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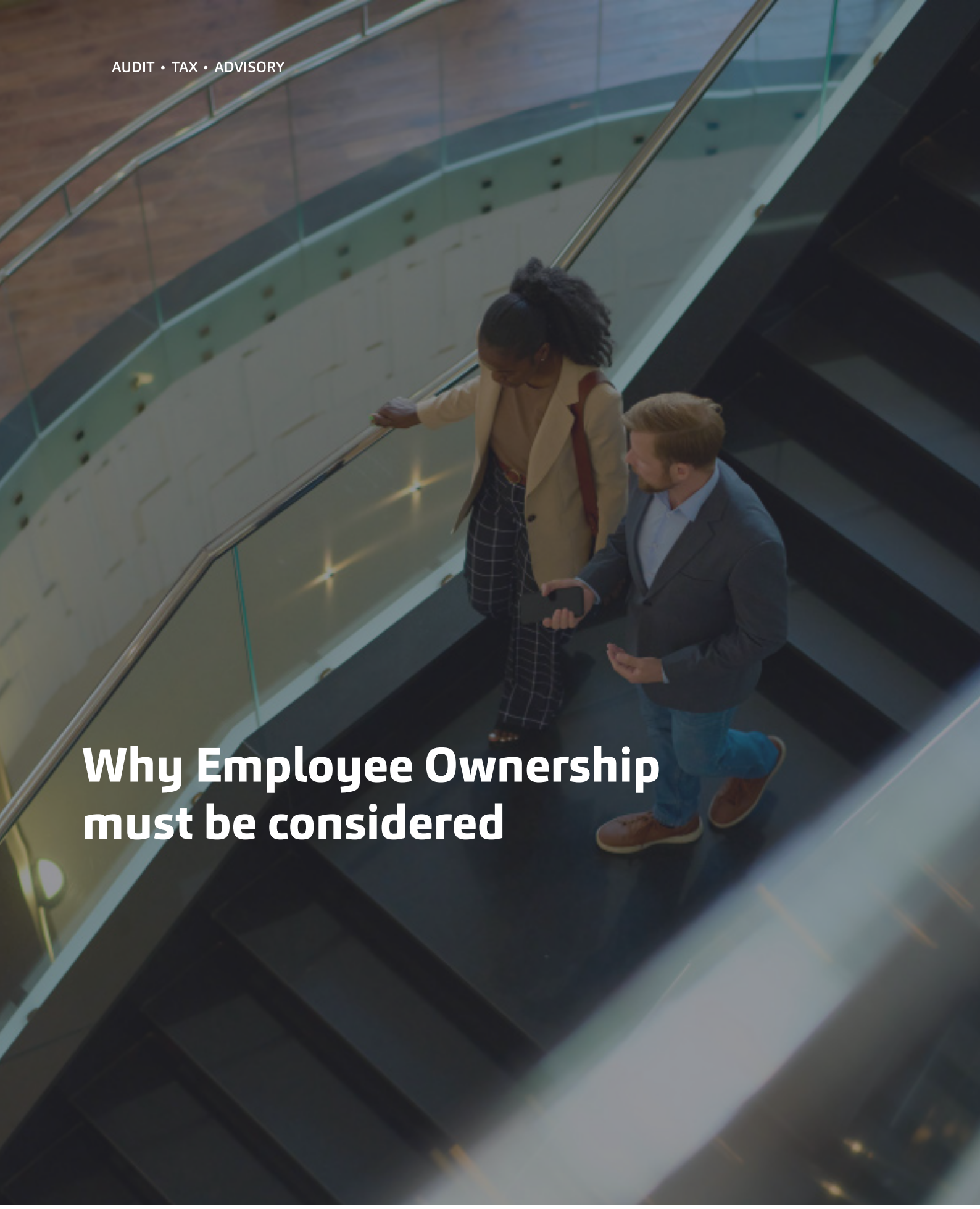

