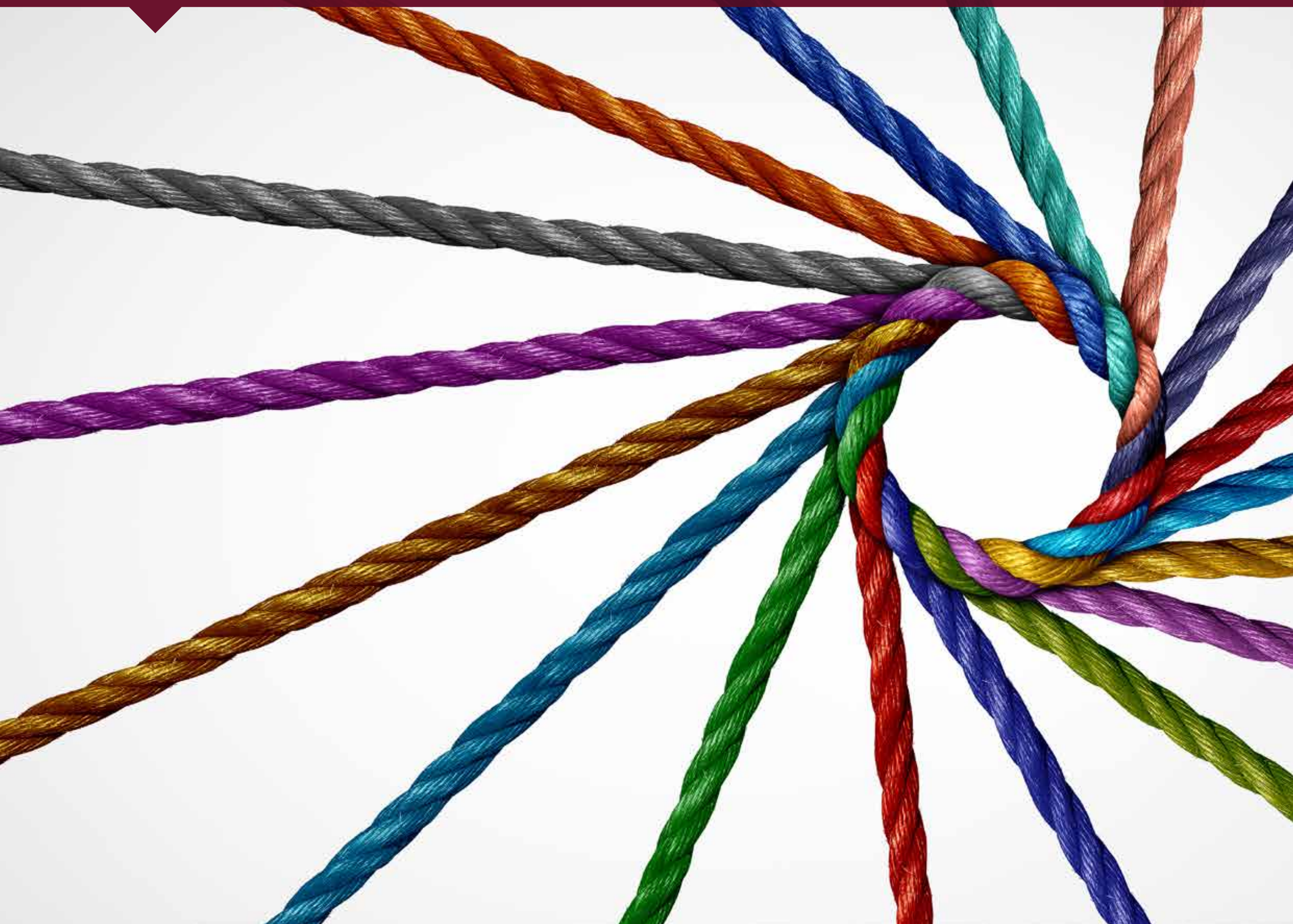
WRIGLEYS
— SOLICITORS —

UNDERSTANDING EMPLOYEE OWNERSHIP



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WHAT IS EMPLOYEE OWNERSHIP SUCCESSION?

