



All Party Parliamentary Group  
**on Employee Ownership**

# Share Value

How employee ownership  
is changing the face of business

Short Inquiry

The All Party Parliamentary Group  
on Employee Ownership

May 2008

## **A statement from The All Party Parliamentary Group on Employee Ownership**

The purpose of the Group is to discuss and support the development of employee ownership.

The Short Inquiry was prepared solely to examine the performance and contribution of the co-owned business sector and to explore policy issues affecting its development. Mutuo and Field Fisher Waterhouse have not been paid to produce this Report. The cost of Inquiry transcripts and printing the Report is simply charged to the organisations who support the Group.

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In the past year the APPG received support of £8,000 from companies in membership of the Employee Ownership Association.

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## Introduction

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### How is employee ownership contributing to the UK economy?



**Sarah McCarthy-Fry MP, Chair**  
May 2008

The All Party Group on employee ownership was formed in June 2007 in response to growing interest in the role of a sector in which businesses substantially or majority owned by their own employees have achieved combined turnover of at least £20-25 billion annually.

The Group decided that that it should launch an Inquiry into the sector's performance and contribution to the UK economy, given the implications of the sector's scale and growth for policy makers; businesses who might wish to adopt this ownership model, finance it or advise on it; the field of business education and research; and employee owned companies themselves.

Evidence was taken in select committee style in three sessions. Invitations were extended to witnesses from a cross section of enterprises as well as expert commentators. All oral evidence was recorded verbatim. We also invited organisations and experts to submit written evidence; a list of witnesses is recorded in an appendix to the report. This report was produced solely with the purpose of examining the performance and contribution of the co-owned business sector and exploring policy issues affecting its development – with Mutuo and Field Fisher Waterhouse producing it for no financial gain.

I would like to thank all the organisations and individuals who gave evidence to our Inquiry and to members of the Group. I would also extend the Group's thanks to the report's author, John Knell. The Inquiry makes a number of recommendations and we will pursue these with Government and other relevant decision makers.

Sarah McCarthy-Fry MP, Chair  
May 2008

### The All Party Parliamentary Group on Employee Ownership Inquiry Panel

The All Party Parliamentary Group on employee ownership consists of 78 Members from both Houses of Parliament. The purpose of the group is to examine the contribution of the co-owned business sector to the UK economy.

Listed below are members of the Group who sat on the Inquiry:

Sarah McCarthy-Fry MP – Chair, Labour/Co-operative	Portsmouth North
Adrian Bailey MP, Labour/Co-operative	West Bromwich West
David Howarth MP, Liberal Democrat Lord Best OBE, Crossbench	Cambridge
Rt Hon the Lord Hamilton of Epsom, Conservative	

## Terms of Reference for the Inquiry

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### CONTRIBUTION OF THE CO-OWNED BUSINESS SECTOR

The Inquiry sought views on the following questions among others:

1. Do co-owned companies succeed in generating exceptionally high levels of productive employee engagement?
2. Are innovation and change managed with relatively high levels of employee co-operation in co-owned companies?
3. Do co-owned companies demonstrate exceptionally high standards of corporate social responsibility?
4. Do employee buy-outs offer a potentially strong business transfer option?
5. Is the co-owned business model well suited to the provision of outsourced public services?
6. Is co-ownership especially compatible with changing customer attitudes to products and purchasing?

### POSSIBLE BARRIERS TO DEVELOPMENT OF THE SECTOR

Views were sought on the extent to which any of the following amount to significant barriers to the further growth of the co-owned business sector.

1. A shortage of data on the extent of the sector and its performance
2. Lack of awareness and information about the sector among business owners, advisers, financial institutions, and public sector policy makers
3. Unnecessarily restrictive tax rules affecting the sector
4. A relative lack of appropriate finance
5. Inadequate Government appreciation of and support for the sector
6. Inadequate recognition in public purchasing procedures of potential value for money advantages offered by co-owned sector providers

## Executive Summary

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The All Party Parliamentary Group [APPG] is grateful for the wide range of evidence that it has received on the co-owned sector: 41 written submissions and oral evidence from a total of 11 witnesses over three hearings.

Our analysis emphatically confirms the vibrancy of the co-owned sector, which is now estimated to have overtaken the agricultural sector in terms of its relative share of GDP.

The APPG believe that **the co-owned model offers enormous potential for the UK economy**. Our Inquiry has confirmed that co-owned companies are exceptional mainstream businesses. A wide array of co-owned companies, operating in competitive markets in the public and private sectors, are delivering exemplary performance through the use of the co-owned model.

Co-owned firms appear **adept at managing innovation and change**, are underpinned by **very high levels of productive employee engagement**, and have an excellent track record in delivering broader **social, environmental and community benefit**.

This performance profile led the APPG to conclude that co-ownership does appear to offer a **potentially very strong business transfer option**. If business succession in the UK was characterised a little less by trade sales, and a little more by employee buy-outs, the overall performance and durability of our economic base would improve.

The Inquiry received some striking examples of the contribution of the co-owned sector to **public service provision**, suggesting that co-ownership offers real potential as a model for such provision. Public service reform efforts continue to place great emphasis on giving front line professionals greater freedom to personalise and improve service delivery to the public. Co-ownership appears to do just that very effectively, offering up the tantalizing possibility of combining a public realm ethos with co-ownership delivery values.

The growth and health of the co-owned sector in the UK has been aided by the efforts of successive Chancellors to create a framework of fiscal incentives that make co-ownership an attractive proposition to employees and entrepreneurs, although respondents to the Inquiry stressed that more could and should be done.

The APPG's efforts to develop more definitive assessments of these and other issues have been hampered by a **significant data gap** as evidenced by the absence of official statistical data on the co-owned sector in the UK. The Inquiry is also concerned about the **lack of awareness** and information about the sector among business owners, advisers, financial institutions, and public sector policy makers.

Whilst these weaknesses are hardly the direct responsibility of the co-owned sector, the APPG concluded that the co-owned sector itself could do more to address some of these failings. Very few co-owned businesses advertise and promote the benefits of the co-owned model in terms of its positive impacts on customer satisfaction and financial performance. If co-owned businesses promoted the benefits of the co-owned model more consistently we believe this would encourage others to do likewise.

To support the co-owned sector's continued growth the APPG has identified a range of recommendations that if implemented will powerfully amplify the co-owned sector's already impressive contribution to the UK's economy and society.

These exceptional firms need to become less exceptional features of the UK economy.

### Recommendations

#### 1. The data gap

The APPG recognises the strength of the evidence presented to us on the data gap.

Given that the sector is now larger than the agricultural sector and is making a major economic and social contribution the UK economy – it would appear perverse that we currently know more about pig farming than we do about employee ownership and its impact in co-owned companies.

We therefore judge that the case is compelling for **Government sponsored research** in this area, and that the Treasury and the Department for Business, Enterprise and Regulatory Reform have an interest in helping to generate a **review** of, and research into, the co-owned sector in order to address the glaring data deficiencies that the APPG Inquiry has underlined.

We believe that there is a strong case for the Treasury to lead such a review.

The APPG recommends that key points of emphasis should include:

- i) *A focus on firm level data* (with both individual-level and company level financial data).
- ii) *An assessment of the performance benefits of co-ownership, and in particular its potential role as a supplier of public services*
- iii) *The appropriateness of the current regulatory and funding environment*

## 2. The knowledge and advice gap

The APPG has been provided with very strong evidence from across the co-owned sector that the level of knowledge and expertise among business owners, advisors, financial institutions, and public sector policy makers is at best patchy, and at worst non-existent.

There are a number of measures the APPG would encourage the Government and others to support to remedy these weaknesses:

- i) The Institutes of Chartered Accountants in England, Scotland, and Wales; The Association of Chartered Certified Accountants; The Institute for Financial Accountants and other relevant professional bodies should ensure that their training and accreditation schemes include **knowledge of co-ownership structures** in order to raise the quality of their advisory expertise in this area.
- ii) Similarly, Regional Development Agency (RDA) Business Link advisors and their equivalents in Scotland and Wales should have a **basic knowledge of co-ownership structures** and systems in order to inform their advisory work with local companies. As a minimum this would allow Business Link advisors to discuss with relevant clients their succession strategy; advise them of the employee ownership option; and build a list of specialist agencies/consultants who can advise on employee ownership.<sup>1</sup>
- iii) Business education is of course vital and the APPG encourages **business schools** and equivalent institutions to integrate cases and materials on co-

owned business models into their MBA curriculum and other similar programmes.

## 3. Tax rules affecting the sector

The APPG have already noted the need for the broader regulatory framework to be reviewed under recommendation one and believe that recent CGT changes are also relevant to such a review.<sup>2</sup>

Without wishing to pre-judge the issue, the instinct of the APPG is that there are a number of possible 'turn keys' which will satisfy both the Treasury's concerns about tax avoidance, and the co-owned sector's desire to offset intelligently the withdrawal of tax relief for companies contributing funds to an employee benefit trust.

- i) The APPG recommends that the Treasury and others explore whether the HM Revenue and Customs approved **share incentive plan** (SIP) trust could involve a permanent holding of shares, in addition to the already existing function of distributing shares to the employees as individuals. This is potentially an elegant and narrow reform of the current regime, building on the SIP trust which is already well-designed to avoid abuse, and therefore requiring no dilution of the Treasury's original objectives behind the 2003 reform.
- ii) The APPG encourages the Treasury to work with interested parties to draw sharper definitional and operational assumptions between **employee trusts** used for the purpose of achieving employee control structures in bona fide trading operation and contrived arrangements involving employee trusts used for the purpose of sheltering from income tax and national insurance contributions.
- iii) The APPG recommends that the Treasury explore how far new research evidence would support a more favourable tax treatment of **SAYE** over Company Share Option Plan [CSOP] schemes which are operated for selected employees only.
- iv) The APPG recommends that the Treasury consider making the **annual allowances** for employee share schemes index linked.

- v) The APPG suggests that the Treasury might also review options for fiscal concessions for **investors and lenders** supporting co-owned start-ups in areas of social and economic deprivation.

#### 4. A relative lack of appropriate finance

The APPG received a wide range of evidence suggesting that there is a shortage of appropriate funds in the UK which is limiting the scope for employee buy-outs. In particular this may be limiting the process of business transfer and succession via a co-owned route in the UK.

- i) The APPG recommends that if the Treasury review were to identify serious market failings in this respect, one possible response would be for key **development agencies**, such as the RDAs, to consider longer-term financing interventions in the co-owned sector.
- ii) The APPG notes the creation of **formal institutions** in Wales and Scotland piloting, and exploring the scope of, such interventions in the co-owned sector, with a particular eye on business succession issues. There is no analogous public institution in the rest of the UK. We suggest that the case for a similar body in England should be considered by the proposed Treasury led review.

#### 5. Government support and encouragement of the sector

The Inquiry received strong evidence that the Government could do much more to support the growth of the sector, particularly in terms of its future role in the provision of public services.

The APPG concluded that there are a number of simple but decisive steps that could be taken to encourage the overall growth of the co-owned sector:

- i) The APPG recommends that the Government nominate specific **Ministerial responsibility** for relationship with the development of the co-owned business sector.
- ii) The APPG recommends that there is a **review of current procurement guidelines** to ensure that the broad range of added value benefits that can be delivered by co-owned providers are better understood by public procurers and that their commissioning decisions are informed by such judgements.
- iii) The APPG recommends that the Government, ideally the nominated Minister for relationships with the co-owned sector, invite the Employee Ownership Association [EOA] to outline how it might work with Government to educate and inform the **commissioners** of public services about the potential contribution of co-owned service providers.



## Exceptional or exception – understanding the co-owned sector and its contribution

*‘The employee owned business sector is extremely diverse – there appear to be few, if any, ‘no-go’ areas for employee ownership in the economy. The high-tech knowledge intensive sectors to which employee ownership appears particularly well suited are ones that the UK economy is going to have to rely upon increasingly if we are to move up the value added chain ourselves’.*<sup>3</sup>

This quote raises an obvious paradox about the co-owned sector, underscored by the evidence that the APPG has received. Whilst nearly everybody in the country has had direct experience of its most famous exemplar – the John Lewis Partnership – that company is just the tip of the co-owned iceberg. Few have any broader knowledge of what else lies beneath the water line – namely the impressive scale of the sector and the consistency with which co-owned firms are delivering high performance in competitive markets in both the public and private sectors.

Co-owned firms have been keen to stress to the APPG that they do not regard their organisations as unusual or quirky. They think of themselves as mainstream businesses, driven by a desire for excellence and competitiveness, differentiated by their use of an ownership and governance model which they believe gives them competitive advantages, and which is much more widely applicable than is commonly understood. As Scott Bader commented:

*‘we are no different from other well run businesses’*<sup>4</sup>

Yet co-owned businesses continue to be regarded as an exception – rather than a mainstream business model that is proven to deliver exceptional performance.

The APPG has received a range of evidence making this case, which sets the broader context for the rest of the Inquiry’s analysis. The key themes that have been identified by respondents are:

- Definitions and scope
- The performance benefits that flow from the use of a co-ownership model
- The core elements of the co-owned approach

We offer a brief review of each of these themes below.

