THE EMPLOYEE OWNERSHIP TRUST
IS IT THE OPTIMAL EXIT?

John Dunlop of Marriott Harrison explores the legal, practical and strategic issues for founders when considering whether to sell their company to an employee ownership trust, a trade buyer or private equity firm.

The choice to sell a company to an employee ownership trust (EOT) has become a serious contender in the thought process for entrepreneurs looking to release capital from their business. This type of exit strategy has become significantly more popular in the last three years, with over 2,200 companies now being owned by an EOT (*see feature article "Employee ownership trusts: time to emerge from under the radar", www.practicallaw.com/w-038-8215 and Focus "The rise of employee ownership trusts: a viable alternative?", www.practicallaw.com/w-020-1476*). This equates to more than 300,000 employees currently working for a company that is employee-owned in this way.

Invariably, founders will have spent many years building up the value in their companies so they should not discount any exit strategy too readily. The traditional exit strategies of selling to a trade buyer or to a private equity firm should also be considered. A fourth choice of exit strategy is an initial public offering, but this brings an enhanced level of regulation and oversight that often puts founders off the listing process (*see feature article "Initial public offerings: changes coming down the track", www.practicallaw.com/w-013-0099*). It will be interesting to see how the new private stock market, the Private Intermittent Securities and Capital Exchange System (PISCES), establishes itself as being within the fourth choice or as a fifth possibility (*see News brief "PISCES: the UK's new private stock market", www.practicallaw.com/w-047-3509*).

This article compares and contrasts the key exit strategies of selling to a trade buyer, a private equity firm and an EOT. It then considers the legal and practical issues to consider when selling to an EOT, and recent legislative changes that affect this process.

CHOOSING AN EXIT

When choosing an exit strategy, it is important to remember that there is no one "right" option. Founders should not discount possible avenues of receiving value from a company without properly analysing all of the relevant facts and strategic considerations (*see box "High-level comparison of exit strategies"*). Thinking about selling to an EOT may make the founders realise that they actually want to sell to a trade buyer or a private equity firm. The reverse can equally be true.

Exit options

Selling to a trade buyer, which is typically a competitor company that operates in the same industry as the target company, can be an attractive exit strategy for founders. By integrating the acquired company into its operations, the trade buyer can expand its market share, access new technologies

High-level comparison of exit strategies

	EOT sale	Trade sale	Private equity sale
Is the sale at market value?	It may be at market value but not above, and is commonly at a discount.	Yes.	Yes, but is often at a premium.
How much is usually paid on day one?	15%.	80%.	50%.
What is the effective tax rate?	0%.	24%.	24%.
Is interest paid on deferred consideration?	Yes.	No.	Yes.
Is there a corporate finance fee?	No.	Commonly.	Almost always.
What is the usual cost of adviser fees?	Low.	Medium.	High.
What is the common timeframe for the deal?	Three months.	Four to six months.	One to two months.
Does the buyer bring trade synergies?	Rarely.	Usually.	Possibly.
Does the buyer bring cross-industry expertise?	No.	Rarely.	Usually.
Is bank finance involved?	Rarely.	Sometimes.	Commonly.
What is the risk of default on deferred consideration based on?	The company only.	The company and the buyer.	The company and the cost of bank finance.
Is there further employee participation in the company?	Always.	Occasionally.	Commonly.

or achieve other synergistic benefits. As a result, trade sales are likely to offer the founders competitive terms and also bring an understanding of industry-specific challenges and opportunities, which may help to effectively scale and integrate the acquired company.

Private equity firms exist to invest in or acquire private companies with the aim of improving their operations, increasing their value and ultimately selling them for a profit. A private equity sale can offer the founders a profitable exit that provides the company with access to capital, strategic guidance and operational improvements, resulting in its long-term success.

An EOT is where the founders sell all or a majority of the shares in the company to a newly formed trust that holds the shares on trust for the company's employees (*see box "Structure of an EOT sale"*). The consideration for the shares is paid over time and a summary is that the consideration is paid free from tax (*see "Tax and drag-along rights" below*). An EOT aligns the employees' interest with the long-term success of the company, therefore increasing employee engagement and motivation, and ensures the continuity of the business without the need for external buyers.

