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UK Government Proposes CGT-Exempt Employee Share Ownership in Exchange for Forfeiting Certain Employment Rights

George Osborne, the UK Chancellor of the Exchequer, announced on 8 October 2012 a proposal for a new type of employment contract under which employees would forfeit certain employment rights in exchange for shares in their employing company.

How Would the Proposal Work?

Under the proposed new type of contract, called an “employee-owner” employment contract, employees would be given between £2,000 and £50,000 worth of shares in the employing company. Those shares would be exempt from UK capital gains tax (“**CGT**”). In exchange, employees would be required to give up their rights to claim unfair dismissal, statutory redundancy payments, request flexible working and time-off for training, and, in addition, female employees would be required to provide 16 weeks’ notice of the date of return from maternity leave rather than the current eight weeks’ notice.

For existing employees, this new type of contract would be optional. However, for new hires, employers (whether established companies or start-ups) could choose to offer only employee-owner employment contracts at the outset. Companies recruiting such employee-owners will continue to have the option of inserting more generous employment conditions into the employment contract if they wish to do so.

Employee-owners who receive full CGT relief on the shares given to them under this new type of contract would still be eligible for other existing forms of tax-advantaged employee ownership such as Enterprise Management Incentive schemes.

The government has indicated separately that employees would be liable to normal UK income tax and National Insurance Contributions (“**NICs**”) on the receipt of the shares.

If an employee leaves employment, there may be restrictions on the extent to which the employer can simply take the shares back from the departing employee; instead the employer may be required to buy them back from the employee at a reasonable price.

Further details of the proposal will be released later this month as part of a government consultation on the proposal.

Which Companies Could Use It?

The proposed scheme would be available to all companies, but is principally intended for fast-growing small and medium-sized enterprises that want to create a flexible workforce. By reducing exposure to employment claims and

incentivising employees, the hope is that firms will be able to improve flexibility and employment whilst also building a motivated workforce.

When Will the Proposal Be Introduced?

The government intends that this new type of employee-owner contract would become available in April 2013.

What Issues Might the Proposal Present from an Employment Perspective?

We envisage a number of legal and practical issues that might arise in relation to this proposal from an employment and share-schemes perspective:

- *Will it actually be attractive to its target audience?* Small and medium-sized enterprises may be attracted to the idea of employees giving up rights to unfair dismissal and statutory redundancy payments. In practice, however, the majority of such businesses may find it cumbersome and relatively expensive to establish and administer a scheme to provide shares, not least because such companies tend to be unlisted; there are likely to be considerable difficulties associated with valuing and delivering such shares (and many such businesses may be reluctant to provide shares that dilute overall ownership). Conversely, those companies that may find it easier to provide shares to employees, such as larger companies that are listed, may be less interested in seeking to have employees waive such rights, as the potential cost of unfair dismissal claims and redundancy rights, etc. may be seen as a less significant cost of the business (and such companies are likely to have established procedures and human resources departments that are used to dealing with such matters).
- *Does a cost-benefit analysis of the proposal actually make it worth taking it up?* For small and medium-sized businesses, there are a number of aspects of the proposal that may potentially make it expensive and cumbersome, e.g. the prospect of giving valuable shares in the business to ordinary employees and associated dilution issues, what valuation mechanism should be used for the shares, the cost of buying back shares at termination of employment, the prospect of a dispute with a departing employee over the value to be paid for his/her shareholding, etc. Conversely, the value of the rights being forfeited may in practice not be that significant. Although the maximum possible award for unfair dismissal is currently £85,200 in most cases, in practice the average award is in the £9,000 range. In addition, statutory redundancy payments are relatively modest (the maximum statutory redundancy payment for someone who has 20 years' service or more and is aged 41 or above is £12,900). Finally, the right to request flexible working is in practice a relatively toothless right, since it is only a right to *request* flexible working and not an absolute right to be given flexible working (albeit that the request can only be refused by the employer on certain specified grounds).
- *Will it just encourage employees to engineer other types of employment claims?* Where there is a breakdown in the relationship, the practical effect of the employee-owner having forfeited unfair dismissal rights may simply be to encourage him/her to seek to "engineer" other types of employment claims that have not been waived and for which there is no cap on damages (for example, a claim based on one or more of the different forms of anti-discrimination protections under the Equality Act 2010). In addition, in relation to flexible working requests, it is currently the case that if an employer turns down a flexible working request from a woman with childcare responsibilities, this can in some circumstances be actionable as unlawful sex discrimination. So, even if the formal right to request flexible working is waived, it is possible that a request that was nonetheless made by a woman in such circumstances, but refused by the employer, could still be actionable as unlawful discrimination.
- *Is it possible as a matter of EU law to waive all types of unfair dismissal?* There are some types of unfair dismissal where the protection given to the employee derives from EU employment protections, e.g. unfair dismissal for pregnancy-related reasons. It is questionable whether the government could, as a matter of EU law, amend UK law to allow employees to waive such rights.