### Defining the co-owned sector

‘Employee ownership’ and ‘co-owned / ownership’ are terms that are sometime used interchangeably, whilst they do in fact have distinct meanings.

The EOA define the two terms as follows:

- *Employee owned businesses*: companies where employees own a controlling stake in the business, i.e. more than 50%. An employee owned company may involve employees owning shares, but may instead or as well involve ownership via one or more trusts – for example, no employees own ordinary voting shares in the UK’s largest employee owned company: the John Lewis Partnership.
- *‘Co-ownership’ and ‘co-owned company’*: a wider definition which includes employee owned companies (as above) but also companies where employees own a substantial but minority stake in the business, say more than 25%. Here again, the employee ownership element may be based on direct share ownership by staff, or indirect ownership via more or more trusts, or a combination of both shares and trust[s].<sup>5</sup>

In this report we refer throughout to ‘co-owned businesses’ or the ‘co-owned sector’ unless we are specifically referring to evidence about employee owned businesses more narrowly defined. This partly reflects the fact that the bulk of the evidence base spans both definitions, hence our preference for the broader definition.

What of the scale of the current co-owned sector? Unfortunately there is no official data about the size of the sector, but the EOA estimates that the ‘co-owned’ sector has a combined annual turnover of £20-25 billion.<sup>6</sup> If we accept this estimate is broadly correct, this means that the co-owned sector has overtaken the agricultural sector in terms of share of Gross Domestic Product.

As the evidence list for this Inquiry demonstrates, the co-ownership model has spread across a broad range of sectors, from its established presence in manufacturing (Scott Bader; Tullis Russell) and retail (John Lewis Partnership) to a wide array of professional services and knowledge businesses (PA Consulting; Arup; Mott MacDonald). All of these respondents were keen to stress the potential of the sector to grow and its suitability for mainstream competitive businesses.

### **The performance dividend of co-ownership**

The APPG has been provided with evidence explaining the performance dividends that flow from the co-ownership model – in both enterprise terms and in terms of customer and employee outcomes. We deal specifically with customer and employee engagement impacts in later chapters, and focus here on enterprise outcomes and how performance improvements are facilitated by co-ownership.

Some of the strongest of the existing academic evidence has a bias to the United States, although there is strong symmetry across all of the evidence on the type and scale of effects produced by co-ownership. Inevitably most of the studies have included companies that have minority ownership stakes as well as majority. Where a distinction has been drawn in the research, the effects of majority ownership have proved more rather than less positive.<sup>7</sup>

The APPG regret that there is not a greater array of recent UK based studies, and we address the issue of data gaps elsewhere in the report.

Notwithstanding these imperfections in the evidence base, there is an extensive body of literature analysing the effects of (widely defined) employee ownership on firm performance. Professor Michie notes that these studies<sup>8</sup> have found that employee ownership tends to lead to:

1. Improved work quality<sup>9</sup>
2. Higher rates of labour productivity<sup>10</sup>

In most studies<sup>11</sup>, employee ownership is found to have a positive effect on the firm's performance by directly increasing labour productivity. Blasi et al, reviewing the US evidence, report:

*'A one-time, but permanent, boost to a company's productivity of about 4 percentage points, compared to what it would have been without employee ownership.'*<sup>12</sup>

### **The core elements of the co-owned approach**

The evidence is also consistent on how co-ownership unlocks this performance dividend, which is through the combination of a co-owned approach with representative participation in wider policy decisions.

The US National Center for Employee Ownership, commenting on 70 empirical studies of the effects of employee ownership on productivity, note that:

*'Researchers now agree that 'the case is closed' on employee ownership and corporate performance. Findings this consistent are very unusual. We can say with certainty that when ownership and participative management are combined, substantial gains result. Ownership alone and participation alone, however, have, at best, spotty or short-lived results.'*<sup>13</sup>

This has also been a long standing feature of the UK evidence. An earlier review of the co-owned sector in the UK confirmed that:

*'Employee ownership on its own does not make a difference to performance. There is a positive outcome on performance when employee ownership is combined with high levels of employee participation.'*<sup>14</sup>

This was confirmed by a number of respondents to our Inquiry<sup>15</sup> who stress the need for the model to wholeheartedly combine the incentive of ownership with participatory involvement. It is the combination that unlocks enhanced performance, either by increasing labour productivity - or indirectly – by lowering absenteeism rates, reducing employee turnover, improving job satisfaction and improving perceived quality of labour output.<sup>16</sup>

## QUESTIONS

# Do co-owned companies succeed in generating exceptionally high levels of productive employee engagement?

The evidence presented to the Inquiry confirmed that there is an extremely strong connection between co-ownership and high levels of productive employee engagement.<sup>17</sup>

For example 85.1% of co-owned companies in EOA's 'Good Business' survey 'strongly agreed' that employees are 'more committed to company success' – rating this as the single biggest advantage of employee ownership.<sup>18</sup>

This reflects the intuitive rationale for co-ownership – namely that an employee who has a financial stake in the company will be more motivated to ensure that the company performs well. This induces them to think and act like owners, making decisions that increase corporate value.<sup>19</sup> Whilst it was acknowledged by some respondents that other firms can also generate high levels of employee engagement, they stressed the scale and depth of employee engagement in co-owned companies, and that co-owned companies achieve this result consistently<sup>20</sup>.

Simon Fowler from the John Lewis Partnership, in his oral evidence to the Inquiry, described the employee engagement dynamic as the 'magic ingredient':

*'The thing that marks us out with customers is the fact that our partners feel very engaged and committed to what they are doing, so we have high levels of engagement from employees, high levels of commitment and a great desire and passion to try and ensure that their business is successful, because the success of their business is a reflection of the success of their company.'*<sup>21</sup>

Other company respondents stressed the importance of this engagement dynamic. UBH noted that:

*'Employee owned companies are generally more successful because the employee is engaged through the collective ownership in the success of the company and in many cases will have a financial involvement beyond the weekly pay packet. This motivates a sense of involvement and commitment at all levels within the company beyond that normally seen in non employee owned companies.'*<sup>22</sup>

In a similar vein, School Trends observed that:

*'Co-ownership is perhaps half the equation of 'productive employee engagement.' Of equal*

*importance, in my experience is 'co-control': an employee's feeling that he or she can genuinely affect change within their organisation. This is something that may be a likely, but not inevitable, consequence of co-ownership.'*<sup>23</sup>

All of which suggests that co-ownership plays a key role in securing high levels of discretionary effort within the workplace. This can be thought of as a commitment dividend – with co-ownership encouraging a greater level of voluntary contribution from owners within the business, such discretionary effort leading to working smarter rather than longer, since ideas and suggestions for process improvement will be welcomed, encouraged and acted upon.<sup>24</sup>

This also improves employee satisfaction and loyalty. Professor Michie in his review of the US and UK evidence found that employee ownership tends to lead to:

1. Improved job satisfaction<sup>25</sup>
2. Lower rates of absenteeism<sup>26</sup>

Respondents to the Inquiry also confirmed that the benefits that flow from this enhanced employee engagement requires professional, proactive management, regardless of the ownership structure.<sup>27</sup> As CDS noted in their submission:

*'it is not necessarily the easy option for any business because it requires two way communication, it challenges management to convince and justify rather than adopt 'do as I say' approaches and it challenges employees to take on additional responsibility and think in 'big picture' terms about any business decisions. The carrot for both management and employees is that there is a bigger cake to be shared out at the end of this process.'*<sup>28</sup>

In other words whilst managers can still manage and decide, they inevitably have to share knowledge and power in ways that enable the employee to feel that he or she can genuinely affect change within their co-owned organisation.<sup>29</sup>

These 'collective voice' effects, allied to financial participation and participative mechanisms, are the key factors in maximising successful business benefits from co-ownership.<sup>30</sup> They underpin productive engagement in co-owned companies, and for a number of our

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respondents they are the key differentiator of co-owned companies.

As Graeme Nuttall noted in his oral evidence to the Inquiry:

*'I am strongly attracted to the proposition that the collective voice in co-owned companies is the catalyst for producing a high level of productive employee engagement, and that this distinguishes employee owned companies from, say, Stock Exchange listed companies with share plans'.<sup>31</sup>*

## Are innovation and change managed with relatively high levels of employee co-operation in co-owned companies?

The APPG received a wide range of evidence confirming that co-owned companies seem to be particularly adept at engaging employees in order to manage change and to encourage innovation, whilst maintaining employee morale.

In terms of managing change the key factor here is that co-ownership underpins employee confidence at a time when change and uncertainty would otherwise disrupt the businesses' performance and productivity. As UBH noted:

*'in general [we] have found that change can be implemented more successfully and with high levels of employee participation in co-owned companies because there is a clear linkage between innovation and change and individual benefit'* <sup>32</sup>

The key dynamic here is that ownership functions as a 'cast iron' guarantee that any reforms are not entirely at the expense of the workforce, ensuring that they gain too. <sup>33</sup>

Thus in general terms, co-ownership can support innovation and change in several ways: by functioning as a credible promise that employee interests will be respected; by providing a pay-off for acceptance of change; and by encouraging long-term employment, leading to a build-up of job and organisational knowledge and an affinity with the company. <sup>34</sup>

This latter point was stressed by a large number of respondents to the Inquiry, with co-owned companies reporting that employees have a greater understanding of the needs of the business leading to a greater acceptance of, and co-operation in, the introduction of innovation and change. <sup>35</sup>

The John Lewis Partnership provided a number of examples where employee consultation and co-operation have played a leading role in making changes to the business:

*'In the last seven years we have made significant changes in John Lewis department stores to both trading hours (5 days to 7 days) and branch names. These changes have been implemented with full engagement of all affected Partners and approved through a vote from elected representatives at branch-level.'* <sup>36</sup>

Other powerful supporting evidence here came from the Wales Co-Op Centre, which over the last seven years has been operating a Business Succession Project aimed at persuading owners who want to exit to sell the company to the workforce. It is the only publicly funded business transfer project of its kind in the UK. Their experience has been that the newly co-owned companies have managed to successfully develop new styles of management and leadership to deal with the new situation post buy-out, with their employees taking the opportunity to proactively change and develop the company. <sup>37</sup>

A number of respondents were also keen to stress that this high level of employee co-operation and initiative is also more likely to be a feature of co-owned companies in bad times as well as good. As Tullis Russell explained in their evidence to the Inquiry:

*'Our industry went through a hugely difficult period last year, and all the people voted voluntarily to freeze their wages because they knew just how difficult things were. The next time, if we make a very good profit, there may be well above average pay rises ... but that is the benefit of involving people and sharing information so that they really know what the company's trading circumstances are.'* <sup>38</sup>

This durability under fire is confirmed by other supporting evidence. Employee-owned companies seem to preserve jobs better than conventional firms in recessions. A range of studies confirms that employee-owned firms adjust pay rather than jobs when business is slow and preserve employment through the business cycle, unlike their conventional counterparts. <sup>39</sup>

The APPG also received strong evidence linking co-ownership with higher levels of innovation, both in the written evidence from the co-owned companies, but also in supporting research provided to the Inquiry. The EOA survey of co-owned businesses confirmed that two thirds thought innovation happens more effectively in their companies than comparable competitors. <sup>40</sup>

Recent empirical evidence from the United States also confirms the strength of this causal relationship, finding that employee ownership of stock is the most consistently positive compensation variable in predicting both the presence of an innovative culture in a work site of a multinational corporation, and the willingness of workers to engage in innovative activity in their work

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site.<sup>41</sup> The National Center for Employee Ownership in the United States, commenting on the US evidence, observed that we do know that employee ownership companies are much more likely to have high-involvement management systems (open book management, employee teams, etc.) and these are strongly associated with innovation.<sup>42</sup>

There have been similar research findings in the UK, revealing that co-owned companies are more likely to adopt human resource practices of employee participation and representation, and these in turn have been found to be positively and statistically significantly correlated with the probability of firms innovating.<sup>43</sup>

## Do co-owned companies demonstrate exceptionally high standards of corporate social responsibility?

The Government defines corporate social responsibility [CSR] in terms of the business contribution to sustainable development goals. Essentially it is about how business takes account of its economic, social and environmental impacts in the way it operates – maximising the benefits and minimising the downsides.<sup>44</sup>

The issue facing the Inquiry is therefore how far co-owned companies take voluntary actions, over and above compliance with minimum legal requirements, to address both its competitive interests and the interests of wider society.

On the balance of evidence received, which is predominantly case study based, it is clear that the values of co-owned companies are extremely well aligned with the aspirations of CSR, and that good CSR practice is therefore common in co-owned businesses.<sup>45</sup> As eaga observed in their written submission:

*'Put simply, in common with other co-owned businesses, we know that the empowerment that our employees take from a partnership approach fosters higher standards of accountability and corporate social responsibility. As shareholders our employees impose exacting levels of corporate transparency and integrity in everything we do.'*

Another company talked of how CSR is second nature to co-owned firms:

*'Co-owned firms tend to seek more of a balance between commercial and social objectives. The main objectives of CSR tend therefore to be second nature to co-owned firms.'*<sup>46</sup>

This is in line with a survey of co-owned companies in the UK, in which eight out of ten said that employee ownership made their company more socially responsible.<sup>47</sup>

However there is not adequate evidence to judge whether exemplary CSR is therefore more common in the co-owned sector as compared to other sectors of the economy, despite the assertion anecdotally that it is.

