Ownership at Work

EQUITY FOR ALL

How a simple trust can spread ownership and wealth to millions

Nigel Mason

OWNERSHIP INSIGHTS

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Foreword


Photographer Gerardo Jaconelli

Two things surprised me about the reaction when I announced my decision to transfer control of the company I founded in 1978 to a Trust on behalf of the people who work for it.

The first shock was the amount of media coverage; I'd expected barely a whisper. The second was my surprise that other people were surprised at my decision. To me the decision to pass the company to my colleagues was, I felt, obvious and a sensible thing to do.

A lot of company founders and owners leave thinking about business succession too late. The result tends to be less than ideal, to put it politely – for the owner, the business and the employees. My father died at 60 and - although I still wanted to be around as Richer Sounds moves to a new chapter and a new generation - I felt this was a great way to secure an orderly succession and perpetuate our company's history.

Why not sell to the highest bidder – the conventional option? Because it probably would have ended the unique culture we've created together. No one knows my business better than the people already in it, so why hand its future to someone who doesn't know it and whose main concern may be to just run it for cash or prepare it for resale?

I welcome Nigel Mason's paper because it tells other owners, and their advisers, about the kind of trust we used to transfer ownership of Richer Sounds to the employees. The fact that use of these trusts is growing fast is evidence that employee ownership can be a terrific solution for a swathe of business owners.

I'm delighted the company I founded is joining a thriving network of co-owned enterprises that now stretches across the whole UK economy. We're proud too to have become members of the Employee Ownership Association.

This paper is exciting because it also talks about using the new trusts to deliberately spread ownership and wealth to many more people – potentially millions… which must be a good thing.

Julian Richer
Founder, Richer Sounds

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Employee ownership in its various forms has the potential to transform our economy.... because it is concerned with the distribution of future wealth rather than the distribution of present wealth; because it provides incentives both to capital and to labour through its effect on efficiency, productivity and motivation generally; and because those incentives are directed to ordinary and well understood concerns for security of employment and a fairer share of wealth.

James Cornford
A stake in the company, IPPR, 1990
[James Cornford was Chair of EOA from 1999-2002]

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The views expressed in this policy paper are those of the author and do not necessarily reflect those of the publisher, Ownership at Work, or the organisation with which it works as a research partner, the Employee Ownership Association.

EXECUTIVE SUMMARY

Employee Ownership Trusts (EOTs) were introduced by the Government in 2014. This paper studies their strengths and weaknesses and suggests how the EOT could create wealth for millions of workers.

The EOT offers incentives to business owners and employees. For owners there is an exemption from capital gains tax; for employees there are income tax free bonuses.

There are now around 240 EOTs in the UK covering around 23,000 employees and their number is increasing at the rate of 30 per cent per annum. Around nine out of ten companies that have adopted EOTs say they would recommend them to others.

The value of an EOT shareholding could become substantial over time. Presently there is no straightforward way of giving employees access to that. There is a strong case for allowing some of that capital value to be allocated to employees in a sustainable way.

With capital wealth in the UK becoming increasingly concentrated in fewer hands, EOTs are a way to spread wealth more widely.

Employee ownership is more common in the USA than in the UK but differs in two ways: the US stake is allocated to individual workers, not held in a collective pool; and the US stake is a recognised retirement savings vehicle, eligible for the same favourable tax treatment as traditional pension plans. The UK could learn from this model.

The number of EOTs, and the spread of wealth to employees, would increase if owner vendors could receive a higher proportion of the sale proceeds in cash, instead of relying on repayment over several years from the company's profits. This would make an employee buyout more competitive with the typical cash offer from a trade buyer or private equity buyer.

Accelerating cash payments to vendor owners could happen if contributions from a business to its EOT were tax deductible.

Another helpful reform would be to exempt vendor loans to EOTs – the amount the owner effectively lends the business on exit – from inheritance tax, so they are not losing an important tax relief.

The EOT structure should also be made more attractive to external investors. This would not only extend EOTs into more capital intensive sectors but also provide the funds to make cash repayments to the vendors.

Current EOT rules mean employees cannot easily acquire their share of the EOT's stake; ownership is exclusively collective. This could lead to unintended pressure to sell the business as a way for employees to unlock the value of their collective stake. A survey by one consultancy shows the equity value per employee could be as high as £175,000 once vendor loans have been repaid.

We recommend that EOTs should have the flexibility to allocate shares to individual employees, as with the current Share Incentive Plan (SIP). Combining the functions of the SIP and the EOT would allow beneficiaries to build a significant personal stake in the business; and could be extended to private equity backed companies, in which employee ownership is largely absent.

