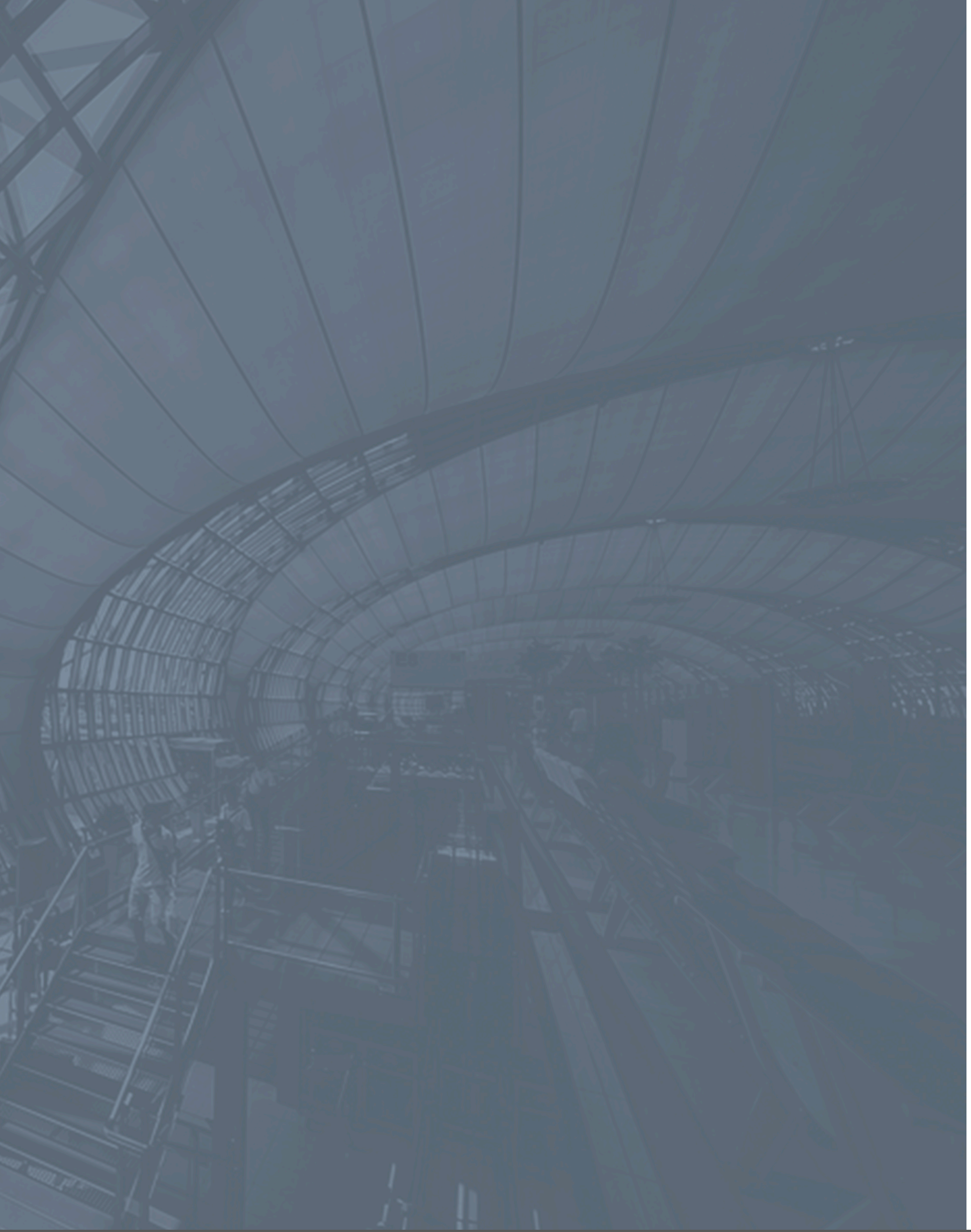
Qualifying Conditions

To carry out a qualify sale to an EOT there are five key conditions to meet:

1. The company whose shares are sold must be a trading company or the principal company of a trading group
2. The trustees of the EOT must restrict the application of any settled property (the shares) for the benefit of all eligible employees on the “same terms”
3. The trustees must retain, on an ongoing basis, at least a 51% controlling interest in the company as mentioned above
4. The number of continuing shareholders (and any other 5% participators) who are directors or employees (and any persons connected with such employees or directors) must not exceed 40% of the total number of employees of the company or group
5. Trust property must generally be applied for the benefit of all eligible employees on the same terms but the trustees may distinguish between employees on the basis of remuneration, length of service and hours worked

Additional Points to Consider

- Trustees would be in control of the benefits of all employees.
- Future profits / growth returns as employment income instead of as dividends or gains.

