Consultation on implementing employee owner status

8 November 2012
Key messages

1. We welcome this opportunity to respond to the Department for Business Innovation & Skills on its ‘Consultation on implementing employee owner status’ published on 18 October 2012.

2. We are strongly opposed to the introduction of employee owner status. Our view is that the Government has made a strategic error in trying to create an artificial trade-off between employment rights and employee share ownership, when there is no logic for this in practice. In developing a preferred policy, the principle of fairness should be respected for both employers and employees, including employee owners.

3. We think the suggested employee owner status might be of some value to a very small minority of companies – particularly those with a small number of employees who are critical to the success of the company as a whole. However, even for such companies there might be very limited benefits; there are plenty of existing ways of incentivising employees, including (for example) share options. We are not against the concept of employee participation, but employee owner status would come at a higher price than pre-existing alternatives, and in our view most companies would not seek to implement the proposals. Once the tax implications and administrative costs are taken into account, we think that the proposals would offer little or no advantages. This challenges the basis of the selected policy objective, and seriously undermines the effectiveness of the proposals.

4. We think the direction taken by these proposals is both rushed and misinformed, and is likely to lead to a flawed policy. We see the fact that BIS has brought forward these proposals as acknowledgement that the Government is aware of the extent to which current employment laws hamper companies that have growth potential. The proposals involve creating an artificial new employee owner status in an exercise that appears designed to circumvent existing laws to help companies, but not unincorporated businesses. Instead, we believe that Ministers should concentrate on ways of improving existing employment laws to help all businesses (regardless of their legal structure) to realise their potential for growth.

5. ICAS has for many years advocated the need for simplification in tax law, especially given that we have a self assessment regime. There is a balance to be struck between fairness and simplicity, and we accept that some complexity may be necessary in the interests of fairness. However, these proposals are discriminatory and would represent unwelcome complications. We think it would be wrong for the Government to promote legislation which is complex, discriminatory and likely to reduce certainty while increasing compliance costs. The proposals do not appear to be in the public interest.

6. We would encourage greater awareness of different ownership models to inform decision-making and widen options. A balanced picture of employee ownership is needed. Much of the recent awareness efforts (such as those sponsored by the Government) are overly focused on the advantages (rather than the disadvantages) of employee ownership, and are therefore too simplistic and potentially misleading. Potential owners need to know both sides of the argument.

7. In general, the introduction of this new employee owner status would cause added confusion for employers and those who work for them. Employers would face increased administrative costs, while there is no certainty that employee owners would gain any financial advantages. Indeed, it is possible that many of those becoming employee owners would fail to understand the true nature of the risks facing them. Many of them could be seriously perplexed by the complicated nature of what might be on offer, and in today's economic climate they might see this as yet another reason for distrusting their employer.
8. Among factors likely to give rise to increased administration costs for employers are the need for different employment rules applying to different groups of employees, the resulting requirement for new contracts of employment and communications with employees, increased compliance work ensuring that new employment arrangements are reported correctly under RTI, and additional costs involved in negotiating share valuations. Furthermore, for employers the risks of disputes at the Employment Tribunal would not be removed, and the possibility of the UK’s new employee owner status being challenged by the European Union would cast doubt over the future of the arrangements.

Detailed observations

9. As a general rule, we envisage that unfair dismissal, redundancy rights and rights to flexible working should not currently be a concern for any employer who values their workforce and the contribution their workers make to the business. By contrast, the employment laws which actively discourage businesses from employing more people are those that insist on extremely generous sickness and maternity rights being given to employees from the day on which they start, and real conflicts between employment and health and safety legislation which truly hamper companies from dismissing employees on grounds of capability to do a particular job rather than on grounds of conduct when doing the job; none of these are addressed by the proposals.

10. The aim of the proposals appears to be to reduce the burdens of employment laws for the employer. At the same time, we think they would impose even greater burdens of tax compliance – involving the reporting, valuing and paying income tax and NICs on shares provided to employee owners. We think the purported reduction in the burdens of employment laws would be much less than the additional burdens of operating different employment rules for different groups of employees, plus all the tax and valuation costs and the inevitable uncertainties that would be involved.

11. We have long supported the Government in its stated aim of simplifying taxes. The Office of Tax Simplification, in its ‘Review of unapproved share schemes: Interim report’ published in August 2012, drew particular attention to areas of complexity for all companies involved in share schemes. Given that the OTS is currently engaged in that Review, we think it wrong that BIS has brought forward these proposals without any reference to how they fit alongside the Government’s tax simplification objectives.

12. The following aspects of the proposals cause us particular concern:

   a. The shares are to be valued at unrestricted market value on acquisition, so income tax and NICs would be calculated on that value. It is unclear what is meant by unrestricted market value, so this aspect of the proposals is already causing uncertainty. It is unclear how the employee would fund the resultant income tax and employee’s NIC. If an employee is giving up valuable employment rights, should that value not be treated as consideration for the shares and taken into account in calculating the tax and NICs liabilities? However, the actual value of those rights is contingent, because the employee might never be dismissed or made redundant.

   b. It is unclear how the requirement to pay income tax and NICs on the value of the shares awarded to employee owners would reconcile with the employer’s obligation under RTI to report on or before payment to the employee. This might create a particular challenge in cases where the employer decides to meet the employee owner’s tax and NIC liabilities by grossing up.

   c. A significant benefit of employee share ownership would normally be the ability to pay dividends on those shares without attracting liability to NICs. However paragraphs 58 and 59 of the consultation document state that other tax legislation might need to be updated, and this could be read as a suggestion (for example) that NICs might be applied to the dividends. Without clarification on

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1 http://www.hm-treasury.gov.uk/d/ots_unapproved_employee_share_schemes_interim.pdf
such a fundamental point, it is doubtful whether any employer would give the proposals serious consideration.