Similarly, whilst the Inquiry received evidence outlining shining examples of CSR practice amongst the co-owned sector<sup>48</sup>, without a sense of the scale of activity across the co-owned sector this evidence does not allow us to judge how far co-owned companies are

differentiating themselves from their competitors through their CSR practices.

There is some survey evidence about co-owned businesses which suggests that customers may be judging co-owned companies to be more ethical, with 76% of co-owned companies stating that customers liked co-owned or employee owned companies most because they see them as more ethical than other businesses, and therefore more likely to behave responsibly and in a trustworthy manner.<sup>49</sup>

The case study evidence is stronger in suggesting a link between co-owned companies and CSR policies that develop a close co-operation with communities. Nearly all of the firms who submitted evidence talked about the much closer co-operation between the community and the company.<sup>50</sup> Many gave examples of their positive engagement with communities; for example Loch Fyne Oysters set up a crèche and playschool in the local village, which proceeded to win a national prize.

*'This community focus has long been identified as a differentiating feature of co-owned companies, who display a strong sense of being part of and desire to contribute to the community.'*<sup>51</sup>

In terms of supporting evidence here a survey of the co-operative and mutual sector found that they gave over 1.35 per cent of their pre-tax profits to directly support their local communities, as against an average of 0.8 per cent for the top 100 leading quoted companies.<sup>52</sup>



## Do employee buy-outs offer a potentially strong business transfer option?

The UK's business transfer record is poor, with relatively few business owners planning their succession, and as a consequence transfers frequently fail.<sup>53</sup>

This matters to the macroeconomic performance of the UK economy to the extent that transferring a viable business to new ownership is more cost effective in economic terms than starting a new business from scratch. Moreover, the academic evidence suggests that many acquisitions destroy value, with a study suggesting that buyers destroy 30% of their pre-acquisition market value.<sup>54</sup>

Despite this, trade sales continue to be recommended as the main option for SMEs to resolve ownership succession. The economic case to encourage co-ownership is therefore strengthened if it offers a potentially strong business transfer option.

To an extent the Government has already accepted the merit of the co-owned sector's claims in this respect. The then DTI Small Business Service's report 'Passing the Baton' (2004) acknowledged the mainstream viability of employee buy-outs and the DTI agreed as a follow-up measure to provide an online guide to employee buy-outs on its business link website ([www.businesslink.gov.uk](http://www.businesslink.gov.uk)) which explains succinctly why a business owner should consider an employee buy-out as succession solution.<sup>55</sup>

Within the limitations imposed by the largely case study based evidence received by the Inquiry, the APPG can confirm that co-ownership does appear to offer a potentially very strong business transfer option.

Some of the strongest supporting evidence came from Co-operative Development Scotland (CDS), which works to promote the development of co-operative enterprise across Scotland. They commented that:

*'There is no doubt whatsoever that employee buyouts offer a strong business transfer option. They retain jobs and wealth creation in the local economy; they help create more enterprising and innovative employees; they offer a longer term solution than venture capital backed buyouts which need to be moved on in another 3-5 years; and they offer owners the chance to see their 'baby' remain independent and supporting the community in which they grew up and they offer another option for existing owners to realise best value for their business (which need not always be the headline price)'*<sup>56</sup>

A number of respondents identified the continuity of management and workforce as one of the key factors allowing effective transfers to co-owned businesses.<sup>57</sup> This continuity brings a number of distinct benefits.

- Firstly, the employees in a company are often the best placed to be able to judge its future potential – the strength of the existing customer and client base and possible new markets, opportunities for product and process innovation, and relation to existing and potential competitors and collaborators.<sup>58</sup>
- Secondly, it is much more likely that if a business has a particular ethos a shift into co-ownership will ensure that it continues in the same form afterwards, and for many owners that is important. They are pleased with the business they have built up and would like continuity of that business going forward.<sup>59</sup>
- Thirdly, a number of respondents noted that the continuity offered by co-ownership was particularly crucial in service and knowledge intensive businesses. As Compton Fundraising Consultants noted:

*'In a service business where 'your assets leave the office at the end of the day', employee buy-outs offer the best way of retaining the value of the business and enabling long-term service delivery and improved levels of competitiveness.'*<sup>60</sup>

This was supported by the design company Alloy, who noted that the option of an organic, one-off transfer acting on behalf of all the employees has been proven a number of times (e.g. Arup) to provide an ideal framework for long term sustainable growth in a creative knowledge business. As Alloy comment:

*'Classical management buyouts only transfer ownership to a new generation able to take the risk. The experience in our industry is that this only alienates the hugely important productive tier below the buyout team, and so supports name continuity but not growth.'*<sup>61</sup>

- Finally, it is also suggested that both fully and partly employee-owned firms survive better than conventional ones, at least in the first few years. Evidence from the Wales Co-op Centre is compelling here. Since 2000 the Centre has helped thirty companies move into employee ownership. As a result a total of 1200 jobs have so far been protected, the total turnover of the companies assisted is £80m, loans totalling £9m have been raised and equity of £3.3 m has been raised by the workforce. None of the companies assisted have defaulted on any loan, and none have ceased trading and most of them are growing in terms of sales and asset value.<sup>62</sup>



## Is the co-owned business model well suited to the provision of outsourced public services?

The APPG has received evidence on two types of outsourcing: where co-owned companies have been successful in winning outsourced contracts, and where the actual ownership of a delivery unit has transferred from public to private, and frequently into social enterprise co-owned status.

The precedents for co-owned business models in delivering public services are well established, dating back to the deregulation of the UK bus industry, after which there were a number of successful employee buyouts of London bus services and other regional bus services.<sup>63</sup> In more recent times, council leisure services, refuse services and care and health services have all been outsourced to co-owned companies or ownership transfers.<sup>64</sup>

None the less, the current scale of co-owned activity in this part of the economy remains very small. Partly as a consequence the APPG's assessment is based on a relatively small number of case studies. However on this limited evidence base, the co-owned business model can lay claim to some significant differentiators in terms of ethos and performance in the delivery of public services.

Firstly given public sensibilities about the ethos and motivation of firms providing public services, some of the defining features of co-owned businesses may make them more acceptable to the public than other private sector competitors. As School Trends noted:

*'The social objectives of co-owned firms, married with the more equitable distribution of resources amongst employees, makes co-ownership a far more palatable option for outsourced public services than traditionally run PLCs'*<sup>65</sup>

In effect co-ownership offers an insurance policy to the broader public, actively reducing the potential for key individuals at the heart of a transaction to either distort or make excessive gain at the expense of the taxpayer.

These strengths are being underscored by the increasing importance placed on local accountability of public services. This has been stressed by Government as one of the advantages of Foundation Trust hospitals: that they will be accountable to their employees, patients and other local stakeholders who have an incentive to ensure that services are both high quality and crafted to local needs. This allows the co-owned sector to make a strong value added pitch for the provision of services.<sup>66</sup>

Secondly, co-owned provision can undoubtedly develop rapid and impressive service improvement.<sup>67</sup> For example Central Surrey Health delivers all the nursing and therapy services in the Central Surrey Health area. This not-for-profit limited company co-owned by over 700 employees went live on 1 October 2006. The Social Enterprise Unit at the Department of Health has presented Central Surrey Health as a model in its 'Pathfinder' programme.

The company reported to the Inquiry that even though they have only been a co-owned business for a year, they are already seeing a significant difference in the activity levels of their co-owners. As they observed:

*'An example is in our physiotherapy teams where through their efforts they have been able to reduce waiting times for the musculo-skeletal service from 16 to 4 weeks...what has changed is that clinical teams are beginning to change the way in which they approach issues, often an intractable problem which has challenged us all for several years. It is no longer somebody else's problem but 'our' problem.'*<sup>68</sup>

This ownership of problems by skilled front-line staff is of course straight from the text book of public service reform mantras. The experience of co-owned companies delivering public services is that until employees genuinely have the discretion to create their own solutions, breakthroughs in performance and delivery will be less forthcoming. As Tricia McGregor from Central Surrey Health commented:

*'We combine the values and principles of the NHS with the can-do culture of a successfully-run business. This means that the people who are most in touch with patients' needs, our nurses and therapists, are now in charge of providing the services. The ethos sits well with the personal beliefs of those who choose to work in public services. CSH co-owners believe that the combination of the co-ownership model with the social enterprise philosophy captures all that was positive about the NHS with the business-like focus that is essential for the future provision of our nursing and therapy services.'*<sup>69</sup>

So at best co-ownership offers up the tantalising possibility of combining a public realm ethos with private sector delivery values – or perhaps more accurately – co-owned deliver values. As Mark Sesnan, Chief Executive of Greenwich Leisure observed:

*'We draw down the skills that the business sector have, the freedom to act and react in the marketplace, but we bring them together with a public sector ethos on the other side and hopefully have a win-win situation in the process.'*<sup>70</sup>

Some of the respondents to the Inquiry, citing the quality of provision being offered by co-owned companies in the public sector, questioned the Government's emphasis on encouraging social enterprise approaches as opposed to a specific focus on encouraging co-owned models of provision.<sup>71</sup>

Respondents operating in this sector also stressed their ability to offer a value added pitch to public procurers. As eaga commented:

*'Our business model and our overall approach to the delivery of outsourced public services which stems from it – which is to add value beyond the remit of any contract we hold – has been cited by public sector clients as a factor in our successful bid for contracts such as the £1.5 billion Warm Front programme contract we hold with the Department for Food, Rural Affairs and the Environment.'*<sup>72</sup>

All of the co-owned firms providing public services also reported much lower levels of labour turnover, ensuring continuity and quality of delivery. At Sunderland Home Care Associates, for example, staff turnover is between 3-5 per cent compared with the industry average of 20 per cent. This in part reflects anecdotal evidence provided to the Inquiry that professionals in health and social care have said working with those in co-owned organisations can provide good opportunities for professional development.<sup>73</sup>

It is perhaps surprising - given these early indications of improved service delivery being combined with good employee outcomes - that public sector unions are not more favourably inclined towards co-ownership. Respondents to the Inquiry noted that whilst union attitudes were variable, with some unions more unsympathetic than others, there is a general lack of understanding of the co-owned model across the union movement, both in terms of the potential benefits for their members, and for the happy co-existence of union membership and co-ownership.

The APPG would encourage unions, co-owned firms, and the EOA, to work harder to develop a greater shared understanding of the benefits of co-ownership and the possibilities for mutually beneficial cooperation. In the first instance some simple myth busting would for help – for example that co-owned companies are hostile to unions.<sup>74</sup>

The APPG was also able to form some preliminary views on which segments of public service provision co-ownership is particularly suited to. Respondents indicated that co-ownership models are highly appropriate for activities which are typically labour intensive, and where the boundaries between delivering a service as opposed to the policy and management of the service are distinct and clear.<sup>75</sup>

As Loch Fyne Oysters noted in their written evidence, co-owned models are particularly suitable 'in areas such as home care where an ageing population is difficult for the public sector to cope with and the type of work requires dedicated, motivated professionals.'<sup>76</sup>

Given the low pay endemic in a wide range of cleaning and care professions in the public sector, respondents were clear that better results will be achieved by staff working in these sectors being motivated and empowered by employee ownership.

Finally the Inquiry received contrasting evidence on the potential scale of co-owned provision in public services. For some, their smaller size means that they face challenges of scale and finance if they are to deliver large swathes of public service provision. As Savant commented:

*'Employee owned companies are normally fairly small and, in our experience, the public sector seems to be loathe to deal with small companies.'*<sup>77</sup>

However we received some fascinating international comparative evidence which suggests that this may be a mindset and ambition issue rather than a real barrier. An expert respondent from Poland, who is currently working for the Polish Ministry of Health, described how he is working to construct a health service system in which county hospitals can be run by employee owned medical companies. Under this model assets such as buildings will remain in the ownership of the county government and leased to the employee owned company.<sup>78</sup>

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The APPG's overall assessment is that whilst the evidence base is currently, and inevitably, scanty with regard to the contribution of the co-owned sector to public service provision, it strongly suggests that co-ownership offers real potential as one model for public service provision, with some notable and powerful points of differentiation compared to other models, which underscore both performance improvement and public support and confidence.

We would also note that we are not alone in holding this view. A recent paper for Government on the creation of social work practices has advocated an employee owned solution to problems endemic in the profession. Chaired by Professor Julian le Grand, a working group concluded that:

*'The Group's preferred model is the professional partnership which is a form of an employee owned company; an enterprise where the majority, or all, of the share capital is owned by the employees themselves.'*<sup>79</sup>

## Is co-ownership especially compatible with changing customer attitudes to products and purchasing?

The APPG received a wealth of evidence to suggest that co-owned companies have a very consistent record in generating high levels of customer satisfaction. As the John Lewis Partnership note:

*'Our Partners' focus on building on our reputation for delivering excellent customer service has, for the second year, resulted in us matching our powerful financial results with two impressive votes of confidence from shoppers, as the Verdict and Which? Customer surveys again rated John Lewis and Waitrose as the UK's two favourite retailers. In March we were also voted Retailer of the Year by a Retail Week panel of our High Street competitors.'*<sup>80</sup>

The more difficult question to answer is how far those high customer satisfaction levels are caused simply by exemplary customer service, or more interestingly by a better fit between co-owned companies and the changing aspirations of consumers, and the reputation advantages of co-owned firms.

