Shared Company
How employee ownership works

www.jol.org.uk
About the authors

Robert Postlethwaite is a solicitor with over fifteen years’ experience in helping companies become employee-owned. Since 1990 he has specialised in employee ownership, and has helped a large number of companies become wholly or partly owned by their employees. Between 1998 and 2001 he was a director of Capital Strategies and between 2001 and 2003 a partner at Pinsents. In 2003 he created his own legal practice specialising in advice to private companies on employee buy-outs, employee trusts and share ownership schemes. He is the author of ‘Management of Employee-Owned Companies’, a guide for employees who become involved in the governance of their company.

Jonathan Michie is Professor of Management at the University of Birmingham where he is the Director & Head of Birmingham Business School. He previously held the Sainsbury Chair of Management at Birkbeck College, University of London, where he was Head of the School of Management & Organisational Psychology, and before that was at the Judge Business School, University of Cambridge. Before moving into academia he worked in Brussels as an Expert to the European Commission and has directed a number of major research projects on human resource management and corporate performance, high commitment work systems and innovation, and employee share ownership and employee motivation, funded variously by the ESRC, The Leverhulme Trust, and the British Academy.

Patrick Burns has been the executive director of JOL since March 2004. Before joining JOL, he was director of advocacy with The Work Foundation (formerly The Industrial Society) where he set up the organisation’s first policy division, wrote ‘The Silent Stakeholders’ and ‘New Dialogue at Work’ reports on employee involvement, set up a monthly journal on management best practice, and led research projects on company law reform for the Department of Trade and Industry, and employee motivation and productivity for the Treasury. He is a former management journal editor with publishers IRS/Eclipse and was a senior economic adviser to the TUC where he wrote policy papers on a variety of workplace issues.

Graeme Nuttall is a solicitor and chartered tax adviser. He is a tax partner at Field Fisher Waterhouse (FFW) and managing director of FFW’s share plans subsidiary, Equity Incentives Limited. He was a member of the HM Treasury Employee Ownership Advisory Group that helped develop the Share Incentive Plan and Enterprise Management Incentives. He drafted the Employee Share Schemes Bill, the only piece of legislation ever created in the UK devoted entirely to employee share ownership. He is legal adviser to JOL. He has worked on developing employee ownership in other countries (e.g. Bulgaria, Macedonia, Romania and Russia), often in conjunction with overseas governments and organisations. Graeme Nuttall is a co-author of or contributor to various publications and, in particular, Employee Ownership – Legal and Tax Aspects, the first UK book on employee share ownership.

Acknowledgements

The authors are grateful for the contributions and comments to this report made by Ann Tyler, David Erdal, Stephen May and Andrew Gunn.

Publisher

JOL is the association of employee owned and trust owned businesses. Founded in 1979 as Job Ownership Limited its member companies include the John Lewis Partnership, other long-established jointly owned companies such as Scott Bader and Swann-Morton, and a range of other employee owned businesses of all sizes from a wide variety of sectors. Wholly independent and not-for-profit, JOL is funded by its member companies.

October 2005
# Contents

**Introduction** 3

Guide to ‘Shared Company’ 3

Definitions 3

Growth of employee ownership 4  
• Role of Government 5  
• Business transfer 5

Myths about employee ownership 6

Why employee ownership is good for the economy 7

**Why employee ownership works – research** 8

Research background 8

Corporate advantages of employee ownership 9  
• Productivity and financial performance 9  
• Innovation 11  
• Customer loyalty 12  
• Talent recruitment and retention 12  
• Increase in shareholder value 12

Features of best performing employee ownership schemes 13  
• Financial participation 14  
• Participative mechanisms 14  
• Ownership culture plus collective voice 15

**How employee ownership works** 17

Employee ownership – the mechanics 17  
• What employee ownership is 17  
• What employee ownership isn’t 17

Routes to employee ownership 18  
• Ownership succession 18  
• Management and employee buy-outs 20  
• Listed companies 20

Importance of the employee trust 21  
• Creating an internal share market 21  
• Providing a permanent employee stake in the business 21  
• Facilitating employee share plans 21  
• Providing tax reliefs for gifts of shares 22
Creating direct employee ownership  
• Buying shares  
• Being given shares  
• Share options  
  – SAYE options  
  – CSOP options  
  – EMI options

Successful employee ownership  
• Is the business viable?  
• Is the necessary finance available?  
• Can current shareholders be paid market value?  
• Can the business be effectively managed?  
• Will the new ownership arrangements be sustainable?  
• What help are the available tax incentives?

Towards a new form of employee trust

Appendices

Appendix 1: Share Incentive Plan (SIP)

Appendix 2: Save As You Earn (SAYE) options

Appendix 3: Company Share Option Plan (CSOP)

Appendix 4: Enterprise Management Incentive (EMI)

References
Introduction

‘Shared Company’ is about the growth of the employee owned business sector in the UK. It aims to explain this growth, why employee ownership works, what forms it takes, when it’s right for companies, and how to make it happen.

JOL is the association of employee owned and trust owned companies – the voice of employee owned business. JOL wants this report to make company owners, business advisers, employees, trade unions, financial institutions and policy makers more aware of employee ownership and its benefits.

Guide to ‘Shared Company’

This report has two main parts:

- A survey of current research into the performance of companies with extensive employee share ownership or other employee financial participation and employee involvement – to explain how and why this combination lifts corporate performance well beyond the norm; and

- A guide to the nuts and bolts of making employee ownership happen – what it consists of, the arrangements and tax advantages that make it possible, the crucial success factors.

The report also provides a commentary on the growth of the employee owned business sector and identifies changes in awareness and in Government policy that would release the sector's potential faster.

Definitions

A number of terms are used throughout this report to describe facets of employee ownership. To avoid confusion, we use these terms in the following ways:

- **Employee ownership; employee owned businesses**: companies wholly or majority owned by their employees, including management (either directly and/or indirectly via employee trusts). In this report, the term employee owned businesses excludes worker co-operatives purely to differentiate – see the definition of co-ops below. We also explain more about employee trusts – an important feature of employee ownership structures – below.

- **Co-owned companies; co-ownership**: a slightly wider definition of employee ownership to include companies where employees, including management, have a large or significant, but minority, stake in the company.

- **Employee share ownership**: any form of shareholding, however large or small, by employees in the company they work for.

- **Employee stakeholding**: some commentators would equate this with employee share ownership, above. In this report, however, we’ve used the term slightly more broadly.
to mean a combination of employee share ownership and employee involvement. This is to distinguish companies where employees have some shares but little involvement, from companies where they have both.

- **Worker co-operatives**: one form of employee ownership. Co-operatives tend to adopt a specific form of legal entity (the Industrial and Provident Society), conform to the seven principles of co-operation, and insist on equal shares and voting rights.

- **Employee financial participation**: any form of employee profit or gain-sharing whether through employee share plans or cash based incentive plans.

- **Trust owned businesses**: this term encompasses businesses in which a company’s shares are owned entirely either or both in an employee trust and a charitable trust, in order to provide permanence to an ownership structure.

The focus of ‘Shared Company’ is mostly throughout this report on the first two above: companies where all, most or a significant minority of the equity is owned by employees including management.

The next section of the report, which reviews current research, looks more broadly at the linked combination of employee share ownership (and other forms of employee financial participation), employee involvement and ownership culture.

### Growth of employee ownership

A decade or two ago, it was possible to dismiss the employee and co-owned business sector by arguing that it consisted of little more than a small number of trust owned businesses – notably the John Lewis Partnership and Scott Bader – and many small worker co-operatives that mainstream corporates in the UK would never want or try to emulate.

Today, the sector is too big, too diverse, too influential and too effective to be dismissed in this way. Along with John Lewis Partnership and a host of co-operatives there is now a growing number of co-owned companies – some wholly owned by management and employees, some majority owned, some with a large minority stake. Companies within the broader JOL network alone (which does not include co-operatives) now have annual turnover totalling around £15 billion, and with the many companies outside the network, the co-owned sector must now comfortably exceed turnover of £20-25 billion. So the sector is sizeable.

The sector is extremely diverse. There seem to be no no-go areas for employee ownership. From home care services to polymer manufacture, from surgical blade manufacture to advertising and design, from oyster farming and seafood processing to engineering consultancy – the sector has companies of all kinds and all sizes. JOL’s member companies stretch from the 65,000 employees of John Lewis Partnership, to a workforce of seven at Micro-Robotics.