Consideration

A trade sale is the baseline for how consideration will be calculated; that is, the market value of the company. Business synergies can significantly affect the consideration that a trade buyer is willing to pay. However, while a competitor is likely to be able to bring synergies to the company, this can involve the risk of back-office redundancies or redeployment. In practice, an EOT is unlikely to bring synergies to the company. This is because, in general, there are no new external voices bringing fresh experience.

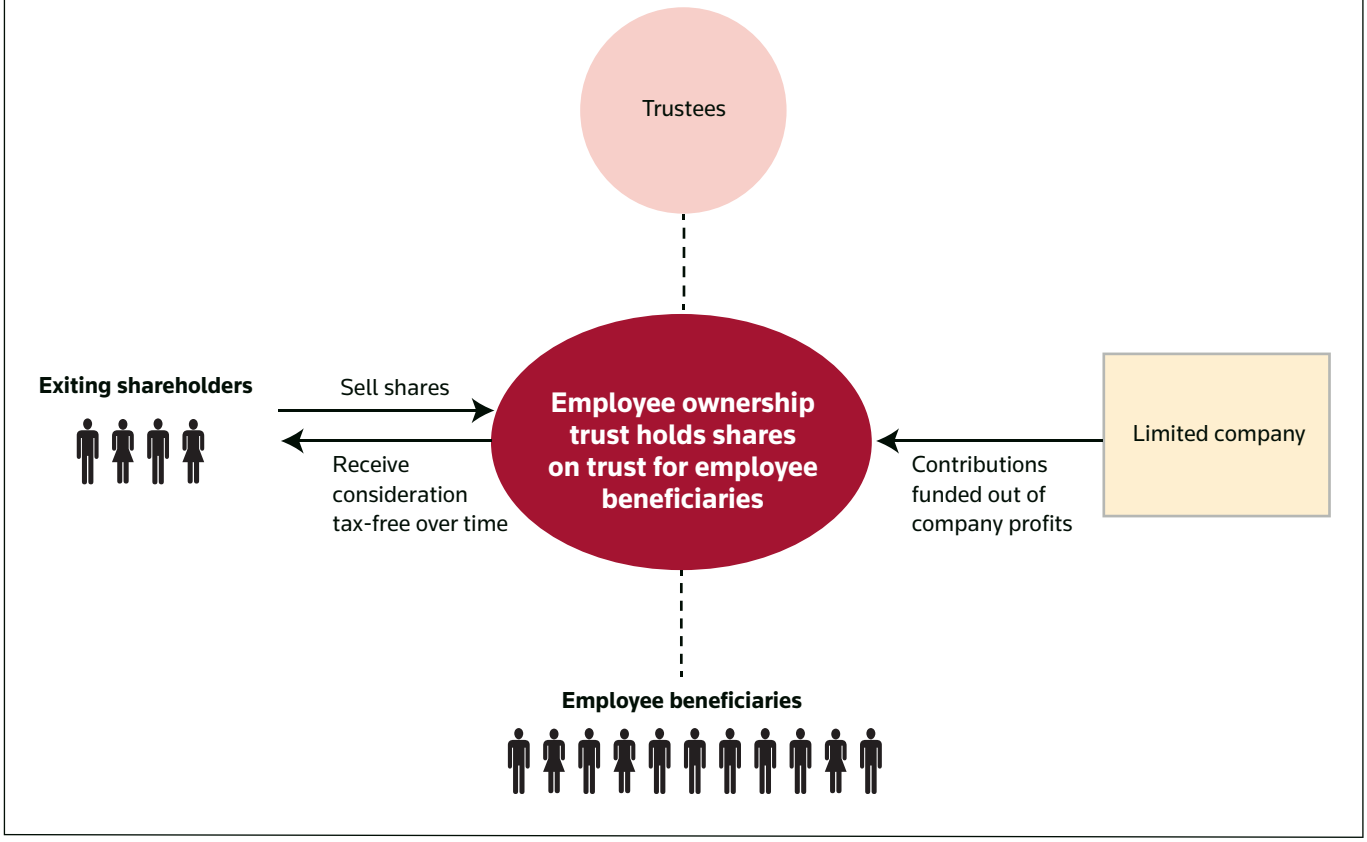
That is not to say that a sale to an EOT cannot give rise to increased profits. It is often the case that, because of enhanced engagement by the employees, an EOT will become more efficient. It would be optimistic to say that this efficiency is always enough to enable an EOT sale to match the valuation of a trade sale. In any event, the social desirability of an EOT in the eyes of the founders often means that a sale to an EOT is undertaken at a discount to market value.