Respondents offered evidence to support all these views. For some co-owned firms the key causal factor is customer responsiveness, which they believe is underpinned by the co-ownership model.<sup>81</sup> As eaga commented in their submission:

*'Our regular customer surveys and interaction through stakeholders who work in partnership with us indicated that our customers understand that our approach to business enables us to exceed their expectations through their interaction with a committed and engaged workforce.'*<sup>82</sup>

How far co-ownership is especially compatible with changing customer attitudes to products and purchasing is much more problematic to judge – the evidence is at best mixed and certainly inconclusive. Some respondents did not see a clear link.<sup>83</sup> For example UBH noted in their submission that:

*'I do not believe it plays a key role in changing customers' attitudes to products and purchasing within our business sector.'*

Others noted that more data would be needed to be able to judge the extent to which changing customer attitudes more generally could be best met by co-owned firms.<sup>84</sup>

However the supporting evidence is stronger on establishing a link between the ethos and reputation of co-owned firms and the strength of customer support and satisfaction. A survey of co-owned businesses revealed that nearly three quarters of those companies

agreed that co-ownership made the business more attractive to its consumers – 51.2% agreeing and 19.1% strongly agreeing. Just under one in four (23.4%) reckoned their co-owned status had no impact either way on customers' views.

In terms of the factors attracting customers to co-owned companies, according to a large majority of businesses surveyed, customers think a co-owned company will be more ethical (93.4%), behave more responsibly (73.7%) and be more trustworthy (65.8%).<sup>85</sup>

The strength of the co-ownership effect, in this respect, led some respondents to wonder why co-owned businesses do not use these points of differentiation as a marketing tool.<sup>86</sup> As CDS commented:

*'With the exceptions of some recent Waitrose advertising ... employee owned businesses have been inexplicably reluctant to use such strap lines as 'we try harder because we own the company.'*

The APPG believe that this ambivalent attitude to self promotion is a weakness of the co-owned sector. It is clear that few co-owned businesses advertise and promote the benefits of the co-owned model in terms of the positive impacts on customer satisfaction and financial performance. Their reluctance to trade on the success of the model is hardly emboldening others to do likewise.

## A shortage of data on the extent of the sector and its performance

This was perhaps the easiest question for the APPG to adjudicate on. There is undoubtedly a major data gap in terms of official statistical data on the co-owned sector. The Inquiry was struck by the difference in the quality and sophistication of the evidence and academic research base in the United States as compared to the UK.<sup>87</sup>

When considered in the round, the combined US and UK academic evidence, coupled with the stock of new primary evidence generated by this Inquiry, is sufficient in scope and quality to enable us to make a strong preliminary judgement as to the contribution of the co-owned sector, its key points of differentiation, and its enormous future potential. But our judgements are inevitably indicative rather than definitive because of the data gap.

Given that based on prudent estimates the sector now appears to have overtaken the agricultural sector in terms of share of GDP<sup>88</sup> – the lack of reliable national data on the sector is becoming difficult to rationally justify. The combined annual turnover of the sector is estimated to be in the range of £20-25 billion. The sector appears to be growing at a significant rate, though again there is no official data to rely on.

The absence of official statistics in the UK and European context is therefore becoming a significant obstacle to a sophisticated understanding of the sector, and to framing the ideal interventions to support its future growth.<sup>89</sup> This shortage of data is particularly damaging with regard to:

1. Those looking to sell their businesses on. At present, the lack of data probably prevents this option from being immediately apparent to the owner, or from being articulated or advocated by advisors.
2. Those providing financing to companies, who will tend to be ignorant of the sector and of its potential.
3. Government and other public policy makers – such as the Regional Development Agencies (RDAs) – who again will have difficulties in crafting appropriate policies and strategies without a firm evidence base.<sup>90</sup>
4. Commissioners of public services.

Many co-owned firms believe that more official data would help them make the case for their businesses with new customers and public sector procurers.<sup>91</sup>

For example eaga note that:

*'Yes there is a shortage of data on the extent of the sector and its performance and many co-owned businesses are unable to outline the benefits of their approach with reliable evidence'*<sup>92</sup>

And in terms of public agencies, Sue White, of the Department of Health's Social Enterprise Unit commented:

*'We would fully support that there is currently a shortage of data on the sector and its performance.'*<sup>93</sup>

The APPG note that other public agencies have also identified the need to respond to the gap. Co-operative Development Scotland (CDS), which since 2006 has been tasked with growing the co-operative, mutual and employee owned sector in Scotland, recently commissioned new research by Heriot Watt University to understand the scale of the sector in Scotland – which generated the following headline figures:

- 550-600 individual co-operative and co-owned enterprises with an annual turnover of £4 billion and gross assets of £25 billion
- Co-operative and co-owned turnover accounts for some 4.5% of the Scottish GDP<sup>94</sup>

The academic respondents to the Inquiry were unanimous in identifying both the need for better official statistics, and on the types of future research required to fill the gap.<sup>95</sup> As Professor Pendleton noted:

*'... if we want to convince HM Treasury and others we do need econometric studies. The evidence in the UK has not been econometric, on the whole, I think because of the diversity of employee-owned organisations – statistically it makes life extremely difficult indeed.'*<sup>96</sup>

Similarly, Professor Perotin commented that:

*'Given the current policy interest in organisational diversity, for example in the provision of public services, systematic collection of economic and firm-specific information on all types of employee-owned businesses would make it possible to carry out the studies needed to inform policy towards the sector (e.g. on barriers to entry, productivity and job creation).'*<sup>97</sup>

Dr Kaarsemaker calls for:

*'a large-scale international comparative employee survey, to match individual-level data with both individual-level and company-level financial data, and to repeat the survey every two or three years in order to build up a database over a number of years.'*<sup>98</sup>

The APPG were struck by the appetite of the professional research community to be given the tools to undertake detailed research on the questions we have explored. For example, they would like to examine how far the size of the individual employee stakes makes a difference to how those employees think and behave within co-owned businesses.<sup>99</sup> They are also keen to distinguish more fully the comparative performance of companies with share schemes (employee share ownership driven) compared with more fully fledged co-owned companies.<sup>100</sup>

None of which is to under-estimate some of the methodological issues which would need to be resolved. As Professor Pendleton notes:

*'A key consideration is that the economic performance of firms at conversion differs very substantially within the sector. On the one hand, there are firms that are market leaders at conversion, and who maintain that lead afterwards. On the other, there are firms that are serious under-performers at conversion and, whilst employee ownership allows them to substantially improve their performance, they may still be relative under-performers afterwards. Conflating these firms together in single econometric studies could falsely indicate that employee ownership does not achieve a performance differential.'*<sup>101</sup>

The APPG would also wish the Treasury to note that we have received interesting commentary on their recent official research and how it could in future be extended to look at the co-owned sector. For example HMRC Research Report 33 looked only at companies that use approved share plans, and has therefore probably understated the positive impact of share schemes on performance because it did not include flagship examples of employee ownership.

The report contains only limited links in its analysis to wider profit share data; the use of employee trusts, and the use of non-tax advantaged share plans. Yet it is a combination of these factors that together work to generate the best performance outcomes.<sup>102</sup>

## Recommendations

### The data gap

The APPG recognises the strength of the evidence presented to us on the data gap.

The key consideration for the APPG has been whether the best estimates of the current size of the sector, and our assessment of its broad contribution to the economy, justify a specific recommendation to address any inadequacies in the current official data. Given that the sector is now larger than the agricultural sector and is making a major economic and social contribution the UK economy – it would appear perverse that we currently know more about pig farming than we do about employee ownership and its impact in co-owned companies.

We also note the recent initiative by The Office of the Third Sector in commissioning extensive research on the environment for a thriving third sector as an analogous response to a similar data gap.

We therefore judge that the case is compelling for Government supported research in this area, and that the Treasury and the Department for Business, Enterprise and Regulatory Reform have an interest in helping to generate a review of, and research into, the co-owned sector in order to address the glaring data deficiencies that the APPG Inquiry has underlined, and to better understand the relative performance and contribution of the sector.

We believe that there is a strong case for the Treasury to lead such a review.

Expert evidence submitted to the APPG also suggests obvious terms of reference for any such a review. Key points of emphasis should include:

- i) *A focus on firm level data* (with both individual-level and company level financial data).

Both UK and European experts who responded to the Inquiry lamented the absence of robust econometric data on the co-owned sector, and facilitating such analysis requires the construction of a panel data set in the UK, and ideally Europe wide, which would be refreshed with new data every three to four years. For example future data gathering could be aided if data on co-owned companies was added to the research frame of the Workplace Employment Relations Survey.

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The resulting database would enable researchers to do rigorous multi-level, longitudinal analyses of employee ownership and its economic, individual and societal dividend.

- ii) *An assessment of the performance benefits of co-ownership, and in particular its potential role as a supplier of public services*

There is much the Treasury could do in terms of commissioning research to promote and understand the benefits of employee ownership. HM Revenue and Customs has published some research recently on the successes of tax advantage share plans and that research could be extended to cover employee ownership arrangements.

Our Inquiry has also revealed real strengths in the co-ownership model in terms of potential public service delivery – but beyond powerful, but limited case study evidence there is little or no official data or assessment.



## Lack of awareness and information about the sector among business owners, advisers, financial institutions, and public sector policy makers

The evidence received by the APPG was unanimous in identifying the lack of awareness and information as a serious obstacle to the development of the co-owned sector.

All of the co-owned companies and wide array of experts responding to the Inquiry were generally scathing of the level of knowledge and specialist advice amongst the professional advisor community. The quotes that follow give a flavour of the almost universally poor experiences of co-owned firms:

*'Co-ownership is not seen as mainstream but a quirky solution that applies for only a few anomalous companies – the majority of professional advisors will not be familiar with the implications, both commercial and fiscal, of co-ownership and as a result will be reluctant to recommend or even discuss this option in their dealing with clients.'*<sup>103</sup>

*'When we first tried to set up an employee owned business our financial advisers said we were mad and did not understand the significance of the benefits of co-ownership.'*<sup>104</sup>

*'The experience of transferring School Trends to co-ownership was frustrating and costly. We felt as though we were paying for the education of some of our advisers.'*<sup>105</sup>

*'Almost every business owner advised by the Equity Incentives team at Field Fisher Waterhouse LLP will say they have had an unsympathetic and uncomprehending previous meeting with other professional advisers, whether solicitors or accountants.'*<sup>106</sup>

This is clearly an issue that needs to be addressed. Not least because co-owned firms related to the APPG how once they get the chance to make their case to investors, as opposed to professional advisors, they are very likely to meet with success. In other words the professional advisor community may be actively limiting the deal flow of co-owned businesses to the investment community. As John Clough of eaga explained:

*'...professional advisers always advised me that the markets, the City, just would not get this employee ownership malarkey and I would have a huge amount of trouble explaining it to them; just the contrary: investors got it absolutely. Once they understood the structure and the fact that employee interests were absolutely aligned with theirs as institutional shareholders, they were very keen to take part and that resulted in a three and a half times over-subscription. Increasingly analysts and other City stakeholders are alive to the added value that this approach can bring.'*<sup>107</sup>

The evidence was also clear cut in suggesting that this lack of knowledge and information is one of the reasons why so few business owners are aware that selling their company to their employees via an employee-buyout is a serious and viable option.<sup>108</sup>

As the EOA note in their submission:

*'Business advisors very rarely draw the option of an employee buy-out to the attention of the client business owners considering business succession. It appears that some are genuinely unaware of the viability of this option, others fail to do so through lack of experience of handling such transactions, and probably the largest group seem to consider an EBO a sub-optimal solution for their clients without fully understanding its potential benefits.'*<sup>109</sup>

The respondents to the Inquiry identified a number of routes forward to tackling these deficiencies.

- Firstly, the need for the co-owned sector, current data limitations notwithstanding, to make a stronger case for just how straightforward a model this can be. As Loch Fyne Oysters noted in their submission:

*'The sector also suffers from being promoted on an evangelical, social experiment level when it should be viewed as a alternative, commercial, credible capital structure'*<sup>110</sup>

- Secondly, respondents identified the need to increase the quality and availability of briefing materials for the professional advisor community.<sup>111</sup> As Simon Fowler from the John Lewis Partnership observed:

*'The first person approached by a business owner looking to sell the company is an accountant or lawyer, usually. Employee ownership is not widely known of among such people, and when it is known of, it is often regarded with suspicion or scepticism. It would be very helpful to make material available for professional advisors'*<sup>112</sup>

- Thirdly, a number of respondents talked about the importance of changing the content of enterprise education. As Cooperative Development Scotland note:

*'It would not be too difficult to progress through primary, secondary, further and higher education in this country, coming out with an MBA but with little knowledge of collective, co-operative or employee owned approaches to enterprise beyond share options as an executive incentive.'*<sup>113</sup>



The APPG endorses these sentiments and suggestions.