Employee ownership is exactly what it sounds like, though it can take a number of different forms. It can be a way in which ownership of the company is put all, or partially, into the hands of the employees (either directly or indirectly) in order to assist retirement or succession planning. It can also be a way to set up a company with an engaged workforce from day one. Employees gain a say in the running of the business, though this is still left to management, and the increased levels of transparency about a company's affairs can lead to greater employee satisfaction.

Employee ownership is one of the fastest growing forms of business ownership in the UK and research suggests that employee-owned businesses have a tendency to be more resilient, competitive, profitable and sustainable. It can be a way of securing the long-term future of a business.

Employee-owned businesses tend to have more engaged and committed employees, as they are consulted more and have a greater vested interest in the success of the business and feel more like part of a wider team.

When considering employee ownership from a retirement or succession planning angle, it is key to realise that this is a way to preserve the culture and nature of the business and the team, which a sale to a competitor or third-party investor may not.

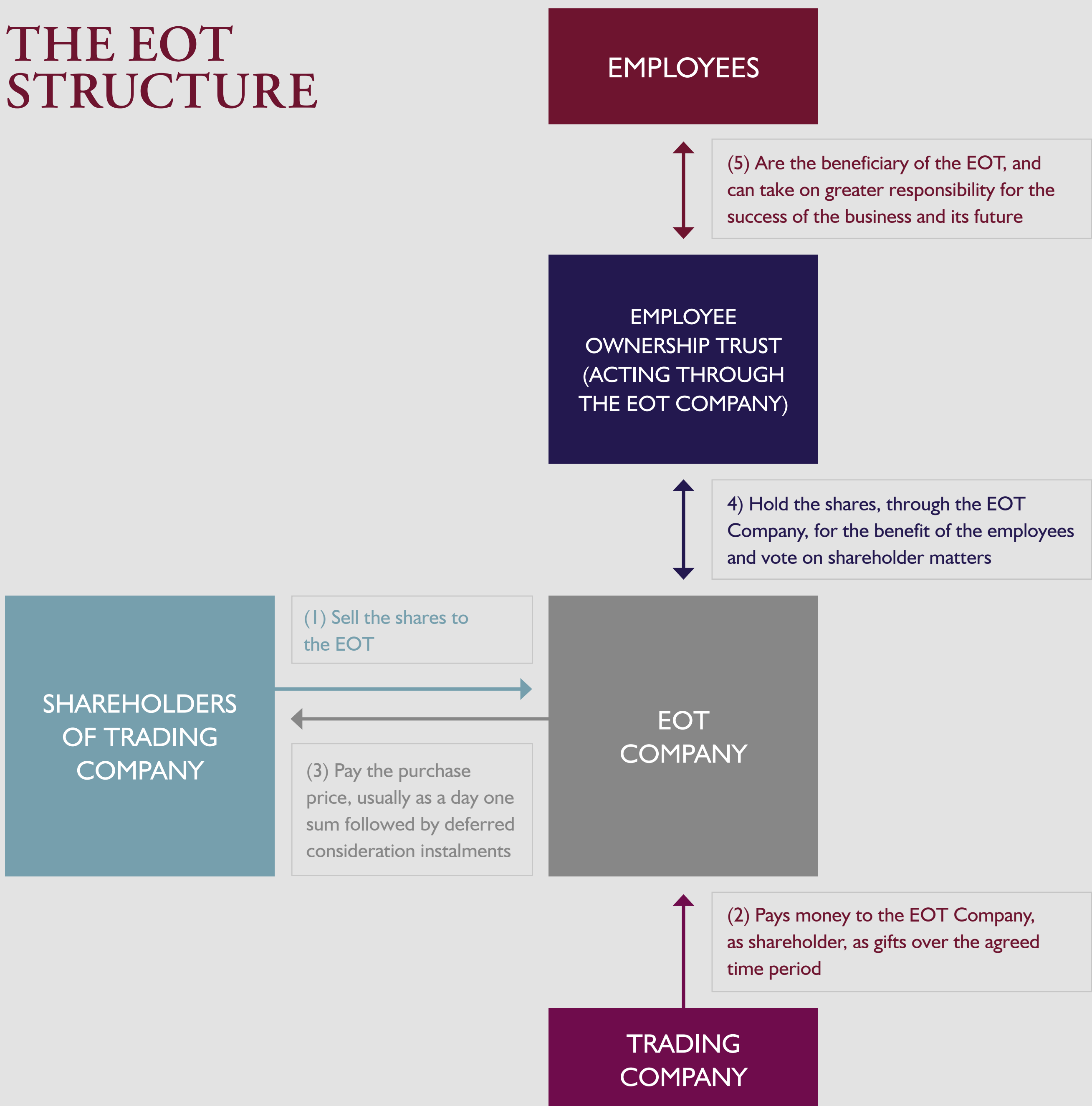
There are three main forms of employee ownership:

1. 100% trust ownership;

2. Direct ownership of shares by individual employees; or

3. A hybrid model which includes a trust and some individual share ownership.

THE EOT STRUCTURE



WHAT STRUCTURES ARE AVAILABLE FOR EMPLOYEE OWNERSHIP?

There are three main structures for an employee-owned company:

1. 100% trust ownership;
2. Direct ownership of shares by individual employees; or
3. A hybrid model with a trust holding the majority, and some direct share ownership by specific employees.

WHAT STRUCTURES ARE AVAILABLE FOR EMPLOYEE OWNERSHIP CONT...

The most common form is the 100% owned trust structure, as this is the simplest and cheapest to set up and, if it relates to an existing business where the owners are retiring or setting up their succession plan, has capital gains tax advantages for the outgoing owners.

Trust ownership

In this structure a trust is set up to hold the majority, or all, of the shares in the company. Usually this is an employee ownership trust ("EOT"). The EOT will be created by way of a trust deed which will evidence the creation and set out the various terms of the trust. The EOT is a trust with requirements prescribed by legislation.

The trust will then take ownership of the shares by way of a trustee. To enable smooth and simple management for the long term it is usual for the trustee to be a newly incorporated company (limited by guarantee) which will have directors appointed from within the company itself (and often an independent trustee director) who can retire and be replaced from time to time without disrupting the trust's ownership of the shares.

Careful financial analysis and planning is required to ensure that the price paid by the trust is financially viable. The trust itself will have no funds so it will either need to source these by raising third party debt or, as is more usual, the company will make a gift to the trust which will be used to pay the price for the shares (either in full or in part, with the balance deferred and paid out over a number of years from further gifts made by the company to the trust).

The trust deed, together with the articles of association of both the trust company itself, and the underlying employee-owned company, will set out the various terms by which those responsible for running the trust and the company must abide, and what consultation, veto, voting rights etc. they may have.
Whilst trustee directors will almost always come from employees of the company (usually a representative from directors, from employees and an independent) it is important to note that as a trustee the individuals will have certain duties to act in the best interest of the beneficiaries (the employees, on which they may be part) which may occasionally conflict with the duties of the directors of the underlying company. The governing documentation will set out a conflicts procedure to assist with this.

In an EOT structure there are certain tax benefits which can be obtained where specific statutory conditions are met, one of which being the EOT owning at least 51% of the shares in the operating company. If these conditions are met, then there should be no capital gains tax payable on the sale by the owner to the EOT (though the CGT liability is not extinguished and will instead be caught when/if the EOT decides to sell the shares). An income tax-free bonus (although do note that NI contributions remain payable) is able to be paid by the operating company to employees in each financial year (as of the date of publication, this is up to £3,600 per annum) if the EOT holds 51% of its shares.

A trust structure is aimed at long-term employee ownership and a desire by the owners to maintain an existing culture/ethos and local employment. A purchase by a third party can present difficulties with sharing sensitive information with a competitor (and therefore be a less attractive option).

