



The Law Society

## **Implementing employee owner status**

Response to the Department for Business, Innovation and  
Skills consultation

November 2012



## **The Law Society**

The Law Society is the representative body for more than 140,000 solicitors in England and Wales ('the Society'). The Society negotiates on behalf of the profession, and lobbies regulators, government and others.

This response has been prepared by the Society's Employment Law Committee, Company Law Committee and Tax Law Committee, and reflects the expertise of solicitors with daily experience of putting employment, company and tax law procedures into practice.

Our interest in employment law and practice is to secure 'good law making', to provide clarity for employers and employees, and to avoid possible unintended consequences. We offer our expertise and experience to help government to shape and tailor its policies accordingly.

We are bound to comment that the restricted consultation period on this occasion has not been a constructive way of engaging with stakeholders. It is unrealistic to provide us and other interested parties with only three weeks within which to respond to a consultation on what are complex issues. It is a self-defeating approach to take, as it is in the government's own interest to have access to good quality advice from stakeholders.

Prior to the announcement earlier this year that the government would follow a range of timescales at the discretion of the relevant Department, the accepted standard was 12 weeks. Cabinet Office Consultation Principles state that 'timeframes for consultation should be proportionate and realistic to allow stakeholders sufficient time to provide a considered response.' Those principles have not been followed on this occasion.

## **Introduction**

The consultation paper states that despite the UK having one of the most lightly regulated and well performing labour markets in the developed world, the government wants to give businesses more flexibility and freedom to allow them to grow and take on staff.

An underlying assumption is that businesses do not take on more employees because they are worried about the risk of employees bringing claims against them in the Employment tribunal. Whether or not that assumption is correct - and we do not believe that it is in fact a major inhibitor on business expansion - for the reasons set out below, it is difficult to see how the creation of a new 'employee owner' status will incentivise employers to create more jobs, or be attractive to employees who are being asked to forego employment rights.

The reality is that this is not a new 'status' at all. Employees will remain employees - they will simply have a right to some shares, the price of which is giving up certain statutory employment rights. Employees can of course be given shares in a company as a reward or incentive without the requirement to give up their statutory employment protection rights.

We expect that small businesses, who are the prime target audience for this proposal, will be unlikely to take up a proposal which brings with it more, rather than less, 'red tape' in the form of complex tax and company law requirements. To the extent that the aim is to protect businesses against unfair dismissal claims, the proposal seems unnecessary given the recent increase in the unfair dismissal qualification period to two years. Removing statutory employment rights will not ease

the regulatory burden on employers, because the proposal creates new and complex requirements on employers.

One of the stated aims of the proposal is to 'give employers and employees more flexibility to reach agreements that suit both parties'. The more flexibility given to an employer in relation to determining the rights attached to the shares, logically, the less valuable the share could be to an employee. It is unlikely to be attractive to employees to surrender the certainty of established rights in return for uncertain capital gains tax benefits in the future and, so far as we can tell, the certainty of an upfront income tax charge. The removal of statutory rights will not place an employee in a stronger position unless the safeguards are so restrictive (in terms of valuing their shares at exit) that the employer will not adopt the scheme, as it would amount to a pre-contractual negotiation of the value of a dismissal.

Acting logically, employees ought to put more value on their employment protection rights. However, the relative bargaining power of an employer and prospective employee needs to be recognised. In most cases, it is the employer who dictates the contractual terms in the employment relationship - for the vast majority of employees there is no 'negotiation' about terms. In our members' experience, even senior employees have little opportunity to influence the overall terms of the contractual offer.

A key feature of UK employment law is the restriction on the contracting out of statutory employment rights. There needs to be appropriate safeguards for employees in a vulnerable position - for example, those without union or collective representation - who might relinquish their statutory employment protection rights without fully realising the consequences of their actions.

