spreading the wages of capital

Esop Centre Members' Webclave 21 March 2022

The Centre hosted its sixth inter-active on-line members' networking event "EOT Development & Reform – Follow-Up" on 21 March 2022. The 60-minute webclave, chaired by Juliet Wigzell, Head of Esop Centre, Z/Yen Group, provided an ideal platform for lively debates on key employee share scheme issues.

Thank you to David Pett, Barrister, Temple Tax Chambers, for introducing the topic and setting out the issues to be carried forward into the two breakout discussions; and to David Craddock, Founder and Director of his eponymous employee equity consultancy, for leading one of the discussion groups.

Present:

Jeremy Edwards, Baker McKenzie
David Craddock, David Craddock Consultancy Services
Chris Booker, Deloitte
Charlotte Fleck, Deloitte
Fred Hackworth, Esop Centre
Malcolm Hurlston CBE, Esop Centre
Juliet Wigzell, Esop Centre
Mark Gearing, Fieldfisher
Anthony Metcalfe Gibson, Gannons
Charlie Germain, Intertrust
Nina Horton, Intertrust
Melissa McConnell, Intertrust
Anton Seatter, JTC
Kathy Granby, Lewis Silkin
John Menke, Menke & Associates
Claire Drummond, Ocorian
Charlotte Nickel, Pinsent Masons
Elizabeth Bowdler, PwC
Andy Nealey, PwC
Louis Paull, PwC
John Bezzant, RM2
Richard Cowley, RM2
June Davenport, Shareworks
David Pett, Temple Tax Chambers
Claire Prentice, Travers Smith
Linda Cook, Z/Yen Group Limited
Mike Wardle, Z/Yen Group Limited

EOT Development & Reform – Follow-Up

Welcome

Juliet Wigzell Head of the Esop Centre for Z/Yen Group Limited, welcomed participants reminding them of the Centre's January webclave on Employee Ownership Trusts, which focussed on the Chartered Institute of Taxation's proposed modifications to the EOT tax regime, for which there was general support; and how best to make the EOT more effective from both the engagement and direct ownership perspectives.

This follow-up debate focussed on David Pett's research.

In his introduction, Centre founder **Malcolm Hurlston** welcomed John Menke, a partner of Louis Kelso whom we celebrate as the inventor of Esops. Mr Hurlston said "since we last covered this topic we have received a fresh evaluation from David Pett. He has concluded that Employee Ownership Trusts should now move towards direct shareholding.
"On top of that I welcome stunning joint research from our friends in California at the National Center for Employee Ownership with the S Corporations of America. For those of you who are as ignorant as I was until a fortnight ago, S Corporations were introduced by President Eisenhower in 1978 and are now nearly five million strong. Their joint research shows just how much better off employees who hold shares are than employees in general. I look forward to hearing a summation of that research in the near future... one thing is clear all round - it is time for a great leap forward."

David Pett explained his evaluation, saying that there can be no doubt that there has been a snowball effect since the introduction of EOT legislation in 2014 and given that 600 to 700 companies have transformed, the indirect employee ownership structure has been a great success. But if we go back to the 1980s, it was David's thesis that, for so long as an employee worked for a company by providing their labours, he or she should participate in the capital growth to which he or she contributes by those labours.
The Existing EOT structure doesn't achieve that.
It is a success in that it gives the owners of the company a valuable incentive to sell or transfer their shares into an employee trust, but what it does not do is allow employees to benefit from capital growth in the company, other than by way of a sale of the company in which they work!
Long before the EOT legislation, David used to advise companies as to how best to achieve the objective of that thesis. One of the most successful companies in achieving this was Xtrac (a specialist engineering company). At the time of the founder's retirement, 49 percent of the company was put into an employee trust and 51 percent into the hands of management. It then initiated a series of employee share schemes with a view to ensuring that every employee would acquire a shareholding in the company which, providing they were a 'good leaver', they would be able to cash out for a life-changing sum.
The company has been very successful – but the one differentiation, when workers deciding whether to work for Xtrac or another engineering company, was this prospect of receiving this life-changing sum. That was achieved by allowing employees to acquire shares under a Share Incentive Plan. Then, when they were good leavers, allowing them to sell these shares back to the general employee trust.
Turning to the EOT legislation, as it stands, there are a number of issues that detract from allowing individual employees to benefit.
This raises the question: Looked at in the long term, what happens to the capital growth in value which is realised by the company? A question that can legitimately be asked of the John Lewis Partnership. David suspects that in the case of JLP, there may be a private act of Parliament that extends the life of the various trusts that the company has, which acts as a "get out of jail free" card for them. But this is uneconomic for most companies.
It might be said that, in the 80s, when employee ownership was the vogue, particularly with the privatisations, they were unstable states and were sold on. But even in those cases, the employees were able to generate capital sums.
What he would like to see, is a situation where the existing legislation is modified:
First - Shares which are passed out to individual employees should count towards the controlling interest which the trust is required to maintain, if it is not to give rise to a disqualifying event and a penal tax charge.