Direct ownership by individuals

Under this structure the company must decide whether it is going to (i) gift shares to its employees (which will have income tax and national insurance implications depending on the value of the shares), (ii) allow the employees to buy shares for at least market value (so there are no tax implications) or (iii) give employees options to acquire shares in the future (tax liabilities may arise when the shares are actually then acquired).

Each of these routes leads to employees becoming direct owners and will therefore have the voting and dividend rights attaching to the shares as set out in the company's articles of association.

Tax consequences for the employees can be mitigated

if the share ownership is structured itself through a share incentive plan (SIP), a save as you earn options plan (SAYE), a company share option plan (CSOP) or under an enterprise management incentive (EMI).

Care must be taken in structuring the share ownership, with restrictions on the number of shares to be issued and the methods for transfer/sale, so that the company is able to control who becomes a shareholder. It is therefore common to see in the articles of association provisions requiring the employees to sell their shares internally, and that if they leave employment, they must offer the shares up for sale.

The direct ownership route allows employees to be incentivised by the potential capital growth in the value of the shares.

Hybrid structure

In a hybrid structure the trust structure is used but it will not hold 100% of the shares. There will instead be put in place some individual share ownership to provide for a direct feeling of ownership, some capital growth opportunity or as a more tangible reward structure to incentivise key employees.

As with the direct ownership structure limits should be put in place on the number of shares in direct ownership, and the methods by which these must be transferred.

WHY TRANSITION TO EMPLOYEE OWNERSHIP OVER A SIMPLE SALE OF THE BUSINESS?

As we covered earlier under the heading 'What structures are available for employee ownership?' there are three main structures for moving to employee ownership, but why would you want to consider this in place of simple share sale to a third-party purchaser? We make the assumption that passing on the business to other family members is not considered workable.

When selling your business to a third party this will often be to a competitor or a corporate investor, each of which are looking to further their own aims and may not necessarily have the best interests of your business at heart. Anecdotal evidence from business owners has shown that the process of selling to a third party can often be fraught, and sometimes unpleasant. The end result may be achieving a reasonable value for the business but the long term future of the business in its current location may be in doubt, and certainly the culture and ethos is liable to be damaged or change significantly.

If the primary driver behind the decision to sell is one of realising the value of the business as soon as possible, then a sale to a third-party may be the quickest, and most financially viable, route.

If, however, realisation of the value can be done over a wider time period, and the owners are concerned about the continued success of the business and maintaining its culture and people, then an employee ownership transition could be more attractive.

A transition to an employee-owned structure is also ideal for putting in place long-term succession planning where you have employees, or family members if it is a family business, who you want to be able to run the company going forward.

