Skadden

Skadden, Arps, Slate, Meagher & Flom LLP
& Affiliates

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Helena Derbyshire
London
+44.20.7519.7086
helena.derbyshire@skadden.com

James Anderson
London
+44.20.7519.7060
james.anderson@skadden.com

* * *

40 Bank Street, Canary Wharf, London
Telephone: +44.20.7519.7000

Four Times Square, New York, NY 10036
Telephone: +1.212.735.3000

WWW.SKADDEN.COM

May 14, 2013

Shares for Rights: Over-Sold or Under-Appreciated?

In this article we consider some alternative approaches to the proposed U.K. status of "employee shareholders," who receive capital gains tax-exempt shares in their employer (or its parent) in return for waiving certain employment rights. The reception for the new status has been cold from employers, employee groups (notably the Trades Union Congress, who maintain that the concept of shares for rights "defies logic") and even the House of Lords, which accepted Clause 27 of the Growth and Infrastructure Act 2013 (the Act) on 24 April 2013 only in return for a number of concessions — after rejecting it twice.

We identify, however, where the new status might come into its own.

1. The Proposal: Shares for Rights

The Act (which received Royal Assent on 25 April 2013) provides for companies of any size to offer employees between £2,000 and £50,000 worth of shares in the employer or its parent company, both of which can be registered outside the U.K. More shares can be granted, but only gains on disposal of shares worth up to £50,000 at the time of grant will be exempt from capital gains tax (CGT). Income tax will not be payable on the first £2,000 in value at the time of grant (if full value is paid for the shares, income tax may be irrelevant). The employee shareholder would then be able to sell those shares at the end of his or her employment, so benefitting from a tax-free lump sum payment and any gain in the shares' value while they have been working in the business. In return, the employee shareholder forfeits certain employment rights, including the ability to claim unfair dismissal and the entitlement to statutory redundancy pay, and his or her ability to request flexible working under the current statutory scheme is limited to when they return from parental leave. The notice required on return from maternity, additional paternity or adoption leave is also extended.

The principle behind the initial proposals, made on the back of Lord Nuttall's report on employee ownership, is simple: Employee engagement and therefore business performance is thought to increase if employees have a vested interest in their employer's business. Lord Nuttall made much of the "John Lewis effect": at John Lewis, all staff are "partners" who receive annual bonuses dependent on the performance of the business.

There is also the common (but not wholly substantiated) view that employers are wary of hiring staff because they fear additional red tape and the potential exposure to claims at the end of the relationship.

Finally, there is also a cynical school of thought, voiced by TUC General Secretary, Frances O'Grady and others, that the proposals are just intended to erode employment rights.

The proposal really is aimed at small to medium-sized businesses with potential to grow, but the new status can be used by any incorporated employer. Although the response to the government's consultation on the subject indicated that "a very small number" of employers thought they might use the scheme, the position statement supporting the first draft of the Act anticipated that 10,000 to 20,000 employers might take it up and a survey of 700 SMEs conducted by Barclays Corporate in April 2013 suggested that 25 percent of respondents might be interested.

While it might be attractive to a small employer to engage new staff in this way, particularly in a start-up business, the smaller the enterprise, the more any grant of shares to employees is likely to dilute the owner's capital and the more significant share forfeiture and valuation (the two areas with least clarity in the Act) will be.

2. The Employment Angle: What Is the Employee Shareholder Really Giving Up?

Only limited employment rights are waived in return for shares. Employee shareholders will still be protected by discrimination legislation, working time and other rights derived from European law. They will also be able to claim unfair dismissal if they are able to show that their dismissal is for a protected reason, such as making a protected disclosure/whistleblowing; for union, health and safety, or pregnancy-related reasons; or, now, refusing an offer of employee shareholder status. If so, the dismissal would automatically be deemed unfair, irrespective of the employee's length of service. From experience, it is likely that employee shareholders would bring such claims if they fall into a protected category, and there is some scepticism amongst employers (and expressed in the House of Lords) as to how much protection employers would really have.