It is also likely that this new status will cause confusion for employers at the outset, but particularly on termination of the employee's contract. There is potential for satellite litigation on a range of complex issues which are likely to arise on termination, which runs counter to the aim of supporting small and medium sized companies through simpler regulation.

#### **Q1 How can the government help businesses get the most out of the flexibility offered and the different types of employment status?**

In our view it is the tax treatment of employment status which is most likely to drive the choices made by the individual employee and by businesses (for example, operation of PAYE), rather than the treatment of employment protection rights.

Businesses will need access to professional advice and support because operating these new kinds of contracts will be beyond the expertise of most firms.

#### **Q2 Do businesses feel able to use all three employment statuses? If not, what restricts the use of different statuses?**

Many businesses use a combination of employees, self-employed freelancers or consultants and agency workers.

There is commonly confusion among employers about the distinction between different statuses, for example, between an employee and a 'worker' who is provided through an employment agency. That lack of clarity appears often to drive the choice between engaging an individual as a freelance contractor on a self-employed basis and taking them on as an employee. The consequent risk of unplanned PAYE liability

and contravening employment protection rights if parties get their employment status wrong might deter employers from the use of different statuses. This is likely to be a particular issue for small businesses with limited access to advice.

**Q3 What restrictions, if any, do you think should be attached to the issue of shares or types of shares?**

An employer will want the ability to seek protections in terms of restrictions on shares for dividends; voting rights and a requirement to surrender on termination, howsoever caused, that are usually demanded when shares are issued to employees under the range of schemes which currently exist. Employers will not necessarily want the share rights themselves to be subject to restrictions as part of the rights expressly attaching to those shares, but may instead want to use the Articles of Association, contractual agreement or both.

If the company's ability to curtail the rights of individuals under the new employee owner shares is restricted, fewer employers will engage 'employee owners' because the value of having control of the company will take precedence over any concerns about possible future unfair dismissal claims. No-one enters into an employment relationship expecting it to end in an unfair dismissal claim, all the more so given that employees now need two years' service to become protected.

An employer in regulated sectors such as a FSA regulated company would have to consider its obligations under the Remuneration Code and could not accept any restrictions which fetter its obligations under the Code.

We anticipate that all employee owner shares would have to contain a restriction on the employee's ability to block a sale or future investment.

Any scheme will need to incorporate the right for the employee to require the employer to buy-back their shares on termination; otherwise the employee could be left with a minority shareholding interest, with no active involvement in the business.

**Q4 When an employer buys back forfeit shares, should this be at full market value or some other level (e.g. a fraction of market value) should some other level be allowed in certain circumstances?**

As is currently the case, companies will want flexibility as to how shares should be valued both generally, for example by reference to profits, net assets or both, and in relation to particular categories of leaving employees. If there is to be a statutory fall-back formula it should apply only where there is for whatever reason no agreement between the company and the leaving employee or no pre-agreed valuation methodology.

As with existing share schemes, satellite litigation could ensue on the question of market value. Such claims would have to be brought before the court rather than the employment tribunal.

A company will probably want to pay less to a 'bad leaver' (for example someone dismissed for gross misconduct) than to a 'good leaver', and to be free to determine what type of leaver falls into which category. Presumably no payment by the employer for the return of the shares will be required if an employee is dismissed for gross misconduct.

However, if that dismissal is then challenged by an employee, for example on grounds of discrimination, it could be months before an employment tribunal

establishes the circumstances. Where there is a dispute about the reason for termination, the employer is not going to make any payment for the shares until the issue is determined by an employment tribunal, with the possibility that the employee will then have to embark on a claim for the value of the shares (which we assume would be valued as at the date of dismissal rather than at the date of the tribunal's findings).

The same issues would arise from dismissals for breach of a statutory requirement. In these circumstances both the employer and the employee will require expert accounting advice for the purposes of any valuation, and the employer will need to know how to treat the valuation of the shares for accounting purposes pending the tribunal outcome.