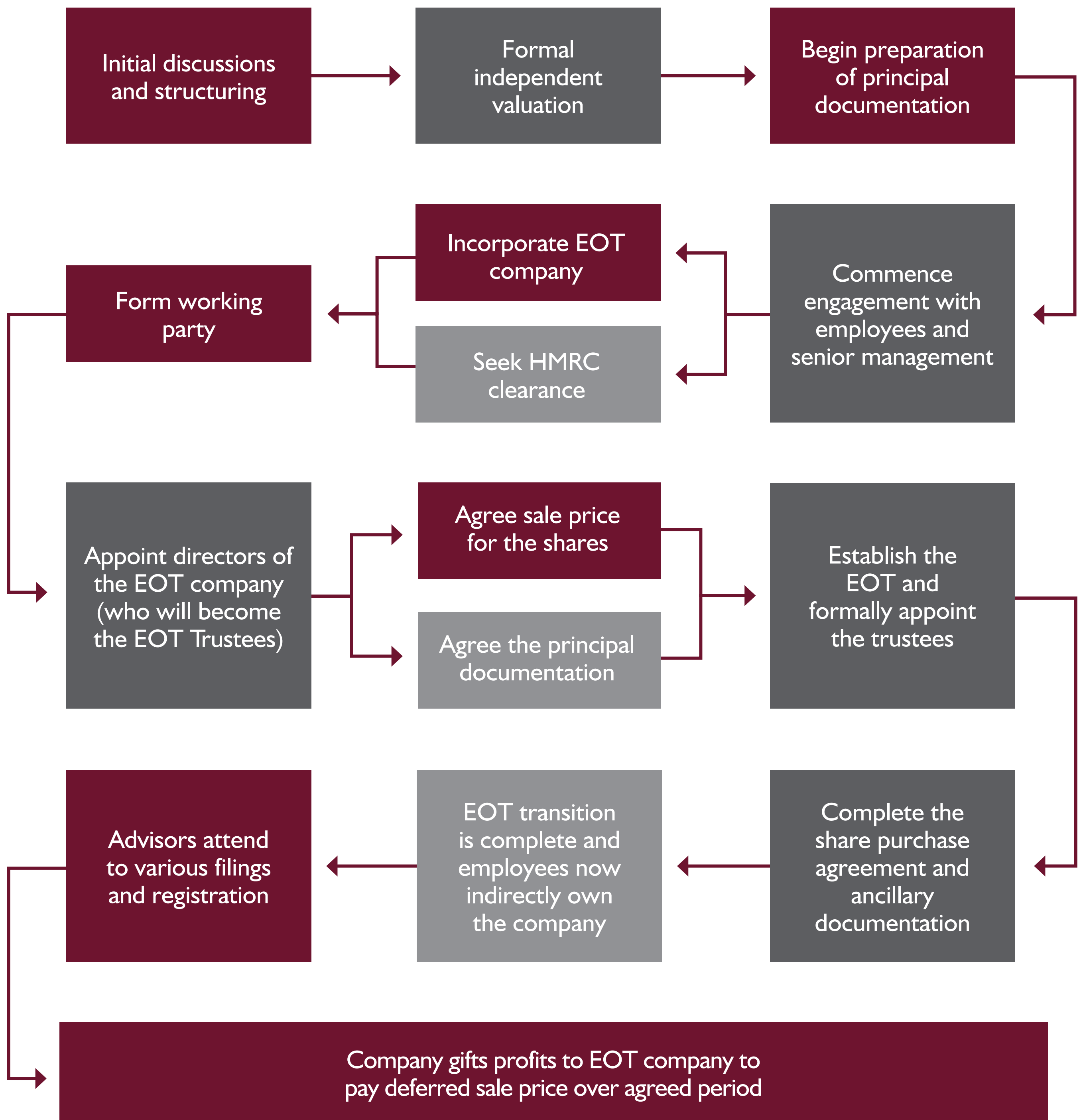
If considering a direct ownership structure then, of course, the employees would need to be able to afford the cost of the shares if these were to be bought, and not gifted. This will often not be viable and so this is why the trust owned structure is more appealing. Sale to an employee ownership trust can also, if certain statutory condition are met, mean that no capital gains tax is due on the sale of the shares, which can mean a substantial saving for the outgoing owner (in particular if the company was set up by the outgoing owner so that the gain is the entire value of the business).

The CGT relief can be used to justify a slight reduction in the sale price (the shares may be sold for slightly less than on the open market, but with no CGT payable the eventual financial gain for the outgoing owner is greater).

When setting up a trust structure the trust itself will have no assets so the company will need to gift money to it in order for it to then pay the sale price for the shares. This is why there is often an initial, day one, payment to the owners with the balance being deferred and paid out over a number of years. Careful analysis of the financial state of the business, a management team for the succession, combined with a robust payment plan for the deferred consideration, is key to ensuring both the continued success of the business and also the financial gain for the outgoing owner.

It is also not unusual for the outgoing owner to remain in the business for a while after the sale, which allows them to keep an eye on the business whilst also starting to take more of a back seat to enable the succession planning to take effect, whilst still being able to enjoy the benefit of selling the shares and realising the financial reward of having grown the business in the first place.

WHAT DOES THE PROCESS LOOK LIKE?



WHAT ARE THE BENEFITS OF EMPLOYEE OWNERSHIP?