Private equity buyers traditionally pay the highest price of all three exit strategies because they can factor in the use of their wider experience; for example, they may introduce better buying strategies and can lean on enhanced IT decision making and strategic thinking. In addition, private equity buyers will usually be prepared to take greater risk, have visibility across a wider range of sectors and disciplines, and will often have more lateral expertise. Trade buyers may not have that wider sector insight, but they will usually be experts in their field, having lived and breathed their sector for decades or more.

Payment terms

In terms of debt finance, it is rare for a sale to an EOT to be funded by debt, although

Structure of an EOT sale



this is changing. In most cases, the EOT is funded from its future profits, which are paid to the founders over time as they become available. The EOT model therefore dictates that the founders usually have to wait around something like four to six years to be paid all of their consideration (*see "Payments to the EOT" below*).

Historically, most trade sales were for a cash price that was paid fully on, or shortly after, completion. This has changed over the last 25 years and it is now almost standard for a sale to a trade buyer to use a more complicated consideration structure than simply pure cash on day one.

Deferred consideration is an extremely popular method to de-risk matters for the buyer; for example, by the use of an earn-out clause with 75% of the consideration to be paid on day one, with the balance to be paid two or three years later. Clearly, having an earn-out clause gives rise to payment risk. It is therefore absolutely crucial that the target company is not amalgamated with the buying company. This is where the M&A lawyer earns their money by making sure that the target company, and its trade, is ring-fenced in the earn-out period and only a fair allocation of cost is ascribed to it, and that the target company's employees are maintained in their roles.

Most private equity transactions have a significant debt component, either on day one of the transaction or envisaged in the coming months. Either way, the interest coupon attaching to this debt should not be overlooked; 5% above Bank of England base rate is not uncommon.

In a sale to a private equity buyer, it is usual to sell 100% of the shares but the founders will normally roll over 50% of their shares into the holding company. Founders and private equity firms will always rank behind any lender by way of structural subordination. The founders will only be eligible for further cash consideration relating to their rolled over 50% holding once the bank's debt and interest has been serviced.

Private equity firms pride themselves on being able to pick companies with high potential; their business model is based on these profitable companies funding their buy and build strategy. One of the benefits for the founders of a private equity sale is that private equity firms always have an exit strategy after around five years. As long as the debt has been serviced, a sale to a private equity buyer gives rise to a second cash payment, which often greatly exceeds the first.

Professional fees

While not impossible, it would be highly unusual for a sale to an EOT to incur any corporate finance fees. After all, the corporate financiers are not introducing the founders to anyone. A corporate finance firm is often involved to help the founders to find the right private equity buyer, but it is not unheard of for private equity deals to be carried out directly.

Founders who are thinking of selling their business to a trade buyer are in the best place to know who their competitors are. They would therefore normally start looking at their own contacts for a potential buyer. The founders may feel confident in identifying and negotiating terms directly, but a corporate finance firm is often engaged to drive the hard bargain that the founders are looking for.

Like all advisers, there is scope to negotiate the fees of corporate finance advisers. While there may be a small monthly retainer, the real fee can be linked to the success of the completed deal. A success fee of around 1% to 2% of the purchase price is not out of line with industry norms. There is nothing wrong with

tying reward to success. If the founders can identify what they believe to be an appropriate level of target consideration, the corporate finance firm can be engaged accordingly, with a greater percentage success fee specified if a higher purchase price is reached.

The adviser cost of a sale to private equity is the highest of the three exit strategies because of the complexity of the deal structure, especially if it is the first deal for a newly set up fund. However, the founders do not necessarily pay all of the adviser fees. The holding company commonly pays the fees relating to the roll-over, so the direct costs to the founders should not be too much higher than for a trade sale.

