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An EOT could be your best succession plan

There will come a time when your mind starts drifting from the weekly 9 to 5 and starts thinking about retiring to enjoy the fruits of your labour.

There's plenty of ways to enjoy a well-earned retirement – from golfing holidays in Florida to shouting at the pigeons attacking your new vegetable garden – but before you make your choice on that, you need to decide what's going to happen to your business while you put your feet up.

The usual suspects

There's a handful of avenues available to you, but not all succession plans are made equal. The most obvious option is an external sale, but that's rarely the best course of action. This path is often fraught with difficulties.

For a number of reasons, professional services firms aren't always the most attractive to people looking to buy businesses anyway.

Plus, the culture change that is almost inevitably guaranteed under a new owner can often ruffle far too many feathers among your former staff.

A management buyout then becomes the default option, but that's fraught with problems too. It's often the case that the second generation of employees just don't have the appetite to buy the business.

Michael Holmes has over 30 years worth of experience as an accountant in professional services firms. He's all too familiar with the issues that can plague the succession process, he says:

"The next generation have often worked within a firm for many, many years and are quite risk averse - they're used to taking home a salary.

Whereas the person who's owned the firm has been entrepreneurial, set up the firm and taken the risk, the second generation aren't really that interested in putting up money."

Occasionally there will be some members who will be keen to take over, but struggle to put their hands on the sort of cash required for a buyout.

The company could take out a loan, with no dividends paid until the loan has been paid off, but unless there's a really strong balance sheet, banks are unlikely to play ball.

Employee Owned Trusts (EOTs)

That leaves us with an Employee Owned Trust (EOT). However, it's not to be thought of as a last resort. In fact, Michael believes it should be front and center of any firm's considerations when planning succession.

"If you actually mention EOT right at the start, often people say 'well let's not go through trying all the other things because this one fits so well, let's do this anyway', that's because it is actually a very good way of selling on your firm and doing decent succession planning."

Sounds promising, so what is it?

An EOT creates a separate legal entity that purchases the shares from the current owners and holds them on behalf of the employees in a trust.

The system was established by the coalition government back in 2014, in response to the Nuttall review which investigated just why firms weren't opting for the Employee Benefit Trust (EBT) succession path.

That report boiled it down to two things:

- Nobody knows what they are
- There's no benefit to them

It's safe to say that point one remains somewhat true (that's why you're reading this after all right?) but the government did manage to come up with some pretty good benefits to entice people to go for what became known as an EOT.

These benefits come in the form of tax breaks, for both the employees and the former shareholder.

Once a valuation of the business is made, the EOT purchases the shares not through a loan, but through the future profits of the company.

This is usually spread over five or six years, but crucially the former owner pays no tax on the payments they receive for their shares.

So not only do you avoid the Capital Gains Tax you'd pay on an outside sale, but you also avoid the tax on the profits you'd incur if you remained in the business and took them as a dividend.

That can be up to 38% in some cases, so not a bad saving at all!

As for the employees, they can get a profit share amounting up to £3,600 tax free too.

Everyone's a winner.

> "EOTs actually have a really good cultural fit for both the shareholder and the employees within the business."
>
> **MICHAEL HOLMES**
> Associate Director at Whitemoor Davis

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It's not just about cold hard cash though. By maintaining the culture of the business and giving employees a stake in its future, you'll encourage future success.

"One of the things that really works for owners of businesses with an EOT is that actually you're selling the business within itself" says Michael. "So, you don't get an external person coming in, the same people remain in the firm, and the culture in the firm remains the same. And you end up rewarding all the people who've helped you on the journey to the success that you've made of your business."

In fact, the Employee Ownership Association has reported impressive increases in sales and profitability for employee owned firms.

Their 2018 annual review reported a combined 6.5% rise in sales for the top 50 employee owned companies.

Productivity rose year-on-year too, up 6.2% in 2016 and then a further 7.3% in 2017.

This rise isn't surprising to Michael Holmes; "Nothing changes the culture of the business to an EOT quicker than people actually seeing a profit share."

It makes sense, right? If people are directly profiting from their hard work, then they're much more likely to put in the extra graft to ensure the business succeeds. This has been borne out by multiple studies over the years.

There are certain criteria that have to be met of course. The EOT must own over 50% of the company in question, and care must be taken not to dilute that share over the years. There must also be at least one independent trustee who has never been employed by the operating company.

Still, there's nothing stopping you as the former shareholder from sitting as a trustee, a director, or both. This could well be a great option to help ease the transition to an EOT structure.

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EOT's have garnered a bit of a bad reputation over the years, despite working incredibly well for the likes of John Lewis. But Michael Holmes is keen to stress that an EOT is not a tax avoidance scheme, but rather a government - sanctioned succession plan.

"The government wants the employees to remain employed so they can take their tax take. So they've come up with this as a route to make it easy for shareholders to sell their business into employee trusts."

"So it's not a scheme, it's a deliberate tax advantage the government have come up with so the company keeps on going."

No dodgy accounting and offshore trusts involved here then, just a straightforward, beneficial way of selling your company on when the time comes.

It's little wonder that more and more companies are opting for this succession path.

"To me, EOTs have a great cultural fit, because they're much more about their employees" says Michael.

"The employees in professional services firms in particular, tend to be highly educated, highly motivated individuals. And therefore, once you get into a proper functioning EOT, they tend to make a real difference to the profitability of the business."

Amen to that.

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