Financial benefits

An incorporated entity has a separate 'legal personality' or identity. There are tax advantages to an employee ownership transition for both the outgoing owner and the employees when using a trust structure (for more on the different structures available for employee ownership, see heading 'What structures are available for employee ownership?'). When the correct conditions are met using a trust structure, there is no capital gains tax payable on the sale price for the shares to the trust, and employees of the company can be paid an income tax free (but NI contributions still apply) bonus in each financial year (as of the writing of this article, this is up to £3,600 per annum). A simplified version of the conditions required to take advantage of the tax benefits are set out below.

A transition to employee ownership still means that the outgoing owners can be paid the market value for their shares.

Where a direct ownership structure is used this can often be structured in a tax efficient manner for the employees if the share ownership is done through a share incentive plan (SIP), a save as you earn options plan (SAYE), a company share option plan (CSOP) or under an enterprise management incentive (EMI).

Commercial benefits

1. Employees can be more engaged, energetic and committed if consulted on decisions. This can lead to greater innovation and entrepreneurial spirit, better retention of talented staff and a greater commitment as a whole to corporate social responsibility.
2. A more engaged and more secure workforce can lead to higher productivity and profitability.
3. Employees should have a clear shared purpose and collaborative way of working.
4. Everyone feels like they have a stake in the business and are therefore more incentivised to work towards its success.
5. Employee-owned business tend to be more resilient and stronger during periods of hardship,due to the collegiate atmosphere and greater transparency.
6. It allows for ownership and leadership succession to be enacted over a number of years, which preserves both the business and its culture which may otherwise be lost.
7. Employee-owned business focus on, and have a commitment to, the longer-term success of the company.
8. The transition can be implemented at a speed which suits all parties and can allow the outgoing owner some additional time to wind down in the business, and stay part of it, for a number of years following the transition.

Social benefits

1. Businesses can develop a family feel and the employee family can be kept together through a transition to employee ownership.
2. Some sales to third parties lead to cost-cutting and movement of the business but not the people to other plants operated by the purchaser. With employee ownership it is more likely to stay local.
3. Selling to employees can provide stability of employment and (once the sale price has been paid) the opportunity for greater financial rewards for employees if the business remains successful.

Statutory conditions for obtaining the tax reliefs on a trust structure

We have included a simplified version of the requirements here for information, but note that this can be a complicated area and advice should be taken to ensure the conditions are met in order to obtain the relevant exemptions.

Capital gains tax relief on sale of shares to the trust

1. The company must be either a trading company or, where there is a group, the principal company of a trading group (trading in this context does not include investment companies which primarily just owns significant cash, land or other investments).
2. The trust must acquire and retain a controlling shareholding in the company, so more than 50%.
3. The trust must be set up for the benefit of all eligible employees on the same terms, so no particular advantage can be leveraged in favour of any subset of the employees.
4. There is an additional requirement which only applies where the outgoing owner has held an interest of 5% or more in the company in the 12 months before the transfer which is designed to avoid abuse. This requirement is that the number of employees who hold 5% or more of the company must not exceed two fifths of the workforce generally and relatives are included with any such shareholders in this calculation. This will particularly effect companies with few employees.

Income tax-free bonuses for employees

1. The company which employs the employees must be a trading company or a member of a trading group.
2. A controlling interest in the company (or the principal trading company if there is a group of companies) must be held by an employee ownership trust for at least twelve months.
3. The company should not have more than a ratio of 2/5 for directors (plus any employees related to them) to employees and directors in total. This only affects very small companies.

HOW DOES EMPLOYEE OWNERSHIP SAFEGUARD THE FUTURE OF THE BUSINESS – IS IT SUSTAINABLE?

A move to employee ownership for a business is always focused on the long-term success of the company and its continued improvement.

Employee-owned businesses, when structured and managed appropriately, are able to channel the energy, commitment and abilities of the employees into an improved culture where everyone in the business shares the “all in this together” mission and has everyone working towards a common purpose. This mission allows employee-owned businesses to weather difficult times more readily than other corporates.

Anecdotal evidence from the crisis caused by the Covid-19 pandemic have shown that employee- owned businesses were able to handle the downturn and challenges raised better than others and are heading into the recovery in stronger positions as a result.