The sector is increasingly influential not least because it’s growing. And it is growing,
essentially, because it is successful. Market pressures are adept at strangling failed experiments at birth, or soon after. Failure is shunned, whereas successful corporate practice tends to get noticed, and emulated. As this report will suggest, employee owned companies are now arguably setting the pace on at least one of the most prized yardsticks for competitiveness: the ability to harness the true commitment and creativity of their employees. Employee ownership, not surprisingly, is good for employee engagement.

Some employers have looked at the sector, looked at the good practice in it, and concluded that the secret is simply employee share ownership, or perhaps simply good communication, or clever participation systems, and copied just the part they admire. Hopefully, many will have improved as a result. But a growing number of company owners, especially those considering an exit or restructuring, are concluding that it's the whole package that works best. As a result, employee buy-outs are on the increase, and decision makers like Allan Leighton, the chairman of Royal Mail, have looked seriously at the employee ownership option as a potential element in a programme aimed at transforming corporate performance and productivity. JOL's recent ‘A Stake in the Post’ report looks at the future of Royal Mail ownership.

Role of Government

What other factors explain the growth of this sector? The policies of successive Governments for a start. For well over a decade – prompted by enterprise and productivity objectives – successive Chancellors of the Exchequer of both main parties have deliberately fostered a tax regime that encourages employee financial participation. JOL has played a significant role in helping to frame some of the regulatory changes involved, such as the Employee Share Schemes Act 2002 mentioned below.

Enlightened new arrangements like the Share Incentive Plan and the Enterprise Management Incentive were designed to create more employee shareholders, rather than specifically the wider outcome of more employee owned companies. But both have been the result.

Largely thanks to HM Treasury’s determination to make employee shareholding a serious element in corporate governance, the UK now leads at least its European competitors in both the degree of meaningful employee financial participation, and in the scale of our employee owned business sector.

Business transfer

Another factor behind the steady growth of employee ownership is business succession. Thousands of company owners and entrepreneurs sell their businesses every year. Classically, most (guided by their business advisers) agree to a ‘trade’ sale, often to a competitor. But employee buy-outs appear to look increasingly attractive to owners looking for the exit door. Why?

In the first place, selling to your current management and employees is a way to acknowledge their role in helping build the business; quite apart from the fact that as owners, they will know the business, its customers and suppliers better than any external buyer.
Second, if it makes as much financial sense to sell the company to your current employees as to a competitor, why choose the latter? The fiscal environment means there can, in fact, be positive tax advantages in the employee buy-out route. We explain more about this environment, and the arrangements involved, later in this report.

Third, owners have greater control over the timing of any sale and generally over the sale arrangements.

Fourth, another and higher visibility sale option – management buy-outs (MBOs) – has a notoriously high implosion rate. Employee buy-outs do not. Company owners who have worked hard to build a business may be starting to conclude in greater numbers that employee ownership has more chance of sustaining the business they created than other, better known options.

Myths about employee ownership

Employee ownership, in the past, has been hamstrung by misconceptions about what it is and how it works. The sector’s growth has undoubtedly been held back because accountants, lawyers, trade unions, financial institutions, policy makers and others can take a negative or sceptical view of it. There is more that can be done to raise awareness of employee ownership, and to understand it, so that it is considered as a valid alternative to other business models. The views of sceptics are frequently based on assumptions that are simply wrong. To take a few examples:

- **Employee owned business means worker co-operatives.** Wrong. Co-operatives are one form of employee ownership. In turnover terms, most of the employee owned business sector does not consist of co-operatives. Most worker co-operatives are Industrial & Provident Societies, conform to the seven principles of co-operation, and insist on equal shares and voting rights. Companies within the JOL network, and a whole range of other employee owned businesses, tend not to embrace these characteristics.

- **Employee owned companies aren’t profit seeking.** Wrong. Employee owned businesses, certainly those within the JOL network, are fiercely committed to being profitable, and have to be in order to survive in the highly competitive markets they operate in. They just distribute profits differently to other businesses. Employee owned companies may be more conservative in retaining profits, and will share any distributed profits with and for employees.

- **Employee ownership and trade unions are incompatible.** Wrong. There’s nothing about employee ownership that rules out a strong, positive role for unions. JOL supports trade unions and the trade union bank, Unity Trust, is a Trustee Member of JOL. Unions operate in various co-owned companies.

- **Decision making in employee owned companies is slow because everyone gets a say before management can do anything.** Wrong. Employee owned companies – that’s companies owned by their management and workforce – tend to employ highly professional managers with decision making powers any plc would recognise,
because that’s the only way to be competitive. But these companies will also have some form of consultative or participative arrangements that allow employee shareholders to question management and hold it accountable.

- **Employee owned companies will avoid tough decisions like redundancies.** Wrong. Baulking at decisions like this would guarantee that employee owned companies go out of business in droves. They don’t. Informed employees are at least as capable as other investors, and probably more so, of seeing what’s needed to keep the business viable.

**Why employee ownership is good for the economy**

The employee owned business sector punches above its weight in terms of its value to the UK economy.

In a number of ways, the sector exemplifies characteristics that the Chancellor of the Exchequer, and successive Secretaries of State for Trade & Industry, have highlighted as imperatives for successful 21st century businesses.

Extensive employee stakeholding – as Governments have intended – tends to foster a sense of individual enterprise that directly fuels productivity. Employees in co-owned companies, precisely because they are owners, tend to be relatively entrepreneurial compared with non-stakeholding staff – they typically have a more creative attitude to their own work and the future of the business; they are more comfortable taking responsibility for decisions and accepting a lot of discretion about the way they carry out work tasks.

Employee owned companies are typically models of the kind of partnership working which the DTI has rightly pinpointed as fundamental to effective employee relations. The relatively high levels of trust and consultation in co-owned companies also mean they tend to be highly innovative. Whereas change is often seen as a threat, not to mention a surprise, in other kinds of company, co-owned companies routinely do the kind of communication and consultation that allows employees to see the purpose of change and adapt to it successfully.

Similarly, the way employee owned companies are structured means they achieve high standards of accountability and corporate social responsibility. The employee co-owners, as shareholders, tend to demand and impose relatively exacting levels of corporate transparency and integrity.

Aside from these ‘micro’ effects at the level of the individual companies, it’s fair to argue that the UK’s economy benefits from having this additional, different and vibrant business paradigm. The employee owned business sector enriches the diversity of ownership models capable of operating successfully – widening choice for consumers, funders, job seekers, suppliers and purchasers.
This section of ‘Shared Company’ explains why employee ownership is a feasible and successful business model. Many co-owned companies out-perform those owned entirely by ‘external’ shareholders. Companies with employee ownership as part of their business model often demonstrate higher productivity, greater innovation, increased customer loyalty, and enhanced talent recruitment and retention.

This is because successful employee ownership plans combine three key factors; financial incentives, employee involvement mechanisms and an ‘ownership culture’ to foster an environment where employees are motivated and empowered to act in the best interests of the organisation. Although these three factors may be present, to a greater or lesser degree, in companies with employee share ownership it is the combination of all three that best generates success. In an employee owned company all three factors will invariably exist.

Research background

The term ‘employee ownership’ – as discussed above – can be used to describe a range of business models, from workers’ co-operatives at one end, to executive share-options at the other. JOL defines a company as employee owned when employees own and control all or a majority of the equity in the company. This ownership can be direct, where employees, as individuals, own shares in the company; or indirect, where a block of shares is held in an employee trust that exercises control of the company on behalf of employees, or through a combination of the two.

However, most of the research on employee ownership chooses a wider definition, to include companies with a reasonably extensive degree of employee financial participation, rather than necessarily having a majority equity stake held by employees. This broader definition then includes thousands of ‘mainstream’ companies, many quoted on the London Stock Exchange, where ownership is largely in the hands of external shareholders but where there is also an employee shareholding plan.

In theory, employee share ownership works because an employee who has a financial stake in a company will be more motivated to ensure that the company performs well. This increased commitment will show itself in higher productivity, lower labour turnover and increased innovation, as illustrated in Figure 1.

Figure 1: Linkages from share ownership to organisational effects and outcomes (Michie, Oughton & Bennion, 2002 p. 6)
These effects can enable companies who use employee share ownership to outperform those using classic business models. Recent research provides empirical evidence supporting this theory, suggesting that employee share ownership does indeed tend to produce improved corporate outcomes. This report summarises these improved corporate outcomes.

The body of research, reported in the pages that follow, also provides a broader analysis of all the critical parts of employee ownership plans that work together to make it such a successful way of doing business. In addition to the financial incentives of share ownership, employee involvement mechanisms and an ‘ownership culture’ are key factors.

More research is needed to confirm that employee owned companies, which almost by definition will have all three critical characteristics, do produce the improved corporate outcomes. There is, however, in our view, sufficient research (e.g. the 2002 Work Foundation report) to explain why employee ownership produces even better corporate outcomes than employee share ownership involving minority employee shareholdings.

