spreading the wages of capital

Esop Centre Members’ Webclave 24 January 2022

The Centre hosted its fifth inter-active on-line members’ networking event “EOT Development & Reform” on 24 January 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 Graeme Nuttall OBE, Partner, Fieldfisher and Garry Karch, Head of the EOT Practice Group at Doyle Clayton, for introducing the topic and setting out the issues to be carried forward into the two breakout discussions.

Present:

Adva Lewitte, Shareforce
Andrew Loan, Fieldfisher
Andrew Nealey, PwC
Ania Adamska, JTC
Ann Tyler, Ownership at Work
Anton Seatter, JTC
Catherine Ramsay, Gannons
Cathy Wears, CMS
Charlie Germaine, Intertrust
Charlotte Fleck, Deloitte
Claire Drummond, Ocorian
Damian Carnell, CORPGRO
David Craddock, David Craddock Consultancy Services
David Pett, Temple Tax Chambers
Eddy Daly, LGL Group
Elizabeth Bowdler, PwC
Fred, Hackworth, Esop Centre
Garry Karch, Doyle Clayton
Graeme Nuttall, Fieldfisher
JD Ghosh, MM&K
Jennifer Rudman, EQ
Joanna Phillips, ESOP Association Canada
John Bezzant, RM2
John Menke, Menke & Associates
Josie Lynch, Baker McKenzie
Julie Chandlen, Ocorian
Juliet Wigzell, Esop Centre
Katherine Neal, Ogier
Linda Cook, Z/Yen Group Limited
Louis Paull, PwC
Malcolm Hurlston CBE, Esop Centre
Mark le Saint, JTC
MichaelMainelli, Z/Yen Group
Michelle Robinson, Deloitte
Mike Wardle, Z/Yen Group
Nina Horton, Intertrust
Richard Cowley, RM2
Sarah Anderson,RM2
Simon Stafford, Shareworks
Sunny Mangatt, Pett Franklin

EOT Development & Reform

Welcome
Juliet Wigzell Head of the Esop Centre, which is part of Z/Yen Group Limited, welcomed participants adding that the purpose of the meeting was to discuss the possibilities, and *whether there is a need*, for development and reform of the Employee Ownership Trust. Before handing over to the day’s speakers, Centre Founder Malcolm Hurlston gave a special word of welcome to John Menke, who was taking part in the meeting. “John is our direct link to Louis Kelso, who started the Employee Stock Ownership Plan many years ago. John was originally part of Louis Kelso’s practice and has carried the torch for Eso ever since. It is an honour to welcome him to this event.”

Graeme Nuttall – The EOT: Background and Where We Are Today

In answering *whether there is a need for development of the existing EOT structure* in law and practise, Graeme focussed on the proposed modifications that CIOT has put to HMRC and HM Treasury, which has now been submitted for consideration.

Where are we now?: Essentially the EOT is a success. It was introduced in 2014 and since then employee ownership has grown significantly - to 2020 there has been 30 percent year-on-year growth. We await stats for 2021, but expect it to have been another good year for the EOT. While the EOT has been successful, the scale of that success has been modest, but this is a vast improvement on 10 years ago.

Outline of the employee trust model: Employee trusts were not invented in 2014, but have a hundred year history with various pioneering experiments; most involving 'collective ownership' ie. a trust of some sort. Throughout, the trustee duty is to ensure there is *genuine* employee involvement.

The Finance Act of 2014: The best practice elements from the previous employee trust experiments were 'codified' and put into tax legislation; the Act does not set out a complete code for running an employee owned company. The key points of the legislation are:

- Emphasis on genuine share holding interest
- Must exist for the benefit of all employees

An important policy decision was to leave it to individual companies to devise their employee engagement mechanism, ie. entrusting the company to "do the right thing" with regard to the employee voice and delivering all those core asks.

Tweaking: There is always a case for keeping ideas under review and ideas for changes to existing legislation have been around for some time. Advisers to the Employee Ownership Association (EOA), during the Capital Gains Tax review, identified two main modifications:

- there is a suggested requirement that the EOT trustee must be resident in the United Kingdom
- a requirement that former major shareholders should not form a majority of the trustees or trustee director

From work with the Ownership at Work charity grew the idea that it would help to have a clear *statement of purpose*: "The inclusion in the legislation of an express statement of the purpose of an EOT as being to promote long-term employee ownership".