With auto-enrolment failing to solve the UK's pension problem – saving levels still aren't high enough to avoid a forecast rise in pensioner poverty – the level of pension contribution should rise from eight to fifteen per cent by 2030. But employers should be allowed to fund this by crediting company shares to employees' pensions accounts, as in the US employee share ownership plan (ESOP). This new type of pension contribution should be allowed tax exemption if paid into this new version of the EOT.

Combining employee ownership with pension saving in this way would lift saving rates while widening employee ownership. Just doubling the current growth rate of EOTs by 2030 would create more than 9,000 employee owned companies and over 1.5 million employee owners.

Ownership at Work

Ownership at Work's mission is to generate new thinking and ideas on employee ownership's contribution to the UK economy. An independent think tank, Ownership at Work publishes policy papers, guidance and research on the fastest growing business model in the UK economy. Holding charitable status, Ownership at Work is a politically impartial research partner of the Employee Ownership Association, the national body which speaks for the UK's £30 billion employee ownership sector.

Ownership at Work wishes to acknowledge the support of RM2 in the authorship and publication of this paper.

RM2

RM2 is a 25 year old consulting business specialising in employee share schemes and employee ownership trusts for private companies. The multi-disciplinary team of lawyers, accountants, tax specialists and administrators helps clients design, install, finance and operate their employee ownership plans to maximum effect. As well as advising clients, RM2 staff do extensive pro bono work in the employee ownership sector, contributing their know-how through publications, blogs, policy papers, webinars and statistical analyses. In 2019, RM2 became wholly owned by its employees.

Nigel Mason

Nigel Mason is a senior associate at RM2, having previously been owner and managing director. A mathematician by training, his early career was in banking. He became interested in employee ownership following a study tour of employee owned companies in the USA. Inspired by their success, Nigel started a number of businesses in the UK to advise and support new employee owned businesses. He advised the government on the introduction of the Share Incentive Plan and EMI share option scheme in 2000, and in 2014 advised the Coalition government on the introduction of the employee ownership trust, the subject of this paper.

1 ABOUT THE EOT

Introduction

Since its introduction in the 2014 Finance Act, the Employee Ownership Trust ("EOT") has transformed the employee ownership sector, doubling the number of employee-owned companies in the UK in five years and providing a neat succession solution for hundreds of owners of small businesses. Yet, for all its strengths, the employee ownership sector is small as a proportion of the national economy.

As the EOT approaches its fifth anniversary, it is timely to examine its strengths and weaknesses, and imagine how this innovative yet simple structure could be used to create meaningful wealth for millions of workers.

Origins

Employees owning a stake in their company are not a new phenomenon. Whether in the form of individual ownership through employee share schemes in public companies or collective ownership through employee trusts in private companies, it has a long tradition in the UK.

The best known but by no means only example of a private company wholly owned by an employee trust is the John Lewis Partnership. That company's long standing commitment to employee participation and profit sharing has inspired other businesses over many decades to follow John Lewis's example. This is despite the obstacles and challenges that lay in their way.

For whereas employee share schemes have enjoyed statutory recognition and successive tax reliefs since 1978, employee benefit trusts ("EBTs") – the preferred structure for achieving majority employee ownership in a private company – have not generally enjoyed official encouragement. Indeed at times they have faced outright hostility, because of the occasional use of EBTs for tax avoidance. As a result, companies wanting to establish genuine majority employee trust ownership have had to navigate complex legislation intended to combat tax avoidance. It was a process fraught with cost and uncertainty, and only a handful of the most committed companies were willing to take that risk to achieve their goal.

The situation changed in 2012 when the coalition government of Conservatives and Liberal Democrats commissioned a review of employee ownership. Graeme Nuttall OBE, a leading adviser in the field, produced a report, the Nuttall Review of Employee Ownership (Nuttall 2012), which recommended a series of measures to raise the profile of employee ownership in the business community.

Changes to the tax code were beyond the scope of the Nuttall Review. Nevertheless, the Government announced in March 2012 their intention to examine options to remove barriers to employee ownership, including tax barriers. This culminated in the introduction of the Employee Ownership Trust in the 2014 Finance Act.

[1] In 1978, the Lib-Lab coalition government introduced approved profit sharing schemes, allowing companies to gift shares tax-free to employees. Since then, a number of different employee share schemes have been statutorily recognised by successive governments, including Save As You Earn share options (1980), EMI share options (2000) and the Share Incentive Plan (2000).

[2] The exception to this general lack of government support for EBTs was the so-called QUEST, a qualifying employee share trust, which the Conservative government introduced in 1989 to encourage employee ownership. Unfortunately it was seldom used other than as a tax planning scheme in larger public companies that already operated employee share schemes, and as a consequence was withdrawn in 2003.

[3] One of the most high profile examples was Glasgow Rangers Football Club, which attempted to use EBTs to pay key employees large sums without deduction of income tax, an attempt successfully challenged by HMRC.

