Employee Ownership Association

The voice of co-owned business

Nigel Mason

A matter of trust

How to create more employee owned businesses

Executive Summary

This paper explains why the growth and contribution of an entire business sector is being held back by tax rules that were not meant to affect it. It builds on the authoritative report published in May 2008 by the All Party Parliamentary Group on Employee Ownership[1], whose principal recommendation was the removal of this tax barrier.

It also builds on recent Employee Ownership Association publications that have shown the contribution of employee-owned companies to the UK economy[2], presented wide-ranging evidence that such companies significantly outperform their peers[3], and illustrated the strength and diversity of the sector[4].

The paper explains why employee-owned companies in which all or the majority of the shares are held in an employee trust for the benefit of all the employees are more sustainable than those in which the shares are directly held by employees.

The sustainability of trust-owned companies is particularly attractive to business owners looking to transfer ownership to their employees and who regard their businesses as being run not just for the current generation of employees but for future generations as well.

Despite previous Government initiatives and support for the employee-owned sector, it has become very difficult to finance transfers of shares to employee trusts since the 2003 Finance Act stopped the up front tax deductibility of company contributions to all employee trusts. This relief is critical to creating new employee-owned businesses.

Since the removal of this tax relief, there have been very few transfers of businesses to employee trusts. Therefore, if we are to encourage more business transfers to long-lasting employee-owned structures, we need to find a way of reinstating it.

We think this can be achieved simply and without risk of abuse. This paper proposes one minor change to the rules of the UK's main tax-advantaged share plan, the Share Incentive Plan, which would solve this problem.

Such a reform would also boost the numbers of Share Incentive Plans and the number of employees who benefit from these arrangements.

Of the 1,000 SIPs in use today[5], just over half[6] are in private companies, a tiny proportion of the eligible company population. We believe that the effect of our proposed reform could be to treble the number of bona fide SIPs in private companies within three years.

1 Share Value – All Party Parliamentary Group report on Employee Ownership (May 2008)
2 Shared Company – How employee ownership works (2005)
3 The economic case for HM Treasury to support the employee owned business sector (2007). See also Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options (Kruse, Freeman and Blasi, 2009) available at www.nber.org/books/krus08-1
4 Sharing Business Success – How employee ownership can provide a solution in business succession planning (2008)
5 HMRC statistics show 940 SIPs at April 2007
6 Source: same source as footnote 5.

Background

The last recession of the early 1990s demonstrated that the rate of failure of employee-owned companies was significantly lower than that of conventional firms.

What makes employee-owned companies so resilient? The two key distinguishing features that give these companies such a strong competitive edge in a downturn are firstly high levels of employee engagement, which has been shown to be linked to high performance, and secondly high variable (i.e. profit-related) remuneration as a proportion of total pay, which allows costs to be flexed without jobs necessarily being lost.

There is also a third distinguishing feature, the existence of which is rather more difficult to measure and prove, and that is their focus on longer-term, sustainable growth rather than on quick profits for short-term gain.

Employee-owned businesses tend to grow organically or by incremental acquisition geared more carefully to their core competences. They tend not to bet the farm on new ventures or diversifications.

Whilst the short term resilience of employee-owned companies is not in doubt, it is the conditions for their longevity - as distinctly employee-owned businesses - that give us most cause for concern.

The current tax treatment of trusts means that employee-owned companies that do not have significant amounts of their shares in an employee trust will be under constant pressure to sell out in order to "cash in" shareholdings in the hands of individual employees. These companies will become unwitting victims of their own success.

Rather than continuing to reap the unique benefits of their employee ownership structure, as many say they would prefer, they will have to sell themselves to realise value for the employee shareholders.

Of course, some employee-owned businesses – usually those with lower levels of employee shareholding and where shares are often held for the benefit of a select few senior managers - are deliberately transient in purpose and always anticipate that they will one day sell out.

For these companies, employee ownership is an expedient arrangement that serves its purpose for a particular period in a company's life, for example during the start-up phase, or as an interlude between major corporate owners. For such companies, employee ownership is not necessarily a status to be protected.

These companies are already well served by the Government's tax-approved schemes, especially the Share Incentive Plan, Enterprise Management Incentive scheme and Enterprise Investment Scheme.