CIOT proposals: Following the growth of employee ownership; newcomers to the EOT, who only had the 2014 Finance Act to look at, were asking questions like "How do we set these up?". In response, CIOT investigated the changes being discussed and put them to a specialist committee, concluding that these three ideas were worthy of putting to the government. In addition, CIOT independently made recommendations to government – prioritising clarification on contributions and tax law. Proposals of note are:

- Confirmation that contributions paid by the target company to fund the acquisition are non-taxable in the hands of the EOT trustee

- Amendments as to who might be EOT trustees: in particular, a requirement for them to be resident in the UK and a prohibition on former owners forming the majority on the trustee board
- The lack of a dedicated code for making a claim for EOT CGT relief
- An opening statement of purpose in the legislation to underpin the policy intent of supporting long-term employee ownership

Poll question: (60 percent of participants voted)
Recently the Chartered Institute of Taxation (CIOT) urged the government to modify the EOT tax regime. Is there really a need for CIOT's proposed EOT modifications?

A. Yes – these modifications are needed, mainly to emphasise employee engagement. (46%)
B. Yes - these modifications are needed, mainly to prevent abuse of the EOTs Capital Gains Tax exemption. (38%)
C. No – The EOT is being used to achieve the intended policy aims. (15%)

The split between answers A and B was as hoped, suggesting that there are twin drivers for need for modifications: employee engagement should be addressed; and that there are legitimate concerns over possible abuse; but a good number think the EOT is working as it is supposed to, so why limit the scope.

Garry Karch – EOT Future Development & Reform

Garry's talk focussed on the scope for reform and modification of the EOT on a wider basis, starting with a poll looking at how direct ownership should interact with the indirect ownership model.

Poll Question: EOTs provide indirect ownership, but should more be done to promote/establish direct share ownership as part of or in conjunction with EOT ownership?

A. Yes, the EOT structure should be modified to include more provision for direct share ownership alongside the collective ownership structure. (24%)
B. Yes, changes to the current share and share option plans are needed to facilitate broader direct share ownership. (16%)
C. Yes, though all that's needed is more publicity for the fact that direct EO can operate alongside an EOT but no changes are needed to existing plans. (28%)
D. No, existing share plans are sufficiently well known and provide enough choice for those that want a hybrid EO model. (32%)

The results show the good mix of responses that Garry had anticipated; with 68 percent choosing the first three options, indicating that there is a desire to facilitate individual share ownership with EOT's collective ownership. The question is: How do we get there?

Making it real: Garry's standpoint comes out of working on the US Esop from 1988 till 2015 when he started working on the EOT in the UK. He compared the EOT with direct ownership through an outside share scheme.
There is no question that the long-term collective stable ownership along with the tax free bonus qualification is of benefit to employees. However, the issue with Income Tax free bonus is that many companies will look at this as an alternative to other bonus plans they have in place. You can't cut salary

or basic remuneration and replace it with an EOT (not permitted), but you can use it to replace a *discretionary* bonus of up to £3,600. The only benefit to the employee is the tax saving on the bonus. The longer term economic benefit really comes from the economics of direct share ownership and the ability to realise those economics without the need to sell the company.

Making changes: CIOT's proposed changes to the EOT structure are generally warranted, but the focus of structural changes should be to remove undue influence on the part of the vendors post-completion; vendors should not be allowed to have majority control of the trustee, particularly when the vendors, related parties, or the existing senior management team will control the company board post-completion; and employees should have representation on the trustee board.

While a statement of support in legislation to the extent that the policy intent of the EOT structure is to support long-term employee ownership, it is also important to realise that there is a good chance that an EOT will represent just another stage in the life of many businesses. It is important to understand that many businesses will be sold at some point and this can significantly benefit employees as well.

Requiring an independent third party valuation addressed to the trustee directors would be a worthwhile reform/requirement.

Facilitation: The EOT structure could be required to provide for direct share ownership in conjunction with the collective ownership model. The US Esop had provided for direct share ownership to employees for decades and has created life changing economic benefits for employee beneficiaries. Another way to facilitate direct share ownership would be to either require EMI option schemes (for qualifying businesses) or other tax-advantaged share schemes in conjunction with EOTs to receive the full benefits available under the EOT structure.

The main cost of direct ownership is that at some point the company will need to buy back the shares from the employee.