By contrast, if a private equity firm is embarking on a buy-and-build strategy, in practice the subsequent deals have more in common with a trade sale than with a private equity deal in terms of fees. It all depends on the complexity of the consideration structure. If there are completion accounts and multiple earn-out payments, the legal spend will increase to reflect this, but there will potentially be more upside in terms of any subsequent cash payment(s). A sale to an EOT is usually the cheapest in terms of deal costs; after all, at its heart it is a friendly deal. The recent changes introduced by the Autumn Budget 2024 have brought enhanced protection, but this comes at a cost (*see "Recent changes" below*) (*see News brief "Autumn Budget 2024: addressing the deficit?", www.practicallaw.com/w-045-0980*).

Timing

Both private equity and trade sales usually start slowly, while the buyer undertakes due diligence and obtains credit or board approval. Once the transaction process starts in earnest, the pace at which a private equity sale is executed frequently surpasses that of a trade buyer. Private equity firms, and their lawyers, pride themselves on getting the deal done quickly.

While a sale to an EOT could be the quickest of the three exit strategies, founders often take the opportunity to pause and reflect whether they are doing the right thing. As there is no one chasing them on the other side of the transactions, professional advisers may need to bring a sense of urgency in order for matters to progress.

It is important to remember that until the sale contract is signed and exchanged, founders always have the option to consider alternative exit strategies. It is not uncommon for founders to be involved in negotiations with a trade buyer while still weighing up whether they actually want to sell the company. As with all of the exit strategies, the founders may change their minds and cancel the transaction at any stage in the transaction. However, founders must be mindful of any obligations that they have undertaken through heads of terms or engagement letters to pay costs if they change their minds late on in the process.

KEY ISSUES FOR EOT SALES

If the founders choose to sell to an EOT, it is important to consider the challenges and pitfalls of this exit strategy. A number of recent legislative changes also have implications for selling to an EOT.

Market value

The sale to the EOT cannot be for more than market value. Even before considering the recent legislative changes, if a sale to an EOT was for more than market value, the founders have always had two issues:

- They would probably have to pay income tax and potentially National Insurance contributions (NICs) on the excess above market value.
- The EOT beneficiaries would have a class action against the trustees on a personal basis for breach of their fiduciary duties.

The income tax charge is a probable issue rather than a definite one because the founders might be able to avoid it if they can successfully argue that the shares are not employment-related securities. However, following *HMRC v Vermilion Holdings Ltd*, this is an extremely difficult argument to win (*[2023] UKSC 37; www.practicallaw.com/w-041-5057*). In *Vermilion*, the Supreme Court held that a share option granted to a director, which was not a reward for employment, was an employment-related securities option because it was granted by his employer and was therefore subject to income tax as earnings.

The class action would be for breach of trust; that is, by paying more than market value the trustees have favoured the selling founders over the beneficiaries of the trust. This is not an advisable thing for a trustee to do even if they have some protection of being a trustee director of a trust company rather than being a trustee in their own name.

Sector-specific advisers

When choosing professional advisers, it is paramount for the founders to engage firms and individuals who have relevant experience of both advising EOTs and advising within the company's business sector. Some sectors are free of heavy regulation but others, such as the health, legal, banking or financial services sectors, are highly regulated, for very good reasons. While these are generally accepted as important issues in trade and private equity sales, they cannot be ignored simply because the sale is to an EOT. For example:

- Sales of law firms cannot take place without the approval of the Solicitors Regulation Authority (SRA). The transaction timetable should factor this in and it is helpful to be ready to explain to the SRA why the transaction is beneficial for the firm's clients.
- The owners of a GP practice cannot be seen to monetise the goodwill of simply being an NHS GP practice. It is essential to look beyond the value of being paid by the NHS to see patients and identify other areas that are permitted to be monetised. This is very much an evolving area.

While both of these examples are of regulated sectors, they also serve as good examples of sectors where more EOTs could be seen in the coming years.

