Temple tax chambers

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Selling an EOT-owned company

EOTs - background

- There are now an estimated 1,750 EOT-owned companies*
- c.30% growth in number in 2023
- This number is increasing ahead of the 30th October Budget
- ***But***, sales of EOT-owned companies are also 'snowballing' ahead of anticipated changes
- There has so far been no reply by government to responses submitted to the HMT Call for Evidence on EOTs and EBTs in 2023
- See my detailed response at:

https://davidpett.tax/2023/08/20/employee-ownership-trusts/

Source: Employee Ownership Association and Exploring the potential of the Employee Ownership business model, a report by WPIEconomics

Use and mis-use of EOTs

Founder could either:

- sell 100% to a trade buyer for, say, £10m subject to 20% CGT (and 10% BADR on £1m) = c £8.1m net proceeds;

OR

- First, (i) sell 60% to EOT for, say, £6m free of CGT (+ interest on outstanding consideration left unpaid), and (ii) grant call option to intended trade purchaser over 40% exerciseable at a pro rata value at time of later sale
- MV increases to, say, £12m when, after 2 tax years, the company is sold to trade buyer
- Original owner receives [£6m] + (£4.8m *less* 20% CGT on £3.8m (and 10% BADR on £1m) = £8.94m (+ accrued interest, subject to IT)
- EOT suffers 20% CGT 'clawback' charge on £7.2m = £1.44m, and pays off outstanding consideration of, say, £5m
- Original owner gets £8.94m – a circa. 10% uplift in net proceeds
- Employees get £760,000 subject to income tax and NICs

Pre-sale thinking

- If there is any conceivable possibility that the company or business might be sold in future, consideration (at least) should be given at the earliest stage to:
- Establishing a **Share Incentive Plan** (and a SIP trust) for the regular distribution of shares (new-issue or from the EOT) to all qualifying employees
- Sales of SIP shares will be free of IT and CGT if company sold (compare tax treatment of EOT distributions)
- Beware:
  - Gift of shares by EOT to a SIP trust (for awards of 'free shares') would breach the all-employee benefit requirement
  - Sale of shares (pursuant to an investment power) for MV needs to be funded by the company
  - Best course is to use new issue shares (par value funded by employer company making contributions to the SIP trust), but ensure dilution does not reduce EOT holding below 51%
- Shares options (EMIs?) for key managers – again, granted by the EOT-owned company – ***not the EOT trustee*** - as conditional rights to subscribe

The players

- trustee(s)
- beneficiaries
- original vendor(s)
- directors of the EOT-owned company
- trustees' bank lender
- company's bank lender
- prospective purchaser
- professional advisers
  - to the trustee(s) [lawyers; valuers]
  - to the original vendors (creditors of the Trust)
  - to the EOT-owned company
  - to the purchaser

The need for independent professional advice

"*An independent member of the bar instructed by the law firm which is acting for all parties is not the same as the same member of the bar being instructed by an independent law firm. Secondly, there will be some degree of added stringency by a law firm, which has not had prior involvement, looking at the proposed transaction, with the possibility that further lines of enquiry may be pursued to ensure the evidence is complete or additional benefits negotiated for the representative group..... It should not be assumed, however, that in future in a similar case objection will not be taken by the court.*"

per Chief Master Marsh in ***South Downs Trustee Ltd & others*** [2018]

Look first at the trust deed….

….to determine:

- who are the members of the class of beneficiaries
- who are the “excluded participators”
- is there a duty or power to make a charitable donation of residual funds?
- what, if any, constraints are sought to be imposed upon the trustee(s), e.g.
  - need for consultation?
  - specific factors to be considered?
  - [purported] restriction upon disposals?
- how are conflicts of interest addressed?
- how/when will net cash proceeds be distributed, and to whom?
- who has the power to remove and appoint (awkward) trustees?
- is there protection against removal of trustee(s) after a change of control?

