What is an Employee Ownership Trust and how does it work?

Kathy Granby and Matthew Rowbotham from our Tax, Rewards and Incentives team discuss the increasing popularity of moving to employee ownership, with a focus on Employee Ownership Trusts (EOTs).

In the changing landscape of business ownership, becoming employee owned has emerged as a compelling alternative for businesses and agencies alike. But what exactly are EOTs, and how do they work? What are the benefits of the structure? Does it have any pitfalls? And where do you need to be as a business to truly embrace it?

Kathy Hello and welcome to Lewis Silkin's Tax and Incentives podcast series. I'm Kathy Granby, Legal Director specialising in employee incentives and I'm joined today by my colleague Matthew Rowbotham; Partner and Head of our Tax Practice at Lewis Silkin.

Today we're here to discuss the increasing popularity of moving to employee ownership, with a particular focus on a specific model called an employee ownership trust or EOT.

In the changing landscape of business ownership, becoming employee owned has emerged as a compelling alternative for agencies. The Employee Ownership Association estimates that in the UK, the employee owned sector contributes over £30 billion to our GDP and the sector is estimated to be growing by around 10% a year.

But what exactly are EOTs and how do they work? What are the benefits of the structure. Does it have any pitfalls and where do you need to be as a business to truly embrace it?

What is Employee Ownership?

Kathy: Employee ownership has become a bit of a trendy phrase. But what does it actually mean and how is it different from employee ownership trusts or EOTs?

Matthew Rowbotham: We'll save everyone the length of employee ownership trust; we'll just refer to them as EOTs. Employee ownership is the umbrella term, and it covers lots of different structures, but the general idea is that a significant proportion of your business is held by employees of the business rather than, say outside investors. When we're talking about employee ownership, we normally go one step further than that, so employee ownership is when a significant proportion of your business is held by a broad cross-section of your employees, not just the managers which is quite a common model where you have owner managers who founded the business.

On the other hand, EOTs are a much more specific kind of structure. EOTs were created in 2014, the government introduced them and the idea behind EOTs was to highlight the existence of employee ownership as an ownership model and to incentivise people to consider moving to that structure. So, very deliberately the government introduced a range of tax reliefs that are only available for businesses that are transferring to an EOT owned structure.

In short, if you meet various conditions and one of the crucial ones is that the EOT has to, hold more than 50% of the company. If you meet all of those conditions you can get capital gains tax exemption when you sell your business into the EOT. You can also get some income tax exemptions on bonuses of up to £3,600 per annum for the employees. It's subject to a wide variety of conditions, but those are the sort of headline things that people tend to find out about EOTs first.

When is an EOT a good fit for a business?

Kathy: When is an EOT a good fit for the business, would you say?

Matthew Rowbotham: It can be suitable for all sorts of businesses and one of the ingredients that we often see that goes into this decision, is that you've got a combination of an ownership or leadership team that's looking to sell, but they also want help with a succession plan and an EOT, as we will come on to, can help support succession planning.

There's also normally another ingredient which any business could if they wanted to go down a much more conventional route of a trade sale. A sale to a larger business in the same sector or a sale to private equity.

Normally there's a reason why businesses are looking at employee ownership rather than those more conventional routes, and it tends to be to do with the sort of mindset or culture within the business. Very often those businesses have a bit more of an independent mindset or culture and they don't want that to be lost. In the course of a sale to an outside investor, they want to retain that degree of independence and in those circumstances EOT's can be a good fit.

Employee ownership can help support a succession plan, it doesn't create it, so the owners and managers of the business still need to think about what the business is going to look like post-employee ownership, who are going to be the managers of the future. All businesses whether they're employee owned or not need some kind of management teams, they need some leadership team.

What should businesses consider before moving to Employee Ownership?

Kathy: What sort of things would a business need to consider before it would decide to structure in this way?

Matthew Rowbotham: We see businesses approach this from all sorts of different angles. An important angle is valuation. When a business is sold into an employee ownership trust, that can be for a price that's anywhere up to the market value of the business; it cannot be more than market value, it can be less than market value, if the owners of the business are feeling quite generous towards the employees, but it can't be more than market value.

Because you aren't dealing with a typical arm's length negotiation with for example, a trade buyer, the owners of the business will very often want to get a professional valuation. In fact, we strongly encourage them to get a professional valuation as a part of the whole process and that professional valuation can help give them comfort that commercially, a move to employee ownership is going to be worth their while. It's not expected that owners will simply give away their business to the employees. Although that's facilitated if people do want to do it. The owners will normally want comfort that there is a fundamental commercial viability to going down this route.

There's a lot more that they need to think about beyond valuation. That's often an initial conversation but the broader conversation will be around the cash flow, how the purchase price will be paid and the identity of the trustees.