Tax and drag-along rights

As mentioned above, in simplistic terms, the consideration paid to the founders on an EOT sale is tax free. However, technically, the consideration is deemed to result in there being no gain and no loss for tax purposes (*see Briefing "The rise of employee ownership trusts: a viable alternative?", www.practicallaw.com/w-020-1476*). While this may seem to be a distinction with no difference, the recent changes announced in the Autumn Budget 2024 introduce a new rule that justifies this distinction (*see "Quick onward sale" below*).

In any event, even if the "tax free" terminology continues to be used, not all of the consideration is actually tax free. The EOT relief only applies to consideration that would otherwise be taxable as a chargeable gain in the tax year in which the EOT gains control. If there is a staged sale with, for example, 75% of the shares sold in year one and the

balance sold in a subsequent year, only that first 75% tranche is "tax free".

This may seem reasonable if, as is common, it is the founders who choose to hold onto a balance of shares to stay emotionally connected to the business. However, the target company may have drag-along rights in its shareholders' agreement, under which the majority shareholders can "drag", or force, the minority shareholders to sell their shares. If the majority shareholding is sold towards the end of the tax year and the balance is dragged along so that the sale date for minority shareholders is not until the new tax year, this is likely to result in the minority shareholders having a higher tax burden and may breach the terms of the drag-along rights, such as that the dragged minority must sell on similar or the same terms.

Therefore, it is better to have the majority shareholders drag the minority in the same tax year as the one they sold in. This needs to be factored into the deal timetable.

Key changes to the taxation of EOTs

The key changes in relation to the tax regime for employee ownership trusts (EOTs) that were introduced as part of the Autumn Budget 2024 are as follows:

- The former owners and persons connected to them cannot retain control of the EOT, either directly or indirectly, after it is sold.
- The trustees of an EOT must be resident in the UK.
- The trustees of an EOT must take all reasonable steps to ensure that the purchase price of the EOT is no more than market value.
- The period in which HM Revenue & Customs (HMRC) may withdraw capital gain tax (CGT) relief if the EOT conditions are breached has been extended to the end of the fourth tax year following disposal.
- In a claim for CGT relief, individuals need to provide information on the sale proceeds and the number of employees of the company at the time of disposal.
- Chapter 3 of Part 4 of the Income Tax (Trading and Other Income) Act 2005 has been amended to introduce a new relief from the income tax distributions regime, giving legislative confirmation of the treatment that was historically confirmed through HMRC clearance applications.

Risk allocation

Establishing the quantum of consideration and the risk apportionment between the buyer and the seller is a balancing act. The EOT trustees want the protection of knowing that they are not overpaying. They should address this by obtaining sound valuation advice and protection by way of warranties and indemnities. In terms of protection for the founders, in practice what they really want is value certainty.

Warranties and indemnities. The bulk of any sale and purchase agreement (SPA) that governs the sale of shares, regardless as to who or what the buyer is, will consist of warranties and indemnities given to the buyer. These are designed to protect the buyer from unexpected liabilities and to ensure that the company it is buying is as expected.

If warranties and indemnities are omitted in a sale to an EOT, it is difficult to justify a sale for full market value. In these circumstances, a discount must be applied to the consideration to reflect the considerable risk that the EOT is taking on by buying the target company on a no-warranty basis.

However, there is a subtle and key nuance in the nature of a sale to an EOT that can shorten the length of the SPA without de-risking the protection for the EOT. Even with the best due diligence in the world, warranties can sometimes seem like a scattergun approach hoping to hit the target. In an EOT sale, although the founders will be slowly exiting from the business and will no longer be the majority of the trustees or trustee directors, they will be in an excellent position to enable the EOT to request, and be given, targeted and focused warranties and indemnities. The founders and the EOT trustees must be wary of conflicts, but the founders know their business better than anyone and, with good advisers, can easily cut the warranties and indemnities in half without reducing their effectiveness. This will reduce the legal costs.

Value certainty. The two main issues for founders in relation to value certainty are the prospects of the EOT mismanaging the business to the point of failure or "flipping" it to a third party.