Comment

- Of all the trust deeds that have crossed my desk thus far – particularly the early ones – there is often a flaw giving rise to a concern that the “relief requirements” may not have been satisfied….
- An issue for the original vendors?
- Thus far, HMRC have shown little interest in enquiring into sales to EOTs beyond those situations in which the consideration has exceeded the MV of the shares sold (HMRC treating such sales by a founding director as ERS, so charges arise under Chapter 3D, Part 7 ITEPA)

Conflicts of interest

- Original vendors/creditors of the EOT as trustees/directors of the corporate trustee
- Original vendors as sellers of minority interests and creditors of the EOT
- Original vendors/creditors of the EOT as directors of the EOT-owned company
- Trustees/trustee directors as directors of the EOT-owned company
- If individuals are unable to participate in decision-making by reason of conflicts, is there a quorum?
- Hence the importance of independent trustee/trustee director(s)

Is a sale in the best interests of the beneficiaries?

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- Who is driving the sale?
- Is it in the best interests of the beneficiaries as a class?
- "*the best interests*" has been taken to mean "the best financial interests" (per Sir Robert MeGarry VC in **Cowan v Scargill** [1985]), but that can extend to job/pension security
- If, after payment of CGT and outstanding debt to the original vendors, there is little left over for beneficiaries, how is it in their interest for the trustee(s) to sell?
- Is it the right price?
  - The trustee(s) need for independent valuation advice
- The trustee(s) do not need to balance the interests of management holders of subscription share options granted by the EOT-owned company

What if the trustees have concerns?

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- Application to the court – see CPR Part 64
- s57 Trustee Act – court may confer a power of sale, if ***the disposal is expedient*** but the power is missing
- The second limb of the rule in **Public Trustee v Cooper** [2001]WTLR 901 Ch – Hart J.- if the trustees have determined upon a course of action they may apply to the court for its blessing of a momentous decision so as to protect the trustee(s)
  - Role of court is to determine if the decision is honest and rational, not unreasonable or improper – not relevant that court would have decided otherwise
- If trustees are deadlocked, can apply under third limb: for court to exercise its own discretion
- (first limb is if trustees unsure if they have the power to sell; fourth limb is if decision later attacked as improper or ultra vires)
- The South Downs case: trustees needed to apply to the court for approval as trust deed included a restriction on sale resulting in a change of control

Need for a change of trustee(s)?

- What if…..
  - Management and employees all want to sell, but trustee is intransigent in refusing to entertain an offer – even if self-evidently beneficial?
  - Who has the power to remove and appoint trustee directors and/or the trustee?
  - The checks and balances that should have been ‘baked in’ to the corporate governance structure at the outset are found wanting?

Tax consequences of a sale of the EOT-owned company

- A “disqualifying event” occurs if, amongst other things:
  - The EOT ceases to have a controlling interest (50% + 1)
  - The EOT ceases to meet the “all-employee benefit requirement”
  - The trustee(s) act in a way which the all-employee benefit requirement does not permit
- EOT trustee(s) treated as disposing of, and immediately re-acquiring, the shares for which CGT relief originally given (and not since subject to a clawback charge), at their MV at that time
- See share identification rules in s236S TCGA 1992
- Deemed disposal is ***immediately before*** the disqualifying event
- If this occurs ***before end of tax year next following*** that in which original disposal to EOT occurred, the CGT relief for vendor(s) is lost
- If later, clawback CGT charge is on the trustee(s) by reference to the inherited base cost of the original vendor(s)
- If trustee is non-UK, a sale may be outside the scope of UK capital gains tax
- Remember **Marren v Ingles** if deferred unascertained consideration

Tax mitigation strategies?

- Distributing the fund ahead of a sale?
  - Does not avoid a CGT clawback charge on the trustee(s)
- Gifting/selling the shares to beneficiaries – even if it could be done on a basis satisfying the all-employee benefit requirement – does not avoid a clawback charge

Avoidance strategy?

It has been suggested that:

- before the sale of the company, options over all the shares held by the EOT are granted to employees (on an equal terms basis) with an aggregate exercise price equal to the aggregate liabilities of EOT, being the amount owed to to the original vendors, plus the CGT clawback charge, exerciseable upon a sale of the company
- employee optionholders are subject to PAYE income tax and NICs on option gains
- trustee is subject to clawback CGT on the deemed disposal for MV of all its shares immediately before the ***grant*** of the options. The EOT is then deemed to reacquire the shares, and its base cost is the market value of the shares at that time (presumed to be equal to consideration to be paid by purchaser of the company)
- when shares transferred to employees on the exercise of the options, the consideration is the exercise price paid (see ss149A and144ZA)
- trustee incurs a CGT loss to be offset against the gain on the clawback charge

Does this pass the "sniff test"? What could conceivably go wrong……?