Why Employee Ownership must be considered

Now, for tomorrow

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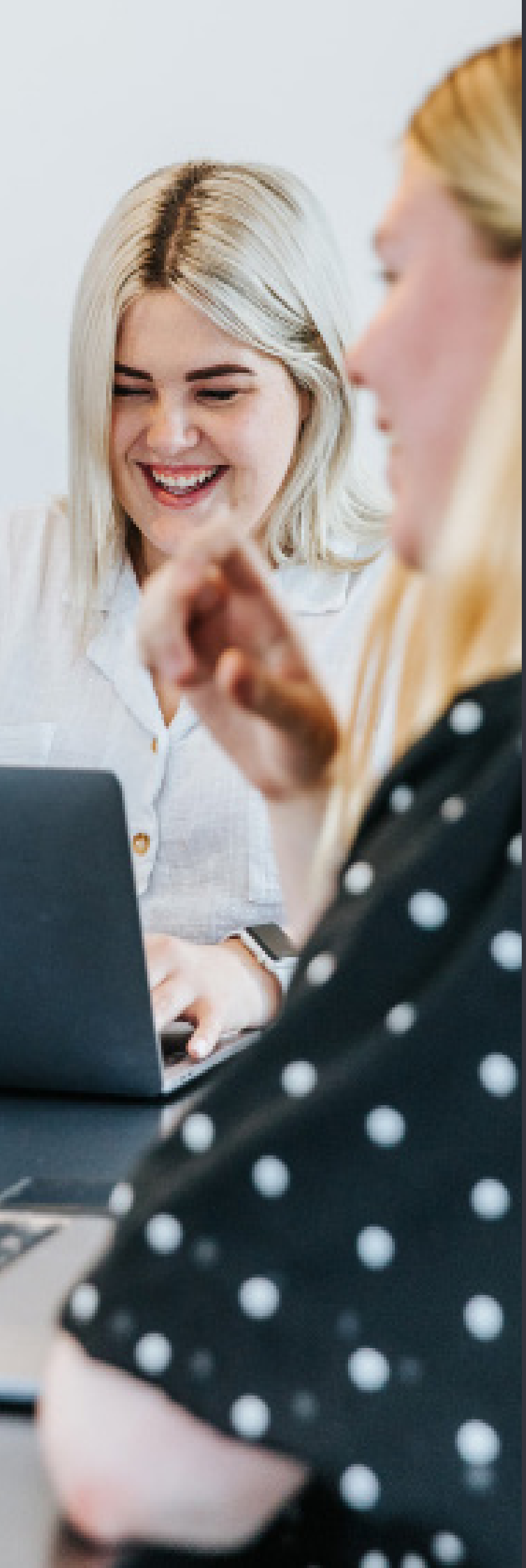
What's inside...



Introduction

As expected, the Budget on 30 October 2024 confirmed Capital Gains Tax ("CGT") rates will increase, and that Business Asset Disposal Relief ("BADR", or "Entrepreneurs' Relief", as it was once known) would effectively be ended. More onerous were the announcements to curtail Inheritance Tax ("IHT") relief for owners of trading businesses and the increase in employer National Insurance Contributions ("NIC").

By contrast, Employee Ownership Trusts ("EOTs") survived the Budget largely unscathed, despite concerns they may be targeted. Notably:

- EOTs continue to offer an uncapped 0% effective rate of CGT to vendors for gifts or sales of company shares to EOTs, provided all the necessary conditions are met.
- The Budget maintained that EOTs can be structured to avoid IHT implications on transfer, making EOTs an even more compelling option when considering that IHT relief for large estates is set to be significantly reduced.
- Whilst EOTs provide no NIC relief, they continue to allow companies owned 51%+ by EOTs to pay annual tax-free bonuses to employees of up to £3,600. This which provides more flexibility on remuneration and could help ease some of the pressure on employers brought about from the increasing NIC burden whilst retaining planned net pay.

Of course, an EOT should not be all about tax—but increasingly the tax benefits of an EOT command the need for a seat at the table for Employee Ownership ("EO") when a responsible business owner considers their exit plan and the future of the business. Hence this article focuses primarily on the tax issues.

CGT

As a reminder, an individual owning shares in a trading company/group worth £10m (before 2020) could have sold these shares with the benefit of BADR to a third party and paid less than £1m in tax. A £9m net receipt and 10% tax rate was very attractive.

In recent years, BADR was only available on gains of up to £1m, so the same individual would have paid tax at 10% on the first £1m of gains (so, £100,000) and 20% on the next £9m of gains (so, up to £1.8m). This means total tax of £1.9m and take-home funds of £8.1m. Still a good result at 19% tax.