All research studies and authors cited are referenced at the end of this report.

Corporate advantages of employee share ownership

There are a number of elements in companies with some degree of employee share ownership which predispose them to outperform ‘classic’ business models. Research from the UK, US and Japan demonstrates that companies with employee share ownership, or significant levels of employee financial participation, have:

i. Higher productivity and financial performance
ii. Greater innovation
iii. Higher levels of customer loyalty
iv. Lower staff turnover
v. Increased shareholder returns.

i. Productivity and financial performance

Recent research from businesses in the UK, Japan and the US has shown that there is a positive causal relationship between employee share ownership and levels of productivity and financial performance (Conyon & Freeman, 2001; Freeman, et al., 2004; Kato & Morishima, 2002; McNabb & Whitfield, 1998; Michie, Oughton & Bennion, 2002).

Further, developing a culture ‘that emphasises company spirit promotes group cooperation, and encourages social enforcement mechanisms’ (Binns, 2004), can cut down the avoidance of workplace responsibilities, through peer pressure and other non-financial sanctions that would, naturally, lead to long-term improvements in firm performance (Freeman, et al., 2004).

For example, research in Japanese firms found an increase in productivity of between eight and nine percent when employee share ownership was applied effectively (Kato &
Morishima, 2002). Similarly, a study of US firms suggested that this increased productivity may at least in part be brought about by discouraging non-productive employees. This classic ‘free rider’ issue is a problem faced by many businesses. It can be overcome through share ownership plans because giving employees a financial stake in the company leads to a wider workplace culture of participation, which discourages avoidance of workplace responsibilities.

The results of this study demonstrated that employees in share ownership plans are significantly more likely to confront a non-performing colleague and report the behaviour to superiors than those without such incentives. This behaviour is even more likely to be found when employees ‘trust management/have good employee management relations and have some form of profit- or gain-sharing or grants of broad based stock options than in other situations’ (Freeman, et al., 2004 p. 4). This strong correlation between employees taking action against underperforming colleagues when there is both financial participation and very good employee-management relations is clearly demonstrated in Figure 2.

![Figure 2: Correlation between worker action, profit sharing and employee management relations (Freeman et al., 2004 p. 28)](image)

---

1 There are several ways in which Japanese employee share ownership plans differ from US and UK counterparts. Firstly, there are no tax incentives for Japanese corporations, though this has not stopped the percentage of those with employee share ownership plans rising from 4.4% of all firms in Japan in 1960 to 95.9% in 1992. Employees are encouraged to participate in plans by the company matching the employee’s contribution and bearing the administrative cost (in a typical example). Executives are often ineligible for membership. Shares are held in a trust, though each participant has a right to withdraw their shares, which then become privately owned and cannot be re-entered into the fund. Retired workers must exit completely and all employees leaving the plan must sell them to the trust at current market value. The trust must have a general director, who is a participant in the plan and therefore not an executive that is chosen democratically by participants in the plan on a one-participant, one-vote basis. The general director then votes independently at the AGM, in the interests of plan participants, though these decisions will not always be based on the majority opinion.

2 In this context a ‘free rider’ is a supplier of labour who deliberately works at less than full effort in the hope of being able to receive more collectively than his/her work rate would receive if rewards were individually determined.
This is consistent with the case study of Tullis Russell reported in Michie, Oughton & Bennion (2002, p. 13), where employees commented on the lower degree of supervision at the company compared to other firms in the area:

“It was reported that there were no managers on the night shift, and that this was made possible because of the commitment of the employees as a result of the culture of involvement and participation. It was said that other companies in the area did not and could not pursue such a policy – supervision would be required. (This was confirmed by the ex-employee described above, whose partner works for another major employer in the area, and who was amazed at such a practice, feeling that it simply would not work in his company.)"

Numerous other studies have noted that employee participation\(^3\) in the workplace is more effective when employees have a financial stake in, and responsibility for, the company’s performance (see for example Caulkin, 2003; Gapper, 2004; Lester, 2004).

**ii. Innovation**

Several studies (including Gudmundson, *et al.*, 2003; Rosen & Carberry, 2002; and Stack & Burlingham, 2002) have found a link between this combination of employee share ownership, financial participation and involvement in decision making (creating a ‘culture of ownership’) on the one hand, and innovation on the other. This is because ‘initiation and implementation of innovation are significantly enhanced when employees are empowered to take action’ (Gudmundson, *et al.*, 2003, p. 14).

The ability to participate in decision making processes, combined with the financial incentive, enhances an employee’s incentive to pass information on about customers, suppliers and processes, and creates a mechanism for these views to be heard and acted upon in a timely manner. Conversely, there is a strong negative relationship between innovation and a bureaucratic, centralised culture. Not only are ideas on innovation not passed up the organisational chain, but there is resistance to suggested changes imposed from above (Rosen & Carberry, 2002, p. 11).

Firms with employee share ownership tap into human capital by operating ‘policies that draw more fully on worker skills and innovation’(Kruse, *et al.*, 2003, p. 6). ‘Innovative human resource practices can improve business productivity, primarily through the use of systems of related work practices designed to enhance worker participation and flexibility in the design of work and decentralisation of managerial tasks and responsibilities’ (Ichniowski, *et al.*, 1996, p. 322).

---

\(^{3}\) Such as joint labour-management committees, quality circles, shop-floor committees and staff representation at board meetings.
iii. Customer loyalty

The use of employee financial participation to encourage quick responses to customer needs through an improved capacity for innovation may increase customer loyalty for these firms. A company’s image as an employer may also influence the behaviour of potential customers as there is a risk of long-term damage to its value if industrial relations are perceived in the public eye to be poor (Gillis, 2004).

Developing a high level of customer loyalty requires every employee to be passionate about the business and the services they offer. That passion comes from ‘ownership, trust and loyalty’ (Rosen & Carberry, 2002, p. 78). Providing employees with a financial stake in the performance of their organisation strengthens this ability to be passionate.

iv. Talent recruitment and retention

Employees demonstrating this passion for the company they work for are more likely to stay with the company and it is likely to enhance a company’s image in the eyes of would-be employees. Research conducted by The Work Foundation and The Future Foundation (2002) found that there was a link between an employee’s perceptions of a company’s image as an employer and their willingness to commit to the organisation. So it’s fair to assume that an employer with a good image will have a greater pool of potential employees to choose from, and as a consequence, if the interviewing process is efficient, they are likely to find a better calibre of employee.

v. Increase in shareholder value

In addition to the above good business reasons for adopting employee ownership, there are clear benefits for outside shareholders of publicly listed companies using some form of employee financial participation. Studies on the effect of employee share ownership have indicated a positive relationship between employee share ownership and higher stock returns when compared to the FTSE All Shares Index as shown in Figure 3 (see for example Conyon & Freeman, 2001, pp 21-23; Equity Incentives Limited, 2003).

Similar evidence on share value has also been reported in the US (see Hollod, 1998). While there remains a great deal of research to be done on examining this relationship, this initial research demonstrates the wide base of benefits accruing to businesses using employee share ownership.
Features of best performing employee share ownership plans

As the above discussion indicates, the greatest advantage comes from combining financial participation with mechanisms that increase employee participation in a company. The influence of these other mechanisms helps to explain why not all companies with employee share ownership exhibit the same beneficial results, even though they may still perform at an above average level (Kruse, et al., 2003).

Financial incentives combined with employee participation work together to improve company performance. But it does require both factors to be present. Expressed logically, how could an employee with a financial stake in a company have an impact when the employee has no way to respond to the incentives of ownership; and, why should an employee take advantage of opportunities to participate, which would lead to improved company outcomes, when there is no economic pay-off for that additional effort (Kruse, et al., 2003)? Ownership without participation and participation without ownership may even decrease performance by frustrating worker expectations and increasing conflict (Conyon & Freeman, 2001).
It is the combination of trust and good industrial relations and some form of employee share ownership that is associated with superior outcomes for companies (Freeman, et al., 2004; Kato & Morishima, 2002). Adding to this body of literature which emphasises the importance of combining employee share ownership with other mechanisms, the theoretical arguments of Ben-Ner and Jones (1995) show that if productivity is to be increased, control and return rights must be combined. This combination of control and return, enabling genuine employee empowerment has been labelled collective ‘voice’.

This body of knowledge leads to the conclusion that successful employee share ownership plans encompass:

i. Financial participation
ii. Participative mechanisms, and
iii. An ownership culture encompassing what academics term a collective ‘voice’.

i. Financial participation

Financial participation can describe a wide array of different incentive arrangements, encompassing employee share ownership, profit sharing, profit related pay, save as you earn schemes, company share option plans, performance related pay and/or bonuses, special pension provisions, and other employee benefits related to the performance of the company.