[4] No such tax would arise if employees were to buy shares from the EOT at market value, but not all employees have the financial means to do this and share purchases by only the wealthier employees could compromise the inclusiveness of employee ownership.

Key features of an EOT

An EOT is a restricted type of employee benefit trust. The trust must hold company shares for the benefit of all employees of a company, unlike most EBTs which operate on a discretionary basis for the benefit of key employees only. The trust creates a form of employee common ownership that provides the basis for employee participation in both profits and corporate governance.

The EOT is controlled by trustees. The EOT legislation is silent on the question of their identity and composition. Usually, they are a combination of employees and independent people. The original business owner can also be a trustee. To ensure that they properly represent the company's employees, EOT trustees in larger companies will often create an employee council to help appoint and advise the employee trustees.

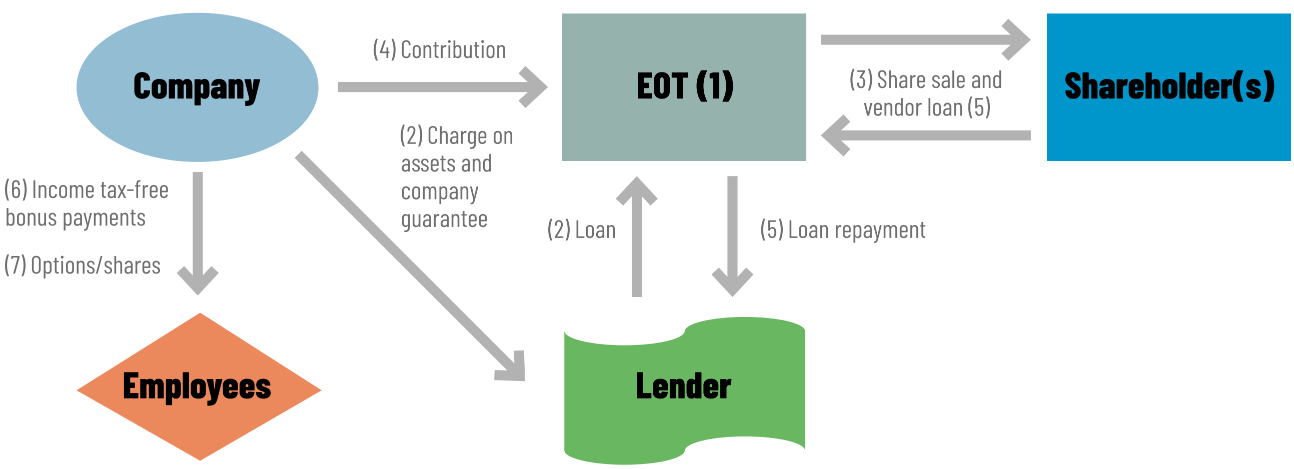
There is no requirement for the EOT to distribute its shares to employees and in practice very few do. In fact, doing so can be problematic: employees would have to pay income tax and the company would have to pay national insurance contributions on the market value of the shares at a time when they might not be readily convertible into cash. Instead, the EOT would usually hold the shares indefinitely for the long-term benefit of the employees as a whole, or until the EOT-owned company is sold.

Until then, the company remains independent and the employees are the ultimate beneficiaries of the business in a sustainable ownership structure. Profits are either reinvested in the company or distributed to employees as bonuses.

All this would technically be possible to achieve with an EBT. What is unique to an EOT is the attachment of two powerful tax incentives.

- The first tax relief is aimed at business owners. In the tax year when an EOT acquires a majority of a company's issued share capital, the outgoing shareholders can claim exemption from capital gains tax on the disposal of their shares. Targeting a tax relief at existing business owners is a smart move: ownership of existing businesses will only be transferred to employees when the current owners are motivated to do that, so the Government is signalling to business owners through the tax code that employee ownership is to be encouraged. It provides owners with the comfort of official approval. Furthermore, an advance clearance is available from HMRC, providing welcome certainty.
- The second tax relief is aimed at employees. Employees of a company that has become EOT-controlled may receive income tax free bonuses (up to £3,600 per person per annum), provided the company pays those bonuses to all employees on similar terms. Although paid by the company and not the EOT, the bonus simulates employees receiving a dividend distribution from the EOT's majority shareholding. It is these two powerful tax reliefs, and the simplicity of the EOT structure itself, which are signalling to business owners that EOTs are an exit route to be considered seriously.