Fast forward to the new rules from the Budget, and a higher rate taxpayer can expect to pay CGT at 14% on the first £1m of gains (so, £140,000) and 24% on the next £9m of gains (so, up to £2.16m). This means total tax of £2.3m and cash in the bank of £7.7m - an effective rate of 23%. From 6 April 2026 the rules will become more onerous still, with CGT at 18% on the first £1m of gains (so, £180,000) and 24% on the next £9m of gains (so, up to £2.16m). This means total tax of £2.34m and cash in the bank of £7.66m - an effective rate of 23.4%.

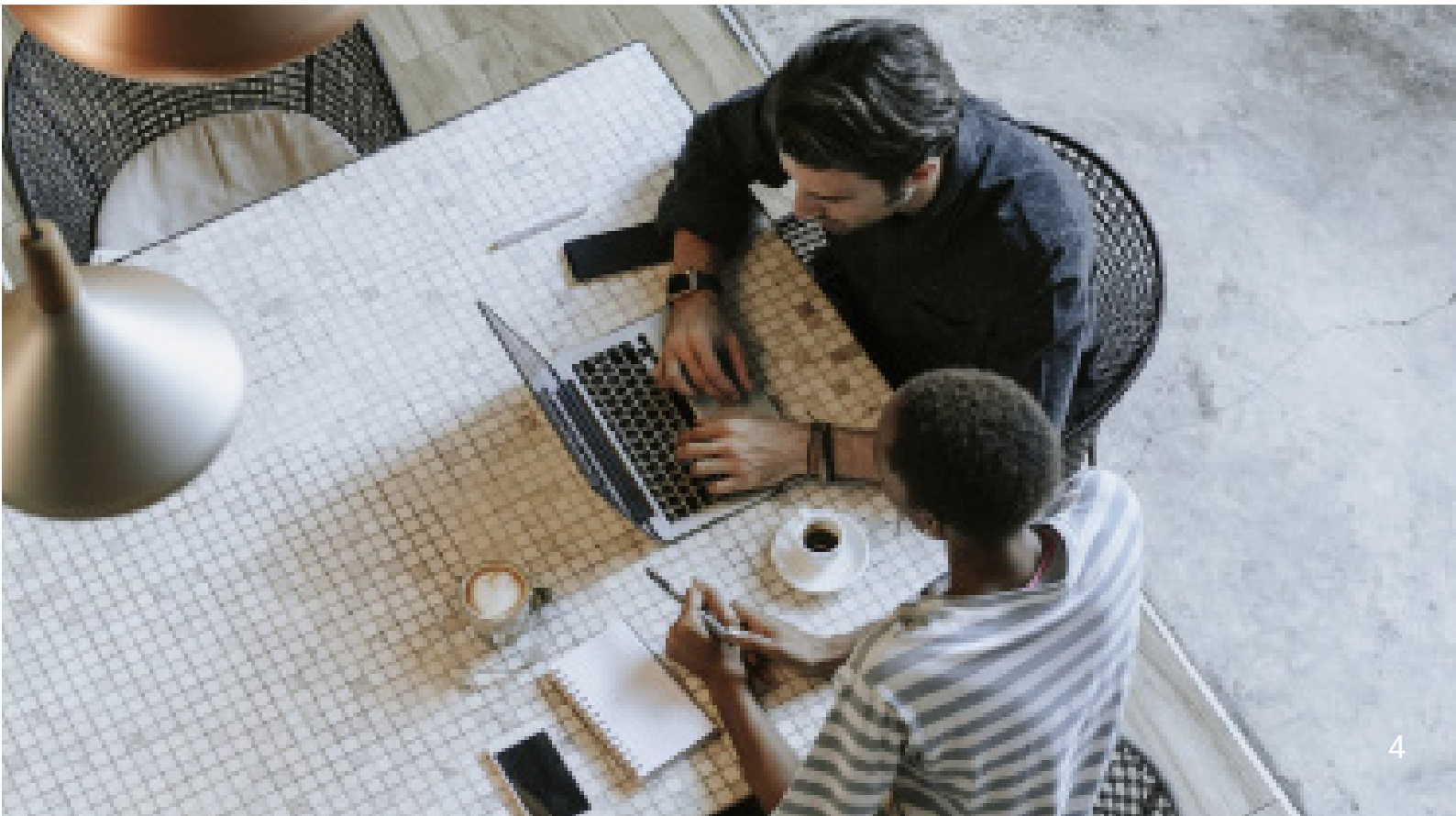
Whilst 23.4% is not a terrible tax rate (when compared to income tax rates) it is clearly going to mean significant reductions in net funds when compared to the old 10% rate and the £9m net funds that a vendor would once have enjoyed.

