

# Client Alert

Corporate and Tax Practice Groups

12 October 2012

## Owner-Employee Contracts – A New Kind of Employment Relationship?

The new owner-employee contracts announced on 8 October 2012 by George Osborne at the Conservative Party conference are likely to be of interest to small or fast-growing businesses with a need to incentivise key employees and who prefer to be able to dismiss employees quickly, if needed, without having to following lengthy dismissal procedures. The proposals are designed to change the mindset of employees from being “just” workers to being owners of the businesses in which they work. The proposals will come into effect in April 2013 for employers who choose to implement them for new employees.

### Owner-employee contracts

Businesses can opt to give employees shareholdings worth between £2,000 and £50,000 as part of a contract under which the employees waive certain employment rights in advance, notably the right not to be unfairly dismissed and the right to a statutory redundancy payment. Both of these rights are currently available to employees after they have served two years’ service. Other rights which owner-employees could be required to waive are the right to request to work flexibly and the right to request time off for training. Female owner-employees could also be required to give 16 weeks’ notice to return from maternity leave instead of eight weeks’ notice.

Currently, employees cannot waive their statutory rights in advance of the events giving rise to potential claims (*e.g.* the dismissal or the discriminatory act). Employees can only waive their statutory rights under a compromise agreement after taking independent legal advice on the effect of the compromise agreement. The employee’s legal adviser has to explain the effect of signing the waiver, *i.e.* the employee is prevented from bring the potential claims or carrying on with any claims filed by the employee against the employer. The government has not yet announced whether new owner-employees will need to take legal advice on the waiver of their unfair dismissal, redundancy payment and any other permitted statutory rights when the employees accept the new owner-employee contracts. If not, the law will need to be changed for the waivers to be effective.

When owner-employees leave, they will be able to sell their shares to the company, although the government has not yet confirmed whether the sale will be at fair market value or some other value. The government has only said that the sale would have to be at a “reasonable” price. The precise valuation methodology will be important for companies to consider before deciding whether to offer owner-employee contracts.

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The government has not yet published details of how the shareholding proposals can be implemented in private companies or other non-corporate structures, such as partnerships.

## Tax – proposals and unknowns

The tax benefit announced is that any gains on these shares would be exempt from capital gains tax. As the details have not yet been published, it is not clear how the award of the shares for the surrender of the employment rights will be taxed, if at all and whether the employer would obtain a tax deduction. In theory, the award could be treated as employment income or a disposal of rights, each of which have different tax treatments. With regards to other share incentive plans, to date the proposal is that this tax incentive will be separate from and not cumulative with other tax incentivised share schemes.

## Comment

Employers will need to consider the benefits of offering these shareholdings to employees against the costs of implementing them. Unfair dismissal awards are currently capped at approximately £75,000 (although this cap does not apply to some dismissals, *e.g.*, whistleblowing dismissals). The recently published employment tribunal statistics show that the average unfair dismissal award was approximately £9,000. The waiver of unfair dismissal claims may not, after all, be a sufficient incentive on employers to offer these owner-employee contracts. Statutory redundancy costs are not significant for most companies. Currently, this payment is capped at £430 per year of service, increasing to £645 per year of service for employees aged 41 years and above. The right to work flexibly is simply a right for the request to be considered. The underlying discrimination rights will be preserved for employees who claim that the requirement to work certain hours or full-time indirectly discriminates against them on the grounds of sex (*e.g.* for mothers with primary childcare responsibilities). In any event, the majority of employees who are dismissed and who are treated fairly do not bring employment tribunal claims.

It is likely that large organisations, who typically have developed HR procedures and who value the publicity of being known as a “good employer”, and other businesses who will continue to comply with best practice procedures when dismissing employees will not be attracted to these owner-employee contracts. New rules requiring employees to pay fees to lodge employment tribunal claims, which will also take effect from next year, are likely to achieve the government’s intended aim to deter spurious claims against employers.

Employees who feel they have been unfairly treated may still decide to bring claims for discrimination compensation which are not capped and which cannot be waived in advance under European laws, even if they have contractually agreed not to bring unfair dismissal compensation claims. Many employers will, therefore, still consider it good practice to dismiss employees for fair reasons, such as performance, misconduct or redundancy, and only after following a fair process even if employees have waived their rights under these owner-employee contracts.

Overall, the new proposals are unlikely to result in a significant drop in employment tribunal claims. They do, however, form part of the government’s wide-ranging approach to reduce the risk of employees bringing claims while at the same time trying to focus tax incentives on job creation.

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