Legal Focus

DRIVING LIFELONG PROSPERITY

July 2022

SPOTLIGHT ON PEOPLE

Welcome...

Welcome to the July edition of our Legal Focus. In this edition, we look at Employee Ownership Trusts, employee benefits trends, the key to successful recruitment and retention and much more.

INSIDE

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Employee Ownership Trusts – where are we?

Employee Ownership Trusts (EOTs) were first introduced in 2014. It was the Government's wish at the time to promote the concept of stronger teamwork and genuine employee ownership to achieve greater success and sharing of financial rewards as a result.

The popularity of EOTs has grown significantly over the last few years, and by January 2021 an EOT was used in one in every 20 private company sales.

The first law firm entirely owned by employees appeared in 2018. Before then we had seen variations of employee ownership via different trust arrangements, but this was the first significant move away from the traditional business models that we have become accustomed to in the legal sector.

However, since then there have only been a handful of firms that have converted to EOT ownership, and not all of those have become fully owned by the EOT.

This article explores the reasons for this, explains the drivers behind the choices available and considers the often-overlooked practical issues of running an EOT business.

BACKGROUND

An EOT is an employee benefit trust established for the benefit of all employees of a company, and that trust then controls the business more generally.

There are certain statutory criteria that an EOT must meet. The main one is that the EOT must have a controlling interest in the company, which means that it must hold more than 50% of the share capital and voting rights in it and be entitled to more than 50% of the profits available for distribution and assets on winding up.

Through the EOT model, employees become owners of a majority of shares in their company through the trust. The most common example is John Lewis, but there have been other high profile EOTs in recent months, showing that this business model is gaining momentum.

WHY ARE THEY SO ATTRACTIVE?

Looking at taxation first, provided the EOT satisfies certain conditions, then the seller will not pay any form of tax on the proceeds from the sale of their shares to the EOT, therefore saving tax at potentially 10% or 20%.

This exemption from taxation is not automatic and has to be claimed, and it is common to make the claim on the tax return where the sale is reported. Depending on the timing of the sale, that could be 22 months after the sale took place, meaning that if legislation changes before the claim has been made, then the exemption might disappear. It is therefore recommended that a claim is made quickly after the disposal takes place.

However, if the main driver behind an EOT structure is taxation, then the business may be starting from the wrong place. While it is difficult to ignore the attractiveness of paying no tax, any long-term structural decision should be based upon what is most appropriate for the business as a whole, to ensure that it can continue to thrive without any unnecessary restrictions.

For many, the appeal of an EOT is that it offers a solution to succession planning. Succession has been, and will continue to be, one of the most significant challenges within the profession, no matter the size of practice. An EOT may be seen as an easier answer to deal with succession planning since there is no significant change in the day-to-day operations and it can be less disruptive than selling to a third party.

For some, there may be an opportunity to realise more value than they would if they sold to a third party, though a robust valuation of the practice has to be undertaken by an independent third party and has to be affordable to the EOT.

Attitudes towards the ultimate ownership of a law firm continue to evolve and in some cases direct ownership is becoming less attractive to the next generation. That does not necessarily mean that they do not want to be involved in managing the business though, and an EOT can help deal with this challenge.

Another issues is that the ability for individuals to borrow money to buy shares in a company is becoming more and more challenging, and an EOT takes that pressure away, since the funding comes from within the business itself.

WHY NOW?

As with other new types of business model, the legal sector tends to be one of the slower adopters in comparison with other industries. We saw this when LLPs were introduced in 2000, and it was a number of years before the legal sector felt confident in adopting the model.

Although EOTs have been around since 2014, it is still relatively early in terms of assessing the long-term impact of an EOT on the success of a firm.

Much of the answer to the question of "why now?" seems to be that it can be a solution to the challenging market that many firms find themselves in relation to the 'war on talent'. Retention and recruitment is, for firms of all sizes, their biggest challenge. An EOT can be an effective mechanism for rewarding employees and giving them a sense of ownership, without them needing to acquire shares directly. Research has shown that this encourages retention and leads to performance improvements, as employees see that they have an opportunity to benefit from a growth in their firm.