Dependent on the likely growth of the business, the prospect of receiving shares that the employee would benefit from at the end of the relationship might be appealing to some employees, particularly in the light of last year's increase in the period of service to qualify for unfair dismissal rights from one to two years (for employees whose employment started on or after 6 April 2012): There would be no qualifying period of service to be entitled to sell the shares at the end of the employee shareholder's employment, effectively conferring a "day one right." Also, for highly remunerated employees, the prospect of growth in the value of the shares might outweigh the potential compensatory award for unfair dismissal that will be forfeit: The government is proposing to cap unfair dismissal compensation at one year's pay (or the current statutory cap, which is £74,200 for dismissals from 1 February 2013, if less).

On the other hand, employee shareholders would be exposed if their employer's business is in distress. Employees are able to claim certain limited sums from the Department for Business, Innovation and Skills (BIS) if they lose their jobs because of their employer's insolvency. Employee shareholders would not qualify for a protected redundancy payment and there would be no compensation for the fact that the shares they have been given have no value.

The intention, as voiced by BIS Minster of State Michael Fallon MP as the Act progressed through Parliament, is that forfeiture of the shares at the end of the relationship "should be left to contractual agreement between" the individuals and employers. It will be interesting to see whether there is sufficient value in the shares they are granted (see below), for example, because there are restrictions on those shares. Also, this approach to compensation gives employers a relatively free rein to determine good and bad leaver events. Given that the employees most likely to claim unfair dismissal are those who are dismissed for misconduct or incapability, being typical bad leaver events, employers will need to ensure that shares have a meaningful value even if the employee is a bad leaver if they are to provide an effective inducement for an employee to waive unfair dismissal rights.

3. How Voluntary Is Acceptance of the New Status?

During the latter stages of the Act's progression through Parliament, a significant objection in the House of Lords related to the appearance that employees would be coerced into giving up their employment rights. As a result, much was made by Michael Fallon MP of the voluntary nature of the status. When introducing the concessions outlined below he stated:

> *"By including these protections we are ensuring that individuals understand the implications of employee status and are genuinely free to decide whether to accept it. No one can be pressurised, bullied or coerced into accepting this new status."*

Employers cannot impose employee shareholder status on current employees without their consent (existing employees can claim automatically unfair dismissal if they are dismissed for refusing an offer of employee shareholder status, and protection will be afforded to employees who suffer a detriment short of dismissal), but there is no proposal to restrict employers' ability to offer only employee shareholder status to new recruits. Employers can therefore decide to recruit solely on this basis with no repercussions: Candidates can either accept the offer of a position as an employee shareholder or look for work elsewhere.

To address concerns about coercion, the government made a number of concessions, the first being an express provision that job seekers would not forfeit their entitlement to social security benefits if they refuse a role that is offered with employee shareholder status only. Further concessions, made at the eleventh hour to persuade the House of Lords to accept the Act on its final reading, include:

- Requiring employers to provide a written statement to the employees with full details of the shares and the rights they carry (this will need to be transparent)
- A provision that the acceptance of employee shareholder status (and attendant forfeiture of employment rights) will be valid only if the employee shareholder receives advice from an independent legal adviser (for example a lawyer, trade union adviser or the Citizens Advice Bureau) on the status and the rights that they are giving up. This is akin to the existing requirement for an employee to obtain independent legal advice for a compromise agreement (soon to be renamed a "settlement agreement") to be an effective settlement of statutory employment claims. Unlike compromise agreements, however, the employer will have to pay the employee's "reasonable costs" (expected to be a tax-free benefit) for obtaining that advice, and there will be a seven-day cooling off period during which acceptance of the employee shareholder status will not be binding and can be revoked. For this reason, employers should make any new appointment of employee shareholder status conditional upon the completion of that seven-day period and wait until it is met before the employee shareholder starts work, in order to avoid inadvertently appointing the candidate as an employee. We would also advise that, although this is not a requirement in the Act, the fact of the advice should be recorded in writing and confirmed by the independent adviser.

If these requirements are not met, new appointments will be of ordinary employment with full employment rights and existing employees converting to employee shareholder status would simply retain their original rights.