It would be inequitable if an employer had to pay the full market value of the employee owner's shares on dismissal following unsuccessful attempts at managing poor performance. In employment solicitors' experience, employers find managing poor performance difficult, and buying back shares at full market value might mean that there is less incentive for the poorly-performing employee to respond.

Conversely, if in these circumstances the employer had to pay full market value for the employee owner's shares, it might be argued that there would be little incentive for the employer to attempt performance management in the first place.

**Q5 How should a company go about carrying out a valuation of the shares? What would the administrative and cost impact be for a company if an independent valuation was required?**

As stated in our reply to Question 4, employers will wish to have, as now, flexibility as to the criteria to apply in a share valuation; the flexibility to reach agreement with an employee and, in default of agreement, to apply a fall-back valuation formula. If there is to be a statutory fall-back, it should only apply in default of there being no pre-agreed valuation basis.

Depending on how the statutory fall-back is set, it could be quite expensive to apply. The cost would depend, for example, on whether the company could use its most recent accounts or whether there would have to be a valuation of the company at the date of the termination of the employment.

It is inevitable given the opposing interests of the employer and the employee that accountancy advice (probably independent accountancy advice) would have to be sought on market valuation.

Were employment related securities to be acquired for a price that turned out to exceed their market value, an income tax charge and a liability to national insurance contributions could arise under Chapter 3D of the Income Tax (Earnings and Pensions) Act 2003, which in many instances would then need to be accounted for by the employer.

In addition, a tax exemption is required under the distribution legislation to prevent an income tax charge arising on an employee where they sell a share back to their (former) employer. Supposing they were treated as paying £1,000 for shares but their fair market value was £3,000 on leaving - without such an exemption the former employee would be liable to income tax on the difference of £2,000, and a capital gains exemption of no value.

**Q6 The Government would welcome views on the level of advice and guidance that individuals and businesses might need to be fully aware of the implications of taking on employee owner status.**

The advice and guidance required will include:

- accountancy advice to both parties in relation to valuation
- employment law advice in relation to the employment protections that are being waived (both for the employee in terms of what they are forfeiting and for the employer in terms of the potential value of the claims they are excluding compared to the value of the shares which they are offering)
- corporate legal advice in terms of the impact of the employee owner status on control of the company.

Depending on the tax treatment of shares, tax advice may also be needed both by employee and employer.

Given the competing interests of employers and employees, and the different circumstances of each company with its own articles of association (which may or may not follow model articles), any general guidance would have to be of a very limited nature, highlighting the issues for each party to consider. In practice, both parties should take their own legal and accountancy advice, but this immediately puts the scheme out of the reach of the vast majority of employees, and creates an unequal playing field given that the employer is likely to have retained accountants and lawyers.

It may be the case that employers who are interested in creating employee owners will be looking towards the lower end of share offers (£2k), in which case there should be no impact on 'control' and accountancy advice may not be needed as much. However, this might be viewed sceptically by employees as more about making the forfeiture of employment rights more palatable than a genuine attempt to encourage employee ownership.

**Q7 What impact will allowing individuals limited unfair dismissal protection and equity shares have on employers' appetite for recruiting?**

Given the recent increase in the unfair dismissal qualification period to two years, we doubt that this scheme will offer any additional incentive to employers to recruit.

Furthermore, the complexity and costs associated with offering employee ownership in return for the forfeiture of employment rights is likely to deter employers from recruiting on this basis. An obvious practical complication is where a 'two-tier' workforce is created if only some employees take up shares on these terms.

In the circumstances, this scheme seems likely to have little impact on the appetite of employers to increase recruitment; we also believe that for the vast majority of employees, employee ownership on these terms will be of little interest.

**Q8 What benefits do you think introducing the employee owner status in with limited unfair dismissal rights will have for companies?**

As with existing employee share schemes, the benefit will be determined by the extent to which the business will be able to determine or limit the market value on termination; and its ability to restrict the rights of employee shareholders on control,

voting and dividends. The more a business is able to curtail those rights, the greater the potential benefit in offering employee owner status.

