Employee Ownership Trusts: A Complete Overview

The HMRC Open Consultation on the Taxation of Employee Ownership Trusts and Employee Benefit Trusts has just closed as at 25 September 2023 and includes a portion dedicated to the examination of Trustee Tax Residency – particularly the use of Non-Resident Trustees for Employee Ownership Trusts (EOTs).

By **Paul Harvey**, 18th October 2023

The HMRC Open Consultation on the *Taxation of Employee Ownership Trusts and Employee Benefit Trusts* has just closed as at 25 September 2023 and includes a portion dedicated to the examination of Trustee Tax Residency – particularly the use of Non-Resident Trustees for Employee Ownership Trusts (EOTs).

Whilst there does not appear to be evidence of widespread abuse of offshore EOTs, HMRC feel there is still scope for offshore EOT planning to go beyond the intentions of Parliament and the purpose of the incentives available to EOTs. Therefore, some refinement of the rules may be in order to obviate the potential for escaping UK Tax liabilities that would be otherwise due on subsequent sales to third parties.

Whilst we eagerly await the outcome of the Open Consultation, we thought it would be a good opportunity to revisit the basics of EOTs, their advantages and underline the value that a properly licensed and regulated Isle of Man Trustee can add to bona fide EOT planning.

In this article we cover the following topics:

1. **What is an Employee Ownership Trust?**

1. **What are the Advantages of an Employee Ownership Trust?**

1. **Why use an Isle of Man Trustee for your Employee Ownership Trust?**

1. How Can Dixcart Help with Employee Ownership Trust Planning?

1. What is an Employee Ownership Trust?

Building upon the Nuttall Review's recommendations, the Finance Act 2014, enacted by the UK's Clegg-Cameron Coalition, was designed to incentivise the employee ownership model. Its chief objective was to foster a more responsible, diversified, and consequently, robust economy. A sentiment that has been supported by the current Prime Minister and Chancellor, Rishi Sunak and Jeremey Hunt, who are currently considering reforms to encourage employee ownership in the UK to boost the economy.

This concept is not unique to the UK and broadly similar company models exist all over the world, albeit there may not be comparable tax incentives. For example, the United States' Employee Stock Ownership Plan (ESOP), France's Société coopérative de production (SCOP), Australia's Employee Share Schemes (ESS) and any number of other workers cooperative or share purchase models.

An EOT is one method of facilitating the employee ownership model. EOTs are a restricted form of EBT that is settled by a Company's Founders or current owners and involves transferring ownership of a business into a Trust for the long-term benefit of all Eligible Employees.

The UK Government has incentivised transferring a business to its employees with notable tax exemptions. Under an EOT, majority shareholders can sell greater than 50% of the share capital to the Trust, receiving tax-exempt proceeds. The agreed sale amount is based on a business valuation carried out by an independent expert. Without a third-party buyer, this amount should reflect what the business can feasibly pay over an acceptable period.

Many owners choose a full 100% sale, while some keep a minority stake in the company for various reasons— ensuring legacy, ongoing income, to pass on the capital to loved ones as part of their personal Estate or even to make the sale more affordable for the business. It is important to understand that any subsequent disposal of retained shares to the EOT will not avail of the tax exemptions. If a minority stake is retained, provision should be made to protect shareholder interests from events, such as dilution.

In essence, the EOT functions as a Trust, comprising a Settlor, Trustees, and Beneficiaries. You can learn more about the basics of Trusts here.

Party to the Trust	Description
Settlor	Person(s) disposing of their Controlling Interest in the Company (i.e. more than 50% of the voting and equity rights).
Trustees	Can be sourced internally from Directors and employees of the Company, or externally by engaging independent Professional Trustees. Some EOTs may call for a mix.
Beneficiaries	**All** Eligible Employees of the company. This is a term defined within the Act as an employee or office holder of a Trading Company or principal company of a Trading Group. There are strict equality requirements.

The EOT facilitates indirect ownership of the Company's shares. While Trustees legally own the shares, eligible employees hold the equitable title, enabling them to benefit from dividends, profits, and voting rights without direct share control. This provides benefits like administrative simplicity and increased stability.

EOT planning is undertaken for many reasons and circumstances and objectives will typically determine whether an EOT is an appropriate solution. Common drivers include where private owners, whether entrepreneurs or a family business, are considering succession planning, to support growth plans or upon initiating a new venture. However, EOTs should not be viewed merely as tax-planning tools. Their establishment should genuinely benefit the ongoing success of the business and its employees. The holistic benefits are explored in the next section.