4. The Tax Angle: Removal of Confusion on Income Tax and NICs?

Only gains on the first £50,000 worth of any shares falling within the scheme (or the taxpayer's lifetime) will be CGT-exempt for employees who (along with persons connected with them) cannot exercise 25 percent or more of the voting rights of the company. The exemption, importantly, only will be available on the first disposal (for CGT purposes) of such shares by the original employee shareholder, *i.e* in most cases, by the original employee shareholder.

Draft legislation on the CGT exemption was published on 11 Dec 2012. The tax provisions relating to employee shareholder shares are intended to take effect on 1 September 2013. The House of Lords and other commentators have expressed concern that employers could manipulate share value to maximise the CGT exemption. However, it is thought that a combination of specific valuation rules, certain anti-avoidance provisions within the employment-related securities regime and the General Anti-Abuse Rule (GAAR) contained within this year's Finance Bill could limit the scope for arrangements that might otherwise be perceived as abusive. (For example, if the proposed GAAR applies, the resulting tax liabilities would be adjusted on a "just and reasonable" basis to counteract the advantage of any abuse.) Furthermore, the CGT exemption would not apply to gains made on the sale of shares received in exchange for employee shareholder shares, *e.g.,* consideration shares issued as part of a share-for-share exchange: a potential trap for the unwary in M&A transactions and group reorganisations[1].

The income tax and national insurance treatment of any awards was clarified in the 2013 budget, and the income tax treatment has been confirmed in the Finance Bill 2013 (Bill). The relevant shares would normally be awarded to the employee shareholder for no consideration (other than the waiver of employment rights referred to above which, for CGT purposes, will not count as consideration for the shares). Such an award may be treated as giving rise to taxable employment income, which might be a deterrent for some employees. As clarified in the Bill, the first £2,000 worth of shares will not attract income tax, and the absence of national insurance contributions will also, in due course, be legislated for through amended secondary legislation prior to September 2013. Accordingly, for income tax and national insurance contributions (NICs) purposes, the employee shareholder, who pays no amounts for the shares, would be deemed to have paid for the first £2,000 of their shares, which would reduce the taxable value on acquisition by the minimum share award but leave the balance subject to income tax and NICs (where applicable).

The employee shareholder provisions would be in addition to — and, depending on the detail of the final legislation, may be capable of combination with — other tax-advantaged share based incentive regimes available in relation to certain employees, such as enterprise management incentive options and shares attracting Entrepreneurs Relief.

In addition, there are certain corporation tax benefits for the company issuing employee shareholder shares. The Bill provides that employer companies are entitled to corporation tax relief in respect of employee share acquisitions. The Bill includes new provisions under which any consideration deemed to have been given for income tax purposes on acquisition will be disregarded for certain corporation tax purposes. There is furthermore no charge to tax on buy-back of exempt employee shareholder shares from an individual if (i) the payment is made in respect of shares in the company, (ii) the shares are exempt employee shareholder shares, and (iii) at the time of the disposal, the individual is not an employee of, or an office-holder in, the employer company or an associated company. This last qualification may cause some problems on partial buybacks or "drag" or "tag" scenarios, where the employee may wish to remain employed but either he/she or the new employer wishes to terminate the employee shareholder programme.

However, it is likely that, in practice, companies will set up an Employee Benefit Trust or similar vehicle to provide liquidity to the employee shareholders and thus address the issue.

5. Valuation: A Piece of String?

The most significant issue that the Act fails to solve is how the shares held by the employee shareholder will be valued. Anyone who has been involved in a shareholder dispute in a private company will know just how difficult (and expensive) it can be for parties with competing interests to reach and agree to a value for shares outside a sale of the business.

---

1 The exemption should apply to a transaction in which exempt employee shares are disposed of in consideration of the receipt of other shares.