**Q9 Do you think these benefits will be greater for larger, smaller or start-up businesses?**

Larger companies are more likely to have robust performance management procedures and access to expert HR and specialist employment law advice. The forfeiture of employment protection rights might therefore be of less benefit and interest to these companies than to others. They may prefer to use existing models of employee share schemes.

For smaller or start-up businesses, control will be of paramount importance. Subject to retaining that control, the exclusion of statutory employment rights, which smaller and start-up businesses may find difficult to manage, could be a benefit. However, the legal and administrative costs of running such a scheme are likely to dilute the value of that benefit for smaller businesses.

**Q10 What impact, if any do you think the employee owner status will have on employment tribunal claims e.g. for discrimination?**

Employer owner status only removes unfair dismissal rights, certain rights to request flexible working and training, and statutory redundancy pay. Employers will still be liable for other claims, including on grounds of discrimination and whistleblowing. Employee owner status will not affect related employment tribunal claims unless an unintended outcome of the scheme is a rise in these claims as employees shift their grounds.

There will always be an incentive for an employee to secure their payments under the employee owner status scheme and then to go on to attempt to secure further payments if possible by asserting protected rights. There will need to be clarity on whether the value paid for employee owner shares on termination would be taken into account when determining any compensation for discrimination claims. We assume not.

The continued liability for discrimination and whistleblowing claims may discourage take up of the scheme by employers.

**Q11 What impact do you think introducing the employee owner status with no statutory redundancy pay will have for businesses, in particular, smaller businesses and start-up businesses? What negative impacts do you anticipate and how might these be mitigated?**

The value of statutory redundancy payments is relatively small. In our experience employers do not have a difficulty in making those payments where they are properly due.

The value of shares being proposed under the employee owner scheme seems to be much higher than the level of redundancy payments that are usually made. So for many employers the prospect of saving redundancy costs should not be a driver for taking up the employee ownership scheme.

**Q12 What impact will this change to maternity notice period have on employers?**

The logic behind amending the provisions for maternity notice periods specifically for owner employees is unclear.

If, as is suggested, planning for maternity returners is difficult for employers at only 8 weeks' notice, then we would suggest that this amendment is made across the board. In our members' experience, most employees know if they are intending to return to work 16 weeks before the expiry of their maternity leave, so it is unlikely that such a change would be prejudicial to employees and it would assist employers in planning for a return.

**Q13 What, in your view, would employers do if employees wish to return early without giving 16 weeks' notice?**

We expect that in the main, employers would reach an agreement with the employee about the date of their return. The advantage of early notice is that it would provide the employer with more time to plan for returners.

**Q14 How will these changes impact on a company's payroll provisions?**

The Law Society has no views on this.

**Q15 What effect will a compulsory 16 weeks early return notice period have on the length of maternity leave that mothers take or adoption leave that parents take?**

We do not anticipate that it would make any difference to maternity leave periods save where the employee was proposing to take only a short period of time as maternity leave, in which event, it may have the effect of extending their maternity leave by about 8 weeks in comparison to the current scheme.

**Q16 Do you think 4 weeks is the right period? If not, why not? What would be the impact of a shorter or longer period?**

This approach to maternity rights and flexible working appears inconsistent with the Government's commitment to family-friendly policies outlined in the 2011 *Modern Workplaces* consultation.

The proposals are likely to have a discriminatory impact as female workers will still be able to make such requests outside this statutory amended scheme. Employers would have to take this into consideration to avoid allegations of indirect sex discrimination.

**Q17 What impact do you think this proposal would have on the ability of employee owners to access support for training?**

The Law Society has no views on this.



**Q18 Do you have any comments on the Government's intention not to amend Company Law to implement the employee owner proposal?**

Companies should be free to decide how to document these arrangements in the same way as they currently are in relation to employee share schemes, and we therefore agree with the Government's intention.