2. What are the Advantages of an Employee Ownership Trust?

Driven by the UK Government and promoted by organisations like the Employee Ownership Association, employee ownership is now the UK's leading SME ownership model. In 2022, there was a 37% increase, with half of all such businesses transitioning since 2021. From just 17 in 2014, the number of EOTs is now well over 1,000 and includes prominent firms like ARUP Group Limited, Adventure Forest Group Limited (Go Ape), and famously, the John Lewis Partnership PLC.

There are many benefits of employee ownership facilitated by EOTs, but simplicity I have divided the most prominent them into three main categories.

i) Benefits for the Business

The UK Government's promotion of employee ownership stems from a core belief in its power to foster a resilient economy. This is grounded in the Nuttall Review's assertion that incentivizing employees leads to enhanced trading performance. Key outcomes include:

- Lower Absenteeism
- A Happier Workforce & Increased Staff Wellbeing
- Lower Staff Turnover
- Faster Employment Growth
- Increased Productivity

The EOT model speeds up employee engagement, typically translating into increased profitability and reduced expenses in areas like recruitment. It also improves the Company's resilience, better equipped to handle challenging market conditions because the workforce now has a direct stake in the outcome, or an 'owner's mindset'.

Selling to employees via an EOT means the business's existing culture, values, and way of operating can be preserved. In contrast, an external third-party might seek to integrate or change the business to fit their own strategies or corporate culture –

possibly even placing the existing employees at risk of an exercise in rationalisation or contract renegotiations. This continuity is especially valuable for SMEs where the founding owners have played pivotal roles in the company's governance, strategy, and overall trajectory from inception. Further, many SMEs do not have a comprehensive succession plan; EOT planning can often serve as a timely catalyst for undertaking succession planning, preparing the next generation of leadership for their roles.

The bespoke nature of an EOT sale offers a great deal of flexibility, from financing options to handover periods. Often, the sale price is spread over several years and is paid out of the business's profits. Depending on the circumstances, this may also allow the Company to gear in a way that better aligns with the long-term interests of the business and its employees e.g. speeding up the route to profit-share by limiting the levels of debt financing required.

In essence, an EOT, under apt circumstances, is a robust strategy to ensure a business's enduring success and stability.

ii) Benefits for Owners

Exiting owners have compelling incentives to sell to an EOT, chiefly the potential for a Capital Gains Tax exemption on the disposal of their shares.

This saving of up to 20% is particularly compelling in the face of a reduced Business Asset Disposal Relief (previously named Entrepreneurs' Relief). The cumulative limit on the lifetime allowance has fallen from £10m to £1 million for qualifying gains flowing from disposals on or after 11 March 2020.

An internal sale process through an EOT offers numerous practical advantages:

- No need to find an external buyer.
- The sale price aligns with an independent market valuation, avoiding lengthy third-party negotiations.
- Pre-determined Sale and Purchase Agreement offer opportunity to tailor terms.
- Involving employees in the transition process, especially incoming Board Members, ensures a seamless handover.

- Transitioning to an EOT acknowledges the workforce's contributions and preserves the owner's legacy.

This approach provides the exiting owner clarity and certainty on aspects that there is typically less control over in traditional trade sales, such as the transaction terms, sale price, and exit date etc.

The arrangement of funding for the EOT sale can also be highly customised. Options include seller financing, external debt financing, engaging investors, or using the company's retained earnings; a hybrid approach is common to optimise the outcome for all. However, the method of financing requires careful consideration and should ideally be advised.

In the right circumstances, an EOT sale offers owners an efficient exit strategy, granting more control over the sale, whilst also ensuring a lasting legacy.

iii) Benefits for Employees

All Eligible Employees benefit from the company shares held in their name through the EOT. As such, EOT-owned businesses offer both financial and non-financial advantages to their employees.

First and foremost,under the Finance Act 2014, employees can access a tax-free bonus up to £3,600 annually. The conditions for this bonus, as defined in s312B of the Income Tax (Earnings and Pensions) Act 2003, include:

- **Participation Requirement**: All employees, including those overseas, and in any company within a group structure, must be eligible for any qualifying bonus award at the point the award is determined.

- **Equality Requirement**: Employees must participate on the same terms. Variables like remuneration, service length, and hours worked can determine the qualifying bonus. The equality requirement is infringed if the scheme wholly or mainly benefits directors or top earners.

- **Office Holder Requirement**: Within an individual company payments will not be qualifying if directors or office holders and other employees connected with them exceed 2/5 of total employees.