There is a tax benefit for employees too, as there is an opportunity to pay them a tax-free bonus of up to £3,600 per annum, although it is still subject to national insurance.

HOW DO EOTS WORK IN PRACTICE?

First of all, an EOT needs to be created as a standalone entity. Consideration needs to be given to who will be the most appropriate trustees, bearing in mind that their primary purpose will be to act in the best interest of the beneficiaries (i.e. all employees).

If the trading entity is currently an LLP or unincorporated partnership, that business needs to incorporate into a limited company first, as it is only the sale of shares in a company to an EOT that benefits from the tax relief.

That company will also need to register with the SRA as an alternative business structure in advance of any EOT involvement, and this will need to be factored into the timetable.

The next step is for the owners of the company to sell either all or part of their shares in the company to the EOT. If they are not selling all of their shares, the EOT must acquire more than 50% of the shares, and the consideration paid for those shares should not exceed market value.

The payment for these shares by the EOT may be partly paid upfront if the business has available cash or bank borrowing has been accessed, or by a series of instalments over a period of time (i.e. out of future profits generated from the company).

The trading company will continue to trade, and if any of the original owners remain, they will be on the payroll and be paid a market rate salary for their role.

As with all trading companies, the profits in the company are subject to corporation tax, currently at 19% but due to increase to 25% from 1 April 2023. After paying corporation tax, the cash generated in the company from the remaining profits can be used for three main purposes:

1. Paying off the amounts due to the former owners. The limited company is permitted to pay lump sums of money to the EOT to allow the EOT to pay the owners.
2. Retention and ongoing investment in the practice.
3. Repayment of any pre-existing debt within the practice.

The business may also wish to use some of its profits to reward the employees, although the difference here is that bonuses paid to employees would be deductible for corporation tax.

It is therefore important when looking at the value to be paid for the practice to consider how the repayment of the shares interacts with the future plans of the business. This is where valuations are important, in order to ensure that the amount to be paid and the period of time over which it will be paid is reasonable and affordable in the context of the future profitability of the practice.

OPERATIONAL MANAGEMENT AND LEADERSHIP

The fact that the practice may be owned by an EOT does not alter anything as far as the need for strong, motivated and strategic management of the practice is concerned. The practice will still need all of these things going forward, irrespective of its business model.

This differs from the role that EOT trustees have, as they are required to act in the best interests of the trust beneficiaries (i.e. the employees) on equal terms.

It is often at this stage that the enthusiasm for an EOT begins to falter, as firms need to feel comfortable that they will continue to have high quality management who are motivated to drive the practice forward and improve on its current success, but the separation of ownership can make this more challenging.

Clearly, there is a remuneration angle to consider for the current team, but it is also important to motivate up-and-coming individuals to ensure longer-term success.

As an alternative approach, it is possible to create a 'hybrid' EOT, which allows the firm to carve out alternative share schemes for certain key personnel to mirror, where possible, the return on ownership, but this will never fully replicate being a true owner of the business.

This motivation of return on risk to be more than just a share in the distributable profits can therefore lead to thoughts around a future management buy-out, with the next generation of owners buying out the current owners and not using an EOT at all.

SO, IS AN EOT RIGHT FOR YOU?

There is no 'right' answer in terms of size of practice.

In the legal sector we have seen EOTs introduced in firms, from the very small through to those with over 250 staff and turnover in excess of £15m.

What drives the answer is first and foremost the culture and, in particular, whether it is an inclusive culture where staff are an integral part of the business.

At the same time, the management team has to be strong and motivated to ensure the future success of the business, and that motivation can come through a remuneration structure that has the ability to attract the leaders of the future.

It is also important that any funding for the EOT, in terms of either taking on third party debt or paying the consideration for the shares over a period of time, does not have a significant impact on the ability of the business to grow, thrive and invest, and therefore the valuation has to be right for all parties.

In our experience, there is a huge amount of interest in EOTs. We anticipate that they will continue to grow in popularity as more and more firms successfully manage the transition and as confidence grows that an EOT can be a viable alternative business model.

We are (not only) in it for the money

If you read any professional practice surveys released in the last five years, you will see straight away that the most critical issue at the front of managing partners' minds is staffing.