**Q19 The Government welcomes views on particular safeguards that would need to be applied, in order to minimise opportunities for abuse.**

It is not obvious what the abuse is that the government fears.

In particular - see our response to question 20 - there will be income tax consequences (and potentially the opportunity for a tax deduction) for employees (and employers respectively).

We could see an argument for curtailing relief afforded to employers were there to be a course of conduct of the employer in question engineering dismissals, and consequently seeking to claw back at less than market value the shares previously issued. However, the level of conduct that justified tampering with the availability of relief might be hard to define.

**Q20 The Government welcomes views on whether the existing tax rules which apply to share for share exchanges (such as might happen when a company is taken over) and schemes of reconstruction should apply where shares issued in return for taking up the new status are involved.**

Before dealing with the issues raised in the question (in relation to schemes of reconstruction and share exchanges) we wish to highlight the consequences for employees of choosing to give up employment rights in exchange for shares.

One scenario is where an existing employee is offered the opportunity to change the terms of their employment in return for receipt of shares. It seems to us that the shares issued would constitute a non-monetary amount liable to tax in the hands of the employee either on basic principles or following the decision in *Hamblett v Godfrey* [1987] 1 AER 916 (the so-called 'GCHQ case'). In that case, a cash payment received in exchange for giving up employment rights was treated as liable to tax as income. There seems to be no reason why a non-monetary receipt, in this case the issue of shares, would not be similarly treated.

In the case of a new employee being offered the right to receive shares in exchange for more restrictive employment rights, we can see that there might be a theoretical argument that if the only offer to the prospective employee was of a limited contract in exchange for receipt of shares, no monetary value could be placed on the rights 'given up' by the employee (because they were never on offer). However, we doubt that HMRC will take that view. Indeed, this would be the implication of paragraph 56 (page 18) of the consultation document (namely that the giving up of employment rights was not adequate consideration for the shares such that part or all of the value of the shares would be taxable on receipt). Indeed, in certain circumstances this could give rise to a liability to collect tax on the part of the employer under the PAYE regime and for National Contributions to be due, without the employer being in a position to fund the tax.

If receipt of the shares is taxable in the hands of the employee, it is questionable whether employees should place much value on the exemption from capital gains

tax, given that individuals are for each tax year entitled to an annual CGT exemption (currently £10,600). So, in other words, the statutory exemption rights would be of limited or no value to the employee, given that they might be able to realise a gain - unless the company performed exceptionally well - without any liability to capital gains tax in any event.

In principle, shares received by an employee in these circumstances would be 'employment related securities' within ITEPA 2003. The consequence of such treatment is that subsequent events affecting the shares or their value may give rise to further income tax liabilities, not liabilities to capital gains tax.

There is an argument, therefore, that as value will have been provided by the employee (ie giving up certain employment rights) a statutory exception would be needed to remove the shares acquired in these circumstances from the employment related securities regime, whether or not any 'discount' on issue had been taxed. If that approach were adopted there would not seem to be any special regime needed for such shares in the context of share exchanges and reconstructions.

If, however, a policy decision was taken that following receipt the shares were employment-related securities, it is likely that an exception from treatment of the newly issued shares as the same asset as the shares cancelled or exchanged would be needed. We see no reason why if an employee could have benefited from CGT exemption had they sold shares for cash, rather than receiving shares in an exchange or reconstruction, the exemption should not apply to the shares received in the exchange or reconstruction.

**Q21 What impact do you think the proposal will have on labour market flexibility - that is, in relation to hiring and letting people go?**

See introduction.

**Q22 Would you be likely take up the new status? What would the impact of the status be on your business?**

Not applicable.

**Q23 What are your views on the take up of this policy by (i) companies (ii) individuals?**

See our answer to Q7.

**Q24 What are your views on the equality impact assessment? Are there other equality and wider considerations that need to be considered?**

See our answer to Q16.