- *Is the proposal arguably discriminatory?* It could be argued that the proposal is itself discriminatory against women. In practice, the vast majority of requests for flexible working are likely to be from women, particularly those with childcare responsibilities. If it became the norm for employers only to offer employment contracts with the waiver included, this could have a disproportionate effect on women.
- *Does the proposal represent a reputational risk for businesses?* From a public and employee relations perspective, many businesses may not wish to be seen as trading relatively modest amounts of shares (and relatively modest individual UK tax advantages) in return for a waiver of fundamental employment rights, particularly when unfair dismissal rights and procedures are often seen in the business world as just a reflection of what should be good human resources practice. For example, Justin King, the Chief Executive of Sainsbury's Plc, has already come out against the proposal saying "*This is not something for our business. The population at large don't trust business. What do you think the population at large will think of businesses that want to trade employment rights for money?*"

What Issues Might the Proposal Present from a Tax Perspective?

We set out below some of the UK tax issues that are likely to arise in relation to the proposal:

- *Will the proposed scheme be attractive to employees from a tax perspective?* Although precise details of the proposed scheme will not be available until the government launches its consultation, the UK Treasury has confirmed to media sources that UK income tax and NICs will be due on the grant of shares under the proposed scheme (in contrast to many existing tax-advantaged employee share schemes). Therefore, employees may need other funds to meet these tax liabilities, likely making the scheme unviable for a large number of people, particularly those employed by unlisted and smaller private companies.
- *Would the proposed scheme actually confer an additional tax benefit in practice?* UK individual taxpayers are currently entitled to an annual CGT tax-free allowance of £10,600. Therefore, assuming that employees earning low to middle incomes would likely only have a modest number of shares in their employer or make modest gains, the exemption from CGT on gains made under the proposed scheme would be unlikely to confer any additional benefit. An employee would only gain an additional tax advantage if his or her annual gains had already exhausted the annual allowance without taking into account any gains made under the proposed scheme; an unlikely scenario for most employees on a reasonably modest level of income.
- *What is the main practical tax consequence for employers?* A potential issue arises in relation to how shares granted under the proposed scheme are to be valued for the purposes of calculating UK income tax and NICs. As stated above, while the new scheme would be available to companies of any size, it is principally intended for fast-growing small and medium-sized companies. Without a listed share price, such companies would either face the cost of obtaining independent valuations or, should they decide to determine the market value of the shares being granted to employees for themselves, later scrutiny and possible audit by the UK tax authorities.

Conclusion

The details of the proposal are yet to be finalised and will only become clear after the government's consultation period. However, the information currently available indicates that employers wishing to use the new type of employment contract may face a wide range of practical difficulties from both an employment and tax perspective. Many employees may also be concerned about forfeiting employment rights in exchange for shares that may, in practice, give them few tax advantages and which will give them no certainty of any future value. It is therefore likely that this scheme will only be attractive to a small number of employers and employees.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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