Employee Ownership Insight

Qualifying employee trust sales are at 0% tax. | They can be gradual and on full commercial terms. | Employee-owned companies see increased productivity. | Employees can enjoy tax free bonuses.

Establishing an Employee Ownership Trust (“EOT”) is an indirect form of employee ownership in which a trust holds a controlling stake in a company on behalf of its employees, the most well-known example being the John Lewis Partnership.

An increasing number of owners are now assessing the benefits of selling their businesses to their employees via trusts versus an open-market business sale. This process can be vendor-led, does not require the employees to drive it and valuations are a commercial discussion with no requirement for the involvement of a 3rd party. Due diligence is light, and the transactions can be funded against an agreed schedule, thereby enabling sellers to both reward and handover over time. There is also the 100% tax-free aspect which is highly attractive.

The ongoing success of the business is of paramount importance – not only to secure your legacy and the employees’ success, but to ensure that the business is able to meet the future financial commitments to you. A current business valuation and some legal paperwork will not achieve this - consideration of the business model, sustainability and the transitional process are just as critical.

There is significant evidence that employee-owned businesses are more sustainable, take better investment decisions and are more productive due to employee engagement and their increased focus on success. For this reason, the main political parties all believe that employee ownership is better for the economy than the more traditional direct ownership models.

Why sell to an Employee Ownership Trust?

EOT businesses are not new - John Lewis is probably the oldest example. An EOT sale has many advantages, in particular, such sales are highly attractive because, subject to HMRC clearance, they are 100% tax-free. In fact, the Government is incentivising such sales as there is significant evidence that EOTs are sustainable and lead to greater productivity and better support of the economy.

- There are benefits for the employees in terms of tax-free bonuses, better job security, and a feeling of inclusiveness. This form of sale aids motivation and staff retention.
- The process can be vendor-led and employees are not required to drive the approach as would be the case in a Management Buy-Out (MBO). EOT sales are also more immediate and require less due diligence than trade sales.
- The fixing of the multiple used to value the trading company is a commercial discussion and there is no golden rule.

What is the employee sale approach?

An EOT sale does not mean that the business has to become wholly run by the employees. The former shareholders can remain involved at management level, although they concede board control of the business to a trust but they can take a position as a trustee after the sale. The key points of the EOT approach are:

- The sale must be for 51% or more of the company shares to benefit from the 0% CGT rate. Many EOT sales are 100% share sales for simplicity.
- Typically, a new company is created which will act as the employee share ownership trust and the shareholders sell their trading business shares to this EOT company.
- A sale and purchase agreement is executed and after the sale, the company trades as a wholly-owned subsidiary of the EOT company.
- A trust document sets out the obligations of the Trust to the employees.
- Once the seller pay-out is achieved, key managers typically end up in the upper pay grade for their sector.

"We are so happy with the result and, as you can see, so are the staff. I was a sceptic but it has actually worked out perfectly. I wanted to be able to help all those people who have stayed with us in the hard times."

John Murphy, Arbuckles Owner

Many owners are choosing EOTs not just because of the 0% tax but because employee sales are more rewarding. Sellers can stay involved and protect their legacy.

"It needed to provide the best platform for the company's continued growth and give a fair return on our investment. We are all absolutely delighted with the result as it achieves all of those things."

Eric Keane, IFSL CEO

How will my business be valued?

Typically, private company valuation multiples range between 4 to 7 but cashflow, financial headroom and reserves will all have a bearing.

The EOT valuation, which will be led by Avondale, is subject to HMRC clearance and will be assessed using comparisons with other private sale benchmarks. The Government is actively promoting the employee ownership business model therefore proceeds from qualifying sales are at 0% tax.

How will the sale be funded?

There are three ways for the trust company to fund the buy-out - company reserves, vendor loans (typically over 5-7 years, from our experience), and sometimes third-party debt is also used. Financial aspects to consider are:

- Any debt or vendor loans are structured in much the same was as a management buy-out from future cashflow (profit after tax) - it is therefore important to analyse seasonality and the head-room to pay debt plus interest from the income.
- Owners' salaries are sometimes adjusted at the point of sale.
- The trade company will make payments out of profits after tax on the vendor loan to the EOT company which will then repay the selling shareholders.
- The vendor loan is often a 'promise to pay' and therefore may not sit on the balance sheet. From a practical perspective this means that if cash flow is struggling, the loan period can be extended.
- Interest on vendor loans must be charged to ensure that there is an incentive for the management and trustees to repay the loans on schedule. Dividends can be restricted until all vendor loans or third-party loans are paid off.
- The vendor loans are typically structured as loan notes secured against the business.
- Any initial payout from reserves needs to leave sufficient working capital. Third-party debt may need personal guarantees from the sellers and will take precedent over the vendor loans in terms of repayment. The trust needs to approve reasonable finance terms.

"Employee Rewards"

- Highly motivated employee owners.
- Increased retention and better productivity as staff increase the 'stakeholder' mindset.
- Trust acts in the best interests of the beneficiaries - the employees.
- Tax free bonuses of up to £3,600 per annum for each employee.

There is significant evidence that EOTs lead to greater productivity and better support of the economy.

"Our margins have never been better, providing evidence for my long-held belief that conventional ownership, and, the cynical management that too often accompanies it, wastes huge amounts of human potential."

Guy Singh-Watson, Riverford

Avondale is a leading business advisor that helps ambitious owners realise value through employee ownership sales and transition. These are typically vendor-led sales structured over time to realise the value of the business and reward and empower the team. We are the only advisor providing a turnkey solution that covers legal, financial, trustees and consulting. This means we both deliver the right structure at the 0% tax but also ensure it works.

We believe that EOTs should be commercial in terms of the return to the seller shareholders, and create a purposeful, employee-driven and strategically advantaged business post-sale.

Avondale - providing the turnkey solution to employee ownership

Legal	Financing	Strategy and Consulting	Professional Trustee
Everything legal: the right protections	Valuation, structure & sustainability	Strong succession & transition plan	Experienced trustee experts
Draft Trust Deed and Sale & Purchase Contract	Create comprehensive due diligence room for trustees, valuation and model	Business review to increase valuation integrity and transition recommendations	Work with vendors to determine corporate trustee structure
Amend articles of target company and shareholders agreement	Model preferred funding and cashflow analysis to ensure payment terms are met	Interview key senior managers	Appointment of EOT trustees in conjunction with employees
Prepare ancillary documents.	Prepare financing memorandum if raising third party debt	Build succession capability and create training plan	Training for EOT trustees and draft trustee job description
Confirm that EOT qualifications are met and not breached by financing arrangements	Valuation integrity - forecasts and modelling - not just historic profits	Roles and responsibilities map for succession - board vs trustee	Co-ordinate legal, financial and trustee activities
Finalise all documentation - organise signing and completion	Viability report, valuation and recommendations analysis	External and internal PR support materials	Governance review - roles/ responsibilities of operating board vs trust board
Stamp duty calculation and submit stock transfer forms to HMRC for stamping	HMRC clearance application and agree loan note terms and schedule	Employee support plan - gradual change to minimise disruption	Trustee meeting agendas
Companies House and HMRC registration. Resignation letters and consent of board appointments	Qualifying clearance - sale at 0% Capital Gains	New board packs	Register corporate trustee entity
Post-completion capital structure (eg. equity allocations to staff, share option scheme)	Completion calculations and fund flow statements	Ongoing management development, support and mentoring (fees by agreement)	Prepare new corporate trustee articles and board resolutions

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