An EOT, as I mentioned, is an employee ownership trust. So, that trust structure is essentially a system by which a group of individuals or, a corporate body holds assets on behalf of other people, in this case, the employees. You need to choose trustees who are going to effectively act as custodians for those shares and safeguard the interests of the employees in the future. You need to think about corporate governance more generally, very often employee ownership is implemented with a view to having a greater degree of transparency amongst employees, greater levels of employee engagement and feedback which is consistent with the employees owning a significant proportion of the business.

It's really important that the business maps out a plan for how it's going to function in a post EOT restructure world and it's confident that employee ownership is at least a viable medium-term plan for the business. If you sell your business into employee ownership and it isn't a good fit, you may try to back out of it or the employee ownership trust has to sell to a third party within a short space of time. That's very often very disappointing for the employees and can be very punitive from a tax point of view. It is important to get everything lined up and feel confident about what that post restructure world is going to look like.

How does a business finance becoming an EOT?

Kathy: So, I understand that EOTs can be appealing to company owners as a way of selling their shares but where does the money come from for that and how does that bit work.

Matthew Rowbotham: There is a really fundamental difference between this and going down any other kind of sale route. If you imagine selling to a trade buyer or a bigger business in a similar sort of sector to you, in those circumstances the buyer might have all sorts of resources. They might have accumulated cash from their own profits, they may be able to borrow competitively. There are all sorts of ways that a buyer might finance that purchase. With an employee ownership trust, you don't have a financial investor that's looking to make a turn or a quick profit. The money fundamentally has to come from the company itself and typically the company will not have enough money in its reserves to pay for the whole business on day one.

If you have a business with a valuation of £10 million, the business will not have £10 million in its bank account, otherwise it would be worth more than £10 million. Typically, the business will have some reserves, maybe it has a couple of million pounds of excess cash, so the business will effectively contribute that to the trust to pay the first instalment of the purchase price. The missing £8 million can come from principally one or two sources. The sellers may agree that they will be paid that out over time. In other words, the company makes further contributions that might continue for a number of years, and the term for that is vendor financing but essentially that's a way that the sellers agree to take deferred payments over time. Potentially the money could be borrowed. There are lenders that specialise in financing employee ownership structures. It's very different to conventional borrowing in some ways.

The money can only ever ultimately be repaid out of the company's profits, so it really does need to be looked at in a lot of detail. In practice our experience is that a lot of SMEs go down the vendor financing route and come to a commercially acceptable schedule for payments over time.

The tricky thing as a vendor in those circumstances, if you’re the former owner manager who's selling your business into an employee ownership trust is that you're fundamentally unsecured. If the business goes downhill, let's say that £10 million business was sold into an employee ownership trust and then suffered some sort of catastrophic incident that meant that the business went downhill and insolvent after a year or two, the real disaster case scenario is that they may just have to write off that deferred payment. This means that the risks and rewards of selling into an employee ownership trust are quite different to other kinds of sale.

Are there any developments on the horizon that people considering an EOT should take into account?

Kathy: Thanks Matt. Are there any developments on the horizon that people who are considering this should take into account?

Matthew Rowbotham: Yes, there are. The government launched a consultation recently. The consultation has closed but we don't yet have the outcome of that consultation. Essentially the government thinks that the rules are a bit too flexible at the moment and is looking to narrow the conditions a business must meet in order to get all of those tax reliefs I mentioned briefly at the outset. You can see this in a number of ways, it does mean that employee ownership might get a little bit less flexible in terms of how you can set it up, but to put a more positive spin on it, it means that the government is recommitting to employee ownership.

There have been, for a while questions as to whether this government is as supportive of these tax reliefs as the government that introduced it back in 2014. This at least seems to be an indication that this is here for the long term.

In terms of how it's getting narrowed, one of the things that the consultation highlighted was that currently there's no requirement that the trustees be independent of the former owners of the business, meaning there could be a heavy overlap between former owners of the business and the individuals who make up the trustees of the EOT.

The government identified that as a potential source of conflict, which is a fair point. It is something that trustees need to be really careful of, and if they are acting as trustees and then they owe duties to the people who they hold assets on behalf, there is that potential for conflict. The government is essentially saying that they want to legislate away that potential conflict by making sure that the trustee body isn't controlled by the former owners of the business. This sounds simple on its face but one of the appeals of the current employee ownership trust legislation is that it allows a lot of flexibility for companies to design a sort of a trustee and corporate governance arrangement that works for them, so hopefully some of that flexibility will be retained and the new rules won't narrow the options too much, particularly for smaller companies.