(There are also technical weaknesses/risks re application of ss 144Za and 144ZB)

Corporation tax relief for share acquisitions

- Note that, if a single corporate trustee, HMRC are of the view that there is no CT relief for share acquisitions/share option gains as the company will be under the control of another company (s1008 and 1016 CTA 2009)
- Is this correct? (EOT-owned company is under the control of a trust of which the trustee for the time being in a company. Yet to be argued !)

Scheme of distribution of net proceeds

- Timing?
- Deferred consideration?
- Who is entitled to participate in a distribution
- And how is their individual ‘slice of the cake’ to be determined
  - Hours worked
  - Length of service
  - Salary level
- But when, and over what period, is this determined?
- Are new joiners eligible?
- Avoid an “earmarking” for DR purposes as this may trigger immediate liability to IT/NICs

Legitimate trustee concerns

- Avoiding the “South of France” factor – especially if there is an earn-out
- If the purchaser has (in effect) power to replace the trustee, does the scheme of distribution need to be made before the sale? Can it bind successor trustees?
- Will HMRC be concerned to intervene if distributions do not comply with the relief requirements (given that a clawback charge will have arisen and distributions are fully taxed)?
- Trustee risks – failure to properly administer the fund
- Risk of a class action – the lessons from the ***Roadchef*** litigation

Need for care re eligibility

- Note the Roadchef decision as to the meaning of "employees *from time to time*"
- The class of beneficiaries must include those qualifying employees (i.e. at least up to 1 year's service) who ceased employment in the 2 years before the trustee "ceased to hold" any shares (i.e. 2 years ending with ***completion*** of sale?) or ceased to meet the "trading requirement" (if the business is sold)
- are new (post-sale) qualifying employees entitled to participate in any distribution? Do they become eligible employees (per s236J(3)) because the company remains the principal co of a trading group – see s170(10) TCGA?
- Is it unfair not to freeze the class to employees at time of sale and those who left within the preceding 2 years?
- This is still unfair on long-serving employees who retired more than 2 years previously but may have contributed to value growth

Distributions

- May be deferred consideration and/or consideration in the form of loan notes or other securities, so there may be successive distributions over a number of months/years
- Check to see who is an “excluded participator” and if non-exec directors have also been excluded
- If trust deed allows for differentiation according to length of service/hours worked/level of salary, it means that relative shares of a distributed amount may vary significantly over time – need for modelling
- Should those factors be applied only as at the time of sale of the company/business, or at the later time of the distribution(s)?
- Does HMRC have an interest once a clawback is triggered, or is the risk that of a class action by the beneficiaries, or a group who are disadvantaged?

Tax treatment of a distribution

- As the law stands, distributions from the trust, whether of income or capital, are taxed as employment income, principally under the DR rules ("relevant step" by a "relevant third person"), but a DR charge is reduced £ for £ insofar as the amount is subject to a 'general earnings' charge
- Hence the advantage of diluting the EOT by operating a SIP/ granting EMI options and allowing employees to become shareholders
- PAYE and NICs on EOT distributions are primarily to be accounted for by the employer company, so there is a need for agreement between the purchaser and the trustee(s) that distributions are made through payroll
- Employers' NICs is a liability of the employer and reimbursement by the trustee is a breach of trust as it benefits a non-beneficiary
  - Consequences for the valuation of the company on sale?
  - Is it legitimate for the purchaser, through control of the EOT, to substitute distributions for employment bonuses?

Bringing things to a close

- If the sum available for distribution after all trustee liabilities, costs and fees are provided for, examine trust deed to see if trustee can simply make a charitable donation
- Is there a power to bring the trust period to a premature end and, if so, exerciseable by whom?
- Remember to comply with requirements of the HMRC TRS
- Should individual trustees/trustee directors expect to rely upon company indemnities after the trust has ceased to exist? Is there a need for fresh indemnities? If so, should these be negotiated as a term of the sale?

And finally…do remember to buy the book…