The new rules will mean that from 6 April 2026 will mean that BADR will now provide a maximum saving of just £60,000 compared to the tax savings it once provided of up to £1m. This trajectory suggests BADR is likely to be phased out cease altogether in the not too distant future.

Of course, CGT rates may increase further and there had been speculation they would align with income tax rates (up to 45%), although the government may have decided that 24% is the sweet spot for collecting tax without deterring people from selling assets or persuading them to become non-resident before they do.

Despite the frightening direction of travel on CGT, the government has continued to support EOTs, and it remains possible to sell one's company's shares to an EOT without a CGT bill arising. So, in the same example, £10m received, £0 tax, £10m in the bank, and £2.34m of tax saved compared to a third-party sale. The EOT relief remains uncapped despite some concern that it might be limited to the first £1m of gains. We may see the EOT CGT relief eventually being scaled back in similar fashion to BADR but for now there is still a great opportunity for business owners to utilise the relief (though, sadly, the gains are likely to eventually be taxed on the EOT trustees due to new EOT rules – see below).

Clearly a 0% tax rate is hard to beat, but vendors must appreciate that the funds will typically need to come from the company unless borrowings can be obtained. This usually makes a third party-sale preferred but the risk/ benefit analysis is now yielding more attractions for an EOT.



IHT

In many cases, it had been a commercially desirable and valid tax strategy to retain shares in a trading company or group and "keep them in the family."

The individual could have died holding their £10m of shares, and their family would have inherited them with a CGT base cost equal to market value at death. There would be no IHT on transfer because shares in a trading company should qualify for uncapped Business Property Relief ("BPR"). This is by contrast to holding cash or investment assets, for example, where the IHT exposure on £10m of value might have been 40% or £4m on death before any relief or exemptions are applied. As such, BPR has been a hugely valuable safety net for owners of trading companies or groups.

Not for much longer. Whilst the CGT uplift on death remains intact for now, from 6 April 2026, BPR will only be available on the first £1m of value. The balance of £9m (or more if the value is higher at death) is subject to an effective 20% charge on death, so £1.8m could now go to HM Revenue & Customs ("HMRC") if these shares are held at death, without planning.

With an EOT, the position under old rules was that a sale would usually see the vendor going from owning fully IHT relieved shares (due to BPR) to holding cash and debt with no BPR. This may have deterred some from selling to an EOT. Under the new rules, a vendor will be going from 50% IHT relieved shares to holding cash and debt with no IHT protection - a less frightening change in their IHT profile. As before, the cash taken from the sale is a liquid asset and allows flexibility for further IHT and wealth planning.

It is perhaps also worth remembering that there should be no IHT charge on a sale to an EOT, even where it is made at undervalue. Therefore, shares in a company could potentially be gifted to an EOT for an amount below their market value. Family could later become shareholders in the company under the EOT structure and continue to be (or become) key figures with a direct stake in the business. The EOT would need to retain more than 50% of the company.

NIC

The Budget confirmed that, from 6 April 2025, employee NIC rates will increase from 13.8% to 15% and that the NIC exempt band (secondary threshold) is reducing from £9,100 to £5,000.