d. It is unclear to us who would be responsible for advising an employee on the value of the shares they would acquire and the value of the rights they would be giving up in return. A long serving employee would be giving up a lot more than a new employee. Who would advise employees on the Articles of Association of unquoted companies, many of which are extremely complex? We think that the proposals could lead to mis-selling claims in the event of the failure of a participating company. Perhaps HM Revenue & Customs should take responsibility for ensuring that employers would have to follow a model which could be twisted or corrupted, and that they could not take unfair advantage of those being offered employee owner status.

e. It is an employer’s market at the moment, and totally the wrong time to be asking employees to give up employment rights of any kind. Because of the shortage of employment opportunities, the proposals would effectively empower employers to force would-be employees to accept reduced employment rights in favour of a share acquisition. We would question whether this might be tantamount to an infringement of their human rights, and we wonder what the ECHR would have to say on this.

f. Paragraph 23 of the document mentions the balance between certainty and cost. It would be naïve to imagine that, under our complex tax system, incurring additional costs would automatically reduce uncertainty. The proposals, if implemented, would impose heavy costs of compliance and administration while leaving much scope for uncertainty. We suspect that the costs of valuations and advice, if done properly, would significantly outweigh any benefit.

g. Paragraph 18 states that, on an employee owner leaving, the company would be required to buy back the shares at ‘reasonable’ value. If that is different from unrestricted market value because the shares are in fact restricted, the outgoing employee owner could be significantly worse off at the end of the day. After all, minority shareholdings in unquoted companies are often of very limited value. Indeed, the shares to be issued to employee owners could be restricted in a variety of ways (e.g. non-voting, no entitlement to dividends, etc) so it seems that a cynical employer could construct a scheme that would remove employee rights in return for the issue of shares which could be utterly worthless from the outset.

h. If the employee owner wanted to sell their shares during their employment, there would need to be a market mechanism in unquoted companies. If the employer company were to buy the shares back, then the employee might need an exemption from income tax and not (as proposed) an exemption from capital gains tax. Furthermore, company law would prohibit the employer from buying back the shares unless it had distributable reserves.

i. In current circumstances small companies rarely have to value their shares. By contrast, the proposals would involve multiple occasions (perhaps many times in each year) when valuations would have to be undertaken and negotiated with HMRC – on assignment of shares, on surrender of shares when an employee owner was to leave, and on sale if and when a continuing employee owner was allowed to dispose of his shares – involving external professional costs in most cases. It is unclear to us whether HMRC would have the resources to agree all these additional share valuations for tax purposes.

j. Companies would face not only the costs of valuations but also the costs of buying back shares. If a company wanted rid of an unsatisfactory employee owner at a time when liquidity was stretched, this could create an intolerable burden. The risks of such situations arising could be an additional factor discouraging many companies from implementing the new employee owner status – especially if no distinctions could be made between ‘good’ and ‘bad’ leavers. The extra cost of having to buy back the shares from a dismissed employee owner would represent an additional cost burden on the company, and
in many cases could be more burdensome than the pre-existing processes which are designed to protect employees against unfair dismissal.

k. The existence of employee owners could adversely affect a company’s ability to raise funds from other investors, particularly where shares offered to a new employee owner could dilute existing holdings and even affect the control of the company.

l. Overall, the proposals would invite certain employees to relinquish some of their employment rights in return for (a) an immediate income tax and NIC bill and (b) an offer of a capital gains tax exemption on a future uncertain gain which would probably be exempt from capital gains tax anyway, either because it was covered by the annual exempt amount or because it was liable to income tax.

Conclusions

13. It is imperative that the potential tax repercussions of employee owner status should be examined in detail and a combined impact assessment of tax and administrative burdens implications carried out before these proposals are allowed to go forward.

14. Instead of developing this impracticable idea any further, we would prefer to see BIS devote its resources to other more positive and practical measures, not only to help employers navigate and comply with existing employment laws, but also to take positive steps to reduce related administrative burdens.

The consultation process

15. We deplore the fact that the consultation document appears to have been prepared with little or no input from HMRC. The potential tax repercussions of employee owner status are far-reaching, and should have been explored in depth before the consultation was launched.

16. We are also very concerned that BIS is following neither the Cabinet Office’s new consultation principles\(^2\) which were intended to take effect from early autumn 2012, nor the previous Code of Practice on Consultation\(^3\) published by BIS (as BERR) in July 2008. In accordance with the new principles, a longer period of consultation should have been allowed in view of the fact that there has been no prior consultation on the measures and they are likely to affect smaller, more vulnerable organisations such as small companies and their employees.

17. Best practice and BIS’s own Code of Practice require that consultations should last at least 12 weeks. This consultation has only had 3 weeks. On the same topic, "Employee Ownership and Share Buy Backs: Consultation on implementation of Nuttall Review recommendations"\(^4\) is only open for 2.5 weeks. The short time allowed for these consultations not only fails the Government’s own standards but reduces public trust in the seriousness of the intent to consult, the effectiveness of the process and the quality of the policy outcome. This is in direct contrast to the Better Regulation agenda. Furthermore, by ignoring most of the potential tax implications, the consultation document fails to give stakeholders sufficient information to enable them to make informed comments.

18. The evidence base presented for the proposed policy is insufficiently robust. We would have expected to see a business and regulatory impact assessment and a tax impact assessment as essential elements of the consultation. These omissions also depart from best practice.

\(^2\) http://www.cabinetoffice.gov.uk/sites/default/files/resources/Consultation-Principles.pdf
\(^3\) http://www.bis.gov.uk/files/file47158.pdf
\(^4\) http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1162-employee-ownership-share-buy-backs-consultation.pdf
About ICAS

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20. Our Charter requires ICAS and its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.