It's all very well if you're a business with hundreds of employees, there may be a very significant talent pool from which to draw potential trustees because very often, some of the trustees will be drawn from the employee pool. If you're a smaller business, there is inevitably an overlap between good candidates for the trusteeship and people who might have held equity in the business before it converted to an EOT structure. We'll see, and as I say we don't have the outcome of the consultation. We're waiting to see if the government will go ahead with reforms and if so what the detail of those looks like.

How does this inspire the next generation and reinforce the culture of the organisation?

Kathy: I just want to pick up on the point around the benefits that this type of structure can bring to the employees, and to the workforce as a whole. How would you say this inspires the next generation and reinforces the culture of the organisation?

Matthew Rowbotham: It doesn't happen automatically, is a really important point to note. If a business is converting to employee ownership then it does have to make effort to ensure that’s made real for the employees and that they genuinely feel that sense of ownership. Superficially, it might be the case that very little changes from the day immediately prior to converting to an EOT and the day immediately after.

Ways in which that can be made to feel more real and help reinforce the culture of the organisation are as I've already mentioned briefly, you can take steps to increase employee engagement. That can involve setting up slightly more formal structures for employees to provide feedback to the leadership team. You can also have better representation of employees amongst either the directors of the company or the management more broadly, ensuring that voices from throughout the business are heard. Those, if you like, are some of the sort of softer things that a business can consider alongside employee ownership and it's all mutually reinforcing because if the employees are owners of the business of course it makes sense that they have a greater degree of feedback in various ways.

The more tangible way in which it can help with incentivisation, and recruitment is that shareholding in the business that an EOT has after this sort of structure is implemented. It has meaningful consequences, particularly (and this is the difficult bit) once the former shareholders are paid off. Inevitably whilst the former shareholders are being paid off, that does put a bit of a restriction on the cash resources of the business. It's good to ensure that employees are incentivised even during that period, but after that period, so once the former shareholders are paid off, those profits are going to stay within the business and be distributed to employees. There are all sorts of ways in which that can be done to really make the employee ownership aspect be felt by the employees of the business.

Perhaps the most obvious example, John Lewis is probably the best-known employee-owned business, and they have a bonus scheme. The way their bonus scheme works is that at the end of each year depending on how well the business has done, they declare a bonus for all employees across the board of the same percentage of salary. In other words, if the business has done very well, it might be a higher percentage, and everyone gets the same percentage of their salary. That functions in a similar way to a dividend would in a more conventional owner managed business. This really creates that connection between the employees and the success of the business. The whole thinking behind employee ownership is that if the employees are stakeholders in the business, they will collaborate better, look for ways to improve the business, be less tolerant of underperforming colleagues, which is a reported effect of employee ownership. It really encourages them all to pull together in the business.

There's all sorts of positive impacts that it can have for a business. Like John Lewis with its size and profile that does bring disadvantages as well because their bonus scheme is routinely reported on in the press and if they're not having as good a year then everyone sees the bonus drop. That acts as a very tangible measure of their success, but for most that's not so much of a concern.

What impact does employee ownership have on brand and client perception?

Kathy: Thanks Matt that's some helpful insight there. We've got time for just one more question around this. Of course, for agencies, brand and client perception is obviously very important. What impact would you say employee ownership has on brand and client perception?

Matthew Rowbotham: Most businesses expect it to have a very positive impact on their brand. Going back to John Lewis, I certainly think it's part of their brand and a lot of people are aware that they're employee owned and that creates positive associations for a lot of their customers.

When you're talking about agencies, who are no strangers to the power of marketing, they will make quite a big deal of moving to an employee ownership model quite understandably and that's at least partly in the hope that it has similar sort of positive associations amongst their customers. It does need to be explained sometimes to customers. I have had situations, particularly with larger non- UK customers, where a client of ours that had been through employee ownership really had to explain fully what this change of ownership actually meant for the business because their non- UK clients weren't entirely understanding of what was going on. But in the UK, there's enough of an awareness of employee ownership as a model that most businesses don't have to go through that process.

Kathy: Thanks Matt. It sounds like really for business owners who are thinking about succession planning, EOTs can be a really great option to consider. Also, from what you were saying there are some potentially very significant benefits to be gained for businesses which stem from that greater employee engagement and that sense of value that employee-owned businesses can inspire in their workforce.

That was fascinating, thank you very much Matt. If you're listening to this podcast and you're considering employee ownership for your business, or you want to learn more about it then please do get in touch with either Matt or myself.

Get in touch with the team:

Matthew Rowbotham
Partner

+44 (0)20 7074 8261
matthew.rowbotham@lewissilkin.com

Kathy Granby
Legal Director

+44 (0)20 07 074 8330
kathy.granby@lewissilkin.com

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