This is not just an issue for firms looking to recruit staff, it can be a struggle for firms to simply retain their existing staff.

However, successful recruitment and retention is a two-way street. There is no shortage of lawyers looking for interesting roles, but finding a high-quality member of staff who can integrate with an established team can be tricky. It is just as important that firms feel as confident when offering jobs as they do when turning down candidates that do not fit. This also applies to the candidates themselves, as it is just as common for a seemingly perfect candidate to turn down a job offer after careful reflection.

When we ask these people why they have turned the job down, we expect at least part of answer to be the money. For a lot of people, that is a factor, but as an industry, professional service firms have a pretty good idea of what sort of remuneration their competitors are offering, and it is unusual that one firm offers anything particularly out of line with everybody else.

So, frequently it boils down to the less tangible factors such as culture. Salary aside, do members of staff see themselves being happy in the firm in the future, irrespective of their role or seniority?

The 'tone at the top' plays a big part in how the culture of a firm is perceived. Culture and tone are very noticeable to everybody inside a firm but are commonly the most difficult factors to be able to quantify, meaning that making changes can sometimes be tough. However, professionals talk to other professionals, and how the partners and staff interact will always be the main talking point at social or networking events.

Making sure that the core beliefs and values of the firm are consistently communicated and always applied is vitally important.

There are also 'semi-tangible' factors at play here. Things like whether the firm has a flagship office in a nice part of town that people want to be seen to be a part of, what the out of hours social life of the firm is like, what the day-to-day facilities in the offices are like and the quality of the coffee will also be up for discussion.

This focus on the physical working environment raises some interesting challenges for firms as we all start to readjust to our longer-term post pandemic working practices, and firms that were championing flexible working practices long before COVID-19 may find that they have lost their USP.

The majority of firms that we speak with feel that, on reflection, increased home working has had a positive impact on their business. Aside from some of the immediate cost saving benefits, lots of firms cite employee mental wellbeing as being the long-term winner, but it is important for firms to appreciate that what works for one person may not work as well for others. While some people thrive on working from home and find that they work more efficiently and productively away from the office, others need a busy office environment to help them stay motivated.

When we talk with our clients, the biggest positive we hear from increased home working is that the work/life equation has improved, but the same firms also say that there have been challenges to overcome to ensure staff members can communicate with their teams properly.

Working from home can also have a detrimental impact on staff training and development, particularly for new starters.

It is all about balance.

It is really important that individuals also appreciate that this need to find balance exists. The operational needs of the business must come first in any conversation around flexibility to ensure that the delivery of service does not suffer.

Sometimes, what motivates some members of staff to join a firm, or stay where they are, goes beyond what they feel benefits them directly. Firms with well-thought-out, properly communicated policies on corporate social responsibility, environmental sustainability and equality may give themselves the edge over their competitors.

Most of this does not just apply to recruitment. There has been an increase in law firm M&A activity recently, and culture considerations, working practices and management styles should sit close to the top of any agenda for firms considering their succession strategy.

Changing trends in employee benefits

As staff return to the office in increasing numbers, but with an element of home working remaining a permanent feature for many, now is time to review the package of benefits you offer to your employees. A well-considered benefits package should help staff to feel rewarded for their efforts and may give the firm an edge in the recruitment market.

Here we look at some topical benefits that you might wish to consider.

SALARY SACRIFICE

This involves an employee contractually giving up part of their remuneration in exchange for something else, typically some form of benefit (which might be taxable or might not). The salary foregone is not subject to tax and national insurance, and there is a national insurance saving for the firm too.

Staff may welcome the opportunity to give up some of their salary to 'buy' extra holiday and you could set a maximum overall holiday entitlement to ensure it does not affect client service.

The salary could be sacrificed in exchange for employer pension contributions. This is particularly tax efficient because tax and national insurance is saved on the salary foregone and there is no tax or national insurance payable on the pension contribution. With the increased rates of national insurance in the current tax year, and the health and social care levy being introduced from April 2023, swapping salary for pension contributions becomes more attractive. The firm may also wish to pass on some of its national insurance saving as an enhancement to the contribution.