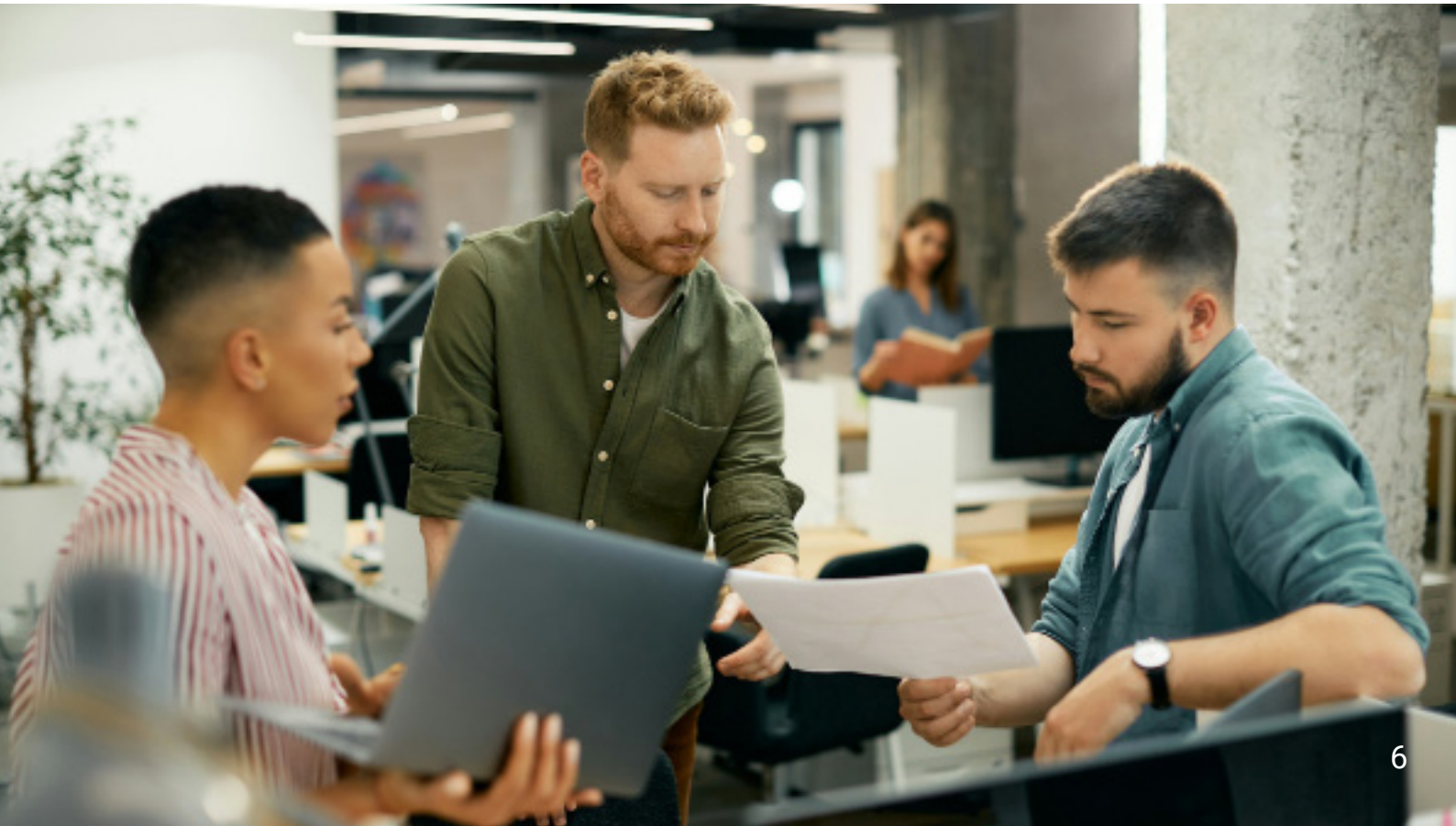
The effect on employers could be significant.

By way of example, if an employee has 40 employees that are each paid £35,000, then under the old rules the first £9,100 of salary for each employee was employer NIC free. The balance of £25,900 each would have been subject to 13.8% NIC, so £3,574 of employer NIC per employee. The salary plus NIC meant a total cost of £1,542,960. With the new rules, only the first £5,000 is NIC free and the balance of £30,000 will be subject to NIC at 15%, so the employer NIC cost is £4,500. The salary plus employer NIC meant a total cost of £1,580,000. This is an increase of £37,040 which is approximate to one person's salary plus NIC.

This The increase in NIC costs may tempt some employers to freeze planned salary increases or bonuses, or even to make redundancies.

An EOT is unlikely to directly solve these issues, but an employer under an EOT structure who is considering making such unpleasant decisions can at least consider turning to paying a tax free (but not NIC free) EOT bonus (up to £3,600 per employee per year) as a means of helping to keep staff motivated, as it allows them to deliver higher net pay to employees, whilst managing their own costs.

For example, an employer within a EOT structure could pay a tax-free bonus of £3,600 per employee and each employee would receive £3,312 after employee NIC. The employer would incur employer NIC of £540 per employee or a total employer NIC cost of £21,600 with 40 employees. Outside of an EOT, paying £3,312 net would have required a gross payment of £4,600 on which the employer NIC cost would be £690 per employee or a total employer NIC cost of £27,600 - a saving of £6,000 per year to the employer whilst delivering the same net funds to employees.