The first challenge can be addressed by ensuring that the founders retain some shares in the company, giving a legitimate reason to have a shareholders' agreement. This mechanism was used in the 1980s when the UK underwent a period of privatisation and the government retained a so-called "golden share" that gave it certain powers to protect national security and the UK's strategic interests.

If the company is "flipped", or sold on quickly, not only will the founders have lost all of their tax advantages, but they will feel "embarrassed". This latter phrase gives the clue to how to protect the founders by adding an anti-embarrassment clause to the SPA (*see Briefing "Adjusting the purchase price: anti-embarrassment protection", www.practicallaw.com/w-028-0712*). This stipulates that if there is a quick sale within, for example, three or four years, the founders would be paid a percentage of the onward profit that the EOT makes. The percentage will reduce with the passage of time and it is difficult to see this as anything other than capital gains in future years, which will be taxed in the year of realisation.

It is dangerous to forget the EOT valuation rules when drafting an anti-embarrassment clause. If the company is worth £10 million, the sale cannot be for £10 million plus a potential future anti-embarrassment payment. The anti-embarrassment right may not be worth much in the context of the particular deal but, by its very existence, it must be worth something. If the EOT trustees pay market value in addition to there being an anti-embarrassment clause, they will have overpaid, giving rise to income tax risk and the possibility of a class action (*see "Market value" above*).

HMRC guidance on consideration

Section 236H(ca) of the Taxation of Chargeable Gains Act 1992 provides that, for disposals on or after 30 October 2024, the trustees of the settlement must take all reasonable steps to secure that:

- The consideration for the disposal does not exceed the market value of the ordinary share capital at the time of the disposal.
- Where some or all of the consideration is deferred, the rate of interest payable in relation to the deferral does not exceed a reasonable commercial rate.

At CG67828 of HM Revenue & Customs' (HMRC) Capital Gains Tax Manual, HMRC sets out the following guidance on the consideration requirement for capital gains tax relief:

"The first requirement is met where the trustees took the steps that a reasonable prudent person would take to verify the consideration for the disposal does not exceed market value. Typically, this could be receiving and considering an independent professional opinion (that the consideration does not exceed market value). This opinion may be obtained by C or another person provided the trustees are entitled to rely on it. The trustees may rely on this opinion unless they have reasonable cause to suspect material facts are incorrect or incomplete. An opinion does not need to be updated to the exact time of the disposal if there are no material changes affecting an earlier opinion."

Unfortunately, this apparent relaxation of the legislative requirement can be removed at any time and would affect any future transactions.

In most cases, the founders will be happy to sell for a discount to market value and the anti-embarrassment provision protects this discount. However, assumptions can be dangerous and should be investigated.

Deal documents

The SPA should be drafted by a legal adviser who has the relevant experience. The trust deed which, among other things, sets up the EOT and establishes rules for its governance and management, must be drafted by a solicitor or barrister (or other authorised person) as it is a reserved activity under the Legal Services Act 2007.

The legislation that relates to EOTs was complicated even before the changes announced at the Autumn 2024 Budget, and includes provisions of the Taxation of Chargeable Gains Act 1992 (TCGA), the Income Tax (Earnings and Pensions Act) 2003 (ITEPA), the Income Tax (Trading and Other Income) Act 2005, the Corporation Tax Act 2010, the Inheritance Tax Act 1984 and the Companies Act 2006, among others.

A legislative checklist serves as an essential safeguard to ensure that advisers, and their clients, have peace of mind. The trust deed and transaction documents should be analysed against the provisions of the EOT legislation, especially the ITEPA and TCGA provisions that dictate what must be in the trust deed, and what cannot be in the trust deed and related documents in particular for the "relief requirements" in section 236H(4) of the TCGA.

It may be helpful to consider adding a catch-all provision which says that, in the case of interpretative doubt, the trust deed should be read so as to comply with the terms of the relevant, specifically named, EOT legislation. This is not a global panacea and one clause cannot solve all drafting mishaps, but it is hard to see how it can hurt.

It is important to consider who should be a beneficiary in the EOT; for example, while non-executive directors are paid through PAYE, this alone does not make them employees. If there is any doubt about specific individuals, the founders should think about getting them to sign a waiver of participation in the EOT.

