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The Employee Ownership Business Model Is Incredibly Welcome News

By Graeme Nuttall OBE

Read all about it "The UK Government endorses tax free buy-outs". Employee ownership ("EO") is finally getting the headlines it deserves. Tax exemptions introduced in the UK Finance Act 2014 are encouraging employee-ownership trust ("EOT") buy-outs and this successful and versatile UK business model is attracting momentum internationally.

As a result of the findings of the Nuttall Review of Employee Ownership (*BIS, 2012*) ("Nuttall Review") the UK Government has introduced tax exemptions with the express aim of promoting EO. Successive UK Governments have promoted share ownership by employees; encouraging individuals to own shares in the company or trust that employs them. Typically this has meant incentivising key executives. Some plans offer awards to all employees, such as the share incentive plan ("SIP"), but the awards are usually only over an insignificant percentage of a company's share capital. What the tax exemptions in the Finance Act 2014 recognise explicitly is it that EO can be part of the ownership and governance of a business. Businesses can be employee controlled and, in particular, through an EOT. An EOT holds shares collectively on behalf of all employees. There are no individual awards of shares and so an EOT is not the UK equivalent of a US ESOP. EOTs provide all employees with a significant and meaningful stake in the business that employs them through shares held in trust on their behalf. This avoids the complications of direct EO, especially for private companies. There is no need, for example, for there to be a share market to allow employees to sell shares.

The EO Business Model

EO is a business model in its own right. Companies wholly or majority owned in this way call themselves employee owned companies. The UK's Employee Ownership Association represents the sector. There are long-established flagship employee owned companies such as John Lewis, Arup and Swann Morton. Since the 1980s others have joined the sector, such as Donald Insall Associates (conservation architects), Wilkin & Sons Limited (Tiptree jams) and more recently companies such as MJP Architects and Quintessa (a mathematical consultancy).

Good news travels slowly. The business community doesn't talk about the positive business outcomes of EO, such as increased productivity and greater economic resilience combined with happier staff, as evidenced by lower absentee rates (Chapter 2, Nuttall Review). The UK Government asked "Why isn't EO mainstream?" in 2012 when it commissioned the Nuttall Review. The Government subsequently supported all 28 recommendations in the Nuttall Review. One recommendation was to change UK company law. UK share buy-backs are now easier, particularly in connection with employees' share schemes. Most of the Nuttall Review's recommendations related to raising awareness of EO. This is why, in a rare move during the Great Recession, the UK Government agreed to introduce tax exemptions to promote EO and in particular EOTs.

Tax Exemptions

Most UK owner managers who sell their companies will benefit from entrepreneurs' relief and pay capital gains tax at 10% (subject to the lifetime limit of £10 million). The new exemption in s.236H Taxation of Chargeable Gains Act 1992 provides for an unlimited CGT exemption for certain sales to an EOT. This exemption does not apply to sales by corporates and must involve an EOT (as defined) acquiring a controlling interest. The 10% difference this tax exemption makes is attracting attention to the idea of a sale to an EOT, rather than a conventional exit route.

The new EOT tax regime also offers a tax exemption that benefits the business and its employees. Once a company is EOT controlled it may pay income tax free bonuses up to £3,600 per tax year to each employee. It is possible to provide similar tax free bonuses through free share awards under a SIP. What the tax exemption fieldfisher

in s.312A Income Tax (Earnings and Pensions) Act 2003 does is remove the need to introduce a SIP. Companies that wish to maintain 100% EOT ownership can now do so without tax planning distorting the ownership model.

Versatility

EO will not be right for every business. Equity incentives for executives can be key to maintaining the development of a business. Trade sales and listings may be necessary for commercial or financial reasons. However, increasingly entrepreneurs and owner managers are looking for alternative ways to structure a business and grow and exit businesses. After the 2008 financial crisis there is greater recognition of the need for transparency and longevity in ownership and governance structures. EO offers such an alternative. At Fieldfisher we have seen start-ups introduce employee trust ownership, ranging from 10% (with a commitment to move to 100 %) in the Mary Knowles Partnership through to 100% employee trust ownership from day one at Marine Engineering Partnership. Others have used EO to provide stability and growth such as Wicker Pharmacy (with an initial 10% employee trust shareholding and a commitment to increase this as existing owners wish to sell). More recently Quintessa has taken advantage of the new EOT regime. As soon as the Finance Act 2014 was enacted its existing shareholders moved to 100% EOT ownership. Interestingly, Quintessa was employee owned before the sale but its employees prefer the EOT ownership model.

Government Endorsement

Quintessa's move to EO was welcomed by Danny Alexander Chief Secretary to HM Treasury who in Quintessa and Fieldfisher press releases said:

"This is incredibly welcome news. The Employee Ownership model not only gives workers a stake – and a voice – in the companies that employ them. It also allows them to benefit from their success. The Government has worked hard over the last four years to create a legal and tax environment that encourages more companies to set up in this way. I'm delighted that Quintessa are doing so."

International Momentum

EO, done the UK way, is generating momentum internationally. The Irish ProShare Association in an article "Lessons from Nuttall" called on the Irish Government to promote EO. The Employee Ownership Australia and New Zealand Association is making progress with support from politicians and likely tax changes. Tony Smith MP, Australian Shadow Parliamentary Secretary for Tax Reform has said

"A revolution in employee share ownership has the potential to add a couple of cylinders to our economic engine".

A delegation from Gipuzkoa, the Basque Province, visited the UK in June 2014 to re-examine EO. The headquarters of Corporación Mondragon is in Gipuzkoa. It was Mondragon that inspired the creation of the UK's Employee Ownership Association and so it is newsworthy that the UK may now be able to reciprocate ideas. These countries are assessing the full range of UK EO models, including public service mutuals.

Another strong influence in the UK has been the US ESOP. Again there are signs that the UK can repay this influence. Fieldfisher is working with US advisers to introduce an EOT into a US parent company. The existing individual owners are attracted to the permanency of the trust model of EO.

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The UK Government has recognised the benefits EO can provide to the UK economy and is encouraging its take up particularly through the EOT model. Professional advisers similarly need to recognise the benefits of EO. When entrepreneurs and owner managers ask for business solutions, EO needs to be in the mix. It needs to be considered in start-ups, growing companies and in business rescues. The new tax exemptions mean it must also be considered as a succession solution. Employee trust ownership will work outside the UK because it is successful without the tax exemptions. In the UK the new tax exemptions are raising awareness of EO, nevertheless the success stories can be repeated in all jurisdictions.

Graeme Nuttall *is a dual qualified English solicitor and chartered tax advisor. He is a partner in Fieldfisher's tax and structuring practice in London and its firm wide Employee and Mutual Ownership Team. Graeme has a longstanding interest in ensuring organisations have the right ownership and governance structures and, in particular, a long time enthusiast for the employee ownership business model.*

In 2012, Graeme took on a part-time voluntary role as the UK Government's independent advisor on employee ownership, to help bring this business model into the mainstream of the UK private sector. As the Government's independent advisor on employee ownership, Graeme produced 'Sharing Success: The Nuttall Review of Employee Ownership' (BIS, 2012). This review made 28 recommendations under three key themes: raising awareness of employee ownership; increasing the resources available to support employee ownership; and reducing the complexity of employee ownership. The UK Government accepted, partly accepted or supported all the Nuttall Review recommendations. An Implementation Group, chaired by Jo Swinson, the Minister for Employment Relations and Consumer Affairs took forward these recommendations. In 2014 Graeme was appointed an OBE for services to employee ownership.