Second – An unforeseen consequence of the legislation on the part of the draughtsmen, is it does not allow those long serving employees, who have recently left the company, to participate in any distribution of benefit.
These changes would not detract from the political objectives of the 2014 legislation. They would enable the capital increase in value that is generated, to be distributed from time to time, and providing also the legislation allowed special provision of benefit to individuals in defined circumstances, such as being a good leaver, there is no reason why that should detract from the overall policy objective.
David then provided five questions to form the basis of the two debate groups, asking "Are we all in agreement that while EOTs provide indirect ownership, they ought to allow a mechanism whereby individual employees can become beneficial owners of shares directly?"

A. Should the legislation allow for shares held by employees and former employees to count towards the 51 percent interest? – What David suggests is that some of that 51 percent could be made available for direct ownership by employees.

B. Should this be restricted to shares acquired under a Share Incentive Plan ("SIP") exclusively or should companies be allowed the flexibility to allow employees to become 'actual' shareholders by other mechanisms?

C. Should the terms of the EOT allow for participation in any distribution by ex-employees? – Should the legislation allow for distributions to good leavers as a derogation from all-employee similar terms basis?

D. Should the legislation allow for employees who leave to benefit from realising the value of shares by selling them back to the trust – even if this means, technically, it is a provision of benefit, perhaps because the shares have been bought back for a consideration, which is greater than, what would normally for UK tax purposes, be regarded as the market value for the shares?

E. If so, should this be at a value which reflects the 'pro rata' value of the shares (as opposed to a discounted value), as it does in the USA?

Group Discussions

Group 1 - EOT Development & Reform led by David Pett

- The point was stressed that EOT legislation does not prohibit setting up of a direct ownership share plan alongside an EOT, though there are complexities in running a hybrid model. However, there was a point on valuation raised: where an employee has a small holding; at some point they may need to sell back to the EOT; so what value do you set? (dilution may also be an issue here).
  At least, the legislation should allow for a situation where a sale back at pro-rata value isn't going to attract a penal tax treatment. (This should be clarified or improved upon).

- Another question is whether you can reach a point where new management can succeed in acquiring control of the company without penal clawback charge.

- US view: the EOT is new to the US. Re: key staff being extraordinarily awarded compensation – would there be some limit as, while the EOT would acquire shares by purchase, the other shares would be by grant, therefore diluting the value? - Yes, the limit is the ruling that an EOT cannot hold less than 51 percent, but the question is whether those shares, which are 'dead in the water' as far as the trust is concerned, may accrue in value, but until the business is sold, there is no effective way of distributing that other than on an all-employee basis (apart from company bonuses).
  The legislative change would be to allow that 51 percent to cover, not only shares held by the EOT, but shares that had been passed out in a regulated manner and which were restricted from being passed out from the circle of the trust and employees.
  Would that still allow an unlimited amount to be held by key staff? – Yes, but if coming out of the 51 percent, it would need to be to all employees, as per the legislation, but if you wanted to benefit the key people you can do that from the company e.g. by issue of new shares. (It can't come from the 51 percent holding).