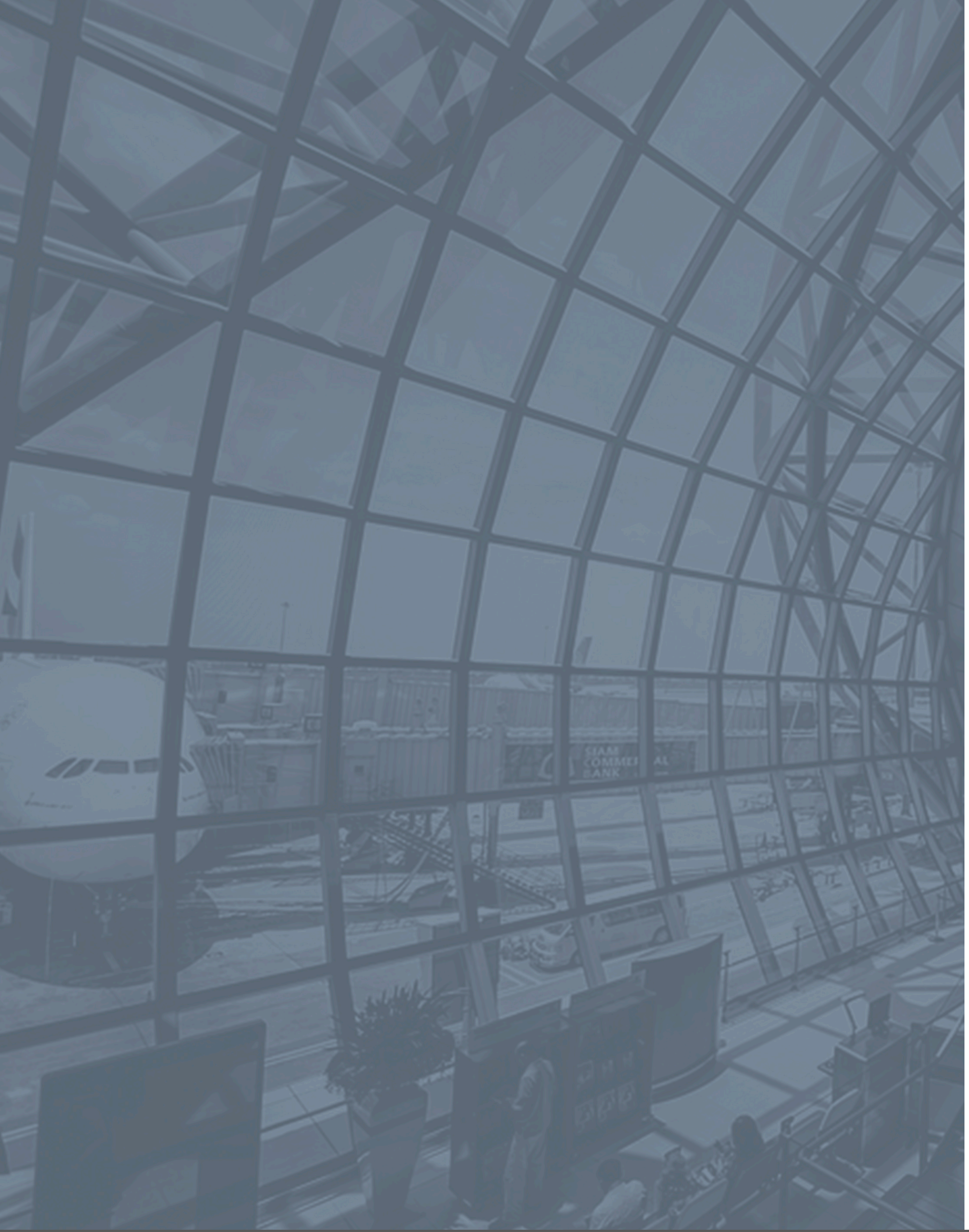


What Next?

The shareholders of the business will usually a have a good feel for whether or not the business can make a successful move to such an arrangement but careful consideration is required in respect of the implications for all involved.

The next steps would be to carry out a critical assessment of the business to consider whether it would succeed as an employee-owned company. It is also recommended to review an initial succession strategy, taking into consideration:

- The percentage of the company's shares that are to be sold and, if any are made available for direct employee ownership.
- The current value of the founder shares, and if they have been independently valued.
- The commercial priorities and values that will determine the succession planning in order to help navigate between potential exit routes.
- The timeframe and financing of the purchase of the shares by the vendors. Can EOT activity and business operations be simultaneously funded by the remaining management, while continuing to sustain and excel financial performance?
- The governance structure that will manage the business going forward.



What Next? Cont.

Once the previous points have been discussed and agreed with employees, the EOT structure can be set up.

In terms of tax, the EOT process of tax clearance is significant, but with a clear structure and EOT objective, is relatively simple. It can take 4-6 weeks for HMRC to approve the tax clearance, as long as the conditions are met.

Sopher + Co work with leading lawyers who can assist with the transition to EOT, and are on hand to provide assistance.

ABOUT US

- Established in 1975, Sopher + Co is a trusted business adviser of choice for entrepreneurs, owner-managed businesses, high net worth individuals, professional partnerships and expats.
- Our client portfolio spans over 20 industries, including Media & Entertainment, Property & Construction and Hospitality.
- Our teams of accountants, tax advisers and business advisers pride themselves on our entrepreneurial approach to our clients' personal and business affairs based on trust and expert advice.
- Offices in Berkley Square and Borehamwood.

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