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UK tax system blocking employee-ownership

I am responding to the call for evidence, in particular, the question about major long-term pressures on the UK tax system.

The issue: tax system reinforcing historical business structures

The issue addressed below is the problem of the UK tax system reinforcing historical business structures and being an obstacle to alternative ways of setting up and running businesses. In the context of promoting economic recovery after the pandemic, the UK tax system does not facilitate businesses which are genuinely employee-owned.

Employee-ownership as a business model is currently receiving some attention at an academic level and, I understand, has been actively discussed by the Scottish and Welsh devolved governments. The UK tax system does not coherently address employee-ownership as a business model. There are workarounds to avoid some of the tax problems that this creates but these work-arounds mean that: i) the business is not owned by its employees but is owned on behalf of its employees; and ii) the business cannot register as a co-operative and access the support network provided by the national and international co-op movement.

There are some straightforward changes which would clarify the taxation of employee-owned business and encourage people to consider this as a valid way of setting up a business. These business will want to adopt a company structure (whether limited by shares or guarantee) to obtain limited liability status but those shares will not confer meaningful capital rights (since such businesses are typically not founded to be sold on) but only a right to a proportion of annual surplus profit. Under the current tax system, people founding an employee owned business can take shares in such a company but employees joining later will be charged to income tax when they are made employee members through an issue of shares.

Making a tailored provision in the tax system for the unique circumstances of employee-ownership to facilitate the introduction of employee members does have a precedent in that changes that were made to remove obstacles for university spin-outs and managers investing in private equity owned companies where inadvertent tax changes had brought those sectors to an effective standstill.

Reason for writing

I have been prompted to write by the failure of the Arcadia and Debenhams retail groups. These business were failing before the pandemic as was the case with many other businesses which were financed and managed in a similar way (Jamie’s Italian, Carluccios, Laura Ashley, Brighthouse, etc). The press is already highlighting failure in management as being a key determining factor in the collapse of these business. Personally, I would also point to the fact that many of these were financed on a private equity model so with very high levels of debt and therefore always facing a precarious cashflow management problem.

This private equity mentality of prioritising short-term shareholder returns over long-term stability is the underlying cause of many of these brand name business collapses. Owners have taken over a brand and used unsustainable levels of debt finance to grow EBITDA by opening new sites with a view to selling on the business before its lack of underlying profitability is found out. It is obvious from the finance structures that private equity returns are primarily generated by the debt finance so the investor is not reliant on any increase in the underlying equity value of the trading business. Chasing

debt-financed growth inevitably gets caught out by economic cycles. It is a concern that the reasons behind the 2008 Credit Crunch were forgotten so quickly and investors have just resumed the same debt-fueled reselling strategy.

The need for alternative business models

What is different with the pandemic is that it has disproportionately affected “white collar” jobs compared to previous economic shocks. There is evidence that this has caused workers to lose faith in employment as providing long-term security. The gig economy and zero hours contracts had already started the process of workers having little engagement with, or trust in, their employers. This is a key reason for the UK’s low level of productivity but the lack of engagement now risks becoming engrained in the UK workforce as a result of the pandemic.

The pandemic has just brought into very sharp focus that many businesses, especially large national chains, are not being managed for the benefit of their workforce or customers but, in many cases, the business is a tool for investors to extract value. As an example, you can analyse listed company executive incentive plans and none of these that I have seen in company reports uses customer engagement as a performance measure. Listed company incentives are primarily focused on financial targets so focus executives on cost reduction and profit margins.

The rush of investor money back into the global stock markets despite the fact that many listed companies are significantly under-performing is a sign that these historic business models are so engrained that even a global pandemic cannot change them.

The investment advisor’s view of stock markets is a very cynical one being that they are effectively underwritten by national governments. This view will not have changed with listed companies, private equity owned businesses, professional partnership and premier league football clubs all claiming government support before approaching their shareholders.

Tax system stifling alternative business models

In a trading context, the UK tax system caters for sole traders, partnerships and companies. Charities, not-for-profit, barter and mutual trading operations are dealt with peripherally but the reactive nature of the tax system is preventing innovation around how business can be conducted.

Coronavirus has shown structural weaknesses in the UK economy but the political ambition does not seem to extend beyond trying to return to pre-coronavirus normality as quickly as possible once a vaccine programme has been rolled out. The opportunity to build in resilience for the future is not on the agenda. Based on public commentary, the unexpected financial insecurity that many people are facing as a result of the pandemic will lead many individuals to seek alternative ways of approaching employment and self-employment. Many UK businesses operating according to accepted business models were in difficultly even in the first month of the lock-down and I believe it is the business model which has been a significant contributory factor.

One business model which is attracting academic attention is employee ownership. I understand that the Scottish and Welsh governments have been investigating employee ownership models with Cardiff University Business School. Sheffield University has independently developed a FairShares multi-stakeholder business model.

The Employee Ownership Trust (EOT) tax rules were introduced in 2014 following a review which identified the benefits of employee owned business and also that the tax system needed to change to facilitate them. The EOT though is a “benign dictatorship” where ownership is kept away from the

actual employees. The EOT was based on the “John Lewis Model” but even John Lewis has shown that indirect employee ownership has its flaws as John Lewis and Waitrose stores have been closed during 2020 to cut costs causing well-publicised resentment amongst staff and customers.

There have only been around 360 business which have converted to EOTs in the 6 years since the EOT legislation was introduced which might suggest that it is not a solution for the business need to was intended to address. It is the next step beyond an EOT which is required in the UK economy and this direct employee ownership of the business they work for where each member has a vote. The EOT tax rules are complex and this will put off many people from the idea so, to encourage people to consider the fact that a variety of business models are open to them, a tax system which recognises the unique circumstances of business which are directly owned by their employees and offers transparent tax treatment of employee members would be valuable as people consider what they wish to do in terms of earning a living after the pandemic. Rather than the default of working as a sole trader, employee-ownership allows people to build a community with like-minded people to create greater scale and better chances of success with an in-built mutual support network. In this situation, the primary concern of the business is to keep its employee members gainfully employed not to squeeze every penny out of the system for the benefit of passive investors.

As referred to above, the original founders can set up a business in a corporate structure and take shares in the company. If the founders want to make all new employees they recruit, members of the company, those employees can be chargeable to income tax on the theoretical market value of the shares they receive. To the extent that employee-owned businesses adopt co-operative principles, the capital value has to be passed on to other co-ops if the business is wound-up so the value on the shares is the entitlement to a share of annual surplus profits. Since the entitlement to surplus attaches only to a single trading year in isolation, I would suggest that similar provisions to those which apply for university spin-out companies in Chapter 4A of Part 7 of the Income Tax (Earnings & Pensions) Act 2003 or the BVCA Memorandum of Understanding set out in the Employee-Related Securities manual at 30520 which applies to venture capital backed business should apply to exempt from income tax shares which are issued to employees in employee-owned businesses. It may be that a tax avoidance safeguard is needed which might be formulated on EOT principles (sections 236H to 236U of the Taxation of Chargeable Gains Act 1992) or, to minimise complexity, that it requires the employee-owned business to adopted co-operative principles which effectively means shares carry no entitlement to capital gains.

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