How an EOT is established and financed



1. The company establishes the EOT and appoints the initial trustees. The company is valued, and a purchase price agreed.
2. The EOT may borrow money from an external source such as a bank. If so, the lenders take a charge over the company's assets.
3. The shareholders sell up to 100% of the shares to the EOT for cash and a vendor loan, subordinated to any external loan.
4. The company makes future contributions to the EOT out of profits or distributable reserves.
5. The EOT uses these contributions to repay the external loan (if applicable) and then the vendor loan.
6. Employees are eligible to receive income tax-free bonus payments up to £3,600 per employee per annum.
7. The company may issue new shares and/or options to employees, provided the EOT shareholding stays above 50%.

2 EOT TRENDS

Experience since 2014

There are now around 240 EOTs in the UK, covering around 23,000 employees (RM2 2019). From a low base, the number is growing at a rate of 30 per cent per annum. They are found in most sectors of the UK economy, in all regions and in firms ranging from five to 2,500 employees.

There are also around 35 pre-existing EBT-owned companies, the largest being the John Lewis Partnership, which were able to apply to be treated as EOTs and thereby benefit from the income tax relief on employee bonuses. These are termed "deemed EOTs".

Adding together newly created EOTs and deemed EOTs, they now represent more than three quarters of companies in the entire employee ownership sector and over half the total number of employees.

	New EOTs	Deemed EOTs	Total EOTs	Total sector	EOTs as % Total
No. of companies	240	35	275	370	74%
No. of employees	23,000	87,000	110,000	215,000	51%

Notes to table

1. For small companies that publish only abbreviated accounts, employee numbers were estimated from total assets, which are disclosed for all companies.
2. The total number of employee owned companies is estimated by EOA and the White Rose Employee Ownership Centre to be 370.
3. Employee numbers for the total employee owned sector were extrapolated from the data compiled by RM2 for the annual Top 50 list of employee-owned companies (RM2 2018).

Styles of EOT

There are different styles of EOT-owned company. Many intend to remain independent for the long term, especially those that are wholly EOT owned. They have no intention of distributing shares to employees and are content to pay cash bonuses from profits. This is a perfectly valid business model where the emphasis is on employee engagement, quality of employment and sustainability. It works for so long as the business is in steady state, does not require external capital and can continue to attract and retain talented employees – the prerequisites for sustained competitive advantage.

A minority have established employee share schemes alongside the EOT stake. In many cases these shares are reserved for selected employees, so that for example members of the management team who might have had their sights set on a management buyout can still enjoy the rewards from minority share ownership alongside the EOT – but without the prospect of a classic exit route such as a trade sale or an IPO.

In very few cases is it envisaged that the EOT stake be allocated amongst employees individually. (As has already been mentioned, this is problematic for tax reasons.) The value of an EOT holding could become very substantial over time. Without a mechanism to allocate some of this value to employees, there may be pressure on trustees to sell a company, not because that is a good outcome for the business but because it is the only way for employees to access some of the value that has accumulated in the trust. Some companies are taking steps to prevent such a sale but it is questionable whether such preventative measures are sustainable. Instead, it may be better to release some of this pressure by finding a way for EOTs to allocate some of their value to employees in a sustainable way. This is covered in section 3.

EOT performance and the justification for public support

It is too early to judge whether EOT-owned companies as a class are performing more strongly than conventionally owned companies. The anecdotal experience so far has been positive; of those EOT-owned companies responding to the EOT Survey (EOT Survey 2017), more than 95% said they would recommend an EOT to other companies.

There is better evidence for the employee ownership sector as a whole, of which EOTs now represent a substantial part. This evidence was gathered by an independent inquiry convened by the Employee Ownership Association in 2017 and published in the inquiry's Ownership Dividend report (EOA 2018), which can be summarised as follows:

- Employees in employee-owned companies enjoy higher engagement, motivation and well-being;
- Employee-owned companies typically achieve greater levels of productivity and efficiency than conventionally owned companies;
- They have stronger workforce retention and find it easier to recruit;
- Employees at all levels are more likely to initiate or engage constructively with innovation;
- They approach decision-making and planning based on long-term stewardship of value, which supports resilience (data shows that employee-owned businesses are more sustainable during economic downturns).

3 EOT POSSIBILITIES

EOTs and wealth creation

Whether or not EOT-owned companies as a group are superior performers, they have the potential – with some reforms to their structure - to spread capital wealth to millions of workers. It has been extensively documented elsewhere how capital wealth in many developed economies, including the UK, is becoming more concentrated and how, without intervention, that trend is likely to accelerate (Lawrence & Mason 2017 and Piketty 2014).

The historic routes to capital accumulation for most people – meaningful pensions saving and home ownership – are no longer available to large swathes of the working population, especially most younger workers and many workers in the SME sector. The largest group of employees by number are found in unlisted private companies, and most of these are employed by small- and medium-sized enterprises (SMEs) (UK Parliament 2016), so if mechanisms can be found to create wealth for millions of employees in the SME sector, this could have a material economic and social impact.