Whilst the provision of a company car is a taxable benefit, the tax regime for fully electric cars is considerably more favourable at present, and the benefit in kind is currently calculated at 2% of the list price. The provision of charging points at the workplace or the employee's home and electricity to charge the car is not a taxable benefit.

Offering employees the option of a company car under a salary sacrifice arrangement could be an opportunity for the firm to improve its green credentials and save some tax along the way. Hybrid cars with low emissions and a reasonable electric range can also be relatively tax efficient.

As salary sacrifice is a contractual arrangement, it must be properly implemented to achieve the tax benefits, and consideration must also be given to national minimum wage requirements for lower paid employees.

PAYMENTS FOR HOME WORKING

For the past couple of tax years, HMRC relaxed the conditions to be met for employees to claim tax relief on working from home costs.

Although this relaxation came to an end from April 2022, there are still opportunities for firms to make contributions towards employees' home working costs, and the only requirement is that there is a formal arrangement with the employee that they will work from home on a regular basis. HMRC will allow a payment of up to £6 per week tax-free without the need for any record keeping.

BENEFIT IN KIND PLATFORMS

There are a number of providers in the market who offer 'platforms' through which employers can tailor their benefits package. Whilst the benefits offered will generally be taxable, these platforms streamline the administration and offer flexibility to employees over the benefits they wish to opt into.

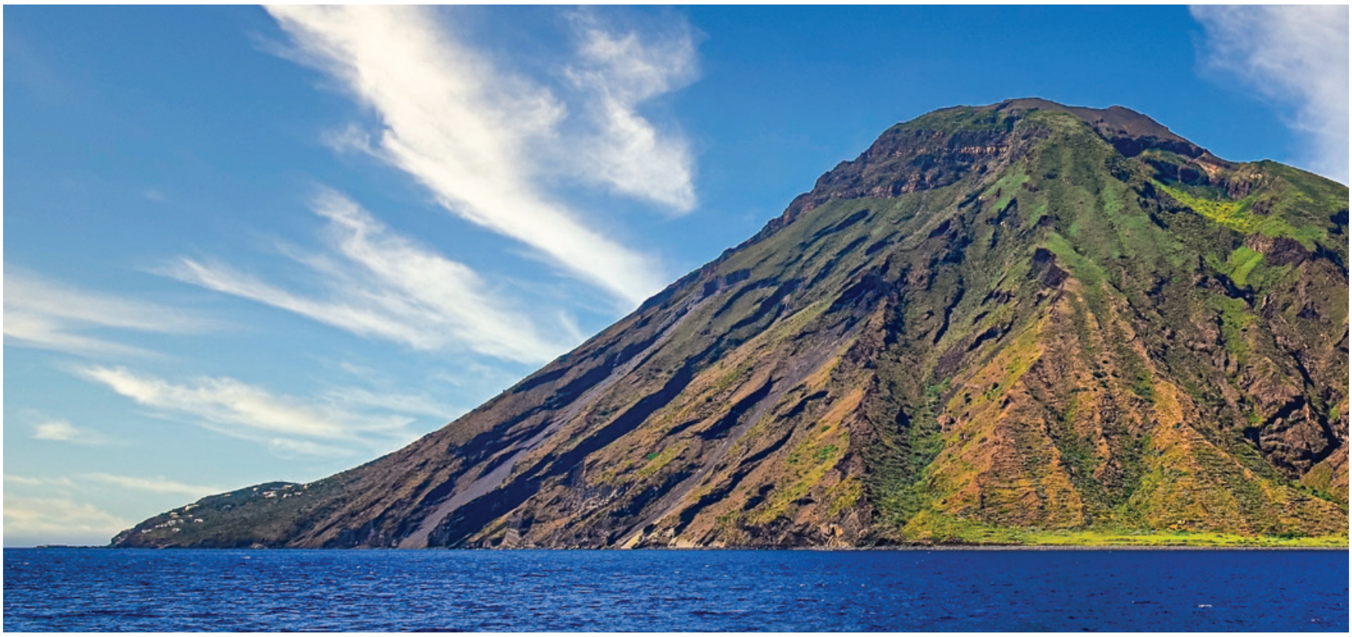
TAX-FREE BENEFITS

If the firm wishes to offer taxable benefits to their employees on a tax-free basis, the firm needs to enter into an agreement with HMRC for the benefits to be grossed up. The tax and national insurance is then settled by the firm on behalf of the employees.