- What percentage should the EOT hold if you include individual employee shareholdings? You could have a situation where the EOT might hold very few shares. - Yes, if looking at company law restrictions, if it held at least 25 percent, it could have a degree of control by maintaining the company's constitution. It is not clear why there should be a fetter on passing out all shares to employees if it is consistent with the commercial objective.

- What would be the mechanics, if you had a lot of employees leaving in one go? Would shares go back to the EOT, with a physical cash out to them? – Yes, and that would need to be funded out of the growth in capital value of the company.

- The current legislation does not preclude the buy-back of shares – It doesn't need a change of legislation, but rather a tweak to the tax rules to allow the company to fund the trust in a cost-effective manner.
  But this doesn't fit well with the ethos of ongoing employee ownership. It may be better to have a structure where employees <u>do</u> hold shares; <u>do</u> attend shareholder meetings; <u>do</u> have shareholder rights, and when they leave, know that there is a pool of cash enabling them to sell back their shares to the trust.

- In the US, through the Small Business Administration, it is now possible for some loans to Esops to be guaranteed, making it possible for normal banks to participate. We still have a problem in the UK, that banks are reluctant to fund an EOT. Learning from the SBA on that would be a great help.

- An EOT fact is that you can work for a company for 30 years, leave as a good leaver, then find there is a distribution in the next year, from which you are excluded. This can't be right?

The EOT gives employees no 'target'. For example, a plan where shares are held on behalf of employees, which crystalise within business plan cycles, of say three or five years, and valued according to how well the company performs, how well the individual performs, and length of service, give employees a target value. (This type of incentive worked well in the Xtrac example given in David's introduction).

- US tax: The IRS recognises the pro-rata value as being not greater than market value. Whereas the UK does not (a failing in our system). However, the US has a very much smaller minority discount – typically 15 percent, opposed to up to 60 to 80 percent, in some circumstances, in the UK.

- There was an NCEO paper published which proposed that there should be no difference, for Esop purposes, between control value and non-control value. In UK company law rules, if the controlling interest of the trust falls below 75 percent it makes a significant difference, or if controlling interest of an EOT falls below 51 percent, that too has in principle, an effect on valuation under tax rules. So it would be helpful if we got rid of that and recognise pro-rata value. This may necessitate regular valuations of the company, but given the incentive value to employees that participate, that is no bad thing. The fact that the only way to realise value of the company is to sell it, runs counter to EOT policy.

- These points are not solely applicable to EOTs, but affect other plans too, but given the way Treasury officials think, there is much scope for abuse if you do not restrict what can be seen as discretion within the tax rules.

Group 2 - EOT Development & Reform led by David Craddock

The aim of this discussion was to answer the questions:

i) *Should more be done to provide more direct employee ownership, particularly within the 51 percent?*
ii) *Can we make the introduction of an EOT conditional on the introduction of an all-employee share plan of some sort, in conjunction?*
iii) *Can we take forward some sort of model, which combines direct share ownership with the EOT?*

- There was consensus that the use of an EMI or SIP along side an EOT is a good idea, however the EMI and SIP do not encourage an employee ownership ethos, but are standard management incentives.
  In a broad-based SIP you would be asking most employees to invest a significant amount into the one company – a lot of eggs in one basket - which could be a moral hazard if the company does not do well. An EOT is de-risking it for the employees. A possibility would be to have an arrangement where it is conditional on having an additional EMI or SIP, although currently

discretionary, it could be stipulated that the EMI must be operated on an all-employee basis. (Would require amendments to both EMI and EOT legislation).

- How can we replicate the simplicity of the EOT, but still have a mechanism for employees to have capital growth when they leave the company? The admin involved in running an EMI or SIP alongside an EOT could inhibit a number of companies – there are extra aspects to consider. While it was agreed that an EOT combined with a mechanism for capital growth is positive, there was concern that asking a company to install an all-employee EMI for example would be too far for the type of company currently installing EOTs.
  An EOT is a benefit to employees in its current guise in a sense, where previously you would have been paying dividends to employee shareholders, there is now this pool, which would previously have gone to shareholders, but is now available to employees. Does that necessarily have to be capital? It is there for employees to receive income e.g. their tax rate bonuses. In that sense the EOT model as it stands *is* a benefit to employees.
  It is important that we should not focus too much on the CGT treatment of EOTs (most employees are happy to receive money they pay tax on rather than receiving nothing at all).