The focus in this paper is on those companies that want to sustain their employee ownership, those that regard their businesses as being run not just for the current generation of employees but for future generations as well. This group represents a significant majority of the employee-owned sector.

Why employee trusts are the key to sustainability

An employee trust is the key building block in a sustainable employee-owned company. There are two main types of trust:

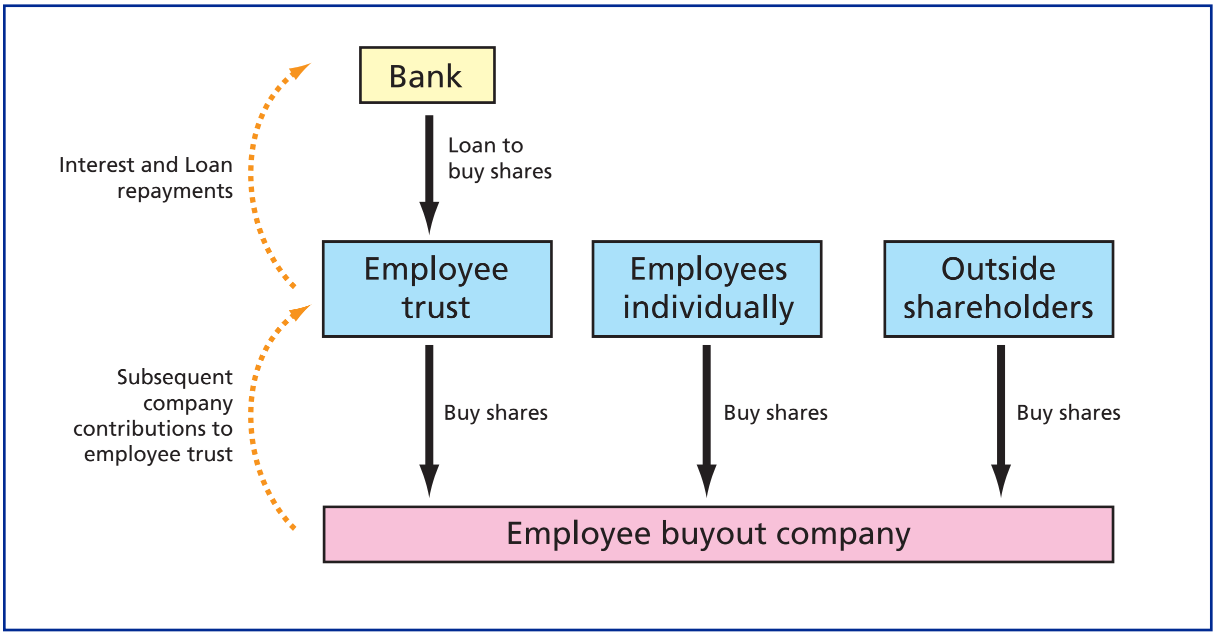
- A Share Incentive Plan (a.k.a. "approved") trust[7], company contributions to which in certain circumstances are tax deductible, but whose shares must be distributed to all employees on similar terms within 10 years – a surprisingly demanding requirement that not all prospective adopters of SIPs are willing or able to meet;
- An "unapproved" employee trust, company contributions to which are not deductible, but which have no requirement to distribute shares to employees.

An employee trust of either type can perform a number of roles, all of which are geared towards creating and then sustaining employee ownership. These roles are:

(a) the employee trust as subscriber in employee buyouts

An employee benefit trust of one type or the other is nigh on essential in an employee buyout, unless employees are wealthy enough to finance the acquisition of the entire share capital of the target company from their own pockets and are content to build their company on individualised ownership – not a common set of circumstances.

Much more commonly, the employee buyout relies on a significant block of shares being acquired by the trust on behalf of employees – future as well as current – and this acquisition is usually financed from bank loans that form part of the buyout finance package, as shown in the following diagram



7 The SIP was introduced in 2000 and its rules are laid out in Schedule 8, Finance Act 2000
8 It is common practice for employee-owned companies to require departing employees to sell their shares, usually after a period of grace, back to the employee trust at the prevailing market price. Without such a rule, the company would become increasingly owned by former employees, and this would be at the expense of ownership by the current working generation.