The SME sector is where EOT companies tend to fit best, because they appeal most to the owners of smaller businesses.

It is this "mass market" wealth creation opportunity afforded by employee ownership which has the potential to transform the economy and society. Wealth creation is a much more radical and ambitious goal than has been contemplated by the employee ownership sector so far.

To realise the full potential of EOTs and to make them truly mainstream, four reforms are proposed below.

But first, some observations about the US Employee Stock Ownership Plan ("ESOP") are informative as the US ESOP in large part provided the inspiration for the UK EOT, and has done much to spread capital wealth broadly to millions of American employees.

Observations from the USA

Since 1974, and with cross party support, ESOPs in the US have been providing an exit route for business owners of small and medium sized enterprises and a means for employees to accumulate a capital stake for retirement. In the US, only 30 per cent of a company has to be sold to an ESOP for the vendor to claim capital gains tax relief, and the company itself enjoys corporation tax relief on payments to the ESOP. Unlike in the UK, the equity has to be allocated to employees, usually pro rata to salary, and held in the ESOP trust until retirement, in what is effectively a form of self-invested pension plan.

The US Department of Labor estimates there are 6,500 ESOP companies with 14.2 million plan participants owning company stock worth $1.4 trillion (NCEO 2016). That is an average value of $98,592 per employee. For employees approaching retirement who may have been ESOP members for many years, the average value will be much higher. Some 92 per cent of ESOPs are in private companies and, of these, 60 per cent are in companies with fewer than 100 employees, proving that the model can operate cost-effectively in SMEs.

Of Americans who work for companies with share capital, one in five own their employer's shares. This is a much higher penetration than in the UK, where barely one in fifteen people who work for companies with share capital own their employer's shares.

There are two key differences between the US ESOP and the UK EOT:

- The first is that the US ESOP stake is allocated to individual employees rather than held in a collective pool.
- The second is that the US ESOP is a recognised retirement savings vehicle, eligible for the same favourable tax treatment as is afforded to more traditional pension plans.

Despite these key differences, US ESOPs can operate in a long term, sustainable manner in much the same way as most UK EOTs, making the promotion of the well-being of employee beneficiaries a primary corporate goal.

Four steps to make EOTs mainstream wealth creators

Inspired by the prevalence of employee ownership in the US, four reforms are proposed to boost the EOT in the UK:

1. **Make the EOT proposition more compelling for business owners**
2. **Make EOTs more attractive to investors**
3. **Allow employees to build their own capital stakes**
4. **Allow businesses to offer EOTs as pensions**

1. Make the EOT proposition more compelling for business owners

Many more EOTs are needed in order to create more wealth for employees, and that means persuading many more business owners to adopt this exit route.

The first way to make the EOT proposition more compelling for business owners is to create the conditions for owners to receive a higher proportion of their sale proceeds in cash.

Unlike a trade buyer or a private equity buyer, an EOT buyer does not have its own cash with which to pay the vendors. Instead EOTs rely on patient vendors willing to wait several years for full pay-out. EOTs cannot match the cash purchasing power of trade or private equity buyers and the CGT relief alone is unlikely to be sufficient to offset that disadvantage. The EOT has therefore appealed so far primarily to philanthropic or patient business owners or to owners of businesses that might struggle to find a buyer elsewhere.

One way of creating the conditions for owners to receive a higher proportion of their sale proceeds as cash is to make an EOT-owned company more attractive to external investors. The investors' money could be used, at least in part, to pay the vendors more in cash. Attracting investors to EOTs is addressed in the next section.

Another way of accelerating the cash payments to vendors is to help the EOT-owned company itself be more cash generative, either by exempting from corporation tax entirely an EOT-owned company or by allowing contributions from a company to its EOT to be tax deductible.

In UK tax law, expenditure by a company that benefits its trade and employees is usually tax deductible in calculating a company's trading profits, but because of historic tax abuse a statutory prohibition on the tax deductibility of contributions to all forms of employee trusts was introduced in 2002. Companies moving to employee ownership therefore have to finance an EOT using contributions from post-tax profits. Lenders and investors therefore view EOTs as tax-inefficient structures that reduce the cash flow available to service debt compared to private equity buyouts.

It is recommended that contributions from a company to an EOT to finance a buy-out should be tax deductible for the company. This will allow companies to pay back EOT debt more quickly and increase its attractiveness to business owners. This reform would help EOTs compete with private equity buyers, which use relatively high debt levels to finance acquisitions and which can deduct from taxable profits the interest expense on private equity debt.