Other benefits of EOTs

As already mentioned, a transition to Employee Ownership ("EO") should not be purely tax driven. However, there are many other benefits to consider with an EOT.

Invasive and expensive due diligence is largely avoided with an EOT where only a modest level of due diligence work is usually considered necessary.

The current shareholder(s) can also largely design the EOT deal themselves (although as discussed further below, great care is needed in determining consideration) and remain as involved as they wish. After the sale, vendors cannot retain control, but they can remain influential and be remunerated for future work (in addition to exit proceeds), and potentially retain or obtain some shares.

Employees should become more galvanised, provided they are properly engaged with EO and the opportunities it provides them and the business. The culture of the business and the founder's legacy may be better preserved, with the founder's "spirit" often continuing after their exit.

The business may also become more successful because of greater employee retention, motivation, and ideas.

After a sale to an EOT, HMRC appear to accept that the value of the company for the purposes of tax employee equity plans (such as the tax favoured discretionary and Enterprise Management Incentive share option plan, or all employee plans like the Save As You Earn plan) will be suppressed by any debt owed to vendors, such that it can be a very attractive time to provide employees with options/shares. Former owners and family are not usually prohibited from partaking.

Of course, this is not an exhaustive list and there are also potential pitfalls to navigate. For example, care is needed to ensure the company can fund the exit proceeds and that all the EOT conditions are met at the date of sale and into the future. However, the key message here is that there is great flexibility with an EOT that may not be available with a management buy-in or buy-out or a sale to a third party.

What has changed for EOTs?

The Budget saw various new EOT rules introduced. More coverage on these changes can be found **here**.

Although the new rules add to the conditions that must be met to secure the tax-advantaged status of EOTs, they are generally considered to be positive changes, as they are designed to help protect the spirit of EO and to ensure a sale to an EOT is not unduly driven by the tax advantages. After all, the tax advantages were only put in place to fan the flame of EO.

EOTs can no longer be resident outside the UK, to close a perceived loophole. As well as adding to the risk of "double tax" where an EOT later sells the business, due to there their being CGT for the trustees and PAYE and NIC for the employees, this change will also add demand for UK based trustees - which creates the risk of opportunistic organisations seeking to exploit that demand, without necessarily having the suitable skills and experience that the existing population of offshore trustee companies in Jersey, Guernsey etc already has.

Under the new rules, it becomes critical to seek support from suitably experienced and qualified accountants, legal advisors, and valuation experts when considering an EOT—not least because the Budget has made it a requirement that trustees take "reasonable steps" to ensure that what they pay consideration to the vendors does not exceed the shares' market value of the shares, and that any interest charged on deferred consideration is at a reasonable commercial rate.

In practice, this may mean an expectation from HMRC for vendors to engage with reputable independent trustees (who may become harder to pick out from an increasing crowd, given the new rules mentioned above on blocking non-resident EOTs) and for those trustees to obtain formal valuations from independent valuers to evidence the new requirements on value has been met. Evidencing a commercial rate of interest may also demand greater engagement with professionals.

Some good news is the reduced need for non-statutory clearance applications to HMRC, due to them legislating on what was the rather grey area of the tax treatment of funds contributed from the company to the EOT. However, this change does not eliminate the need to apply for the relevant clearances to HMRC on many other points that arise during an EOT transaction. Rather, the new rules increase the need for careful tax planning and clearance applications to HMRC, to help manage the increased number of conditions and associated risks.

Conclusion

The initial changes to EOTs announced in last month's Budget, although designed to tighten the regime, look from the new government are generally positive for EOTs which appear to be here to stay.

The tax benefits are now even harder to overlook and, in some cases, may now be material enough to put EOTs as the first choice for an exiting business owner.

Given the increasing attraction of an EOT, HMRC will no doubt be looking at the new rules closely to ensure they are successful in limiting abuse.

How we can help

MHA are supporter members of the Employee Ownership Association and have significant expertise and experience in exit planning and EOTs. We can assist in determining whether an EOT is the right choice and then in designing and implementing the sale to the EOT, if that is the chosen route, whilst managing the tax and valuation issues throughout and providing the necessary support and guidance pre, during, and post-implementation to vendors, employees, and the business. Where an alternative route is required, our tax and Corporate Finance teams will be able to provide the advice and assistance required.

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