(b) the employee trust as ownership stabiliser

The larger the trust holding (as a proportion of total ownership) in an employee buyout, the more robust the resulting structure. Shares acquired by an unapproved trust need not be sold again, whereas the greater the proportion of shares held by employees individually or by a SIP trust (which is compelled to distribute to employees individually), the greater the pressure eventually to arrange a sale of the whole company to deal with the mounting number of expectant sellers, as employees leave or retire[8] or simply ask to cash out.

The obligation on employee-owned companies to buy back the shares of leavers –becomes particularly cash-draining in companies whose share price has risen steeply, as a result of profit growth or de-gearing in the years after a leveraged buyout. The price of each leaver's share can become unaffordable, forcing the company to contemplate raising outside capital or ultimately arranging an outright sale.

Furthermore, the higher the rate of labour turnover in a company, the faster the churn of employee shares, and the more company cash is required to underwrite the repurchase of departing employees' shares, hence the more unsustainable the employee ownership. (To deal with this issue of high labour turnover, some companies put probationary periods on the entitlement to own shares - the maximum permitted by SIPs is 18 months – in the same way that membership of an occupational pension scheme is normally reserved for longer servers, but this practice arguably discriminates against mobile workers and companies with flexible workforces).

So, a company with a large shareholding by an employee trust has a much more stable structure that does not suffer from the propensity of individualised employee ownership to unravel.

(c) the employee trust as internal market maker

To the extent that some shares are held by individual employees, the same employee trust can act as buyer of shares from those employees, creating an internal market, keeping the shares "in-house" and preventing them from being bought by outsiders.

Of course, even a small trust can fulfil this buyer role, but the larger the trust's holding, the fewer remaining shares are out in circulation amongst eventual sellers and the greater the trust's financial clout to effect a purchase.

(d) the employee trust as responsible owner

A significant employee trust can play a stabilising role in the governance of a company, as its trustees must by law act responsibly in the best interests of the employee beneficiaries.

The fiduciary nature of the trustee role provides a clear code of conduct and requires a minimum level of professionalism that is healthy in the running of a private company. Trustees will tend to build a close and constructive relationship with the directors, but, like the most engaged institutional investors in public companies, retain a healthy distance from operational management.

They may be professionally advised, they may include independent people as well as company directors, and they may include employee representatives, howsoever selected.

The bigger the better

Nearly a century of experience has shown that a majority trust holding is the most sustainable. It is no coincidence that the most famous, durable and successful employee-owned companies such as John Lewis, Scott Bader, Ove Arup, Swann-Morton and Tullis Russell are all mainly or wholly owned by trusts.

The current tax rules

The current tax rules for employee trusts are the result of numerous changes in the last ten years as shown in the table below.

To summarise, if an approved SIP trust acquires 10% or more of the issued share capital of a company and distributes those shares to employees within 10 years (of which 30% must have been distributed within 5 years), company contributions to the trust are tax deductible when they are made[9] (c.f. when shares are later distributed).

This is clear enough, but this position is much more restrictive than the position that obtained prior to 2003. Until then, all bona fide company contributions to employee trusts of all kinds, both approved and unapproved, were tax deductible under case law. This was the framework that allowed employee buyouts to flourish for so many years.

Unfortunately this flexibility came to be abused by companies – principally financial services companies and investment banks - using trusts artificially to avoid national insurance contributions, so the Finance Act 2003 removed the tax deductibility of company contributions in most cases and for reasons that the EOA supports[10].

Pre 2000	Case law established that company contributions of a revenue nature to an employee trust (including unapproved trusts) were tax deductible.
2000	SIPs introduced. Allowed companies a statutory tax deduction on contributions to the SIP trust when shares are allocated to employees.
2002	The Employee Share Schemes Act 2002 included a clause allowing companies to claim a tax deduction at the time contributions are made to SIPs, provided the SIP owns 10% or more and provided the shares are allocated to employees within 10 years. This was a welcome shifting of the timing of relief (from the time of share allocation to the time of company contribution) but the deadlines on share allocation make it unattractive to most private companies.
2003	The Finance Act withdrew the long standing corporation tax deduction for contributions to "case law" employee trusts, following evidence of abuse in tax-avoidance schemes. However, the withdrawal hit bona fide employee ownership schemes hard. Consequently, there have been few transfers of ownership to employee trust companies since 2003.