Research has found that these sorts of incentives do have a positive relationship with the financial performance of the company, but that providing more than one of these benefits may not result in further financial performance improvement (McNabb & Whitfield, 1998).

Additionally, some research (see Kruse, et al., 2003 for example) has found that the percentage of the company owned by the employees has no significant impact on the measures of performance, and that financial participation in the absence of supporting participation mechanisms may actually decrease company performance (Conyon & Freeman, 2001).

ii. Participative mechanisms

Participative mechanisms, used as part of a company’s human resource management strategy, encompass employee involvement in decision making processes, methods of sharing information with employees and other policies that encourage dialogue between different parts of an organisation.

5 Such research cannot on its own establish causal relationships between the two variables, merely a strong positive correlation. Hence the need for detailed case study work, as reported for example in Michie, Oughton & Bennion (2002).

6 Such as quality circles, employee task forces, autonomous work groups, employee involvement in new hires and employee representation on the board of directors.

7 Including newsletters, memos, email, internet, bulletin board, regular meetings at dept./workgroup level, regular meetings at company level, centralised file of policies/procedures and new employee orientation.

8 Including formal grievance procedures, labour-management training, employee surveys, bonuses paid on individual performance and a suggestion system.
Research on the role of such participative mechanism in establishing a culture exhibited in successful employee share ownership firms has found that the more of these human resource policies a firm incorporates into its structure, the more employees are likely to show greater effort (Kruse, et al., 2003, p. 11).

Logue and Yates (1999) found that, though employee participation without financial participation may be effective in the short-term, firms that offer this will find that in the long-run employee enthusiasm for participation will diminish as employee participation, in several instances, will involve greater worker responsibility. So staff are likely to feel cheated by the employer if there is no financial reward for this increase in responsibility.

These findings add further weight to the argument that employee share ownership is more successful if coupled with employee participation.

iii. Ownership culture plus collective voice

A culture of ownership encompasses the previous two conditions for successful employee share ownership plans and implies that employees feel able to act in a way similar to that of any other business owner – implementing changes to benefit the business as a whole. Stack and Burlingham (2002) have, amongst others (for example Chu, 2003; Rosen & Carberry, 2002), pointed to a ‘culture of ownership’ as being the key to a company’s ability to innovate.

A culture of ownership cannot be fostered where there is cynicism about the motives for offering employee share ownership plans, or a lack of visible change to management practices after the transition. If the company offers an employee share ownership plan but this doesn’t change a fundamentally negative employer attitude to the workforce, the employee is likely to see the implementation of employee shareholding in a cynical light. In other words staff will see it as simply another management ploy and not actually linked to a drive for increased employee satisfaction, improved company performance or employee involvement.

An effective means of ensuring that a culture of ownership comes about as an extension of offering employee share ownership is to ensure that employees are properly consulted, and the most effective way of achieving this is to create – and then listen to – a collective ‘voice’ of the employees (The Work Foundation & The Future Foundation, 2002).

In Japan, employees’ shares are held in a trust and this perhaps goes some way to explaining the 8-9% increase in productivity that Japanese firms using employee share ownership enjoy (Kato & Morishima, 2002). These trusts act as a collective voice for the employee owners, ensuring that their views are incorporated in all levels of company management.

Such trusts, or employee shareholder associations, have the capacity to represent employees’ opinions as a whole, and hence to become a more powerful voice than could be achieved if each individual employee spoke separately. In UK companies it is unusual for there to be employee shareholder associations with the potential to act as a pool for
employee owned shares. There are, however, in employee owned companies invariably one or more employee trusts, as explained below. A mechanism like this permits more employee empowerment and influence in the governance of the firm (Pendleton, 2001). If the voting rights, though not necessarily the ownership (as is the case in Japanese firms) are pooled together, employees would have a significant voice. Employee shareholding, if it was coupled with an employee share trust, would therefore be the medium through which financial performance and the welfare of employees could be improved (Michie & Oughton, 2001).

For most quoted companies, pension funds and various financial institutions are the majority shareholders. Shareholder pressure can lead to decisions being made for short-term reasons rather than re-investing capital into areas which will only pay dividends over a longer time period, such as research and development. The short-term returns that institutional shareholders often expect may prove unsustainable in the medium to long-term if internal investment suffers as a consequence (Michie & Oughton, 2001).

So there may be a conflict of interest between those who wish to ensure the long term success of the company (likely to include the workforce) and those such as fund managers, who are likely to prefer short-run growth in the share price and high dividend returns. Institutional shareholders in the UK tend not to be greatly interested in aspects of the company other than the share-price and dividend payouts. They tend not even to attend the AGM and there is nothing stopping them selling their stake at any time. If employees own shares they are more likely to have a long-term view.

So employee shareholding, and more specifically, pooling these shares into trusts would be likely to enhance the long-term view that is vital to ensuring increased investment in R&D and the workforce, which in turn is key to closing the productivity gap with the UK's competitor economies. The UK needs to boost long term investment not only in R&D, innovation, and ‘human capital’, but also in the capital stock more generally, where we have lagged behind other countries since the mid-1960s (Kitson & Michie, 2000, pp. 118-20).
Employee ownership – the mechanics

What employee ownership is

Employee ownership enables employees to own a controlling interest in the company for which they work. This could involve all, or a majority, of the company’s shares being held by or on behalf of all employees, including management.

Employee ownership can take two main forms: direct and indirect.

• Direct employee ownership involves employees becoming individual share owners – together holding a majority of the shares in their company; receiving dividends; voting at shareholder meetings (and together being able to determine who its directors are); and receiving sale proceeds should they sell their shares;

• Indirect employee ownership involves shares being held on behalf of employees, normally through an employee trust. The trust is the shareholder and the trustees – who may include trustees elected by the employees – decide how any benefits they get from their share ownership should be used. Typically, these might include:
  – how to vote the shares at shareholder meetings
  – whether to pass on to employees financial benefit deriving from the shares (typically, dividends), and if so, how
  – whether to pass any of the shares to employees, so changing from indirect to direct share ownership

There are other uses of an employee trust, as explained below.

What employee ownership isn’t

As this report has already emphasised, employee ownership is distinct from:

• other arrangements under which employees hold shares or have shares held on their behalf, where those shares together do not amount to a controlling interest;

• other forms of financial participation, such as profit sharing, commissions, bonuses and gain sharing. Each of these involves a cash reward linked to the financial performance of a business, a team or an individual, but none of them involves holding a long term financial stake in a business.
Routes to employee ownership

Employee ownership can work successfully in any business; it isn’t ‘sector specific’. In the UK, there are successful employee owned companies in manufacturing, department stores, civil engineering, specialist printing, architecture and many other sectors. Looking at companies which have arranged for a majority of their shares to be held by or for their employees, the next part of ‘Shared Company’ describes the main routes they’ve taken to achieve this.

Ownership succession

A number of UK private companies have chosen employee ownership as a way of allowing shareholders to sell. Typically, the owner managers of a business built by entrepreneurs (or inherited as a family business) might sell the whole or a significant block of their shareholding to an employee trust. This is how the process will often happen:

- Shares are acquired by an employee trust
- The trust is financed by contributions from the company, or from an external loan which is repaid (wholly or partly) from company contributions
- If the trust is solely financed by the company, it may take some time before the trust has received sufficient funds to finance the purchase of all or even a majority of the issued shares in the company
- If the trust is partially or wholly financed by an external loan, this may enable it to acquire a majority shareholding or even all the issued shares in one go
- The trust may retain some or all of the shares which it has acquired on a long term basis, or it may distribute shares to employees over time. To the extent that employees pay the trust for their shares, this will reduce the amount the company needs to provide for the trust
- The intention may be for the company to remain wholly or partly owned by employees and/or the trust indefinitely
Steps:

1. Bank lends to an employee trust
2. Trust uses loan to buy shares from current shareholders
3. Shareholders transfer shares to trust in return for payment from trust
4. Over subsequent years, company pays funds to trust (financed by company profits)
5. Trust uses those funds to repay its loan and pay interest
6. Trust may transfer some or all shares to employees

An increasing number of banks and other financial institutions have experience of financing this sort of structure, although banks may have a relatively high level of minimum lend. Banks could do more to publicise their willingness to provide this sort of lending (sometimes called cash-out lending).

The arrangement described above begins as indirect employee ownership – placing shares in a trust. But over time it may evolve into partial or full direct employee share ownership as well, as *shares are transferred into individual employees’ hands*.