The second way to make the EOT proposition more compelling for business owners is to safeguard an exemption from inheritance tax. Presently, under UK inheritance tax law, shares in an unlisted trading company fall outside the business owner's estate for inheritance tax purposes. For an elderly owner of a valuable business, this is important. On selling their shares to an EOT, business owners replace an asset that is exempt from inheritance tax with one (deferred consideration) that is subject to inheritance tax on death, even though payment has not yet been received and may not be for several years.

It is therefore proposed that vendor loans to EOTs should be exempted from inheritance tax, so that elderly owners do not have to relinquish their valued inheritance tax relief. This change would also signal to a particular group of professional advisers (private client advisers and wealth managers) that an EOT is a valid succession solution for their clients.

2. Make EOTs more attractive to investors

There are two reasons why it is important to make EOTs more attractive to external investors. Firstly, it will broaden the appeal of EOTs beyond self-financing SMEs to include capital-intensive or high-growth businesses that need lots of investment. Secondly, it will enable vendors to receive a higher upfront cash payment for their shares. As has been seen in the previous section this is needed to enable EOTs to compete with trade buyers as an attractive exit route.

EOTs don't sit comfortably with external investors because for many years most of a company's profits are intended to be contributed to the EOT to pay off the vendor. For an external investor, those same profits could have been distributed "fairly" to all shareholders as dividends. From the investor's perspective, the EOT and ultimately the vendors are getting unacceptable preferential access to company profits.

There is a simple structural solution that would mitigate the vendor's preferential access to company profits: allow the company to lend money to the EOT rather than have to gift money to the EOT. The EOT would repay the loan from dividends (or the cash equivalent of dividends) or from the proceeds of share sales. An external investor would be more supportive of a recoverable loan being made to the EOT than an irrecoverable gift.

Currently, under UK tax law, when a company lends to any "participator" (that is, a shareholder including connected parties who owns more than 5% of the company), it must pay 32.5% tax on the value of the loan. This tax is reimbursed when the loan is repaid but nevertheless it is a nasty cash outflow which few companies could afford. So effectively, a loan to a significant shareholder is taxed as a distribution, as if it were a dividend. It is a long-standing blanket anti-avoidance provision that catches loans to EOTs.

It is recommended that this tax charge on company loans to EOTs is eliminated. This will open up the scope for EOTs in a wider range of companies:

i. if loans are made by a company to an EOT, rather than having to make outright contributions to the EOT, this avoids prejudicing minority investors (who are not receiving equivalent payments);

ii. it allows a company to finance an EOT where the company does not have distributable reserves sufficient to make gifts to the EOT; and

iii. it could also increase lenders' comfort in financing EOT transactions as lenders generally prefer to lend directly to a trading company, rather than to a non-trading trust with a company guarantee.

3. Allow employees to build their own capital stakes

A threat to the long term future of EOTs lies embedded in the way they are currently structured. In the current set up, employees have no right of access to the equity value locked up in the trust. So a successful EOT business could face pressure to accept a takeover offer so that all or some of the equity value trapped in the trust can be distributed to the employee beneficiaries. The dilemma for EOT companies is that holding all equity collectively in trust is good for long term, stable governance; but bad in that employees have no right to a share in potentially rising capital values.

As an illustration of the scale of value in EOTs, in the twenty EOT transactions advised on to date by RM2, the equity value per employee will be £175,000 once vendor loans have been repaid, assuming (very pessimistically) no appreciation in the value of the company in the meantime. One can imagine some employee beneficiaries questioning why such value should remain inaccessible to them indefinitely.

It is proposed that EOTs should be able if they wish to allocate their shares to individual employees on an equitable basis, in exactly the same way as a Share Incentive Plan, without the cost and complexity of needing a separate SIP trust. This should be presented as an option and not be mandatory, so that companies preferring the simplicity of trust ownership may continue to operate that model if they wish.

Share Incentive Plans – SIPs

A Share Incentive Plan is another special type of EBT, introduced in 2000, which can acquire and hold shares for employees in a tax-free manner. Shares worth up to £3,600 per employee can be gifted each year, and shares worth up to £1,800 per employee can be purchased each year from an employee's pre-tax salary. Whether shares are gifted or purchased by employees, the offer has to be made available to all employees on similar terms – exactly the basis on which EOTs must operate.

Furthermore, if a company chooses to subsidise the purchasing of shares by employees, it may credit up to two free "matching" shares for every share purchased, taking the total feasible annual tax-free value per employee up to £9,000. This is a generous but under-utilised tax shelter, under-utilised because very few private companies are aware of it. It can be thought of as a kind of single company ISA sponsored by an employer and with the tax shelter lasting for as long as the employee remains employed by that company.

By consolidating the functions of an EOT and a SIP in what from now on could be termed an Employee Share Ownership Trust ("ESOT"), a single all-employee trust would be able to:

- offer an exit route to business owners
- pay tax-free cash bonuses to employees
- (for those companies who want to) award free shares to employees and facilitate share purchases by employees through payroll, up to a maximum value of £9,000 per employee per annum.