We would also note that whilst improving the level of knowledge and expertise amongst the professional advice community will undoubtedly aid the development of the co-owned sector, some significant barriers would still remain – for instance the motivations of both owners and advisors.

Owners need to be committed to co-ownership in that they often have to display a 'willingness to forego easier or more lucrative options.'<sup>114</sup> Similarly, expert witnesses to the APPG stressed that some advisors have little incentive to learn more about the co-ownership model, as many do not want their clients to adopt an employee buy-out because it is not a lucrative for them, as for instance, getting a brokerage fee for finding a buyer.<sup>115</sup>

This latter point is important. Given the co-owned sector's broad contribution to the economy, and its advantages in terms of business succession already discussed, this would suggest that public interventions to address this information and expertise gap are appropriate and necessary.

## Recommendations

### The knowledge and advice gap

The APPG has been provided with very strong evidence from across the co-owned sector that the level of knowledge and expertise among business owners, advisors, financial institutions, and public sector policy makers is at best patchy, and at worst non-existent.

There are a number of measures the APPG would encourage Government support to remedy these weaknesses:

- i) The Institutes of Chartered Accountants in England, Scotland, and Wales; The Association of Chartered Certified Accountants; The Institute for Financial Accountants and other relevant professional bodies should ensure that their training and accreditation schemes include knowledge of co-ownership structures in order to raise the quality of their advisory expertise in this area.
- ii) Similarly, Regional Development Agency (RDA) Business Link advisors and their equivalents in Scotland and Wales should have a basic knowledge of co-ownership structures and systems in order to inform their advisory work with local companies. As a minimum this would allow Business Link advisors to discuss with relevant clients their succession strategy; advise them of the employee ownership option; and to hold a list of specialist agencies/consultants who can advise on employee ownership.<sup>116</sup>
- iii) Business education is of course vital and the APPG encourages business schools and equivalent institutions to integrate case studies and materials on the co-owned business model into their MBA curriculum and other similar programmes.

## Unnecessarily restrictive tax rules affecting the sector

The Group noted the widely held view in submissions to us that successive Governments have enabled the growth of employee ownership through pragmatic use of a variety of fiscal incentives. The Share Incentive Plan in particular appears to have been a robust and effective innovation. The Group also noted, however, the view in many submissions that justified action by the Treasury to address tax avoidance has inadvertently disadvantaged a key mechanism in the employee ownership model: the deployment of the employee benefit trust.

Specifically, the Finance Act 2003 decision to withdraw tax relief for companies contributing funds to an employee benefit trust has attracted more comment in our Inquiry than another other element of the APPG's terms of reference, as well as constructive proposals for how the Treasury could remedy a situation it is unlikely to have intended to create.

In structuring our presentation of the material, and mindful of the inappropriateness of a long technical discussion in a report of this kind, we have attempted to achieve the following:

- A brief account of the perceived disadvantages to the co-owned sector caused by the Finance Act 2003 decision to withdraw tax relief for companies contributing funds to an employee benefit trust (EBT)
- To summarise the strength of feeling towards, and specific criticisms of, that change from the co-owned sector and other experts
- To flag the co-owned sector's probable concerns about the most recent capital gains tax changes
- To offer the APPG's judgement as to whether these issues should be re-opened by the Treasury and if so in what form

### Of tax and EBTs

The Finance Act 2003 removed the ability of a company to donate money to an employee benefit trust (EBT) before corporation tax. The motivation behind the reform was to stop the use of such trusts for the purposes of tax avoidance.<sup>117</sup>

A business seeking to become a co-owned enterprise has to provide finance to an employee trust to enable it to retain shares permanently in that trust. The simplest way to understand the impact of the change is that it has made the financing of employee benefit trusts considerably more expensive for businesses considering the creation of a co-owned enterprise.

After the 2003 reform every £100 share bought from a retiring business owner costs £143 (i.e. £143 worth of

profits after a deduction of corporate tax at 30% reduces to £100).<sup>118</sup>

Graeme Nuttall in his evidence to the Inquiry underlined that the reform has had a major impact on the co-owned sector since its introduction, noting that:

*'My experience is that before the changes in legislation business owners would take an immediate decision to press ahead with a conversion to employee ownership. The tax system did not provide a deterrent. Since the tax rules changed business owners show a significant reluctance to proceed with a conversion to employee ownership.'*<sup>119</sup>

One way to think about the change is that it has increased the scale of the financial challenge on employee buy-outs to find the necessary funding, because less money is needed from external funders if a company's own contribution to its employee benefit trust is tax deductible.<sup>120</sup>

It has also undermined one of the key foundations of many employee owned structures. As the EOA note:

*'Stability is the major long-term financial advantage of having a significant proportion of shares in an employee owned company held by a trust. The shares in that trust never have to be sold again, whereas shares held by individuals will have to be sold at least once every generation...If all the shares are held by individuals, in effect the company has to fund a 'new' buy-out of itself in every generation – something very few companies can afford.'*<sup>121</sup>

### Of babies and bathwater

It is therefore unsurprising that this reform has caused dismay across the co-owned sector. The quotes below are typical of the key reactions from co-owned firms across the sector:

*'We need to return to the tax concessions of gifts to the employee benefits trusts. This was a case of tipping the baby out with the bathwater when HMRC withdrew the concession because of abuse of the scheme (not by genuine Employee Owned Companies)'*<sup>122</sup>

*'The recent elimination of the tax incentives surrounding EBTs has destroyed our legitimate transfer scheme and is preventing us from completing a transfer to employee ownership without resorting to external capital'*<sup>123</sup>

*'Without the ability to fund an employees' trust out of pre-tax profits, where the trust retains the shares rather*

than passing them out to employees, few companies, if any, are ever likely to choose this route. It is inconceivable that any new 'John Lewis's' would emerge. If this ownership model is considered attractive by Government, it needs to find a way of allowing a corporation tax deduction for providing trust finance in this way, at the same time continuing to prevent the abuses.'<sup>124</sup>

The Government 'removed the ability of a company to donate money to an Employee Benefit Trust before corporation tax. The employee benefit trust is a key vehicle for fostering employee buyouts: a project should be started to reintroduce that corporate tax relief for EBTs, in a way that avoids abuse by non-bona-fide employee buyouts.'<sup>125</sup>

Many firms in the co-owned sector were explicit that unless the Government commits to an intelligent reform of this measure the prospects for continued growth of employee ownership will be damaged.<sup>126</sup>

As Lindum commented:

*'the current rules tend to [almost] assume that the company is operated to reduce tax [not true] rather than the real purpose which is to share the benefits of the team's performance for the long term future of all its stakeholders'*<sup>127</sup>

Similarly, Savant in their written submission noted that:

*'In our direct experience, the Inland Revenue viewed us primarily as a tax avoidance case rather than looking at the merits of what we were trying to achieve.'*<sup>128</sup>

What has particularly upset the co-owned sector is that the negative effect of this change is to downgrade – wrongly in its view – the importance of a collective shareholder in maintaining any long term employee ownership structure.<sup>129</sup> We recommend that the Treasury and the co-owned sector address this issue by devising a means by which employee trusts can – without re-opening the door to tax avoidance - resume their previous role as a legitimate reinforcing element in many employee ownership structures.

A key issue that the APPG has therefore had to consider is the status of any tax incentives in this area. Respondents to the Inquiry have been keen to point out that the APPG should not think of any such provision as a tax break. As an expert witness noted:

*'Probably a stronger argument however is that one should not think of it as a tax break. Most businessmen expect to get a tax deduction when they pay salaries or when they pay for an advertising campaign, and they see contributions to an employee trust to promote genuine employee ownership as being bona fide business expenses. After all, the aim of the expenditure is to improve the profitability of the company so why should they not get a tax deduction? In some cases, the lack of a tax deduction gives the impression that there is something wrong with this idea and owners are put off.'*<sup>130</sup>

### **Of lightning striking twice**

The APPG has also picked up real concerns among the co-owned sector that they are about to suffer further disadvantage from the recent proposed changes to the CGT regime aimed at tackling issues external to the co-owned sector.

The need for brevity precludes a detailed discussion of this issue, and we direct attention to the recent EOA submission to the Treasury on these issues.<sup>131</sup>

The issue that is of particular concern to some of our respondents is the position of the employee shareholders and what happens when they realise their capital gains. As IFS ProShare commented:

*'We are also concerned about the impact of the capital gains tax changes announced in the October 2007 Pre-Budget Report as we think this may have a serious impact on a significant minority of employee shareholders'*<sup>132</sup>

In many cases, the gains that are likely to be realised will fall within the capital gains tax annual exemption, which is £9,200 in the 2007-08 tax year. However for many employee-owned companies, particularly those that are directly owned by their employees, and where employees are encouraged to acquire shares throughout their working life, their gains are likely to exceed the annual exemption, and it is clear from the feedback from members of the Employee Ownership Association that there is significant discontent.

As one expert witness noted:

*'In particular, the prospect of genuine employee owners paying tax at 18 per cent whilst those privileged enough to hold five per cent or more of the shares would only have to pay at a reduced rate, courtesy of entrepreneurs' relief, is an unfair situation and something must be done to redress that discrepancy.'*<sup>133</sup>

## Recommendations

### Tax rules

The APPG acknowledges that the Treasury was entirely justified in their wish to address the abuse of EBTs for tax avoidance purposes through the Finance Act in 2003. However, we are concerned that the 2003 changes in tax provisions affecting the co-owned sector are proving to be a significant impediment to its growth and future stability.

We suggest that as part of our proposed Treasury-led review of the co-owned sector, the Treasury also considers the appropriateness of the sector's current regulatory and broader funding regime.

Without wishing to pre-judge the issue, the instinct of the APPG is that it should not be impossible to find a smart solution which satisfies the Treasury's concerns about tax avoidance, and the co-owned sector's desire for a level playing field.

There would appear to be some potential 'turn keys' to unlocking these issues. Firstly, the Treasury and others need to explore whether the HM Revenue and Customs approved SIP trust could involve a permanent holding of shares, in addition to the already existing function of distributing shares to the employees as individuals.<sup>134</sup> The proposal has a number of clear merits.

- Firstly, it is an elegant and narrow reform of the current regime, which builds on the SIP trust which is already well-designed to avoid abuse, and hence does not dilute the Treasury's original objectives behind the 2003 reform.
- Secondly, this innovation would have the additional benefit of simplifying the position of a co-owned company in so far as it would only need a single trust both to hold shares and to distribute them, making it easier to understand and set up.
- Finally, this approach would also tie in well with an existing CGT roll-over relief for sales of shares to a SIP and so act as a strong encouragement to exiting owners to consider employee ownership. The CGT position of business owners should, nevertheless, be further considered, as part of the general review proposed.

More broadly, the APPG encourages the Treasury to work with interested parties to draw sharper definitional and operational assumptions between employee trusts used for the purpose of achieving employee control structures in bona fide trading operations, and contrived arrangements involving employee trusts use for the purpose of sheltering from income tax and national insurance contributions.<sup>135</sup>

In terms of other issues for consideration, the APPG would also direct the Treasury's attention to interesting evidence on the differential impact of different profit sharing schemes on overall enterprise performance.<sup>136</sup> So for example, 'SAYE' schemes are an all-employee scheme, in that in order to obtain tax reliefs under this scheme, it must be offered to all eligible employees. It is interesting to note that the long run improvement of companies using SAYE schemes is markedly better than companies using any tax advantaged share scheme (for example a company share option plan, which tends to be for the benefit of selected key employees). The Treasury may wish to explore whether the research evidence would therefore support a more favourable tax treatment of SAYE over say CSOP schemes.

The APPG also note that the annual allowances for employee share schemes have not been indexed linked and adjusted to allow for the rise in salaries. For example, the current SIP maximum of £7,500 remains unchanged since the introduction of the SIP on 28 July 2000, while salaries have of course been increasing over time. Again, if the broader contribution of the co-owned sector is accepted, the Treasury might also wish to consider making the annual allowances for employee share schemes indexed linked from the current tax year onwards, with one-off increases initially to adjust the allowances from their 2000 level.

One of the more imaginative recommendations suggested to the APPG - given the strength of co-owned firms' contribution to the local economies in which they reside - is that the Treasury might review options for fiscal concessions for investors and lenders supporting co-owned start-ups in areas of social and economic deprivation. This might lead the Treasury to consider piloting targeted support for both employee buy-outs and co-owned start-ups in selected localities, possibly economic development areas.

Given the apparently higher continuity rates of co-owned businesses, this is another issue which the Treasury might wish to include within its review of the sector.