Where employees do acquire shares directly, it would be unusual for the trust ultimately to become entirely empty of shares because of the benefits of retaining some shares in trust. Sometimes a policy decision will be taken that shares are not to be distributed to employees by the trust. Such a decision is actually necessary for the long-term retention of employee ownership. We go further into the reasons for this approach later in this report.
Management and employee buy-outs

MBOs, often backed by private equity, are a recognised solution to ownership change in the UK. A typical scenario is the sale of a non-core or underperforming subsidiary to a new company, financed by private equity and debt, in which directors and possibly senior management make a substantial equity investment. The theory is that the management team will look at their business in a new light, with a new and powerful motivation to develop profitable new businesses and make existing business lines perform better.

And the practice supports the theory, as the amounts of private equity tied up in MBOs bears out. With more than twenty years experience, the UK has developed comprehensive know-how and a powerful infrastructure for planning, negotiating and financing MBOs. According to the Centre for Management Buy-out Research, private equity houses had £37 billion invested in UK MBOs at the beginning of 2004.

MBOs are big business, but how often are the rewards of success shared with the employees who have contributed so significantly to achieving it? While some companies in the UK have experimented with employee buy-outs, or management buy-outs with employee participation, the reality is that few buy-outs currently involve employee ownership. Most private equity houses, now the usual masterminds behind an MBO, take the view that employee ownership makes the process too complicated. They may also assume that arranging for a majority stake to be acquired by or for employees won’t provide them with sufficiently high returns on their investment.

However, there are occasional exceptions to this approach (one of which – Baxi Partnership – is discussed later in this report). The number of buy-outs involving employee ownership would rise sharply if more private equity investors were prepared to endorse this approach.

Listed companies

UK listed companies have proved highly committed to encouraging their employees to become shareholders. Since the privatisations of the early 1980s which gave employees priority in applying for shares, employee shareholders have been a constant feature in the ownership of UK listed companies. The availability of tax incentives (SAYE and SIP) has been one positive factor, but it has also become accepted wisdom in senior management that having employee shareholders can make stronger companies. It is estimated that 97% of companies in the FTSE 100 operate an SAYE option plan.

There are no listed companies which could describe themselves as employee owned. However, there are opportunities for some listed companies to be taken private in ways which featured employee ownership. For example, employees of an underperforming company which needed to restructure and reduce overhead might negotiate a majority shareholding as part of a wider agreement on terms of employment. A listed company could take a long-term strategic view that it no longer needs to have a public market in its shares. It may not need, in the foreseeable future, to raise equity finance or make corporate acquisitions by ‘share for share’ acquisitions: an employee ownership model could provide the best long-term ownership structure for the business.
Importance of the employee trust

This report has already made frequent reference to employee trusts. An employee trust is a trust for the benefit of employees. Without an employee trust, it’s unlikely that most companies will ever become employee-owned. This is because in the majority of companies, employees can’t finance the purchase of a controlling interest. They might be able to buy some shares, and may be willing to take out a personal loan to contribute to the purchase price, but they can rarely raise all the money. An employee trust provides a solution. As already explained, the trust, by borrowing funds itself (normally guaranteed by the company) will often be able to acquire a significant shareholding. Having done so, it will repay its loan from future contributions by the company – in other words out of normal cash flow and profitability.

An employee trust has other potential benefits. These include:

- **Creating an internal share market**
- **Providing a permanent employee stake in the business**
- **Facilitating employee share plans**
- **Providing tax reliefs for gifts of shares**

**Creating an internal share market**

- One of the frequent uses of an employee trust is where a company wishes to create some liquidity to make share ownership more meaningful for its employees.

- Employees wishing to sell can offer their shares to the trust which can be funded either by other employees wishing to buy shares, or by the company. The company can fund the employee trust either by way of loan or by a cash gift and this enables shares to be recycled for employees.

**Providing a permanent employee stake in the business**

- A company may choose to park a number of shares in the safe and stable hands of an employee trust. By putting a block of shares in the hands of trustees whose duty is to act in the best interests of employees, an employee trust can help create long term stability in an employee owned company. This can act well as an employee communication tool. In effect value is captured for employees, which could be distributed to those employees if there is ever a sale of the company.

**Facilitating employee share plans**

- An employee trust may be used to hold a pool of shares pending their distribution to employees under one or more employee share plans. There are limits on the value of shares that may be distributed to employees under the Government’s tax advantaged share plans and so it may take several years before the pool is fully allocated. A reserve
of shares may be retained in the pool to be used for awards to new employees as the company expands.

**Providing tax reliefs for gifts of shares**

- If an owner of a business wishes to give away shares, or sell shares at less than market value to an employee trust, there are inheritance tax and capital gains tax reliefs to encourage this.

**Creating direct employee ownership**

It will often be the case that employee ownership begins with an employee trust, holding shares on behalf of employees. But over time, *direct employee ownership* of shares can be created. Ownership of shares brings access to potential financial rewards and, if the shares are voting shares, some element of employee involvement. The financial rewards come through receiving any dividends and any profit on a sale of the shares. Government policy aims at enhancing direct employee share ownership and so an understanding of the HM Revenue and Customs 'approved' tax effective ways of employees acquiring shares is important when planning an employee ownership business model. Quoted companies can easily make use of tax incentivised share awards as part of benefits packages. In order to compete when recruiting, trust owned companies, that would otherwise prefer not to distribute shares, may have to introduce tax advantaged share plans.

In the UK, employees typically become shareholders directly in their company through one of the following routes:

- *Buying shares*
- *Being given shares*
- *Being granted share options*

**Buying shares**

- Buying shares in your employer is a relatively high risk form of investment, as it is both equity (value can go down as well as up) and concentrated in one company. In a private company, shares may be difficult to sell or to sell at full value, which is another reason why the investment is relatively high risk. For this reason, employee share purchases occur mainly where there is relief against income tax and National Insurance, so that the share purchase is financed from an employee's pre-tax income, under the *Share Incentive Plan (SIP)* – see below and Appendix 1. The ability to buy shares out of pre-tax income may be seen by many employees as a reasonable incentive to take the risk.

  - Alternatively, employees are occasionally given an opportunity to buy shares in their company at a *discount to market value*. This may be another way of compensating for the risk described above, although employees buying discounted shares would
normally be liable for income tax (and possibly National Insurance) on the value of the
discount. In a SIP a similar effect is achieved with greater tax efficiency through the
company’s offering matching shares for shares purchased by the employee.

• In the 1990s, there were a number of privatisations involving employee buy outs, in
which employees got the opportunity to invest in buying shares in their own company,
often with loans from their employer at preferential rates. In more recent years, this
has become less common.

• In some companies, notably co-operatives, each employee may purchase a single
share, or a limited number of shares, for low or nominal value. Here, the objective of
share ownership is to provide the employee with a shareholder vote and a sense of
participation, and perhaps to confer rights to a fixed annual return or a dividend
based on the performance of the company. But the aim isn’t to enable any
shareholder to enjoy growth in share value. In companies structured in this way,
shares will have a fixed value throughout the company’s life.

Being given shares

• As a way of acquiring a capital stake without risking personal savings, awards of free
shares can be very attractive for employees. By using a SIP, free shares can be
awarded tax free. Without a SIP, employees receiving free shares will normally expect
to pay income tax (and possibly also National Insurance) on the shares’ value.

• The value of any free shares awarded to employees will normally now be shown as a
cost to the company in its profit and loss account.

Where employee ownership involves personal share ownership by employees, a SIP is
likely to be the first port of call. For example, where an employee trust has acquired, or is
in the process of acquiring, a majority shareholding, it may feed shares through to a
separate SIP trust, for allocation and ultimate transfer to, employees.

Alternatively, a SIP trust could be the body which acquires a majority holding of shares
from current shareholders, who would be able to claim deferral of capital gains tax by
selling to a SIP (subject to various conditions). Having acquired shares, the SIP trust
would then allocate and transfer them to employees as described above.

The Employee Share Schemes Act 2002 introduced a helpful tax deduction if a SIP trust
is used to buy shares from individual shareholders. A company can get a corporation tax
deduction for money paid to its SIP trust. The payment must be used by the trustees to
acquire not less than 10% of the total ordinary share capital of the company in the year
immediately following the initial purchase of shares made with this money. The shares must
not be bought from a corporate shareholder. The company gets an immediate tax deduction,
whilst the SIP trustees then have up to 10 years in which to award shares to employees. The
full amount of the deduction will be clawed back if at least 30% of the shares acquired have
not been distributed to employee beneficiaries within 5 years, or if all the shares acquired
with the payment are not distributed within 10 years. Where the deduction is withdrawn
and the relevant shares are subsequently transferred to employees the company can claim a deduction for the period of account in which all the shares are finally transferred.