HMRC's Open Consultation considers key issues regarding the Income Tax-free bonus. Notably, the Employee Ownership Association points out that due to inflation, the real value of this tax-free bonus has decreased since 2014. They suggest a current appropriate limit should be £4,600+.

Beyond the bonus, Eligible Employees have a voice in the business and can benefit from future profit-sharing once the EOT's funding commitments are met. This longer-term financial incentive means employees can benefit from the business's growth, driven by improvements in their increased engagement and commitment, in turn leading to greater trading performance.

While the EOT benefits all Eligible Employees, the strict requirements do not prevent the business running other initiatives. For example, provision can be made for key staff to directly buy company shares outside of the Trust. This offers more individualised approach to recognition, aiding talent retention.

It is vital that employees are well-informed about the EOT and the incentive structure. The business should take a proactive approach to education, which can include regular communication from the Trustees and management regarding timelines and mutual benefits.

The business can choose to establish an Employee Council to facilitate optimal communication between the workforce and Trustees. The Employee Council represents the interests of the Eligible Employees, giving them a voice and a means to be informed about and influence the EOT's activities. Specific rights and powers can be reserved for the Council within the EOT's constitutional documents. For example, the power to veto certain actions, approve certain decisions or have the right to be consulted on certain matters. Alternatively, the Council's role might simply be advisory in nature.

Finally, trade sales to external parties can be fraught with uncertainties. Conversely, the transition to an EOT is more straightforward as the employees are the purchasers, and they already possess a deep understanding of the company's operations, culture, and vision, ensuring business continuity and hopefully stable growth.

In the appropriate context, transitioning to an EOT offers advantages not just to the business and the exiting owner, but also to all Eligible Employees. This structure can address talent retention and inflation-related wage concerns, promoting a resilient economy and a more equitable society.

3. Why use an Isle of Man Trustee for your Employee Ownership Trust?

The Trustees appointed to administer the EOT will hold Legal Title to the EOT Shares and owe the Beneficiaries a blend of Trustee Duties and Fiduciary Duties. These legal duties can be onerous and carry a level of liability. Particularly pertinent duties that must be considered, include:

- To maintain and act in the interest of the Beneficiaries
- The requirement to avoid conflicts of interest
- To exercise reasonable care and skill
- To understand and carry out their obligations in line with the terms of the Trust
- To act fairly and with impartiality in their capacity as Trustee

While it's common for EOT Trustees to be individuals or an external Professional Trustee, some businesses opt for a SPV to serve as a Private Trust Company (PTC). When this route is chosen, Trustees become the Directors of the PTC. While the PTC structure offers Limited Liability, safeguarding the Trustee Directors' personal assets from legal action targeting the PTC, it does not provide an absolute shield. For example, in cases of criminal liability, failure of Fiduciary Duties or Gross Negligence etc. the Trustees can face personal, or even joint and several, liability.

Acting as a Trustee is a serious undertaking that can be complex and must be fully understood prior to appointment. Selecting the right Trustees for an EOT is crucial due to the potentially long-term nature of the appointment. Typically, candidates can be categorised into Lay Trustees and Professional Trustees. You can read more on the general differences between Lay and Professional Trustees here.

Lay Trustee Options for Employee Ownership Trusts:

Employee Trustees may be considered for as they are well placed to direct insight into the day-to-day operations and challenges of the business, bridging communication between the workforce and the Trust. Further, this appointment can provide an opportunity to develop talent to form part of the wider succession plan. Therefore, an Employee Trustee may add value in strategic decision-making and potentially promote an EOT-aligned culture, whilst preparing them for future responsibilities.

Businesses often also consider appointing Board-level Trustees. In particular, Non-Executive Directors can offer a balanced perspective on the strategic mind of the company, providing Board representation for the Trust and acting with increased independence.

Exiting owners may also be inclined to take up Trustee roles or appoint close associates, anticipating a retention of influence over the business. While this can initially seem logical, especially for Founders who deeply care about their company's trajectory, it carries pitfalls. Ongoing control and influence for the exiting owner can hinder the business's evolution and negate the genuine benefits of transitioning to an employee-owned model.

The HMRC Open Consultation considered exiting owner appointments and recommends limiting the participation of former owners and their close associates to a minority role. Any breach of this after disposal would be a disqualifying event, leading to an immediate CGT Tax charge to the trustees, or the former owner if within the first year following disposal.