## A relative lack of appropriate finance

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On the balance of evidence received the APPG judge this to be a significant barrier, confirmed by the majority of respondents to the Inquiry.<sup>137</sup> The overall position is well captured by the following observations:

*'There is no doubt that a lack of patient capital or employee owned risk equity is a major factor holding back the development of the sector. In any situation, buyout of existing or new start to business, the lack of significant sums of risk equity can put an employee owned option at a major disadvantage. The success of the Baxi Partnership illustrates what could be achieved but their £20m fund is small beer in the context of the wider economy.'*<sup>138</sup>

*'Investors are nervous about investing in co-owned companies due to a lack of understanding of the performance and benefits of co-ownership as a business model and this is reflected in the rates charged and the covenants placed on these companies.'*<sup>139</sup>

The APPG found it difficult on the available evidence to determine whether the problem is an absence of finance per se, or rather the absence of sympathetic finance and funding.

Some of the respondents tended to the latter view,<sup>140</sup> noting that outside of the specialist finance providers (cf. Baxi Partnership, Co-operative and Community Finance, and Unity Trust Bank) banks are generally unfamiliar with this type of lending or, if they do have experience, it takes time to identify individuals or departments responsible for this type of lending and there may be a minimum lending threshold that restricts access to finance.

This is broadly confirmed by survey data from the EOA, which revealed that roughly a third of co-owned firms had experienced difficulties in accessing or generating finance for investment.

Some respondents singled out venture capital financing as a particular problem:

*'[the venture capital] business model is more strongly biased toward accountability/control of the individual entrepreneur (or senior management group), and focuses on particular exit routes via trade or public sale. There is not just ignorance, but positive ideological opposition grounded in the 'exit route' preferred by venture capital funds.'*<sup>141</sup>

More broadly, respondents took the view that once data about the sector improves, and understanding of the performance of the co-owned sector grows, finance will begin to flow. At the moment the unfortunate reality is that:

*'investors are nervous about investing in co-owned companies due to a lack of understanding of the performance and benefits of co-ownership as a business model and this is reflected in the rates charged and the covenants placed on these companies'*<sup>142</sup>

### Recommendations

#### A relative lack of appropriate finance

The APPG received a wide range of evidence suggesting that there is a shortage of appropriate funds in the UK limiting the scope for employee buy-outs. In particular this may be limiting the process of business transfer and succession via a co-owned route.

Part of the necessary response to this problem is the data gap we have already identified - therefore underscoring the need for better research and official data. If more comprehensive data about the sector was made available, funders would become more aware of the potential of the sector to repay investment over time.

Some expert submissions queried whether improved information would be enough however to fill the funding gap, given the short-term horizons of much UK finance, and the longer term horizons of the co-owned sector. If the Treasury review were to identify serious market failings in this respect, one possible response would be for key development agencies, such as RDAs, to consider longer-term financing interventions in the co-owned sector.

The APPG notes the creation of formal institutions in Wales and Scotland piloting and exploring the scope of such interventions in the co-owned sector,<sup>143</sup> with a particular eye on business succession issues. There is no such public institution in the rest of the UK. We suggest that the case for a similar body in England should be considered by the proposed Treasury led review.

## Inadequate Government appreciation of and support for the sector

On the balance of the evidence presented to the APPG, it is clear that the co-owned sector wishes to engage constructively with Government to identify measures that will address key barriers to continued growth of the sector.

Respondents to the Inquiry have identified a number of concerns including:

- The lack of formal ownership of the issue inside the machinery of Government
- A relative over-emphasis on individual or direct employee share ownership as against collective or indirect employee ownership
- A corresponding over-emphasis on employee share ownership in relation to actual employee ownership of companies
- A need for Government review of how specific policy initiatives may unintentionally be inhibiting the growth and success of the co-owned sector

With regard to the absence of any clear Ministerial responsibility in this area, the EOA submission notes:

*'No Government Minister holds even a nominal responsibility for relationship with the sector, in contrast to the justified focus in the Cabinet Office on the social enterprise sector, which is comparable in total turnover terms to the co-owned sector.'*<sup>144</sup>

Cooperative Development Scotland echoed the importance of formal ownership within the machinery of Government:

*'There is no UK department or ministry within enterprise accepting responsibility for developing the employee owned sector. The CDS budget is less than £1M pa against a £500M spend on enterprise in Scotland and that £1M comes directly out of Scottish Government budgets and not the enterprise one. It is difficult to see major progress being achieved until some part of government is given responsibility and commensurate budgets for employee ownership.'*<sup>145</sup>

A number of respondents also expressed concern about Government's underlying view of employee ownership.<sup>146</sup> Attention has focused almost entirely on employee share ownership as a tool for companies to improve productivity rather than on the broader option of co-ownership. As one respondent commented:

*'The Government has done a lot to promote employee share plans, but it has always been in the context of individual share ownership...What has not been done is to promote the concept of employee ownership itself and in particular the ownership of businesses through employee trusts, so I believe the Government could*

*make a clear policy statement that it supports employee ownership and in particular ownership through employee trusts....I believe that would make a significant difference'*<sup>147</sup>

Respondents also gave powerful examples of where broader Government policy has unintentionally inhibited the growth and success of the co-owned sector. For example the Inquiry was told of how in the health sector, primary legislation rules out the possibility of co-owned companies with an employee benefit trust bidding for the work. An area of particular frustration for organisations looking to use the co-ownership model is NHS regulations which are outdated and make it difficult to achieve co-ownership. For example, the common model involving employee benefit trusts does not meet NHS regulations which require every shareholder to legally and beneficially own their share/s.

As Tricia McGregor of Central Surrey Health noted:

*'We would have preferred, for example, to hold our shares in an employee benefit trust, we felt that that would be a really secure long term option for us and I think the Department of Health felt that was a good model, but the current primary care legislation in the NHS Act means that shares in a Personal Medical Services contractual relationship must be legally and beneficially owned by the shareholders and so an employee benefit trust was not possible ... If you have an employee benefit trust then the legal and beneficial ownership is split and so that was not possible, so we would need a change in the regulations to allow that.'*<sup>148</sup>

### Recommendations

The APPG recommend that, in addition to the wide-ranging review proposed earlier in this report, Government take the following step to underline its support for the co-owned sector and encourage its growth:

The APPG recommends that the Government nominate specific Ministerial responsibility for relationships with, and the development of, the co-owned business sector.



## Inadequate recognition in public purchasing procedures of potential value for money advantages offered by co-owned sector providers

The APPG received very limited evidence to assess this question, although that evidence was unanimous that public purchasing procedures across the public sector should be modified to take account of the added value offered by co-owned service providers.

Two exemplar case studies were mentioned by a wide range of respondents, namely Sunderland Home Care Associates and Surrey Central Health. These two organisations are effectively beacon organisations for the co-owned sector - offering strong support for the value for money and added value contribution of co-owned service providers.

However, it is only fair to note that given the very small number of co-owned service providers operating in the field of public service provision, it would also be a surprise if there wasn't inadequate recognition of the potential value for money advantages offered by sector providers.

But given the rich potential of the co-owned sector in providing public services, there is clearly a need to promote more dialogue and development of relationships, and therefore understanding of what the sector can offer.<sup>149</sup> Some organisations are already attempting to promote the use of co-operative and social enterprise businesses in public sector contract delivery.<sup>150</sup> However, as the Wales Co-op Centre notes, 'much work needs to be done to change culture, understanding and practice of the public sector procurers.'

As Sunderland Home Care Associates observed:

*'There seems to be a reluctance for public purchasers to recognize the strengths of the co-owned sector i.e. extra quality in the service provided, local people employed at a competitive rate and benefits, benefits to the local economy, employees' self esteem and career development.'*<sup>151</sup>

The clear challenge for commissioners of services is to start looking at best value considerations in terms of multiple bottom lines. As Cooperative Development Scotland noted:

*'With clear policy decisions to pursue the wider social, economic and environmental benefits to be gained from buying goods and services locally and from locally owned and controlled enterprises then employee owned enterprises will not be forced to compete solely on price and procurement officers will still be able to work to specification which produce best value for the public purse. Specification is crucial.'*<sup>152</sup>

The best of the co-owned sector is already very much aware of the possibilities here, always seeking to make an added value pitch in their tendering responses.<sup>153</sup>

The EOA in their submission made the following recommendations to remedy these weaknesses:

- 'Current public procurement guidelines will need to be reviewed to ensure that they adequately acknowledge the potential added value offered by co-owned service providers'
- 'Intensive communication and guidance needs to be aimed at the commissioners of public services to raise their awareness of the possibility and value of considering and commissioning co-owned providers'
- 'Government and other agencies should collaborate with EOA on building capacity within the sector to deliver public services – along the lines pioneered by the Department of Health with social enterprise 'Pathfinders''<sup>154</sup>

The APPG believe the first two recommendations are actionable now, in the spirit of creating a level playing field for co-owned service providers in this segment of the economy.

The APPG took the view that the final recommendation should be reconsidered by Government when more research has been undertaken to understand the size and relative performance of the co-owned sector generally, specifically in the case of public service provision.

### Recommendations

- i) The APPG recommends that there is a review of procurement guidelines to ensure that the range of added value benefits that can be delivered by co-owned providers are better understood by public procurers and that their commissioning decisions are informed by such judgements.

The challenge here is to start looking at best value in public procurement in terms of multiple bottom lines, allowing some consideration of the wider social, economic and environmental benefits to be gained from buying goods and services locally and from locally owned and controlled enterprises.

This of course represents a challenge to the established EU procurement regime – in which one of the perceived barriers to effective competition is not only that contract requirements are shaped to suit a given, national supplier – but also where pressure is applied to use locally-based sub-contractors.

- ii) We also recommend that the Government, ideally the nominated Minister for relationships with the co-owned sector, invites the EOA to outline how it might work with Government to educate and inform the commissioners of public services about the potential contribution of co-owned service providers.

## References

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- <sup>1</sup> See Succession London written submission
- <sup>2</sup> See Appendix 'Chancellor's Pre-Budget Report 2007 – Response by the Employee Ownership Association to the impact of changes to Capital Gains Tax Provisions'
- <sup>3</sup> Michie, J. (2007.14) 'The economic case for HM Treasury to support the employee owned business sector through tax breaks and the reform of the treatment of employee trusts' Unpublished paper for the Employee Ownership Association
- <sup>4</sup> Scott Bader written submission (2007)
- <sup>5</sup> EOA written submission (2007)
- <sup>6</sup> See Michie, J (2007) 'The economic case for HM Treasury to support the employee owned business sector through tax breaks and the reform of the treatment of employee trusts.' – for a full discussion of the scope and scale of the sector in the UK and elsewhere
- <sup>7</sup> David Erdal written submission (2007) 'Questions in Employee Ownership – Research Note'
- <sup>8</sup> For a full description of the studies see Professor Michie (2007.10) 'The economic case for HM Treasury to support the employee owned business sector through tax breaks and the reform of the treatment of employee trusts' Unpublished paper for the Employee Ownership Association
- <sup>9</sup> Long, R.J. (1978a) 'The effects of employee ownership on organizational identification, employee job attitudes, and organizational performance: A tentative framework and empirical findings. *Human Relations*. 31 (1). Pp.29-48 in Michie (2007) *ibid*.
- <sup>10</sup> See Robinson, A. M. and Wilson, N. (2006) 'Employee Participation, Ownership and Productivity: An Empirical Re-Appraisal, *British Journal of Industrial Relations*. 44(1):31-50 in Michie (2007) *ibid*.
- <sup>11</sup> See David Erdal written submission (2007) 'Questions in Employee Ownership – Research Note' for an excellent summary of the key evidence
- <sup>12</sup> Michie, J (2007.1) 'Responses to questions posed by All-Party Parliamentary Group on Employee Ownership'.
- <sup>13</sup> NCEO 'Employee Ownership and Corporate Performance' [www.nceo.org](http://www.nceo.org)
- <sup>14</sup> The Centre for Tomorrow's Company (2004.4) 'Employee Ownership in Tomorrow's Company'.
- <sup>15</sup> David Erdal written submission and Corey Rosen, National Center for Employee Ownership written submission, including 'NCEO Issue Brief: Employee Ownership and Corporate Performance. A Review of Research on US Companies' (2007) National Center for Employee Ownership
- <sup>16</sup> Michie, J. (2007.10) 'The economic case for HM Treasury to support the employee owned business sector through tax breaks and the reform of the treatment of employee trusts' Unpublished paper for the Employee Ownership Association
- <sup>17</sup> For example eaga submitted findings from their most recent Partner (employee) engagement survey which powerfully demonstrates how co-ownership motivates its employees. The majority (88%) of eaga employees would describe themselves as actively engaged or engaged. Additionally, eaga employees' opinions were responsible for eaga's top 40 position for two years running in The Sunday Times top 100 companies to work for (2004, 2005)
- <sup>18</sup> Burns, P. (2006) 'Good Business: The employee ownership experience' EOA
- <sup>19</sup> Martin Conyon and Richard Freeman: Shared Models of Compensation and Company Performance: UK evidence, National Bureau of Economic Research, Working Paper 8448. <http://www.nber.org/papers/w8448>
- <sup>20</sup> Lee & Priestley written submission
- <sup>21</sup> Simon Fowler, John Lewis Partnership, oral evidence
- <sup>22</sup> UBH written submission
- <sup>23</sup> School Trends written submission
- <sup>24</sup> *Ibid* (2007.3) – for a full discussion of the relationship between co-ownership and increased discretionary effort in co-owned workplaces
- <sup>25</sup> See Freeman, R. et al (2006) 'Creating a bigger pie? The effects of employee ownership, profit sharing, and stock options on workplace performance.' Quoted in Michie, J. (2007) 'The economic case for HM Treasury to support the employee owned business sector through tax breaks and the reform of the treatment of employee trusts' Unpublished paper for the Employee Ownership Association
- <sup>26</sup> See Culpepper et al (2004) 'Employee stock ownership plans and three-component commitment.' *Journal of Occupational and Organizational Psychology*. 77. pp 175-170 quoted in Michie (2007) *ibid*.
- <sup>27</sup> See Loch Fyne Oysters written submission
- <sup>28</sup> Cooperative Development Scotland written submission
- <sup>29</sup> School Trends written submission
- <sup>30</sup> Postlethwaite, R; Michie, J; Burns, P; and Nuttall, G. (2005) 'Shared Company: How employee ownership works' EOA
- <sup>31</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence



- <sup>32</sup> UBH written submission
- <sup>33</sup> Professor Pendleton's written submission
- <sup>34</sup> Ibid.
- <sup>35</sup> See for example the written submissions by Tullis Russell, IFS ProShare, John Lewis Partnership, UBH, School Trends, and Scott Bader
- <sup>36</sup> John Lewis Partnership written submission
- <sup>37</sup> Wales Co-operative Centre written submission
- <sup>38</sup> Fred Bowden, Tullis Russell, oral evidence
- <sup>39</sup> See Professor Perotin's written submission – citing Craig and Pencavel's 1992 study of the US plywood co-operatives and conventional firms and the two studies of Italian conventional and employee-owned firms by Pencavel et al (2006) and Bartlett.
- <sup>40</sup> Burns, P. (2006.4) 'Good Business: The employee ownership experience' EOA
- <sup>41</sup> Evidence submission written by Professors Blasi, J. and Kruse, D. (2007)
- <sup>42</sup> Corey Rosen, National Center For Employee Ownership submission (2007) ([www.nceo.org](http://www.nceo.org))
- <sup>43</sup> Michie, J. and Sheehan, M. (1999) 'No Innovation without representation? An analysis of participation, representation, R&D and innovation', Economic Analysis, Volume 2, Number 2, pp. 85-97
- <sup>44</sup> cf. The UK government gateway to Corporate Social Responsibility ([www.csr.gov.uk](http://www.csr.gov.uk))
- <sup>45</sup> cf. the written submissions from Lee & Priestley, IFS ProShare, and the John Lewis Partnership
- <sup>46</sup> School Trends written submission
- <sup>47</sup> Burns, P. (2006.4) 'Good Business: The employee ownership experience' EOA
- <sup>48</sup> cf. Sunderland Home Care Associates was awarded the Social Enterprise of the year award in 2006 at the Enterprising Solutions Awards
- <sup>49</sup> Burns, P. (2006.3) 'Good Business: The employee ownership experience' EOA
- <sup>50</sup> cf. the written submissions from Loch Fyne Oysters and Tullis Russell
- <sup>51</sup> The Centre for Tomorrow's Company (2004.4) 'Employee Ownership in Tomorrow's Company'
- <sup>52</sup> Michie, J. and Blay, J. (2004.22) 'Mutuals and their Communities: how one in three enjoy the mutual advantages' Mutuo
- <sup>53</sup> cf. DTI (2004) 'Passing the Baton'
- <sup>54</sup> cf Paul Guest et al (2002) 'Do takeovers create value? A residual income approach on UK data' The ESRC Centre for Business Research, University of Cambridge, Working paper no. 252
- <sup>55</sup> Business Link (2007) 'How to achieve an employee buy-out'
- <sup>56</sup> Co-operative Development Scotland written submission
- <sup>57</sup> cf. written submissions from UBH and Lee & Priestley
- <sup>58</sup> Michie, J (2007) 'Responses to questions posed by All-Party Parliamentary Group on Employee Ownership'.
- <sup>59</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence
- <sup>60</sup> Compton Fundraising Consultants written submission
- <sup>61</sup> Alloy written submission
- <sup>62</sup> Wales Co-operative Centre written submission
- <sup>63</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence
- <sup>64</sup> Professor Pendleton written submission
- <sup>65</sup> School Trends written submission
- <sup>66</sup> Michie, J (2007) 'Responses to questions posed by All-Party Parliamentary Group on Employee Ownership'.
- <sup>67</sup> For example Sunderland Home Care Associates and Central Surrey Health. Sunderland Home Care Associates (20-20) Limited ('Sunderland Home Care Associates') provides a personal care service to people in their own homes. In 2004, Sunderland Home Care Associates won the best participation and best company awards from North East Social Enterprise Partnerships. The business model established by Sunderland Home Care Associates is now being reproduced elsewhere (Newcastle Home Care Associates, North Tyneside Home Care Associates and Manchester Home Care Associates).
- <sup>68</sup> Central Surrey Health written submission
- <sup>69</sup> Tricia McGregor, Central Surrey Health, oral evidence
- <sup>70</sup> Mark Sesnan, Chief Executive of Greenwich Leisure, oral evidence
- <sup>71</sup> cf. Co-operative Development Scotland written submission
- <sup>72</sup> John Clough, eaga, oral evidence
- <sup>73</sup> Department of Health Social Enterprise Unit written submission
- <sup>74</sup> Simon Fowler, John Lewis Partnership, oral evidence

- <sup>75</sup> John Clough, eaga, oral evidence
- <sup>76</sup> Loch Fyne Oysters written submission
- <sup>77</sup> Savant written submission
- <sup>78</sup> K. Ludwiniak written submission
- <sup>79</sup> cf. Professor Julian le Grand (2007.7) 'Consistent Care Matters: Exploring the Potential of Social Work Practices' DFES
- <sup>80</sup> John Lewis Partnership written submission
- <sup>81</sup> Cf. see written submissions from the Lindum Group, Compton Fundraising Consultants, David Erdal, Tullis Russell, and the John Lewis Partnership
- <sup>82</sup> See eaga written submission
- <sup>83</sup> cf. written submissions from Scott Bader and UBH submissions
- <sup>84</sup> Michie, J (2007) '*Responses to questions posed by All-Party Parliamentary Group on Employee Ownership*'.
- <sup>85</sup> Burns, P. (2006.7) '*Good Business: The employee ownership experience*' JOL Ltd
- <sup>86</sup> cf. Co-operative Development Scotland written submission, and Simon Fowler, John Lewis Partnership, oral evidence
- <sup>87</sup> Michie, J (2007) '*Responses to questions posed by All-Party Parliamentary Group on Employee Ownership*'.
- <sup>88</sup> EOA written submission
- <sup>89</sup> See Succession London written submission
- <sup>90</sup> See Michie, J (2007) '*Responses to questions posed by All-Party Parliamentary Group on Employee Ownership*' for a full discussion of these issues
- <sup>91</sup> cf. see the written submissions from eaga, G3 Baxi Partnership, Sunderland Home Care Associates, and the Department of Health Social Enterprise Unit
- <sup>92</sup> See eaga written submission
- <sup>93</sup> Department of Health's Social Enterprise Unit written submission
- <sup>94</sup> Co-operative Development Scotland written submission
- <sup>95</sup> cf. see London Succession written submission for a comprehensive list of relevant variables
- <sup>96</sup> Professor Pendleton, oral evidence
- <sup>97</sup> Professor Perotin written submission
- <sup>98</sup> Eric Kaarsemaker (2006) '*Employee ownership and its consequences: Synthesis-generated evidence for the effects of employee ownership and gaps in the research literature*'
- <sup>99</sup> Professor Pendleton written submission
- <sup>100</sup> David Erdal written submission
- <sup>101</sup> Professor Pendleton written submission
- <sup>102</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence
- <sup>103</sup> Tullis Russell written submission
- <sup>104</sup> Make written submission
- <sup>105</sup> School Trends written submission
- <sup>106</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence
- <sup>107</sup> cvii John Clough, eaga, oral evidence
- <sup>108</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence; David Erdal written submission
- <sup>109</sup> EOA written submission
- <sup>110</sup> Loch Fyne Oysters written submission
- <sup>111</sup> UBH written submission
- <sup>112</sup> Simon Fowler, John Lewis Partnership, oral evidence
- <sup>113</sup> Co-operative Development Scotland written submission
- <sup>114</sup> The Centre for Tomorrow's Company (2004.4) '*Employee Ownership in Tomorrow's Company*'
- <sup>115</sup> See Corey Rosen, National Center for Employee Ownership written submission and David Erdal written submission
- <sup>116</sup> See Succession London written submission
- <sup>117</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence. As he notes, the Treasury's key concern in terms of closing off the possibilities for tax avoidance was with cash bonus schemes rather than employee share schemes. 'A typical example of an employee trust that was using an unacceptable way is one that was set up offshore and in which large bonuses would be deposited. The financial institution or other employer paying those cash bonuses would claim a tax deduction as the money went into the offshore trust. The money would be earmarked for a particular employee who would choose never to withdraw it from that offshore employee trust because to do so would trigger a tax charge. Instead, they would leave the money to be invested tax free offshore, waiting until their retirement when that much larger fund could then be withdrawn perhaps at a time when they were not a higher rate taxpayer, or could be withdrawn in stages. HM Revenue and Customs objected to the lack of symmetry, the fact that a tax deduction was given to the employer when the cash went into the employee trust but there was no immediate tax charge on the employee for whose benefit that cash sum was earmarked. That is a very

different situation from a company wishing to acquire shares in an employee trust and hold them indefinitely into an employee trust so as to make a company employee owned for the benefit of all its employees.'

<sup>118</sup> EOA written submission

<sup>119</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence

<sup>120</sup> Michie, J (2007) '*Responses to questions posed by All-Party Parliamentary Group on Employee Ownership*'.

<sup>121</sup> EOA written submission

<sup>122</sup> Sunderland Home Care Associates written submission

<sup>123</sup> Alloy written submission

<sup>124</sup> Robert Postlethwaite written submission

<sup>125</sup> Simon Fowler, John Lewis Partnership, oral evidence

<sup>126</sup> cf. see written submissions from School Trends and UBH

<sup>127</sup> Lindum written submission

<sup>128</sup> Savant written submission

<sup>129</sup> Michie, J. (2007.14) '*The economic case for HM Treasury to support the employee owned business sector through tax breaks and the reform of the treatment of employee trusts*' A report for the Employee Ownership Association

<sup>130</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence

<sup>131</sup> '*Chancellor's Pre-Budget Report 2007: Response from the Employee Ownership Association to the impact of changes to Capital Gains Tax provisions*' EOA

<sup>132</sup> IFS Proshare written evidence

<sup>133</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence

<sup>134</sup> The SIP trust regime already permits an up-front tax deduction in certain circumstances pursuant to the tax relief introduced in the Employee Share Schemes Act 2002 (ESSA 2002). The EOA suggestion is to amend these ESSA 202 provisions to permit some shares to be retained permanently in the SIP trust. (cf. EOA, unpublished submission to HM Treasury, October 2006)

<sup>135</sup> Postlethwaite, R; Michie, J; Burns, P; and Nuttall, G. (2005.31) '*Shared Company: How employee ownership works*' EOA

<sup>136</sup> Conyon, M. and Freeman, R. (2001) '*Shared models of compensation and Firm Performance: UK Evidence*', NBER Working Paper, Number 8448. Their research suggested that the effect on productivity of giving shares to all employees is over 40% stronger than giving options to managers

<sup>137</sup> Only two organisations who responded to the Inquiry did not believe this was a significant issue (see written submissions from Scott Bader, IFS ProShare)

<sup>138</sup> Co-operative Development Scotland written submission

<sup>139</sup> UBH written submission

<sup>140</sup> Compton Fundraising Consultants and Field Fisher Waterhouse written submission

<sup>141</sup> Rory Ridley-Duff written submission

<sup>142</sup> UBH written submission

<sup>143</sup> Namely Cooperative Development Scotland and the Wales Co-operative Centre

<sup>144</sup> EOA written submission

<sup>145</sup> Cooperative Development Scotland written submission

<sup>146</sup> Professor Pendleton written submission and Field Fisher Waterhouse written submission

<sup>147</sup> Graeme Nuttall, Field Fisher Waterhouse, oral evidence

<sup>148</sup> Tricia McGregor, Central Surrey Health, oral evidence

<sup>149</sup> Department of Health Social Enterprise Unit written evidence

<sup>150</sup> See Wales Co-operative Centre written submission

<sup>151</sup> Sunderland Home Care Associates written submission

<sup>152</sup> Cooperative Development Scotland written submission

<sup>153</sup> Ms Margaret Elliott, Sunderland Home Care Associates, oral evidence

<sup>154</sup> EOA written submission (2007.13/14)

**Appendix 1****Names and dates of witnesses examined**

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**Tuesday 27 November 2007**