For additional information on how a SIP operates, see Appendix 1 at the end of this report.

Share options

• Another way of managing risk for employees is to grant them share options. Typically, an employee would be given the right to buy shares in their company from some future date (called the vesting date), paying the market value of those shares as at the date the option was granted.

• From the vesting date, the employee would have a period in which to decide whether or not to buy the shares (exercise the option). If the share value had risen, they might decide to exercise the option because they’d be buying shares for less than their now market value. But if the shares were worth the same amount as when the option was granted, or had fallen, employees would probably choose not to exercise.

• Although share options are very common as an incentive for executives and directors, they are also extremely popular in creating wider employee share ownership, notably through Save As You Earn (SAYE) options (see below), which also provide tax benefits for participating employees.

There are three ways for UK employees to acquire shares in their employer through the exercise of share options and be exempt from income tax and National Insurance on any option gains. An option gain is the paper gain made by an employee on exercising a share option. In other words it’s the difference between the exercise price and the value of the shares at the date of option exercise.

These are:

• SAYE or sharesave options;
• Company Share Option Plan (CSOP) options;
• Enterprise Management Incentive (EMI) options.

Of these, the most relevant for creating direct employee ownership are usually SAYE options.

SAYE options

The majority of companies wishing to create widespread employee share ownership through options use SAYE options. They are often considered the most attractive choice because:

• They are linked to a special savings account which provides income tax-free interest. Employees save monthly by deductions from pay and this provides the means to finance the exercise of the SAYE options;
• It is possible to set the exercise price at a discount of up to 20% below market value at the date of option grant, this discount being included in the income tax-free zone;
All employees must be eligible to participate (or at least all those who have completed a certain period of employment with their company), and
There are SAYE plan administrators that provide the special savings accounts and administrative support as part of a single tried and tested package.

For more information about SAYE options, see Appendix 2 at the end of this report.

There are two other forms of option – CSOP and EMI – which could also have a role in creating employee shareholders in an employee-owned company, and we provide a little information about them in this report as well.

**CSOP options**
CSOP options were designed for companies wishing to grant options to selected senior employees, but there is no reason why they could not be used to grant options to all employees in a company. CSOP options are typically only used now by companies that cannot use EMI options. This is because the tax advantages under EMI are better and available sooner.

For more information on CSOP options, see Appendix 3 at the end of this report.

**EMI options**
EMI options were designed for smaller to medium sized companies wishing to attract key people. Companies operating certain non-qualifying trades cannot grant EMI options, unlike the other types of tax advantaged share plans mentioned in this report.

There is no reason why EMI options should not be granted to all employees in a qualifying company, so long as the rules and financial limits are not breached. The key advantage of an EMI option is that it allows an employee to benefit very tax efficiently from a future increase in share price. For more information on EMI options, see Appendix 4 at the end of this report.

In principle, any of these kinds of option arrangement could be used to create direct employee ownership. Where an employee trust had acquired a majority holding of shares, or was in the process of doing so, it could grant options to employees – enabling them to become direct shareholders when they exercise their options.

**Successful employee ownership**

Next we summarise the factors companies who want to become employee owned should consider.

The tax-advantaged arrangements described over the previous pages can be very attractive in creating individual *employee shareholders*.

However, *employee ownership* of a company – where a majority of shares is held by or for employees – takes things to a very different level.
Any company (and its shareholders) thinking about moving to employee ownership should think out answers to these key questions:

- Is the business viable?
- Is the necessary finance available?
- Can current shareholders be paid market value?
- Can the business be effectively and decisively managed?
- Will the new ownership arrangements be sustainable?
- What help are the available tax incentives?

Is the business viable?

There should be no compromise on this question. It might be tempting to see employee ownership as a panacea that lets awkward questions about the strength of the underlying business be glossed over.

Employee ownership might help achieve improvement in a strong business, but it won't work miracles for a business which is not viable. Employee ownership creates an environment in which good management can flourish and move more quickly, and it will tend to encourage employees to contribute more, but if the strategy is wrong the business will still fail.

From time to time, fundamentally sound businesses become insolvent. It is frequently hard to find a buyer willing to acquire and continue the business, with the result that the business ceases to trade and valuable jobs are lost. For those businesses, where the model is fundamentally strong but cash-flow has been weak, a purchase by, or on behalf of, employees will often be a good solution.

Is the necessary finance available?

The financing needs of employee ownership may take the following principal forms:

- **Personal finance** – loans to individual employees to enable them to invest in shares
- **Finance for employee trusts** – gifts and loans by the company whose shares the trust owns or is to own, or loans from a third party
- **Vendor finance** – exiting owners may be prepared to sell shares in stages or for a price payable in instalments: known as vendor financing
- **Equity finance** – where an employee buy out of a company cannot be financed in the ways described above an investor may agree to provide equity (rather than loan) finance to fund any shortfall.

Clearly taking out a personal loan for the purchase of shares is something which no employee should do lightly. However, there may be circumstances where this is appropriate. The UK's personal loans market means it will often be possible to find lenders willing to provide finance on reasonable terms. Given sufficient advance notice by the existing owners, of a proposed buy out, employees may be able to save to
finance the buy out. In some situations (e.g. corporate recoveries) employees may accept changes to pay and conditions to help make the finances of the employee buy out work.

The prospects for financing employee trusts are mixed. As already mentioned, banks will often be willing to lend to trusts, so long as any loan is backed by a guarantee and security from the company itself. However, loans from the company are likely to incur a tax penalty on the company (see below), gifts from the company will frequently not be deductible for corporation tax and there have been cases where HM Revenue & Customs has indicated it might treat contributions to trusts as full distributions – so they end up being taxed as dividends. So there are disincentives to companies providing finance for an employee trust.

Vendor finance is often used in succession solutions, where implementing a change in ownership can take place over several years, with planning starting well in advance. Care is, needed though to avoid unexpected tax charges. In some circumstances a vendor may have to pay tax on the value of consideration he has not yet received. It would help if there were a tax exemption for sales to an employee trust so that this is not a problem. Most vendors will expect to pay capital gains tax at no more than 10% (i.e. because they benefit fully from the taper relief regime). However, when shares are, in particular, bought in tranches, HM Revenue and Customs may try to recategorise the payments (under section 707 Taxes Act 1988) as disguised dividends and tax them accordingly (at income tax rates up to 40%).

With a few exceptions, equity finance in the UK is often seen as incompatible with long term employee ownership, because:

• investors often want to realise their investment within three to five years, usually by arranging a sale of the whole company;
• there is a tendency amongst private equity houses to resist employee share ownership, which they may be too ready to label as too complicated and not the best use of scarce equity.

Some investors are willing to provide debt, designed to play the role of equity in the funding structure, to solve the particular needs of companies with substantial employee ownership. This is the approach taken, for example by the Baxi Partnership – but this solution is not yet in the mainstream. It’s possible that if demand for this form of quasi-equity finance grew and there were opportunities for investors to get reasonable returns, the quantity and quality of provision would increase.

Individual equity investors in UK private companies can frequently claim income tax relief on their investment, under the Enterprise Investment Scheme. However, no equivalent relief is available for an employee trust acquiring a majority equity stake, nor for investors who provide the trust with loan finance – the optimum for this approach.

Can current shareholders be paid market value?

Current shareholders can be paid market value in an employee buy out but it is often difficult to compete with the deep pockets of a trade buyer or an offer backed by a
private equity house. Some family shareholders, or other company owners, are prepared
to sell their shares to employees or an employee trust for what they believe to be market
value but without actually testing this in the open market. Others are prepared to sell, for
personal reason, for what they know is less than market value. But for employee
ownership to become a completely accepted way of transferring company ownership, it
needs to be able to deliver competitive value per share compared with potential
alternatives such as a trade sale, management buy-out or, in some cases, flotation.
Access to the right kind of finance will help create an environment where this is possible.
Maximising the use of available tax reliefs (see below) will also help ensure buy-out
teams make competitive offers for a company.

**Can the business be effectively managed?**

Addressing this question is perhaps more about dealing with perceptions than reality.
There are well-developed structures to make sure that employee ownership is not seen
as management by employees, but company owners and managers can have quite
understandable concerns that the right of managers to manage might be undermined in
a company with substantial employee ownership.

In practice, as long as managers accept the challenge of systematically communicating
with and involving the employee-owners, and the give and take of an open culture, an
employee owned company is a most rewarding one to manage, because everyone is on
the same side.

One substantial company, Tullis Russell Group, found that the quality of manager they
attracted when recruiting from their industry rose noticeably when they became
employee owned. Perceived positive factors included the commitment to independence,
the fact that the managers are the leaders of the whole community, and the fact that
employees tend to be supportive and committed to making the business successful.