9 s1(3) Employee Share Schemes Act 2002
10 Schedule 24, Finance Act 2003

What's the problem?

The current tax rules present a dilemma.

Either a company must be prepared to distribute all SIP trust shares to employees within 10 years as the condition of securing immediate tax relief on company contributions, an action which concentrates all the fruits of ownership on the current generation of employees, and a degree of concentration that might not have been contemplated by the founders, or the funding of the employee buyout – to the extent that it relies on post-tax company contributions – is prohibitively expensive.

Faced with this unpalatable choice – tax deductions leading to concentrated and unstable individualised ownership or no tax deductions at all – business owners are being deterred from pursuing employee ownership at all. Without a gift of shares or cash from a philanthropic founder, it is now simply unaffordable for a company to finance the creation of a sizeable employee trust that would secure the long term ownership of the business for the benefit of its employees. In the absence of tax relief, every £100 of employee trust shares cost £139 in company cash, which is a punitive premium. As a result, fewer employee buyouts can be financed and, of those that do get started, a higher proportion will unravel prematurely.

Business vendors are deterred from supporting an employee buyout if they think it is going to be a short-lived and temporary phenomenon. They want to support something that will last.

There is also a psychological barrier. If payments are not tax deductible, businesses are reluctant to incur them. It creates the erroneous belief that such company payments are in a sense illegitimate.

So, the single biggest obstacle to progress in the employee ownership sector is the requirement of SIP trusts to distribute their shares. Lift this requirement, and the barriers to long term, sustainable employee ownership are set aside at a stroke.

The solution

A simple proposal, which has the virtue of building on the widely used and highly regarded SIP mechanism, is to enable a SIP trust to hold shares indefinitely, if the company and trustees so desire, rather than be forced to distribute them to employees in order to claim a tax deduction.

This would require the simplest of amendments to current tax laws: the deletion of the distribution requirement introduced in section 1(4) of the Employee Share Schemes Act 2002.

This simple reform has two merits:

- It builds on the SIP mechanism which has proved to be robust, popular, effective and untainted by misuse.
- It ties in well with the related CGT rollover relief which is designed to encourage business owners to transfer big shareholdings to SIPs in return for tax relief.

SIP legislation already contains important safeguards which have deterred abusers:

- The SIP trust must be UK resident and HMRC approved;
- The SIP trust can only have essential or incidental terms, ensuring that it cannot be misused.

This suggested change could be accompanied by additional safeguards to eliminate any possibility of abuse. These could include preventing the founding company from abusing the tax relief through a winding up and stronger governance requirements for trustees.

Benefits of these reforms

To summarise, this simple reform would stimulate the economy in the following ways:

- More employee buyouts would be encouraged as employee trusts would once again have the attractive advantage of being able to finance their acquisition of shares from pre-tax company contributions.

- More business owners would be motivated to support conversions to employee ownership, safe in the knowledge that they would be encouraging a sustainable form of ownership that does not over-reward the current generation of employees with direct share ownership at the expense of future generations.

- More private companies would establish SIPs as the administration costs would be reduced. By introducing the option for companies to establish all-employee SIPs without the requirement to allocate shares, the Government would be opening up the SIP to more companies, especially private companies, who have hitherto rejected the SIP on grounds of cost or complexity.[11]

  Of the 1,000 SIPs in use today[12], just over half[13] are in private companies, a tiny proportion of the eligible company population.

  We believe that the effect of our proposed reform could be to treble the number of bona fide SIPs in private companies within three years.

11 In the HMRC's research into SAYE and SIPs published in September 2008, of those companies surveyed who had not established a SIP (73% of a total of 984 companies surveyed), the perceived degree of complexity of providing such a scheme was reported as the most common reason for not providing a SIP or SAYE (63 per cent of employers). The cost of administering the scheme was also a common reason given for never providing a SIP or SAYE (62 per cent of employers).

12 HMRC statistics show 940 SIPs at April 2007

13 Source: same source as footnote 5.