Garry remarked that there was still no stand-out UK based cash flow lending facility for EOTs in the banking community, perhaps because there was a greater risk of loss with privately-held SMEs. A new loan facility structure, perhaps a quasi-governmental organisation, which offered at least partial loan guarantees, is urgently needed.

Group Discussions

Group 1 - EOT Development & Reform with Graeme Nuttall

The group broadly welcomed the CIOT proposals, and noted that in implementing change:

a) It was important that employee representatives were not given a controlling vote or veto
b) There may need to be a staged implementation to allow employee representatives to be developed and introduced (perhaps two years)
c) It may be helpful to develop guidance or a handbook to support employee representatives and to help ensure employee views are properly represented
d) It was noted that independent trustees may in particular help to support and guide employee representatives.

e) Requiring trustees to be UK-based appeared sensible and would help to clarify matters*
f) Having onshore trustees would also help avoid any tax avoidance and help promote tax advantages of the EOT*
g) The proposals were in a sense regularising existing developments in EOTs

There was some discussion on whether the purpose of an EOT should be spelled out in legislation. It was argued by some that trust law already required trustees to act in the best interests of beneficiaries, and that it was not possible to limit the purpose given in a trust deed through legislation. For these reasons, legislation was not necessary. Others thought that it would be useful to ensure clarity.
**please note: there were no Channel Island trustee members represented in this group.*

Group 2 - EOT Development & Reform with Garry Karch

The aim of this discussion was to get a sense of what employee ownership means to everyone.

Q1: Is EO collective ownership, or is EO direct ownership? And how does this become meaningful to employees?

Employee ownership is an evolutionary process:

Employee engagement: Sense of ownership and therefore employee behaviour, depends on culture of the company and how it is communicated internally. A company might start with an EOT and as employees become more engaged, so the management has more confidence in the employees, so direct ownership plans are introduced. The two components empower and engage; one without the other brings 'normal' results; it does not have the same impact as the two together.

Use of off-shore trusts for EOTs: SMEs usually stay on-shore for cost reasons, plus a feeling that off-shore trusts look at this as a sort of acquisition, rather than as a third party buyer. Off-shore trusts are usually used by two types of company: a) Industry specific start-ups expecting to grow quickly; and b) Smaller EOT transactions where there is an existing relationship from wealth management or family trust arrangement. Bespoke incentive trustee teams have, so far, viewed EOTs from a distance, but their view of EOTs is changing. A third party trustee can be exposed to higher risks in an EOT than they would normally using other employee trust schemes.

Q2: Should direct share ownership be very strongly encouraged (though not mandatory), as part of the shift towards an EOT ownership model; do employees really see benefit of just collective ownership or do you need to provide economics to them as well?

Profit share: Not many current EOT transactions are at a stage where it is pure profit share. Once you achieve profit share, there is no need for direct ownership, unless you are going to have a further exit at some point. But, the current structure of the EOT encourages future sale which may not be into employee ownership – the only way of getting capital return is by selling the company again creating perverse incentive to sell.

Direct ownership: The benefit of direct ownership is that the employee has something tangible, eg a statement that says how many shares they as an individual hold. The barrier is how the shares are held – it needs to be made easy and transparent. The harder the structure is to understand; the harder it is to get buy-in to.

Distribution: Legislation references any distribution is made on 'same terms', which is formula based. In practice, though, you don't see distributions made from the trust on an on-going basis as this would be tax inefficient.

After listening to the discussions today, it would make sense to recommend companies be permitted to have direct share ownership, especially for all employees. At managerial level, for recruitment/incentive purposes, this can be done already by setting up, for example, an EMI scheme alongside the EOT for key staff, though it is not currently used more broadly than that.

Summing Up

Group one focussed on the CIOT proposals, for which there was general support, plus other points relating to needing best composition of trustee directors and extent to which that should involve an independent chair and employee representatives; and publishing reports on best practice and good behaviour.
Group two focussed on how best to make the EOT more effective from engagement and direct ownership perspectives. Key points were that the cultural and internal communications aspects are as important as being just employee owned – you don't get the benefit of the structure if no effort is put in to encourage employee engagement; and there was consensus that direct share ownership was the way forward.

Looking forward

A follow-up webclave on EOTs has been suggested, perhaps with focus on recent research by David Pett of Temple Tax Chambers. Please let us know if you would like to take part in a follow-up discussion.

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

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