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Employee Ownership - The Third-Party Sale Alternative

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For many owners, there comes a time when succession planning or even selling their business becomes more than a consideration. A trade or other third-party sale is often the obvious route, but selling to an Employee Ownership Trust (EOT) can be a better option financially where the transaction is appropriately structured. This is due to the EOT being able to pay fair market value for the business, combined with Capital Gains Tax (CGT) relief and a commercial vendor financing structure.

Recent changes to Business Asset Disposal Relief (BADR, formerly Entrepreneurs' Relief) have reduced the lifetime capital gains allowance from £10m to £1m. This means that for taxpayers within the highest tax bands, capital gains over £1m will now be taxed at the higher 20% rate. This significantly reduces the potential proceeds from a third-party sale.

With EOT CGT relief, the reduced BADR lifetime allowance is irrelevant with EOT transactions. There is a significant impact, however, on sale proceeds from third-party sales. With third-party sales, the CGT payable on proceeds between £1m and £10m has basically doubled compared to the previous Entrepreneurs' Relief provision. Gains between £1m and £10m are now taxed at 20% rather than 10%.

With CGT relief and a commercial vendor financing structure, EOTs can deliver better financial results than other options, even at lower valuation multiples. Structuring subordinated vendor financing on commercial terms can provide vendors with an all-in return of 10-12%.

The key takeaway here is that an EOT transaction can be very competitive financially with other sale options and it also comes with a number of other advantages:

- Excess cash can be distributed to the vendors tax-free as part of equity value. The alternative is often paying the cash out as dividends subject to a dividend tax of 38.1% for taxpayers in the highest tax bands.
- Transaction variables are under seller control, significantly reducing execution risk.
- EOT transactions are highly flexible and can complete quickly compared to a third-party sales.
- Transaction expenses are generally much lower than those with a third-party sale.
- The vendor loan structure allows sellers to diversify wealth and generate income over time.
- Selling to an EOT doesn't preclude selling to a third-party in the future.
- The EOT transaction eliminates the need to engage and share confidential information with third-party buyers in a distracting, adversarial sale process.
- Employees in an EOT-owned business are eligible for income tax-free bonuses of up to £3,600 annually and would share in the proceeds of a future sale.
- The EOT transaction can provide long-term, stable ownership, help ensure vendor legacies and help preserve jobs.
- Finally, EOT structures can be combined with tax-advantaged share schemes to facilitate direct share ownership among staff along with their participation as trust beneficiaries.

At the end of the day, vendors need to make the right decision for themselves, their families and employees, but selling to an EOT is definitely worth considering.

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