However, there are tax-free benefits which can be offered to employees, such as:

- Payment of professional fees and subscriptions that are on HMRC's approved list
- Work-related training or exams that are relevant to the job role
- One mobile phone per employee with no restriction on private use
- Workplace parking at or near the office
- Cycle to work scheme, often provided through salary sacrifice
- One health check per tax year
- Trivial non-cash benefits costing up to £50 per person

As with any tax exemption, there are conditions to be satisfied in order for the benefits to qualify as tax-free, so if you would like to explore whether anything here could be right for your firm, or review the qualifying conditions in more detail, please get in touch.



Employee share schemes

If you operate through a limited company and wish to incentivise your employees by giving them a stake in your firm, but decide that full employee ownership is not for you, what other options do you have?

There are many different ways to incorporate employee ownership into a business, including share options and share awards, and within these categories many different share scheme approaches are possible. Some share schemes are 'approved' by HMRC, meaning they carry certain tax advantages provided a number of qualifying conditions are satisfied.

You may have read about popular approved employee share schemes such as Enterprise Management Incentives (EMI), Share Incentive Plans (SIP) and Save As You Earn (SAYE) schemes. Unfortunately, they are generally not available to, or suitable for, law firms as legal services are specifically excluded from the list of qualifying business activities for an EMI scheme, and both SIP and SAYE schemes must be offered to all employees.

Arrangements that are available to limited company law firms include the following:

GROWTH SHARES

Growth shares allow employees to participate in the future growth of the firm. The employees are awarded the shares from the outset but will only benefit from a future disposal of the shares if a certain financial hurdle is reached. Law firm owners have the flexibility to set the participation hurdle over which the employee starts to benefit.

When they are issued, the value of growth shares is usually quite low, so that they can be bought at modest cost and without triggering any significant tax liability. Any future growth in value is charged to capital gains tax when the shares are sold. This compares favourably to bonus arrangements based on future performance, which would usually be taxed at income tax rates of 40% or 45%.

COMPANY SHARE OPTION PLAN (CSOP)

This is an approved share option scheme, under which tax-advantaged share options with a maximum value of £30,000 per individual may be granted to selected key employees/directors. Usually, there is no tax or national insurance payable on the grant of the share option, nor on any increase in share value when the option is exercised, provided the options are exercised between three and 10 years after the date of the grant.

In recent years, we have seen a gradual increase in the number of firms offering growth shares to key employees and, so far, very few firms have explored the CSOP option. One possible reason for the low take up is that, ultimately, both arrangements only work if shareholders are able to sell their shares on, and this usually requires a firm to be sold in its entirety - either to another firm, a private equity investor or by listing on the stock market.

If you would like any further information on how an employee ownership structure could work for you, please get in touch.

Introducing Ian Johnson

As some of you will know, we recently welcomed Ian Johnson back to Hazlewoods as an Associate Partner in our Legal Team.

Ian returns to us after a few years working in London and with his own business consultancy company, and so we asked Ian to give some background to what he has been up to and why he returned to Hazlewoods.

WHO I AM AND WHAT I HAVE DONE

I originally joined Hazlewoods back in 2009 as a manager in the Legal Team. I had always worked with law firm clients before this, including some large international practices during my time with a Big 4 accounting firm, and wanted to really specialise in the sector. Hazlewoods was the perfect fit for me as it was in the unique position of having a full-time dedicated legal specialist team.

I have always enjoyed working with solicitors and legal professionals. As trained professionals, we share lots of common ground and the conversations we have are usually enjoyable and interesting.

I spent many happy years as a manager, and then director, at Hazlewoods before leaving to pursue an opportunity in London. Working in the centre of London was a fantastic experience; I met a lot of people and learned a lot in a short space of time.

When lockdown arrived, I set up my own consultancy company, specialising in providing business advice to law firm leaders, technical and compliance support to COFAs and regulatory compliance and financial management training.