Good governance of an employee-owned business is built upon proper communication, transparency, and planning, with all employees able to see and understand where the business is going and what the key challenges are. Use of employee councils and/or employee representatives in larger businesses allow additional avenues of ideas to be taken advantage of, further evidencing why the collaborative nature of an employee-owned business can have a positive impact.

The employee ownership trust can be the forum for considering not only the financial performance of the business as shareholders, but also employee engagement and whether directors are properly observing their s.172 Companies Act duty to have regard for the employees of the business.

When structured correctly the financial obligations relating to paying the outgoing owner for their shares do not impact heavily on the business, so sustainability is considered from day one. The process of moving to employee ownership involves taking advice not only from solicitors, but also the company’s accountants to ensure that the financial plans are viable to support both payments to the former owners and the continuing success of the business.

HOW DOES MANAGEMENT CONTINUE TO EFFECTIVELY RUN A COMPANY WHEN IT IS OWNED BY THE EMPLOYEES?

Following a transition to employee-ownership a trading company will continue to be run by the directors and its senior management. (There may be a need to recruit new managers before the change if the outgoing owner is no longer wanting to be a part of the business, or indeed they may stay on for a short period to help with the transition or even continue as before but with more accountability to the employees). Managers should be committed to greater transparency and will hopefully obtain greater engagement from employees.

Employee engagement is not a given. The transition does bring about a change in the running of the company as the employees will have more of a say in the future of the business and certain key decisions may be subject to their approval going forward. This is a cultural transition which affects all employees and should be carefully planned for to make it work at the same time as the legal transition takes place.

In an Employee Ownership Trust (EOT) - owned company there is usually one or two employees (depending on the trading company's size) selected to sit as a trustee director on the board of the trustee company (alongside a trustee director nominated from amongst management and, often, an independent trustee director). The role of the trustee directors, however many in number and from wherever they are appointed, is to ensure that the EOT owned trading company is run for the benefit of the beneficiaries (in this case, the employees). When putting the structure in place there will be a trust deed which, together with the articles of association of both the trustee company itself, and the underlying EOT-owned trading company which will govern the responsibilities of the EOT. Directors of the EOT-owned trading company itself will have to gain the consent or approval of the EOT (in its capacity as shareholder) and sometimes the employees themselves, to certain decisions or actions.

Some examples of the sort of decisions which may require the consent of the EOT or the employees are:

1. any resolution to wind up or dissolve the trading company or any subsidiary of the trading company;
2. any substantial change in the nature of the business of the trading company and its subsidiaries (if any) taken as a whole;
3. any amendment to its articles of association;
4. declaring or paying any dividend or making any distribution by way of bonus to employees;
5. any sale of the trading company and/or any subsidiaries of the trading company;
6. the provisions of a remuneration policy;
7. appointment of trustee directors for the EOT.

Where an outgoing owner is owed deferred consideration for the sale of the shares to the EOT, the governing documents will also include restrictions relating to these actions which mean that the outgoing owner may also need to consent, until such time as they are paid in full (or to a certain threshold). A preference share is often issued to the outgoing owner to give them enhanced voting rights in order to assist with these protections.

If there are sufficient numbers of employees then an employee council can be set up, which will consult with management on various matters as set out in the articles of association. Where the employee numbers are small then instead there will usually be a right for the employees to be consulted as a whole, with a minimum threshold (e.g. 75%) of consent needed to proceed with certain actions.

Which decisions require employee consent and which are retained by management is at the discretion of the trading company when putting the employee-ownership documentation into place.

Where a direct ownership structure is used, rather than an EOT, the employees will be direct shareholders and will have all of the attendance and voting rights given to those shares in the articles of association of the company. The statutory directors' duty of making decisions which are for the benefit of the company, for its members as a whole, will therefore encapsulate those employees who are then shareholders and the directors will be answerable directly to them as with any other shareholder.

HOW DOES MANAGEMENT CONTINUE TO EFFECTIVELY RUN A COMPANY WHEN IT IS OWNED BY THE EMPLOYEES?