However, the appointment of *any* Lay Trustee isn't without challenges:

- **Trust Expertise**: Lay Trustees might not have prior experience in Trust governance, fiduciary duties, or corporate oversight which require training and ongoing CPD commitments. This could mean a steeper learning curve, which can lead to errors or inefficiencies.

- **Conflicts of Interest**: Employee or exiting owner trustees may find themselves in situations where the best interests of the Trust conflict with the immediate interests or sentiments of their colleagues or the Board. For instance, the exiting owner may have personal financial interests or other agendas that could conflict with the best interests of the Eligible Employees or the business's long-term success. Further, whilst a NED is more independent, they are still employed by the company and far closer than an external party may ever be.

- **Administrative Burden**: Serving as both an employee or NED and a Trustee can be demanding, especially when balancing professional and Trustee responsibilities.

- **Objectivity and Independence**: A deep-rooted connection with the business is a double-edged sword. It can aid in understanding nuances but may also hinder unbiased decision-making. Further, where exiting owners or Board Members act alongside employee Trustees, it is important to acknowledge that these parties may tend to dominate important debates and decision-making, owing to strength of character and experience. Further, EOT Trustees will naturally face pressure from members of the business, which can make it difficult to maintain impartiality or to make unpopular but necessary decisions.

- **Legal and Regulatory Compliance**: Trust governance often involves complex legal and regulatory responsibilities. Inexperienced Lay Trustees might not be familiar with these areas, potentially leading to non-compliance or legal issues.

Professional Trustee Option for Employee Ownership Trusts:

Selecting a Professional Trustee for your EOT fundamentally addresses various concerns related to trust management and risk mitigation. This choice safeguards the EOT from potential mismanagement and legal non-compliance by employing a third-party specialist whose core focus is trust governance.

A Professional Trustee, being entirely independent, guarantees impartial and unbiased decision-making, which is paramount in safeguarding the interests of the EOT beneficiaries and ensuring robust governance. They play a pivotal role in mediating conflicts, leveraging their extensive experience, and providing a fresh, external perspective to strategic planning.

Equipped with specialised systems and methodologies for efficient EOT management, they devote undivided attention to trust administration, ensuring no conflict with other roles and responsibilities. Importantly, unlike Lay Trustees, a Professional Trustee can deliver a continuous and stable relationship with the EOT in perpetuity, especially when a Trust Services Provider with low staff turnover is chosen, fostering a consistent, long-term business connection.

Isle of Man Professional Trustees for Employee Ownership Trusts

As at time of writing, no IHT charges arise on the transfer of the exiting owner's shares to an EOT and the EOT is also exempt from the IHT Relevant Property Regime. Therefore, even where the exiting owner, company and employees are UK Tax Resident Domiciliaries, there is currently nothing to prevent the use of Non-Resident Trustees. In fact, there can be very compelling non-Tax reasons for choosing Non-Resident Professional Trustees, such as those located in the Isle of Man. However, it is important to acknowledge that each case needs to be considered on its own merits – as with all things Trust related, one size does not fit all.

Isle of Man Trustees, such as Dixcart, are required to be licensed under the Financial Services Act 2008 and the Regulated Activities Order 2011, ensuring consistent regulatory oversight by the Isle of Man Financial Services Authority. This oversight assures clients that these trustees adhere strictly to best practices in their EOT obligations.

Furthermore, the Isle of Man is globally recognised as an exemplary international financial hub, boasting a stable political, economic, and regulatory landscape. With deep roots in intricate Trust and Corporate planning, the island's financial services sector is populated by seasoned professionals.

The Isle of Man and UK are separated by the Irish Sea, meaning Isle of Man Professional Trustees are truly independent from the EOT-owned UK business. However, its proximity and transport links mean that Trustees can promptly attend crucial UK meetings, offering an ideal blend of autonomy and accessibility.

4. How Can Dixcart Help with Employee Ownership Trust Planning?

Dixcart Isle of Man have been assisting with owner-managed businesses, complex Trust arrangements and intricate employee share ownership structures for over 30 years – therefore, we are exceptionally well placed to assist with Employee Ownership Trusts.

By leveraging Dixcart's expertise and quality focused services, we can deliver an effective bulwark between the businesses and its ownership, providing checks and balances on the business, assurance against conflicts of interest and that the rights and interest of the beneficiaries will always be the first priority.

Get in Touch

If you would like to discuss how our Professional Trustee services can augment your Employee Ownership Trust planning, please feel free to get in touch with Paul Harvey at Dixcart: advice.iom@dixcart.com

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