RECENT CHANGES

Before the 2024 general election, HM Revenue & Customs (HMRC) was consulting on potential changes to the EOT legislation (*see News brief "Reforms for EOTs and EBTs: refocusing the reliefs", www.practicallaw.com/w-040-5003*). As part of the Autumn Budget 2024, the new government announced changes to the tax reliefs and conditions for EOTs, and also published responses to the consultation (*www.gov.uk/government/publications/changes-to-the-taxation-of-employee-ownership-trusts-and-employee-benefit-trusts/taxation-of-employee-ownership-trusts-and-employee-benefit-trusts; www.gov.uk/government/consultations/taxation-of-employee-ownership-trusts-and-employee-benefit-trusts*).

Some of the changes were expected to one degree or another. The changes to the rules on offshore trustees took almost no one by surprise and the changes in relation to quick onwards sales and independent trustees were highly probable. However, the other changes were a surprise to most, if not all, commentators. All of the changes took effect for disposals on or after 30 October 2024 (Budget day) (*see box "Key changes to the taxation of EOTs"*).

Offshore trustees

Previously, within certain limits, a company could be sold to an offshore EOT, such as in the Channel Islands, and a relatively short while later the offshore EOT could sell the company. The practical impact of this was that there was no tax payable on either of the two disposals. This was an extremely generous rule and permitted some relatively simple tax planning. However, it has now been prohibited and, from Budget day, sales to offshore EOTs are no longer allowed.

The EOT industry tried to persuade HMRC that, if offshore trustees were to be prohibited, some relief should be introduced to stop the double tax arising when an onshore EOT sells (*see below*). However, this hoped-for relief was not introduced on Budget day.

Quick onward sale

Once a company or, more precisely, 51% of the shares in the company, has been sold to an EOT, there has always been the risk of a subsequent capital gains tax (CGT) charge on the original founders. This usually only arises if the EOT sells its shares in the company and the founders' risk depends on the timing of that onward sale. The quantum of the tax at stake broadly relates to the actual gain that the founders made. The timing dictates who pays.

For a company that was sold to an EOT before Budget day, the founders were at risk for the rest of the tax year in which the disposal took place plus one more tax year. For a company sold to an EOT since Budget day, the time period has been extended by three years; that is, the tax year of sale plus four more tax years. Protection can be given to the founders by either giving them a veto right over sales in this period or insisting on being given a tax indemnity for this period. Whichever route the founders choose, it is important to consider the implications for the trustees' fiduciary duties and valuation issues.

After this four full tax year period, there is still a tax charge for an onward sale by the EOT but it is the EOT that bears it. If the EOT is making a return it has always had to pay tax on the gain that the EOT is itself making. There is nothing in principal to stop an EOT onward selling the company and a number of successful businesses have been sold on, such as risk and data analytics consultancy 4most's sale to private equity firm Phoenix Equity Partners in April 2023 (*https://4-most.co.uk/insights/4most-announces-investment-by-phoenix-equity-partners*).

The criticism of the EOT legislation following Budget day relates to an uncomfortable double tax charge: the EOT pays CGT and then distributes the sums to the beneficiaries, who pay income tax and NICs through PAYE. Elements of this can be softened but not entirely discounted. A number of commentators have argued strongly that this was the fair reason for using an offshore EOT.

Independent trustees

For sales on or after Budget day, the trustee needs to be independent of the founders. In practice, the trustee is usually a newly formed company so the independence is tested at the level of the trustee directors. If there are two founders who wish to contribute their time as trustee directors, three independent trustee directors are now needed. This is likely to mean that EOTs will have higher trustee director fees in the future. Moreover, finding trustee directors is not always straightforward. The company's auditors or accountants will need to weigh up any conflict, or similar, issues they have to decide when considering whether an individual can be a trustee director. With suitably mature businesses, it may be appropriate to have an employees' council or similar, but this will not be right for all companies.