When setting up a trust-owned structure an employee ownership trust will be created by way of a trust deed, which sets out the terms by which the trust must be operated.

The trust itself will be operated and run by its trustees. The role of the trustee is to manage the assets of the trust (in this case, the shares in the company) for the benefit of the beneficiaries as a whole (in this case, the employees of the company). The trustee role is therefore not to manage the underlying company, this remains with management and the directors, but instead is to influence the management team to ensure that the company is being led in the best way possible and that they are maximising the engagement and experience of the employees.

We would always advise that the trustee itself is a corporate body, usually a newly incorporated company limited by guarantee, and that the governing documentation (trust deed and articles of association) include provisions for the appointment of the directors of this new trust company, who will act as trustee directors and carry out the role of the trust. The reason we advise this is a corporate, instead of a group of individuals, is that it makes ownership and management of the assets held by the trust significantly easier and cheaper to maintain. The shares are put into the name of the trustee company and remain there notwithstanding any change in its directors. Its directors are usually known as trustee directors to distinguish them from the directors of the trading company. This allows the trustee directors to rotate, retire and be added to from time to time with little administrative burden other than updating the company's statutory books and making the necessary filings at Companies House. It also means that signing any documentation is much simpler than if you have many individual trustees.

If you wish to read more about the interplay between the trust and the management team who will continue to run the company, please see heading 'How does management continue to effectively run a company when it is owned by the employees?'.

WHAT HAPPENS IF THE EMPLOYEE OWNERSHIP TRUST SELLS THE SHARES?

As with any asset in the UK capital gains tax will be payable on the sale of the shares if they are disposed of by the employee ownership trust ("EOT").

Where an EOT is in place this is usually done to (i) put the company into employee ownership for all of the associated benefits that come with that, but also (ii) to allow the outgoing owner to obtain an exemption on the payment of CGT on their sale of the shares to the EOT (subject to certain statutory conditions).

Where a company's shares have been sold or gifted to an EOT, and the CGT relief applied, it is important to note that this does not actually extinguish the CGT. Instead, the CGT itself is rolled forward and will become due and payable by the EOT if it ever decided to sell the shares. This is important to note because the CGT could be significant if the value of the business has continued to rise, as the CGT will be calculated from the date on which the original owner (who sold the shares to the EOT) acquired them, not the date on which the EOT acquired them. The CGT liability will fall to the EOT to settle and cannot be claimed back by the EOT from the previous owner. This is one of the reasons that employee ownership is seen as a long-term solution for the company in question, since it is not an efficient way of flipping a company in the short-term following any rapid expansion or development.

In situations where the outgoing owner is still owed monies by the EOT for the shares sold to it initially, there should be restrictions placed in the company's governing documentation and articles of association which will allow that outgoing owner control over any decision to sell the shares, until such time as the payments due to them have been met. This provides comfort to the outgoing owner that they will be paid out ahead of any onward sale.

If the shares are sold by the EOT then the articles of association and the trust documents will cover off whether the value of the shares can be distributed amongst the employees (as beneficiaries of the trust) or if they instead should be applied for charitable purposes or to some other purpose. This is a commercial decision to be agreed during the process of setting up the employee ownership structure.

WRIGLEYS EMPLOYEE OWNERSHIP PODCAST SERIES

Our associate Mike Ford has recorded a series of podcast episodes taking a closer look at employee ownership.

These are available for you to listen to on all main podcast outlets or can be downloaded by following the QR code.

HOW CAN WRIGLEYS SOLICITORS LLP HELP?

We can provide advice, guidance and assistance with the entire process of transitioning to employee ownership, from the very first exploratory conversations and feasibility assessments through to document preparation, employee and senior management engagement, HMRC liaison and completion and registration.

We work closely with a number of financial advisors and accountants who can provide the formal valuation service, and can seamlessly build communication with them into our offering to give you the whole service in one place.

We can also provide advice to established employee owned businesses, or the trustees of those EOTs, about how to navigate their post-transition world and provide support with any queries about how the updated ownership structure works.

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