Employee shareholders: A brave new world?

23 October 2013

On 1 September 2013, a new concept of "employee shareholder" was created. The provisions are principally aimed at fast growing SMEs and designed to allow companies to create a flexible workforce by allowing employees to exchange their employment rights in return for shares in their employer.

Many will question the underlying philosophy, but even enthusiastic supporters of the idea are likely to be disappointed by the final provisions, which are of limited scope and create their own mountain of red tape.

The new rules at a glance

The key aspects of the new rules are as follows:

• Employee shareholders will give up their right to claim for "ordinary" unfair dismissal and statutory redundancy and the right to request flexible working or time off for study or training.

• Many employment rights will, however, be retained. In particular, shareholder employees will retain the right to bring discrimination and "whistle blowing" claims (for which there is no minimum period of service required and no financial cap on claims).

• The new status cannot be imposed on existing employees but can be stipulated as a condition of new offers of employment.

• In return for giving up their rights, the employee must be given shares in the employer company (or its holding company) with a minimum value of £2,000. The valuation can be agreed with HMRC prior to the issue of the shares.

• The shares must be fully paid, but there are no other limitations on the nature of the rights they must carry or the restrictions to which they are subject.

• There are many procedural hoops to jump through in order to successfully confer employee shareholder status. In particular:

- the employee (or applicant) must be provided with a written statement setting out details of the rights and restrictions attaching to the shares and explaining the rights they are giving up;

- the employee (or applicant) must take independent legal advice and the employer must pay the reasonable legal fees incurred (whether or not the role is ultimately accepted);

- there is a 7-day cooling off period for the employee.

• The first £2,000 of shares will be exempt from income tax and national insurance contributions (NICs) and the first £50,000 worth of shares (valued at the date of issue) will be exempt from capital gains tax on disposal. Any excess over £2,000 will trigger an income tax charge for the employee (and possibly NICs).

A damp squib?

The government clearly has high hopes for the new rules (it estimates that 50,000 to 80,000 individuals a year may eventually benefit from the income tax reliefs) but many remain unconvinced. There are concerns about the scope and application of the rules and potential pitfalls for employers. Employers who fail to comply with the technical rules when issuing the shares will find themselves with employees holding shares who nonetheless retain all of their employment rights.

Using the new rules will impose a considerable administrative burden on SMEs. Many will not be keen to send new recruits off for independent legal advice before accepting their offer of employment, and of course if the applicant subsequently declines the offer, the employer will still have to pick up the tab for the fees. There will also be a raft of documentation to prepare and valuations to agree with HMRC.

Significantly for employers, there is considerable doubt as to whether the new legislation will materially reduce the risk of employee claims. Employee shareholders will retain the right to bring discrimination and whistle blowing claims (and other types of "automatically" unfair dismissal claims) and it is not difficult to foresee an increase in that type of claim. Employers could also be caught out inadvertently. For example, failing to consider a flexible working request could still be discriminatory, even though the employee has "opted out".

The new regime may not be a viable option for start-ups. Given the substantial discounts generally applied in valuing shares with restricted rights in private limited companies, shares worth the minimum of £2,000 could represent an unacceptably large stake in the business. Further, it appears that the shares may have to be paid up by capitalising reserves, which could prove problematic for start-ups, which are commonly loss-making for the first few years of trading.

The new regime seems most likely to be used by large organisations which already have share schemes in place and are therefore better placed to deal with the additional administrative burdens. They may also be appealing to senior executives attracted by the CGT exemption and potentially less concerned with their employment rights. All of which suggests that the legislation may have missed its target market and that SMEs are likely to continue to favour enterprise management initiative options and other tried and tested employee incentives for the foreseeable future.

Scott Leonard is a partner at Russell-Cooke LLP