Checklist of contacts

A number of different people and entities need to be contacted after a sale, including:

- ✓ Minority shareholders, in particular if there are any drag-along or tag-along provisions in the articles of association.
- ✓ Optionholders. If optionholders are entitled to exercise their options, they may become minority shareholders.
- ✓ The bank and other lenders.
- ✓ Any relevant regulator.
- ✓ Employees, particularly if pre-sale conversations were limited to key managers.
- ✓ Key clients, customers and suppliers.
- ✓ Anyone with whom there is a change of control provision.
- ✓ The accountants and other advisers.
- ✓ Any marketing agency.
- ✓ HM Revenue & Customs' (HMRC) trust registration service.
- ✓ The Stamp Office.
- ✓ Any landlord.
- ✓ Companies House.
- ✓ HMRC, in order to claim tax relief.

Putting aside the tax advantages of the Channel Islands, one of the big selling points of going offshore was the long-standing experience of offshore companies being trustees in similar circumstances. With time, the UK equivalent market in professional trustees may catch up to the Channel Islands' models, but it would be optimistic to think that this will happen overnight.

It is important to watch out for pitfalls in using old precedents. A popular provision permitted the company to be able to change the trustee but this is now specifically prohibited. However, HMRC does recognise the subtle distinction between changing the trustee, which is prohibited, and changing the trustee directors, which is permitted. HMRC's Capital Gains Manual (the HMRC manual) states at CG67827 that a "power to appoint or remove a trustee director is not a power to appoint or remove a trustee" (*www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg67827*).

Valuation of the company

From Budget day, trustees must take all reasonable steps to secure that the consideration does not exceed the market value. This change was the one that surprised most people in the industry. Clearly, it is important to ensure that the EOT does not overpay the founders but, as mentioned above, there have always been two key protections: the possibility of an additional income tax charge and a class action by the beneficiaries against the trustees (*see "Market value" above*). It was the threat of these consequences, rather than HMRC action or actual class litigation, that tempered the whole process and ensured accountability for all parties.

It was therefore a surprise to see that this is an area where the government thought that more protection was needed. The question arises of whether the government is attempting to solve a problem that does not exist. Initially, there was a fear that this

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was to be an extremely onerous obligation, but the HMRC manual has tempered matters (*see box "HMRC guidance on consideration"*).

Payments to the EOT

An EOT is funded by way of capital contributions from the company using its post-corporation tax surplus profits each year. A capital contribution is, in essence, a gift. Before the changes announced at Budget day, there was concern that this would be taxable in the hands of the EOT trustees. It was usual to get tax clearance from HMRC that this was not taxable, and this clearance was readily given. Following Budget day, there is now a detailed tax exemption for EOTs in this area so that the specific clearances are no longer necessary. This is undeniably helpful and detailed explanation is in the HMRC manual at CTM15580.

POST-SALE CONSIDERATIONS

It is easy to relax after any sale process, assuming that all of the work is done. In reality, this is where the communication and change programme begins. There are some immediate actions that need to take place shortly after the sale to the EOT and legal advisers may find it helpful to consider reminding their clients of these actions as a marketing exercise and a way to keep in touch; for example:

- Stamp duty is payable within 30 days.
- An EOT beneficiary bonus scheme needs to be in place so that the beneficiaries can benefit from the £3,600 per person tax-free payments.
- The target company must continue to pay its obligations, such as employer's NICs, and trust fund monies must not be used to pay for this.
- The EOT needs to be registered with HMRC's trust registration service (*www.gov.uk/guidance/register-a-trust-as-a-trustee*).
- Most importantly of all from a financial point of view, the "tax-free" status is not automatic and needs to be claimed in the founders' self-assessment tax return.

There are a number of individuals and entities that will need to be contacted after the sale (*see box "Checklist of contacts"*). Hopefully, the founders will have communicated with their key stakeholders before any sale process, especially in relation to any contracts which have change of control provisions. This checklist should therefore be considered as a list of people to consider both before and after the sale, with subtly different engagement depending on timing.

It is imperative that day-to-day business under the EOT's new ownership gets off to a flying start. A simple bonus scheme will have been put in place as part of the EOT. If qualifying tax-free EOT bonuses are paid promptly under this scheme, this will go a long way to getting the employees to buy into the concept. While the employees may not directly own shares, they are key to the future success of the company.

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