
# EOTS: THE CREDIBLE ALTERNATIVE TO SUCCESSION

David Craddock, Founder & Director, David Craddock Consultancy Services

Webinar

Tuesday 27 May 2021  15:00 BST

FS Club

# A Word From Today’s Chairman

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# Today’s Agenda

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- 15:00 – 15:05   Chairman’s Introduction
- 15:05 – 15:25   Keynote Presentation – David Craddock
- 15:25 – 15:45   Questions & Answers

# Today’s Speaker

**David Craddock**

Founder and Director

David Craddock Consultancy Services

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# David Craddock Consultancy Services

Specialist in Employee Share Ownership and Reward Management,
Share Valuation, Management Buyouts,
Employee Ownership Trusts (EOT)
& Investment Education

Founder, Principal and Director:
David Craddock, MA(Oxon)
Consultant and Lecturer
Author of **"Tolley's Guide to Employee Share Schemes"**

★ *Expertise and Experience* ★

# Employee Ownership Trusts (EOT)

**The Latest Triumph in Employee Ownership**

The Employee Ownership Trust concept, inspired by the John Lewis model is:
Pro-Business, Pro-Employee, Pro-Community, Pro-Growth, Pro-Development

- **The Coalition Government**

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.

- **The Concept of Collective Employee Ownership**

Unlike EMI and the SIP, which deliver direct personal employee share ownership to individual employees, the EOT offers indirect collective employee ownership for the benefit of the employee workforce as a whole.

- **The Unique Structure of the EOT**

The unique feature of the EOT is that the 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.

# Employee Ownership Trusts (EOT)

**The Key Headline Advantages of the Employee Ownership Trust**

- The selling shareholders can sell their shares to the EOT at zero capital gains tax.
- As a credible succession alternative to the trade sale, there is no third-party acquiring company required for the exit.
- The existence of the EOT allows the company to pay bonuses to its employees with a full exemption from income tax.
- The ownership of a controlling interest in the company's issued share capital by the EOT establishes the independence of the trading company in perpetuity.
- By avoiding a third-party sale and takeover reorganisations for economies of scale, continuing employment for the workforce is secured.
- This indirect collective ownership model does not preclude the introduction of direct share ownership or share options for individual employees, say, for example, through EMI or SIP.

# Employee Ownership Trusts (EOT)

**The Controlling Interest Requirement**

- Under Section 236M, TCGA 1992, the controlling interest 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.

# Employee Ownership Trusts (EOT)

**The Implications for Inheritance Tax**

- 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.

# Employee Ownership Trusts (EOT)

**The Qualifying Bonus Payments to Employees**

- Under Chapter 10A within Part 4 of ITEPA 2003, 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.

# Employee Ownership Trusts (EOT)

**The Practical Operation of the Employee Ownership Trust Arrangement**

- **The Parties to the Sale and Purchase Agreement**

The Sale and Purchase Agreement for the sale of the shares is between the existing shareholders and the EOT trustees, usually one trustee company, acting on behalf of the EOT.

- **The Funding from the Company**

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.

# Employee Ownership Trusts (EOT)

**Immediate or Deferred Consideration?**

- **The Linkage to Whole Company Value**

The whole of the sale proceeds, linked to the whole company value, will be paid to the existing shareholders immediately following the sale, provided the EOT has the available funds, albeit supplied by the trading company.

- **The Implications of Deferred Consideration**

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.

# Employee Ownership Trusts (EOT)

**More on Deferred Consideration and the Departing Shareholders**

- **Funding from Future Company Earnings**

The deferred consideration approach requires 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.

- **The Continuing Role of the Departing Shareholders**

The departing shareholders may remain after the date on which the deferred consideration has been paid, often with the role of mentor to the successor management of the company, thereby working to ensure that the shareholder succession is matched by management succession. Also, they can be appointed as directors of the trustee company and play a significant role in the developing nature of the new arrangements and EOT structure in which the company is now operating.

# Employee Ownership Trusts (EOT)

**The Successful Implementation of the Employee Ownership Trust**

- **Efficient and Effective Implementation**

The whole process can be undertaken and completed in a short time span, typically over four to six weeks.

- **Winning the Support of the Employees**

The implementation should be supported by strong employee 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.

- **Investment in Human Resources**

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 the company's strategic objectives.

# Employee Ownership Trusts (EOT)

**The Hybrid Version of the Employee Ownership Trust**

- The most tax-efficient and motivation-maximising management buyout approach through the application of the EOT legislation is a structure that allows the tax-advantaged schemes, EMI and/or SIP, to operate alongside the EOT structure.
- Typically, the hybrid model is where the EOT purchases the whole of the issued share capital and any new EMI options are satisfied through the issue of new shares that dilutes the EOT 's shareholding from 100% but to not less than 51%, thereby still maintaining the controlling interest.
- Finance Act 2016 contains a provision to establish that the acquisition of a controlling interest by the EOT is not a disqualifying event for EMI. The direct interest employee shareholders act as the ambassadors for the EOT and the whole hybrid structure.
- Any subsequent arrangement for trading in the in EMI shares is through a separate employee share trust, typically based offshore, thereby ensuring that the EOT shareholding is not disturbed.