Shares will need to be valued on the date they are granted (to determine whether the qualifying threshold is met and any income tax or NICs charges apply) and then again at the end of the relationship, when they will be sold either to a third party in a "drag" or "tag" scenario or back to an employer entity. The final version of the Act simply proposes that the value of the shares is their market value within the meaning of Part VIII (Sections 272 and 273) of the Taxation and Chargeable Gains Act 1992 (TCGA). There is a potential disconnect between the provisions of the Act and those enacting the proposed CGT exemption in this regard: While the CGT exemption takes the TCGA valuation into account, it also requires certain restrictions to which the shares may be subject to be disregarded in ascertaining the relevant valuation for CGT purposes.

There is also concern amongst employment lawyers that the Employment Tribunals will be asked to assess share value some time after the event to determine jurisdiction in subsequent disputes about employee status. Without very clear guidance, such as the guidance issued by the British Venture Capital Association (BCVA) in connection with employment-related securities, valuation is likely to be a minefield and could lead to expensive litigation and disputes at the end of the relationship, and, if outside the Employment Tribunal, consequent legal and expert costs for the parties, which many smaller enterprises will not be able to afford.

The government initially proposed to issue an explanatory document for employees and guidance on share valuation and forfeiture. Any such guidance would not have binding effect however, and, in response to the concerns expressed in consultation, the Act includes the power to introduce secondary legislation to regulate the terms on which the employing company can buy back the shares, including the ability to set a minimum value for the buy-back of the shares. Whether this will be implemented remains to be seen, but Michael Fallon MP gave a strong indication that it will be used only as a last resort, saying at the Commons debate on the third reading of the Act and again at its final reading that: *"The power will be used only if it is needed to safeguard employee shareholders in the unlikely event that employers behave unscrupulously."* Pending the promised guidance we can only speculate as to what the best practice will be deemed to be, but it is extremely likely that in the absence of binding legislation this will be an area ripe for litigation if the proposal is taken up.

6. Redeeming Features?

It is the case that employee shareholder status has not been welcomed with open arms, but the government has been intent on rushing the legislation through: Originally proposed last October, the plan was for employee shareholder status to be available from 6 April 2013. This has slipped to 1 September 2013, but the Act has been approved within six months. This is not long for legislation to be fully debated and developed, hence the current gap with regard to valuation. In addition, the last-minute addition of the requirement that employee shareholders obtain legal advice for the status to be binding with no real debate as to how this will be funded and the requirements of a binding agreement (for example, what would be the "reasonable cost" of the requisite advice, and what will the advice need to cover — just the rights given up or broader advice on the tax treatment of and rights attaching to the shares?) will leave some uncertainty for employers wishing to offer the new status this autumn.

However, for businesses used to offering equity incentives and keen to offer a competitive edge and seeking greater flexibility in how to structure their workforce, the proposal offers a CGT-efficient way of executive reward. Given the cap on unfair dismissal compensation, and the need for qualifying service to claim that a dismissal is unfair, executive severance is more about the contract (and prenegotiated notice terms) than statutory rights, in any event: What effectively amounts to a performance-related, share-based top-up on termination of employment with tax benefits might be attractive to both executive employees and their employers.

There is another angle to consider. Under the Alternative Investment Fund Managers Directive, due to come into effect shortly, there is a strong (and growing) incentive to structure remuneration based on equity in the employer (or the fund, although that is subject to ongoing debate). Likewise, under the Capital Requirements Directive IV and its application to the financial sector, there is a growing concern that cash bonuses will soon be significantly limited. Accordingly, in many ways the employee shares concept is “swimming with the tide” from a regulatory perspective and may make the grant of such shares for regulatory reasons more palatable to both employer and employee (HMRC is already engaged with the Financial Conduct Authority and the Treasury to understand the tax impact of these regulatory changes and how any resulting tax harshness could be mitigated).

Finally, for corporate members of LLPs that are currently engaged in incentivisation programmes based around capital retention in the corporate member pending future performance by staff, the prospect arises of using the grant of employee shares by the corporate member to reflect accrued and taxed profits in the corporate member from time to time.

So, in conclusion, whilst inevitably the legislation has significant wrinkles given the speed of its introduction, its use by a collaborative employer and employee to deliver a tax-efficient compensation framework, as well as a more flexible workforce, may well be something to look forward to and may disappoint its many critics over time.