John Clough MBE, Chief Executive, eaga

Mark Sesnan, Chief Executive, GLL

David Erdal, Director, Baxi Partnership

Hugh Facey MBE, Chairman, Gripple

**Wednesday 30 January 2008**

Margaret Elliott OBE, Founder Director, Sunderland Home Care Associates

Fred Bowden, Chairman, Tullis Russell Group

Graeme Nuttall, Tax Partner, Field Fisher Waterhouse

**Wednesday 5 March 2008**

Simon Fowler, Head of Internal Communications, John Lewis

Mike Thompson OBE, Chief Executive, Child Base

Tricia McGregor, Joint Managing Director, Central Surrey Health

Professor Andrew Pendleton, University of York Management School

## Appendix 2

# Written evidence submitted to the All Party Parliamentary Group on employee ownership

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CHILD BASE, MIKE THOMPSON  
SUNDERLAND HOME CARE ASSOCIATES  
SCHOOL TRENDS, PETER BEEBY  
GRAEME NUTTALL, FIELD FISHER WATERHOUSE  
LINDUM GROUP, DAVID CHAMBERS  
JONATHAN OXLEY, LEE & PRIESTLEY  
COMPTON FUNDRAISING CONSULTANTS, ANDREW DAY  
COREY ROSEN, NATIONAL CENTER FOR EMPLOYEE OWNERSHIP  
SCOTT BADER, PHILIP BRUCE  
DAVID ERDAL  
RORY RIDLEY-DUFF, SHEFFIELD UNIVERSITY  
GRIPPLE, HUGH FACEY  
NORMAN WATSON, WALES CO-OPERATIVE CENTRE  
CENTRAL SURREY HEALTH  
UBH, JIM LYON  
ALLOY, GUS DESBARATS  
ROBERT POSTLETHWAITE  
EMPLOYEE OWNERSHIP ASSOCIATION  
EAGA  
PROFESSOR JONATHAN MICHIE, BIRMINGHAM UNIVERSITY  
JOHN LEWIS PARTNERSHIP  
PROFESSORS JOSEPH BLASI AND DOUGLAS KRUSE  
SUCCESSION LONDON, GREGORY COHN  
PROFESSOR VIRGINIE PEROTIN, LEEDS UNIVERSITY  
MWH, ANDREW COWELL  
CARE & SHARE ASSOCIATES  
PA CONSULTING, MARK THOMAS  
SUE WHITE, DEPT OF HEALTH SOCIAL ENTERPRISE UNIT  
ALEX BRYSON, POLICY STUDIES UNIT  
MAKE, BARRY COOKE  
PROFESSOR ANDREW PENDLETON, YORK UNIVERSITY  
PROFESSOR RICHARD WILKINSON, NOTTINGHAM UNIVERSITY  
MOTT MACDONALD, PETER WICKENS  
G3 BAXI PARTNERSHIP  
TULLIS RUSSELL, GEOFF MILLER  
LOCH FYNE OYSTERS, BRUCE DAVIDSON  
CO-OPERATIVE DEVELOPMENT SCOTLAND  
K LUDWINIAK  
PLUNKETT FOUNDATION  
SAVANT, IAN HENDERSON  
IFS PROSHARE, FIONA DOWNES

## Chancellor's Pre-Budget Report 2007 – Response by the Employee Ownership Association to the impact of changes to capital gains tax provisions

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The EOA wishes to respond to Government on the impact of the proposed changes to CGT announced in the 2007 Pre-Budget Report from the point of view of existing owner managers (who may be in a position to consider employee ownership as a succession solution) and the shareholders in employee owned companies (e.g. the trustees of employee trusts and employees).

The following comments have been prepared by our legal adviser, Graeme Nuttall, tax partner with Field Fisher Waterhouse, and after consultation with our member companies. They relate to the proposed introduction of a flat rate of CGT of 18% from 6 April 2008.

The EOA is a business association representing the co-owned company sector – enterprises wholly or substantially owned, individually and collectively, by the people who work in them. As such the EOA is the 'voice of co-owned business'. It has over 50 member companies and has grown rapidly since adopting business association status within the past two years. The organisation was, until December 2006, known as Job Ownership Limited [JOL] since its formation in 1979 as a research-based advocacy group promoting the employee ownership of businesses and fiscal reform to facilitate and encourage conversions to employee ownership.

As Job Ownership, what is now the EOA played a prominent role in the passage of the Employee Share Schemes Act 2002; and our legal adviser was a member of HM Treasury's advisory panel which devised the Share Incentive Plan and the Enterprise Management Incentive schemes.

As a business association, the EOA is governed by its member companies, who predominate on its controlling board of directors. Its members include a majority of the UK's largest co-owned companies, including Europe's largest single-entity co-owned corporation, the John Lewis Partnership, along with a range of other successful enterprises. Membership is spread across a very wide range of sectors, and includes companies of all sizes.

Our overall comment, based on reactions from member companies, is one of surprise and disappointment. We believe that successive Chancellors have genuinely attempted to create an environment in which widespread employee financial participation, including the employee ownership of businesses, can thrive. We have severe criticisms, already voiced to the former Chancellor, Rt Hon Gordon Brown, and to Treasury officials, about the impact of the Finance Act 2003's removal of the ability of a company to donate money to an Employee Benefit Trust before corporation tax, while justifiably trying to stop the use of such trusts for the purposes of tax avoidance.

The proposed changes to CGT will make the situation and prospects for employee ownership worse – the only debate is about how much worse. Rather in the same manner as with the Treasury's treatment of trusts, the co-owned business sector is about to suffer collateral damage resulting from the Government's intention to tackle a quite different policy issue, or in this case several issues.

### Overall recommendation

The scope for successful employee ownership will unquestionably be narrowed by the proposed changes and **we strongly recommend that they be revised**. We set out below separate suggested recommendations as regards existing owner managers and shareholders in employee owned companies. We have made the assumption that the Government will wish to keep to its overall stated aim of simplifying the CGT system through the introduction of a general flat rate of CGT.

### Existing owner managers

The EOA has contact with owner managers who have implemented, are currently considering or may be persuaded to consider an employee buy-out as part of a business succession solution. The immediate reaction is one of annoyance. Existing owner managers knew that if they sold their company they would only pay tax at 10% (on the basis that all owner managers are higher rate tax payers). The increase in tax to 18% is seen as a cost (even if owner managers had no immediate plans to sell).

In the short term, owner managers who were uncertain about selling their businesses may be prompted to sell because prior to 6 April 2008 they will only pay tax at 10%.

We do not believe that employee ownership will benefit from this short term incentive. The process of understanding employee ownership and educating employees as to what it means takes time, as does raising the finance. What is more likely is that there will be an increase in trade sales of private companies prior to 6 April 2008.

From 6 April 2008, the key question is to what extent will the increased tax rate act as a deterrent to converting companies to employee ownership.

At a 10% tax rate, there was almost a positive incentive to consider selling a company. This tax rate is generally seen as generous. An 18% rate clearly creates some resistance to selling (to anyone).

An attractive alternative in family owned businesses is to retain shares until death. There is no CGT on death and if shares are left to a spouse there is no inheritance tax ("IHT"). The spouse can then sell the business free of CGT. This is because the spouse inherits the shares at market value for CGT purposes and so can sell without having any liability to CGT on the basis that the shares will not have increased in value since death. Even if shares are left to other family members there is another IHT relief that probably means there is no IHT to pay on the shares. The other family members can similarly sell free of CGT.

If an owner manager wants to sell, he or she will think much more about tax planning when there is tax to pay at 18%.

Takeovers by listed companies may be a preferred method of selling. Companies that are listed on a stock exchange can offer their own shares (or loan notes) as consideration for acquiring a company. This defers an immediate liability to CGT and gives the vendor control over when they realise their capital gains. A similar result can be achieved in employee buyouts through careful structuring but the financial risks for the vendor are greater.

## Recommendations regarding existing owner managers

We recommend that **a new form of "retirement" relief is introduced** (or as a less welcome alternative the new fixed rate is no more than 15%).

So called "retirement" relief could be reintroduced in a revised form. This straightforward CGT relief was withdrawn in 2004. It did not actually involve an individual retiring. Subject to meeting various qualifying conditions the relief applied on the disposal of shares once a shareholder had attained the age 50. Maximum relief was available for shares held for at least 10 years. The first part of any chargeable gain up to a specified amount was exempt from tax and only half of the next tranche of any gain was subject to tax.

In order to avoid age discrimination, we would suggest that there is no minimum age threshold and that, instead, the emphasis in the new relief is on owning the shares for a required period. After owning shares for, say, 10 years an initial £500,000 of gain would be exempt with only half of the next £1,000,000 of any gain subject to tax. This relief would provide an attractive incentive to existing owner managers to consider selling their shares to an employee trust.

The relief could be generally available or a further condition could be added, namely, that the sale of shares must be to the trustees of an employee trust (as defined for Section 86 Inheritance Tax Act 1984 purposes).

## Employee trustees

The change in CGT rates will not affect employee trusts that have permanent shareholdings (i.e. because they do not sell the shares they hold).

Employee trusts that have regular dealings in shares have probably been set up in the Channel Islands so that they are outside the scope of CGT. From 6 April 2008 it will be more cost effective to set up an offshore employee trust for this purpose.

## Employees

In broad terms, the arrangements for employees to get shares tax efficiently remain the same (e.g. income tax



and national insurance contribution ("NIC") charges can be avoided by using tax advantaged share and share option plans). The relative merits of an EMI share option plan as against a CSOP share option have changed. Both retain income tax and NIC advantages (and these are greater under EMI). However, from a CGT point of view there will be no difference between the two plans from 6 April 2008. Prior to 6 April 2008 there was an advantage receiving an EMI option because taper relief started from the date of grant of the option (rather than the date of acquisition of shares as is the case with CSOP).

However, what will change from 6 April 2008 is the net of tax benefit employees can receive from owning shares.

Many employee shareholders will probably continue to benefit from tax free capital gains because whatever gains they realise are within the CGT annual exemption (£9,200 in 2007/8). Also, any shares held within a SIP are free of CGT until they leave the SIP.

The Chancellor's proposed CGT changes will not affect employees whose potential benefits fall under the £9,200 ceiling. However, feedback from EOA member companies is that a significant number of employees will be hit by the change because their potential benefits exceed the cap. Higher paid employees and those seeking quite legitimately to leave a scheme and cash in their gain, including typically those on retirement, will be penalised, in our view quite unjustifiably. The cumulative effect of annual awards makes it more likely that this will be a concern.

To the extent that there are employee shareholders who are basic rate tax payers (taxable income between £2,231 and £34,600) or higher rate tax payers AND who have used up their annual CGT exemption, the CGT changes will be significant.

From 6 April 2008 the basic rate of income tax will be reduced from 22% to 20%. Had taper relief been kept then basic rate tax payers would only pay tax at 5% on any capital gains they realised (in excess of the annual exemption). The increased tax rate for this category of

employee shareholder is therefore from 5% to 18%. If a taxable £5,000 gain is realised, an additional £650 tax is due from this category of taxpayer (assuming they remain a basic rate taxpayer). Higher rate tax payers will see the rate of tax change from 10% to 18%.

In those employee owned companies that operate a regular internal market, it should be possible for employees to manage any CGT exposure by selling shares on a regular basis to use up their CGT annual exemption. However, the EOA cannot understand why the Chancellor would wish to encourage such a short term attitude to share ownership and stakeholding in the business. This surely contradicts the Government's view about the long term value of employee financial participation.

We expect co-owned companies affected by the proposed changes to have to introduce elaborate and expensive procedures to permit employees to sell shares over a number of tax years preceding retirement (to maximise use of the annual exemption).

The EOA accepts that the introduction of the CGT flat rate makes no difference regarding employee trusts that are offshore and/or retain shares permanently.

However, we would reiterate that the position of the significant number of actual and potential employee shareholders who realise gains in excess of the annual exemption is worse. Company assistance with tax planning to maximise the use of annual exemptions will reduce the impact, but we strongly question why companies should have to incur this inconvenience and cost in order to offset what will otherwise be a narrowing of the scope for active long term employee ownership.

### **Recommendations regarding employee shareholders**

#### **We recommend that:**

(a) gains (in excess of the available annual exemption/s) on the sale of shares **by employee shareholders** are taxed only at a **flat rate of 10%** (i.e. on sales of shares owned by an employee in the company for which he or



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she works (or in the parent company of their employing company). This rate would not apply to anyone once they own more than, say, 5% of a company's shares.

and

(b) that the CGT annual exemption is enhanced as follows:

- (i) By providing for the **carry forward for one tax year of any unused CGT annual exemption** (this facility already exists for any unused annual exemption for inheritance tax purposes), and
- (ii) A facility is introduced to **transfer any unused CGT annual exemptions from one spouse (or civil partner)** to another.

As regards (b)(ii) above, this relief is in effect, already available for shares in listed companies. It is a straightforward matter for an employee to transfer shares in a listed company to their spouse or civil partner. However, it is often impossible to do this in employee owned companies because of restrictions on who may or may not own shares in a company. The above suggested "retirement" relief would also apply to long term employee shareholders whatever percentage shareholding they hold.

We urge the Chancellor to recognize the problems created for employee ownership by the proposed changes and to accept our above recommendations.

**Employee Ownership Association**

December 2007

## Notes

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All Party Parliamentary Group  
**on Employee Ownership**