Including the £2,000 tax-free dividend opportunity on SIP shares, the total theoretical tax-free allowance per employee is £14,600 per annum. When added to the tax-free personal allowance, which all employees enjoy (£12,500 in 2019/20), this is a big wealth creating opportunity for lower and middle income workers. Such reforms would allow beneficiaries of an ESOT to build a significant capital stake in their employers. The 50% ownership threshold for vendor CGT relief and income tax relief on bonuses associated with EOTs would remain, as would the requirement to allocate shares "on similar terms".

The ESOT trust itself would be exempt from capital gains tax on its allocated shares but, if onshore, would pay capital gains tax on the disposal of any unallocated shares.

The SIP elements of the trust could be reformed to reflect the changing nature of the contemporary workforce, with more itinerant millennials and fewer long-serving full-time employees. The holding period for SIP free shares would be reduced from three years to one year, though forfeiture provisions need not change. The period after which SIP shares are free of tax would be reduced from five years to three years. Companies ought to be able to allow former employees' shares to remain tax-free in trust if they wish.

Under the proposals in this paper, private equity backed companies would be allowed to operate the new ESOT as well as the other tax-advantaged employee share schemes. Although low profile to the point of being practically invisible, companies that have received private equity funding account for the employment of around 3 million people in the UK, equivalent to 21% of UK private sector employees. At any one point in time (private equity ownership being a transient state), such companies are estimated to employ 400,000 people in the UK (BVCA 2019), all of whom are unfairly denied access to tax-free shares.

Furthermore, the ESOT could be allowed to grant options to employees on similar terms – rights to shares instead of actual shares. This would provide attractive flexibility for those companies that are planning to be sold and which don't intend to stay independent indefinitely. If private equity backed companies still choose not to spread ownership once the ESOT opportunity has been created for them, the government should consider applying pressure by making the continuation of private equity's favourable tax treatment (such as income tax relief on carried interest schemes) conditional on their adoption of ESOTs.

4. Allow businesses to offer EOTs as pensions

So far, this paper has focused on measures to increase the voluntary adoption of EOTs by private companies, but more radical reform is needed if EOTs are to become truly ubiquitous in the private company sector. One such radical reform would be to combine employee ownership with pension saving, as happens in the US ESOP, with striking impact. Such a move could not only dramatically increase the take up of EOTs – spreading equity ownership to millions more people – but also lift the level of savings they can expect in retirement.

Rethinking the pension connection

Conventional pensions arrangements suffer from a number of drawbacks and inefficiencies:

- Pension contributions leave companies in the form of payroll deductions to external institutions, depriving the business of productive cash
- Fees and commissions paid to these external institutions can deplete an individual's pension pot by as much as forty per cent over their working life (Miller 2013)
- Savings that could have been productively invested in the employing business, where risks are understood, end up dispersed in nano-holdings in whatever portfolio the pension fund decides to invest them.

As well as these structural weaknesses, the UK pension system is suffering from chronic under funding: the new auto-enrolment system is not expected to generate adequate levels of saving for those reaching retirement age.

[5] Presently, private equity backed companies are prevented from operating tax-advantaged employee share schemes because the companies are technically controlled by the private equity investor, and only "independent" companies can operate such schemes. This can be easily remedied; for example, the EOT legislation provides for EOT-controlled companies to operate employee share schemes even though they are controlled by a corporate trustee. The same provision could apply to companies controlled by a private equity investor.

The auto-enrolment gap

Under the pension auto-enrolment system, by 2018, all UK employers (including SMEs) had enrolled their workers into a qualifying pension scheme, contributing in total (including tax relief) eight per cent of employees' gross pay to a low-cost pension scheme. Three-quarters of all workers are estimated to be eligible for auto-enrolment, which is estimated will lead to £17 billion of extra pension saving per year by 2019/20 (DWP 2016).

While auto-enrolment is an important reform, it is not sufficient to solve the UK's pension problem. Most pension experts argue that the UK needs to adopt a national retirement target of fifteen per cent of lifetime earnings to ensure adequate future pension provision and avoid a sharp rise in pensioner poverty (IRRI 2016). This rate of savings would also bring us into line with the best pension systems internationally, such as the Netherlands and Australia (ibid.)

Mathew Lawrence and Nigel Mason, Capital Gains:
Broadening company ownership in the UK economy, IPPR, 2017

Government could tackle the pensions shortfall by a twin track reform:

- Lift the level of pension contribution required under auto-enrolment – for example, a gradual rise from eight per cent now to fifteen per cent by 2030
- Allow companies to make their additional contributions by crediting company shares to employees' pension accounts – the US model – rather than having to pay more into the standard pension portfolios

It is important to address issues of risk here. Employees need reassurance that investing savings where they work is not a riskier second-best to a conventional external portfolio.