**Will the new ownership arrangements be sustainable?**

This will only be achieved if the structure is designed to be sustainable. An employee
trust will invariably be part of a suitably designed structure. There is one particular reason
why employee ownership can become a victim of its own success and why an employee
trust is essential.

In any company with growing profits, the value of its shares is likely to rise. This applies
as much to a company with employee ownership as to any other. Ultimately, employees
will wish to realise the value built up in their shares, and the more successful the
company, the higher the price they will expect to receive. Share price is normally
determined on a regular basis using specialist advice, to ensure it's fair.

In a listed company with a wide pool of non-employee shareholders, it will normally be
possible for employees to find buyers for their shares. In a private company, there may
not always be the same degree of liquidity. Where a high proportion of the company's
shares (let us assume more than 30-50%) are owned directly by employees, the number of shares placed on sale may stretch the capacity of the company to provide liquidity.

A solution is for the company to fund an employee trust to acquire shares which are placed on the market, or those shares which other employees don’t want to buy. Companies can fund an employee trust by making loans. This has the advantage of avoiding the permanent commitment of a monetary ‘gift’. So if the trust can later sell shares which it has purchased with funds supplied by the company, those funds can be repaid.

However, the ‘loans to participators’ legislation will normally require a company funding a trust in this way to deposit 25% of the loan with the HM Revenue and Customs.

A different approach to employee ownership is to create an indirect ownership structure in which all shares are held in the long term for employees by an employee trust. Companies such as John Lewis Partnership (employing 65,000, with annual turnover of over £5 billion) and Ove Arup (international consulting engineers) have thrived using this form of ownership. Its key advantages are:

- Employee ownership is achieved and maintained;
- If shares are not released to individual employees, the problem of arranging for the purchase of employees’ shares is avoided;
- Although employees do not hold an investment personally, they can be rewarded through cash bonuses.

Even in a trust owned business, a tax advantaged share plan may be used to deliver some shares to staff. This provides, in effect, a way of remunerating staff tax efficiently but the number of shares and the rights attached to those shares will be restricted to ensure the plan does not undermine the trust ownership structure of the business.

In addition to loans, a critical funding source for a trust will normally be gifts from the company, but it is extremely difficult now for the company to get a corporation tax deduction on that expenditure. The main reason for this is because the Finance Act 2003 (Schedule 24) generally only allows a corporation tax deduction when taxable value passes out of the trust to employees. This measure was introduced to counteract tax avoidance but its scope is very wide and it catches employee trusts used to achieve and maintain employee ownership as well as offshore executive remuneration trusts. It can have technically obscure adverse side effects, such as creating inheritance tax liabilities if non-tax deductible contributions are made to an employee trust established by a closely controlled company.

If an employee trust retains the shares it has acquired, rather than distributes them to employees, no corporation tax deduction is possible. Although holding shares for the long term in a trust presents an attractive way for companies to create a sustainable form of employee ownership, it is now a more expensive route to follow. Unless the corporation tax rules are changed some will decide they cannot afford this route.
What help are the available tax incentives?

Tax incentives do exist for employee share ownership, and we have summarised some of these in an earlier part of this report. The SIP, SAYE, CSOP and EMI plans all provide tax incentives for employees acquiring shares directly.

Awards under a SIP and SAYE options, in particular, are key ways of fostering direct ownership of shares by employees, with the SIP having the potential to become the lynchpin.

The SIP tax incentives go beyond relieving employees of the income tax liabilities they would otherwise pay on free shares or shares bought at a discount (and also removing the related employee and employer’s national insurance contributions). The corporation tax deduction introduced in the Employee Share Schemes Act 2002, for certain SIP contributions, is mentioned above. For companies, a corporation tax deduction is otherwise normally available as and when free or matching shares are awarded under a SIP, and generally for any share-based benefits which employees get directly.

Capital gains tax on disposals of shares to a SIP trust can be deferred. However, such a trust – based on the allocation of shares to employees – is not a suitable vehicle for a type of employee trust that might wish to retain shares indefinitely. Capital gains tax taper relief usually means an individual selling shares only has to pay tax at 10% and so deferral is, in any event, not necessarily a sufficiently attractive benefit to encourage company owners to go down this route.

It’s important that these tax-advantaged share plans remain available – especially the SIP – and that they are kept under review to see how they may be improved.

What characterises each of the above is that the tax incentives are centred on direct (i.e. individual) employee share ownership.

Achieving sustainable employee ownership will often require the creation of a long term shareholding in an employee trust. Current tax rules are not aimed at achieving this objective. There are no tax breaks for employee trusts with long term shareholdings (for example, exemption from income tax on dividends), although such a move was canvassed in the review begun in late 2003 of trust taxation.

Nor, as already noted, is a corporation tax deduction available for a company contributing to an employee trust, if the trust retains those shares for the long term benefit of employees. The corporation tax deduction introduced by the Employee Share Schemes Act 2002 envisages that all shares will get distributed from the SIP trust within 10 years.

In relation to direct employee ownership, there is one single and simple step which the Government could take to make employee ownership significantly more attractive.

Under the SIP, the current requirement is for shares which have been allocated to be held in trust for (normally) five years before they may be released. The reality is that many companies would establish a SIP if it could be largely self-financing – in other words if shares allocated to staff were paid for (at least in part) by the employees themselves,
since this avoids or minimises any cost to the company in paying for employees’ shares. However, many employees, when told that if they buy shares they will have to wait five years before being able to sell them, will decide not to participate – even though they can buy the shares from their pre-tax income. In JOL’s view, the five year ‘waiting’ period is too long. Reducing it to three years – still a long time frame – would make the SIP significantly more popular.

In relation to indirect employee ownership a fundamental change of heart is needed by Government.

Towards a new form of employee trust

JOL welcomes the UK’s progressive tax environment for direct employee share ownership. But one inevitable comment when explaining how to make employee ownership happen is that, despite the Government’s promotion of direct ownership, companies which want to create sustainable indirect ownership – through employee trusts – are at a disadvantage.

The research surveyed in this report points to employee trusts as the key to unlocking the best possible corporate outcomes from employee share ownership plans. Share ownership on its own can provide financial participation to employees. Although this may be muted in privately owned companies. The rewards will depend on a company’s dividend policy and the strength of its internal market. Individual shareholdings, with uninfluential voting rights, do not in themselves create a strong basis for employee involvement. An employee trust, with a significant shareholding, adds another dimension. Trustees have to take into account the interests of beneficiaries. An employee trust provides a means of rewarding employees financially and can deliver the necessary employee involvement and collective voice, to ensure all three key factors to boost productivity are present. An employee trust designed to benefit all employees in this way is less likely to be abused by the few. HM Revenue and Customs has agreed in discussions with JOL that there is a distinction between employee trusts used for the purpose of achieving employee control structures in a bona fide trading operation and contrived arrangements involving employee trusts used for the purpose of sheltering remuneration from income tax and national insurance contributions.

JOL believes that the Government should provide statutory recognition of an acceptable form of employee trust, contributions to which are tax deductible even if shares are retained indefinitely in that trust. The trust should benefit from other tax advantages in order to promote employee ownership, such as an exemption from the loans to participators provisions and other measures to remove the barriers identified above, and even to encourage such trusts. In proposing change, we acknowledge the Government’s positive steps to foster employee share ownership and also its need to prevent and address tax avoidance. JOL looks forward to continuing its dialogue with the Government on this important issue.
Buying and being given shares income tax-free – how the SIP scheme works

Under a SIP, employees can obtain shares in three main ways:

- **Purchase** – employees may buy *Partnership Shares* out of their gross pay, with full income tax relief. For example, an employee investing £1,000 of their pre-tax pay in shares in their employer company will not have income tax or National Insurance deducted, so they will have shares worth £1,000 allocated to them. If instead they simply take that £1,000 as part of their normal pay, they would receive a cash amount after deduction of tax and National Insurance.

- **Free** – employees may be allocated *Free Shares*, without being required to pay income tax or National Insurance on their value.

- **Matching** – employees may be allocated up to two *Matching Shares* free for every one Partnership Share they agree to buy – again without being required to pay income tax or National Insurance on their value.

Also, dividends paid on any of these shares can be paid as additional shares (*Dividend Shares*) instead of as cash, in which case they won’t be subject to income tax.

When and how are shares allocated?

- **Partnership Shares** can be allocated just once, or occasionally, or every month. Or instead, employees could have Partnership Share money deducted from their pay once a month for up to twelve months (an *Accumulation Period*), and then it would be used to buy Partnership Shares at the lower of share value at the beginning and end of that period. This transfers the risk of downward share price movement over that period from employees to the company.