- Experience has shown that the natural friend of the EOT is a progressive profit share arrangement. This enables the building of an employee ownership culture. It could be applied to gig workers too, so then would satisfy many different needs within the company.

- There is a slight cross purpose between EOT and EMI – EMI is exit driven and EOT is Long term. By including direct ownership you get higher staff turnover and people realising their investments. But you need to be able to fund all this, so the profit share and access to bonuses make more sense. Being involved in the company is more of a key point than having capital.

- The original policy objective for the EOT was to preserve employment levels in the regions (EOTs are geographically more widespread than other share plans). The EOT's power is that it is an alternative to a third-party sale. But David Pett makes the point that EOT status of a company might not necessarily be for the long term and could at some point still be sold. There is a danger that, in adverse economic circumstances, a good many employees could start pushing for an early exit, which may not be in the long-term interest of the company *and* might not be in the long-term interest of the employment prospects of the employees.
  We are moving to the "next phase" of the EOT, where it could be considered as a fourth exit route after IPO, trade sale and sale to Private Equity. Now you are in an EOT what is going to be the long-term strategy for the business – if IPO/trade sale/PE wasn't right for you before, will it be in future? Therefore, on what basis are you running the EOT? This is what needs to be considered before deciding If any other capital mechanisms are needed.

- The main strengths of the EOT are its flexibility and simplicity. If conditions are imposed to legislation, there is a danger of losing that flexibility.
  There has been real momentum in EOTs since the pandemic mindset shift. There is a risk of making things too complex (we had an EMI consultation in May 2021 and many would rather see more progress there, particularly for the "missing middle" companies that have become too

big for EMI). General point is not to get too complex and to let the EOT run now that there is more general understanding of it.

Looking at David Pett's questions A & B: *Should the legislation allow for shares held by employees and former employees to count towards the 51 percent interest? – If so, should this be restricted to shares acquired under a Share Incentive Plan ("SIP")?*

- There is nothing to be lost from having direct ownership shares contributing to the 51 percent, so long as you are able to stabilise the 51 – if the shareholders sold their shares it may bring it below the 51 percent, so you would need some caveat, so those shares are held on an unallocated basis.
  Would government be open to reducing the 51 percent interest to 35 or 40 percent? This would give greater room for other arrangements.

David Craddock's concluding suggestions:

- Keep EOT structure as is, but strengthen the tax advantages of the Employee Share Trust, therefore giving us two models.
- There is value in marrying simple flexible profit share with the simple flexible EOT.

Summing Up

David Pett: Some of what he proposed is already available with the EOT, but not all. In particular the idea that a long serving employee should benefit from the capital growth in value to which they contribute is difficult to achieve in terms of commercial practicality.
Legislation needs tweaking to enable companies to, cost effectively, allow good leavers to benefit from that growth in value.
There was general support for this – perhaps the Centre could put forward a paper to the Treasury, with a few ideas for tweaking the legislation to allow that.

David Craddock: Predominant factor in the group's discussion was that people do not want to lose the flexibility, simplicity and the idea of the EOT. Main recommendation is to strengthen the EOT by a tax freedom around more substantial profit share.
US research has shown that the benefits of the Louis Kelso model are substantial. There maybe a case for two models, echoing Graeme Nuttall's call to not toy with the EOT, but rather add an EST of US Esop type model to enable more direct ownership.
In David's view, there are substantial advantages in encouraging government to embrace a US Esop style model, either to replace, or run alongside the EOT.
There is also merit in including a SIP or EMI plan with the EOT – perhaps an all-employee EMI, so we may wish to call for further reform of EMI.

Looking forward

Future webclaves will focus on SAYE/Sharesave and, we hope, on the NCEO/SCOA research on US S Corporations, mentioned by Malcolm Hurlston in his introduction.

We thank members for their participation and look forward to comments and suggestions.

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