Conditions for a tax-free sale to an EOT

1

The Trading Requirement

The trading requirement is that the company being sold must either be a trading company, or the holding company of a trading group. Whilst a degree of non-trading activity is possible within the company, overall, its activities must be substantially trading.

Whilst there is no statutory definition for the word 'substantial', HMRC regard this to mean greater than 20% when considering the following metrics:

- The extent to which the turnover of the company relates to non-trade activities.
- The extent to which the asset base of the company is comprised of non-trade assets,
- potentially including amounts of cash in excess of working capital requirements.
- The amount of expenses or management time incurred on non-trade activities.

When deciding whether a company is a 'trading company' HMRC will view all of these factors in the round, and over a reasonable period of time.

2

The All-Employee Benefit Requirement

The all-employee benefit is that the benefit of the assets held by the trust, being the shares in the company, must be applied for the benefit of all eligible employees and on equal terms.

Eligible employees will be all employees or officers of the company, apart from (broadly) anyone who holds at least 5% of the ordinary share capital of the company and their relatives.

There is scope to vary the benefit between employees based on the following factors:

- Employee Remuneration
- Length of service
- Hours worked

3

The Controlling Interest Requirement

The controlling interest requirement is that the trust must acquire control of the company, being at least 51% of the company, measured by shareholding, voting power, and rights to dividends and assets. This majority ownership will ensure that the EOT has effective control over the decision-making process and direction of the company.

It is important to note that CGT relief on a disposal to the EOT is only available in the tax year in which the EOT takes control of the trust, so careful consideration should be given as to proportion of shares that will be disposed of and the timing of disposals.

The Limited Participation Requirement

The limited participation requirement requires that the ratio of participators who are also office holders to non-participator employees must never exceed 2/5: this is called the 'participator fraction'.

A 'participator' will be any person who has an interest of at least 5% of any class of shares in the company. This may include any person who is entitled to acquire shares, such as under an employee share scheme, and in some circumstances it may also include loan creditors.

This condition must be met for the 12 months up to the disposal into the EOT, as well as afterwards. In cases where the entire share capital of the company is sold to the EOT, there will be no individual participators after the disposal, so the ratio will always be 0.

4

When the requirements must be satisfied

The requirements must all be satisfied at the time of the disposal, except for the limited participation requirement, which must also be satisfied for 12 months before the disposal.

The requirements must also be satisfied forever afterwards. Otherwise, relief can be withdrawn from the vendors or a tax charge can arise on the trustees.

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EOT PROCESS

1. Determine if a sale to an EOT is appropriate. Ownership by an EOT is first and foremost a business structure, not a tax relief. Careful consideration must be given to ensure that the business can continue to succeed as an EOT or whether an alternative plan may be appropriate. Otherwise, we run the risk of the tax tail wagging the commercial dog.

2. Carry out a valuation. The company will need to be valued, to establish a fair market value for the sale to the EOT. This is important for the vendors – who will obviously want market value for their shares – and the trustees (effectively, the buyers) – who must ensure that they do not overpay.

3. Negotiate terms. The vendor shareholders will need to negotiate terms of the sale with the trustees of the EOT. This will include agreeing the sale price and payment terms. It is common for the vendor shareholders to also act as a trustee, so this step is relatively straightforward in most cases. But it is important to note that they are distincty roles with different responsibilities and care must be taken to avoid conflicts of interest.

4. Arrange governance. The trustees of the EOT will be responsible for overseeing the trust’s activities. They must work together to ensure the long-term success and sustainability of the company while also ensuring that it is run in the interest of the employees.

5. Secure funding for the sale. The EOT will need to ensure it will be able to secure the funds necessary to purchase the shares. This is usually achieved through contributions of excess cash of the business, but it is important to ensure that the company is left with enough cash in order to meet its working capital requirements.

6. Get tax clearances. We will write to HMRC to get the appropriate clearances for various elements of the transaction. This gives us assurance that HMRC agrees with the reasons for the sale and the funding arrangements.

7. Get legal documents drafted. Solicitors will draft up the necessary documents to transfer the ownership of the company to an appropriately constituted trust.

8. Completion. Once the legal documents have been agreed the sale will complete on the agreed date.

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