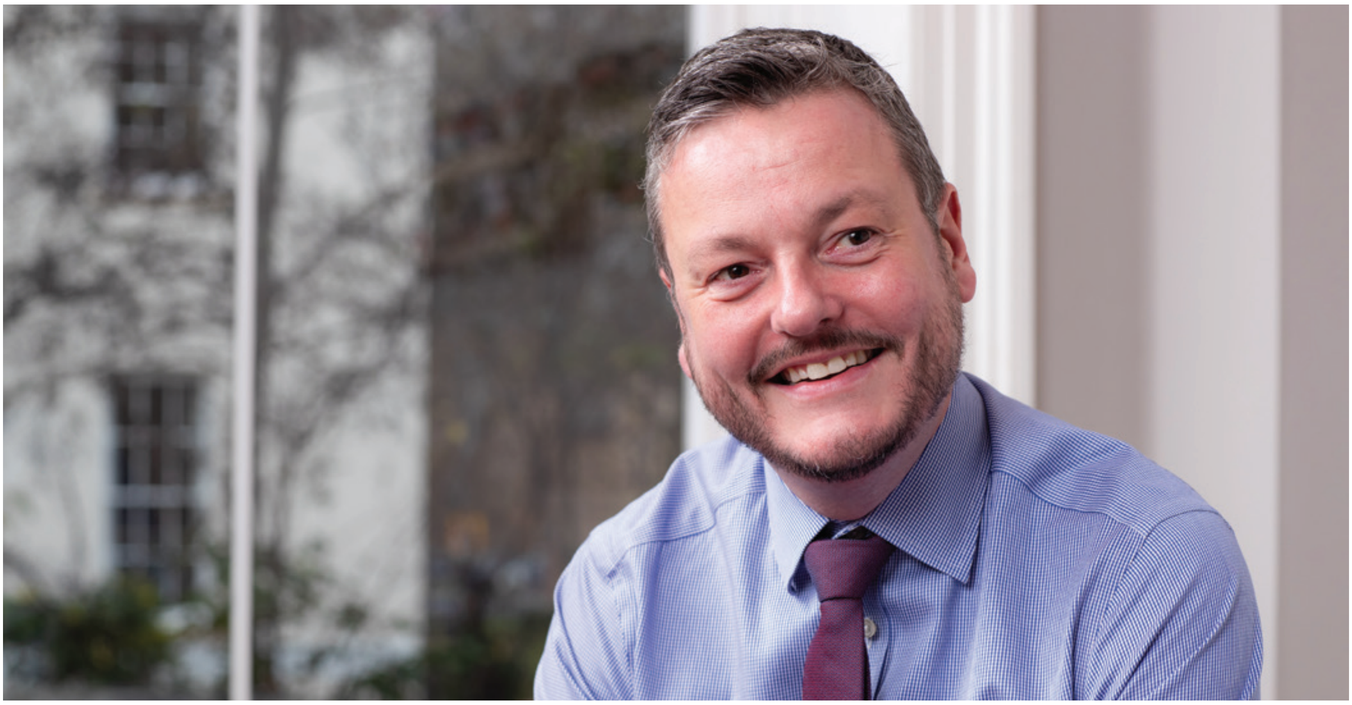
The legal sector is an ever-changing and dynamic industry and I have to make sure I stay very much at the front of things. To help with this, I hold posts with The Institute of Legal Finance and Management (ILFM) where I have been the Chair of the Executive Council and a Company Director for the past few years, as well as being the Vice Chair of the ICAEW Solicitors Community Group, which issues guidance and support to Reporting Accountants.

WHY I AM BACK

Being away from Hazlewoods for a little while was a real eye opener for me. I discovered quite quickly that no other firm of accountants has the depth of knowledge of the legal sector that we have here, and it is a knowledge that spreads across the whole team, not just a handful of managers and partners.

What it really boiled down to was that I missed the people that I had worked with here and wanted to be part of the team again.

Happily, I have been able to integrate my own business into Hazlewoods and so have achieved the best of both worlds. I am back working closely with a team that I know and trust, in a firm that I always loved being a part of and one which I missed when I left.



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