- **Free Shares** can be allocated whenever the company wishes, so long as within the annual limits (see below).

- **Matching Shares** will be allocated at the same time as the Partnership Shares to which they relate.

They must always be purchased by a special form of employee trust – a SIP trust – using each employee’s money if they are Partnership Shares or the company’s money if they are Free Shares or Matching Shares – then allocated to the names of participating employees.
Appendix 1: Share Incentive Plan (SIP)

Are there any conditions?

- It’s an all employee plan, so everyone must be invited to participate, although the company can require employees to have worked for a qualifying period of up to eighteen months.
- Any shares allocated to employees must be held on their behalf in a special SIP trust – normally for five years to ensure the income tax reliefs.

There are several other conditions, including strict rules as to the type of shares that may be used, and a rule preventing, in broad terms, a SIP being used to allocate shares in a subsidiary.

Benefits for the company

In addition to the intended positive benefits on the company’s performance:

- The company doesn’t have to pay employer National Insurance on any pay used by employees to buy Partnership Shares so long as they are then left in trust for the full five years, so saving the company up to £128 for every £1,000 invested by employees.

- The cost to the company of providing Free Shares or Matching Shares is deductible against corporation tax (there may be enhanced tax deductions if the SIP trust is used to buy not less than 10% of the total ordinary share capital of the company from individual shareholders for use in the SIP over a 5-10 year period).

- Any award of Free Shares may be linked to achievement of performance conditions, which can be company-wide or linked to a particular business unit.

- Free Shares or Matching Shares can be forfeit if employees leave as ‘bad leavers’ (dismissal or voluntary resignation) within three years.

Financial limits

- Partnership Shares – £1,500 or 10% of salary (whichever is lower)
- Free Shares – £3,000
- Matching Shares – up to twice the number of Partnership Shares
- Dividend Shares – £1,500
How SAYE options work

What are SAYE options?

They allow UK employees to participate in share options without having to pay income tax or National Insurance on their option gains.

How do they work?

Imagine that:

- In 2006 a company wishes to offer each of its employees a share option. This allows them, after a fixed period of time has passed, to buy a fixed number of shares at today’s share price (£1.25 per share) or at a discount of up to 20% on that price (£1 per share). The company decides to grant the option with a £1 exercise price;

- Each employee will only be granted the option if they agree to save a fixed amount per month for a minimum of three years, so that the total of their savings and interest will provide enough money for them to exercise their option;

- One employee, Justin, decides to save £100 per month for three years. After three years, this will give him, say, £3,600 plus a tax-free interest bonus of £190, total £3,790. He is granted an option to buy 3,790 shares;

- Three years later (2009) the share price has increased to £2.50. Justin uses his savings to exercise his option in full, paying £3,790 for shares, which are now worth £9,475, so making a gain of £5,685.

Normally Justin would have to pay income tax and possibly National Insurance on this £5,685 benefit (even though it may only be a paper gain if he hasn’t yet sold the shares). However, because the option is an HM Revenue and Customs approved SAYE option, he doesn’t have to do so.

So is it completely tax free?

No, if Justin sells the shares – which he might do either immediately or after some time – he will then have to pay capital gains tax (CGT) on any gain he has made up to the point of sale. But it will often be much better to pay CGT than income tax or National Insurance:

- there is an additional tax free slice – £8,500 for 2005-2006
- taper relief can significantly reduce the rate of CGT
- unlike income tax or National Insurance, CGT is due only when he sells the shares, and so when he has some cash to pay his tax bill.
What happens if an employee doesn’t wish to exercise their option?

There is no obligation to exercise, and it would be unusual to do so where the share price had fallen below the option exercise price. If the option isn’t exercised, the employee may simply keep the savings and bonus.

Can a company choose which employees are granted SAYE options?

No, SAYE is an all-employee plan, so it must invite all employees to participate, or all employees who have worked for the Company for a specified minimum period (which can be set at up to five years).

Are there any limits?

The maximum monthly savings allowed per employee is £250. The savings period can be either three or five years. The option period can be the same as the savings period, or if a five year savings period is chosen the option period can be extended to seven years. In all cases, the option can be exercised within six months of the end of the option period.

What happens to leavers?

Any employee who leaves due to redundancy, injury, disability or retirement must be allowed to exercise a proportion of their options linked to the amount saved so far and any accrued interest. Any option gains are not subject to income tax or National Insurance.

Benefits for the company

Apart from the potential commercial benefits of a carefully designed SAYE plan (employee motivation, creating a sense of ownership and fostering commitment) there is also a tax advantage for the company. Any gains enjoyed by employees may be treated as an expense of the employer company for corporation tax purposes.
How CSOP options work

What is the CSOP?

The CSOP allows UK employees to participate in share options without having to pay income tax or National Insurance on their option gains.

How does it work?

Imagine that:

- In 2006 your company grants an employee, Grace, an option, under which – after three years have passed – she can buy 10,000 shares at the share price at the time the option is granted (£3 per share).

- Three years later (2009) the share price has increased to £5. Grace decides to exercise her option in full, paying £30,000 for shares, which are now worth £50,000.

Normally Grace would have to pay income tax and possibly National Insurance on this £20,000 benefit (even though it may only be a paper gain if she hasn’t yet sold the shares). However, if the option is a CSOP, she doesn’t have to do so, so long as (normally) at least three years and no more than ten years pass before she exercises her option.

So is it completely tax free?

No, if Grace sells the shares – which she might do either immediately or after some time – she will then have to pay capital gains tax (CGT) on any gain she has made up to the point of sale. But it will often be much better to pay CGT than income tax or National Insurance:

- there is an additional tax free slice – £8,500 for 2005-2006
- taper relief can significantly reduce the rate of CGT
- unlike income tax or National Insurance, CGT is due only when she sells the shares, and so when she has some cash to pay her tax bill.

Are there any limits?

No employee may be granted CSOP options over shares worth more than £30,000. So in our example Grace could not immediately be granted any more options.
What happens with leavers?

Normally if CSOP options are exercised within three years of grant, the employee will pay income tax and possibly National Insurance on their option gains. However, this does not apply to employees leaving for redundancy, injury, disability or retirement.

Do all employees have to participate?

Unlike awards under a SIP and SAYE options, CSOP options do not have to be offered to all employees, allowing the company to select which employees participate.

Benefits for the company

As with SAYE options, apart from the potential commercial benefits of a carefully designed plan, any gains enjoyed by employees may be treated as an expense of the employer company for corporation tax purposes.
Appendix 4: Enterprise Management Incentive (EMI)

How EMI options work

What is EMI?

EMI is targeted at smaller to medium sized companies, and is widely considered to be the most tax efficient share plan available.

Companies which qualify

• EMI is only for companies with gross assets of no more than £30 million
• Companies running certain businesses are excluded
• The company must be independent – it must not be a subsidiary of or controlled by another company
• The company must operate wholly or mainly in the UK

Do employees qualify?

• Any employee who is to participate must work for the company for at least 25 hours a week, or if less, for at least 75% of their working time. Anyone holding 30% or more of your company’s ordinary shares won’t be eligible.

Are there any limits?

• Options may not be granted over shares with a market value in total of more than £3 million
• For each employee, there is a limit of £100,000

Tax treatment

• Assuming the option exercise price doesn’t exceed the market value of the shares at the time of option grant then there is no income tax or National Insurance payable upon exercise of the option.
• If the option exercise price is less than market value on the date of grant, income tax (and possibly National Insurance) will be payable on exercise, on the difference between the exercise price and market value on date of grant.
• When shares acquired are eventually sold, capital gains tax (CGT) will be due on option gains (the difference between exercise price and sale price). Taper relief will often result in a significantly reduced rate of CGT.
• When calculating when the ownership period starts for taper relief purposes, EMI options have a great advantage. Normally, the period starts when shares are acquired.
With an EMI option the period starts when the option is granted.

**Could anything affect the tax treatment?**

If certain things happen (*disqualifying events*) between option grant and exercise so that the options cease to qualify under EMI, income tax (and possibly National Insurance) can become payable on gains up to the date of exercise.

**What happens to leavers?**

Option holders who leave can be allowed to exercise their options without tax penalty.

**Do all employees have to participate?**

Like CSOP options, EMI options do not have to be offered to all employees, allowing the company to select which employees participate.

**Benefits for the company**

As with SAYE and CSOP options, apart from the potential commercial benefits of a carefully designed plan, any gains enjoyed by employees may be treated as an expense of the employer company for corporation tax purposes.
The references are sources for research described in Section 2: **Why employee ownership works – research**