- The government should establish a national ESOT 'utility' capable of administering schemes for smaller employers and providing core services – like record keeping and share valuation – that would help keep costs down. There is a precedent in the way the government, before introducing auto-enrolment, established the National Employment Savings Trust (NEST) as a default low cost provider for smaller employers.
- A second requirement would be a degree of insurance protection for savers and arrangements to diversify investments in the years leading up to retirement away from illiquid shareholdings in private companies and in to more conventional liquid investments, as happens in US ESOPs.
- A third requirement would be to enable ESOTs to hold equity for leavers too. Currently, SIPs must 'expel' the shares of employees who leave the company. They can only hold shares for current employees. This means that at present SIP shares are at best a medium-term savings vehicle; they are not a vehicle for long-term capital accumulation.

Such reforms would stimulate a major increase in the formation of employee ownership trusts. An indicative forecast is included below.

Some additional safeguards

Trustee safeguards

There is no stipulation in the EOT legislation as to the identity or composition of the EOT trustees. This permissive approach is understandable; it recognises there is a wide variety of styles and governance practices in private companies, and that businesses are best placed to make their own decisions on trustees, safe in the knowledge that all trustees, whoever they are, have a legal fiduciary duty of care to the employee beneficiaries.

A significantly more prescriptive approach than this would be unwelcome to most businesses. On the other hand, it is questionable whether it should continue to be possible for the EOT trustee to be an offshore company, outside the realms of UK tax. This creates the possibility that EOTs may currently be established purely for tax planning purposes (for example: allowing business owners to sell to the EOT free of CGT only for the EOT to be sold on in short order to a waiting trade buyer, leaving employees with little or nothing of value).

It would be prudent to stipulate that the trustees of an EOT must be UK resident. This would close down a potential loophole, whilst still giving companies freedom to choose.

It would also mean that the government would collect more tax. In the event of an onward sale of an EOT-owned company, the EOT would pay capital gains tax on the difference between its sale

[6] The present rate of capital gains tax for discretionary trusts is 20%.

proceeds on its unallocated shares and the original base cost of the vendors' shares. Under the share allocation system outlined above, the capital gains tax would apply only to the EOT's unallocated shares, not to the shares that have been credited to workers' accounts.

There is a case for going further and stipulating that at least one trustee should be a professionally qualified and competent person such as a lawyer or accountant. In US ESOPs, there is a requirement for the ESOP trustee to be a professional fiduciary, but the effect has been to increase ESOP running costs, making them economically unviable in small companies.

Valuation safeguards

Another safeguard that should be considered, especially if ESOTs start to be used as pension supplements, is to introduce a requirement for a professional opinion as to the value of company shares. Presently, there is no legal requirement for a valuation opinion. Trustees would be in breach of their fiduciary duty if they paid more than "market value" for a company's shares, but market value in a private company is subjective, and trustees do not usually have access to all the information with which to judge value, running the risk that they might be led into over-paying, to the detriment of employees' financial interests.

Realising the EOT's full potential

It is hard to predict how many UK businesses could eventually adopt an EOT. The pace of growth was always likely to be initially quite measured because change-of-control transactions are once-in-a-lifetime events for most business owners and they happen only after very careful thought and planning. If the experience of the long-standing US ESOP is a guide, continued steady expansion is likely as positive experience spreads, especially if the UK EOT is reformed as proposed along the lines of the US ESOP.

Even just doubling the current growth rate of EOTs could lead to over 9,000 EOT companies by 2030, with over 1.5 million employee owners (see table below). This would mark a significant diversification of capital ownership and expand a model of business ownership that roots control and benefits with employees.

STATUS QUO	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
EOT Companies	285	371	482	603	754	905	1,086	1,249	1,436	1,580	1,738	1,912
EOT Employees	27,485	37,568	51,248	67,319	88,385	111,390	140,351	169,487	204,606	236,380	273,019	315,370
Projected growth rate in EOT companies		30%	30%	25%	25%	20%	20%	15%	15%	10%	10%	10%
Growth rate in employee numbers	5%											
Average employees per company	96											

WITH NEW REFORMS	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
EOT Companies	285	456	730	1,095	1,643	2,300	3,220	4,186	5,442	6,530	7,836	9,403
EOT Employees	27,485	46,175	77,617	122,247	192,598	283,094	416,148	568,042	775,406	976,952	1,230,960	1,550,977
Growth rate in EOT companies (double)		60%	60%	50%	50%	40%	40%	30%	30%	20%	20%	10%
Growth rate in employee numbers	5%											
Average employees per company	96											

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