# Employee Ownership Trusts (EOT)

**The Headline Corporate Governance Issues**

- The trust company acts on behalf of the trust, in order to enable the trust to operate and engage in the transaction to buy the shares and have a voice.
- The composition of the board of directors of the trustee company will typically at the outset be some, or all, of the departing shareholders, possibly a responsible representative from the employee workforce and possibly an independent professional person, although the composition will typically evolve as the trading company evolves in its new EOT-owned state.
- The potential for conflict of interest arises, given that at the outset and possibly into the future the same individuals control both the trading company's board and the trustee company's board. Specific procedures must be in place to deal with that conflict of interest, typically either a requirement to abstain from voting on particular issues, or, simply, a declaration of interest prior to voting.
- Always remember that the EOT controls the shareholding and has the responsibility to act in the interests of the trust beneficiaries who are the employees.

# Employee Ownership Trusts (EOT)

**The Credible Alternative to Succession**

**The Corporate Trustee is the Controlling Shareholder and is in Control!**

- The corporate trustee has the responsibility to protect the assets of the EOT for the benefit of the trust beneficiaries. The assets of the EOT are the Company's shares. The beneficiaries are the Company's employees.

**The Preference to a Third-Party Sale of the Company**

- The comparative ease of implementation, the establishment of independence in perpetuity, the avoidance of third-party reorganisation, the preservation of company culture, the security of employment and the benefit to the local community and geographical region, are all factors that recommend the EOT.
- The management of the debt profile requires careful financial modelling at the outset, but the debt is not onerous third-party debt and can operate more flexibly given that the EOT is funded by voluntary contributions from the trading company.

# Employee Share Schemes

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and Specialist in Employee Share Schemes and
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Share Valuation, Management Buyouts,
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# Questions And Answers

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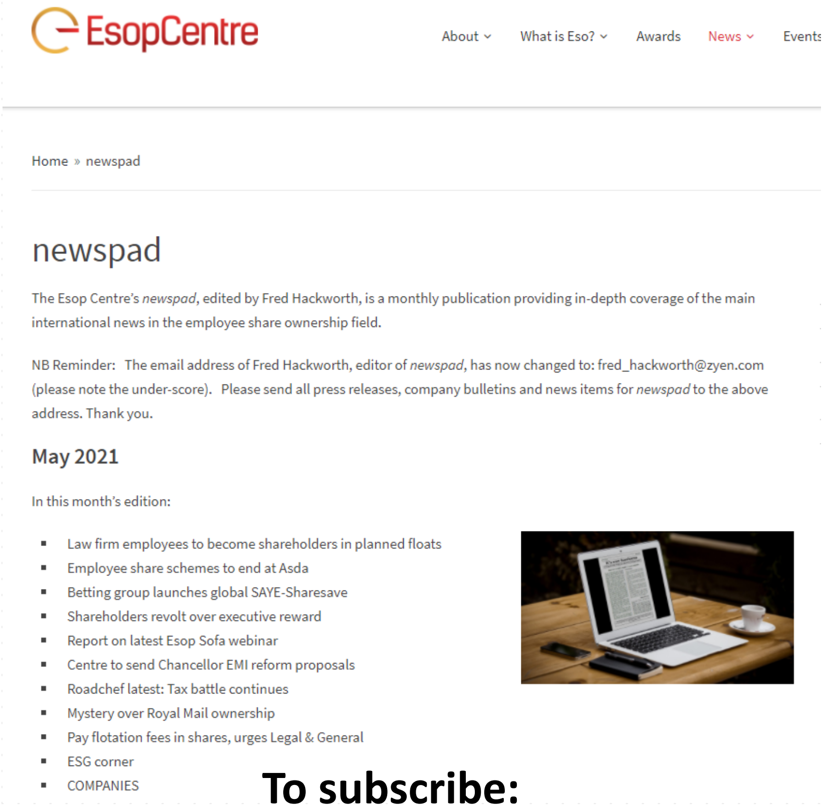
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The Esop Centre's *newspad*, edited by Fred Hackworth, is a monthly publication providing in-depth coverage of the main international news in the employee share ownership field.

NB Reminder: The email address of Fred Hackworth, editor of *newspad*, has now changed to: fred_hackworth@zyen.com (please note the under-score). Please send all press releases, company bulletins and news items for *newspad* to the above address. Thank you.

May 2021

In this month's edition:

- Law firm employees to become shareholders in planned floats
- Employee share schemes to end at Asda
- Betting group launches global SAYE-Sharesave
- Shareholders revolt over executive reward
- Report on latest Esop Sofa webinar
- Centre to send Chancellor EMI reform proposals
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**Forthcoming Events**

- Thursday 27 May (18:00) — Building Back Better With Your Employees Through Shared Ownership
- Wednesday 2 June (15:00) — Climate Change, An Uninsurable Risk - What Role Should Finance Play?
- Thursday 3 June (16:00) — Crypto Asset Regulation – An International Survey And Key Developments
- Friday 4 June (11:00) — Brexit: Ending The City's Dominance Of European Finance?
- Monday 7 June (11:00) — How To Create A Knowledge City – Evidence From London's Flat White Economy

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