Newsletter

BURGES SALMON

Family Business

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Welcome

Welcome to the latest edition of Family Business, discussing current issues of interest to family enterprises.

New Year's Resolutions!

The start of the New Year is a good time to re-assess and to set goals for the year ahead. This edition of the Family Business newsletter looks at recent developments in the areas of **employee incentives**, **tax efficient sales** and **alternative finance**, which may be of interest over the coming months. In addition we look at the results of two recent surveys and consider the key points which they illustrate.

Employee incentives

Many family businesses struggle with the issue of whether and how to incentivise employees and particularly whether key staff should be given a share of the business. There are understandable reasons for caution, the most obvious being the desire to keep ownership and control within the family. The good news is that giving employees options or shares need not lead to loss of control. Moreover, two recent changes mean that shares and options given to employees now benefit from significantly improved tax treatment.

No loss of control

Concerns about loss of control are the main reason why family businesses balk at the idea of giving shares or share options to key employees. However, what many do not appreciate is that shares and options are very flexible and most concerns can be addressed by the way the share rights are drafted. For example:

- ***"Issuing shares could mean that we lose control over decision-making"***. Normally this is not a concern because the number of shares which are issued to employees cannot materially affect voting. However, it is also common to ensure that employee incentives comprise non-voting shares, which benefit from the company's economic success but have no effect on decision-making. If a choice is made to issue options (as opposed to shares), the concerns about control are further removed, because an option holder doesn't actually become a shareholder (and therefore has no shareholder rights) until he or she exercises the option (which may only be at the point of leaving the company).
- ***"If we issue shares or options and employees leave we will have shareholders who have no connection to the business"***. It is normal to ensure that when an employee leaves they must sell their shares, either to the other shareholders, to the company, or possibly to an employee benefit trust (which can reissue the shares to current employees who need to be incentivised). Provided that the employee is not leaving in acrimonious circumstances, the departing employee would receive a payment for the shares, which would reward them for their work. Options and shares can therefore provide a suitable incentive even where there is no intention to sell the company because the employee will sell the shares when they leave the company and realise value at that stage.
- ***"If we issue shares and buy them back when the employee leaves, we would have to pay***

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an amount which reflects value created before the employee joined the company". This need not be the case because shares can be given rights to participate only in value created after the date of issue - ie the employee benefits only from the value they have helped to create.

- ***"If we issue shares the employee could transfer them to someone else"***. It is important that shares and options issued to employees are non-transferable (or at least must be offered back to the majority shareholders first), so that share ownership cannot spread in this way.
- ***"If we issue shares and, later, decide that we want to sell the company, we would be at the mercy of minority shareholders deciding whether they, too, want to sell"***. It is normal to put provisions in a company's articles to ensure that the decision to sell belongs entirely to the majority shareholders and that they can, if necessary, force minority shareholders to sell at the same time.

"Shares and options are more flexible than most people realise and recent changes have led to better tax treatment."

Improved tax treatment

EMI share options: option holders can now receive entrepreneurs' relief

Enterprise Management Incentives (EMIs) are tax-advantaged share options which are designed to help small companies recruit and retain key employees. The benefit of EMI options is that, in the normal course of things, employees pay no income tax on issue or exercise of the option, so they are only required to pay tax if they exercise the option and sell the shares for a gain. The rules relating to EMI options have changed recently to allow employees with EMI options to receive entrepreneurs' relief on the sale of the shares arising from options. This means that when the employee sells the shares, provided they have held the options for at least one year, any capital gain would be taxed at a rate of 10% (as opposed to 18% or 28%). The employee must still be employed by the company at the time of sale of the shares, but (unlike for normal entrepreneurs' relief) the relief is available regardless of the number of shares they hold.

As noted above, using an option means that no shares are issued until the option is exercised and EMI offers a large degree of flexibility over when exercise can occur. EMI options can be granted over non-voting shares and shares with the sorts of restrictions noted above (eg restrictions on transfer and sale on retirement) which ensure protection of the family shareholders.

Employee shareholder status

Another recent development is the introduction of Employee Shareholder status (ESS). This has received mixed press coverage because the premise is that employees give up certain employment rights in return for receiving shares in the company. However, ESS is beginning to attract attention, due to the fact that the tax advantages are so generous: when the employee sells their shares they pay no capital gains tax. There are also exemptions from income tax if the company buys back the shares. As noted above, concerns about loss of control can largely be addressed by issuing non-voting shares and ensuring that shares must be sold back by the employee when he or she leaves the company.

Tax efficient exits

Although few owners of family businesses want to sell, if a decision is taken to sell the business, a recent announcement in the Chancellor's Autumn Statement may be of interest. The Government announced that as a further incentive to employee ownership, a new tax break will be established providing a complete exemption from capital gains tax where a controlling interest in a company is sold to a trust holding shares for the benefit of the employees.

Why would a family want to transfer a controlling interest to an employee trust? It could be that the family is seeking a partial exit and would prefer to keep ownership within the community of family and employees rather than introducing a third party "outsider" who may not share the same long term aims for the business. In these circumstances a partial sale to an employee trust provides a tax free way of realising value on some of the shares, while allowing the family to ensure the longevity of the family business and its ethos for the benefit of the employees. The family could retain a very substantial stake in the business and day to day involvement and would have ensured, through the terms of the employee trust, that the spirit of the business would be preserved.

Alternative funding

It was announced just before Christmas that Scottish micro-brewery Brew Dog had successfully raised £4.25 million of new funding. The unusual thing about the funding is that the funds were raised predominantly from Brew Dog's own customers and that it is the third time that Brew Dog has successfully raised money in this way. Brew Dog's approach will not be for everyone - in particular because they offered a mixture of equity and rewards (only public limited companies can offer shares to the public) and their "Equity for Punks" campaign relied on maintaining a high profile and generating significant PR (including driving a tank around the Bank of England!). It is interesting, however, that such options exist.

> *"The decision to go it alone and pursue an alternative form of finance is a bold one..."*

There are other forms of "alternative" funding which might be of interest to family businesses. For example, a number of companies have raised finance from their customers (and the wider public) in return for a mixture of debt and rewards. In 2010 Hotel Chocolat raised £3.7 million in return for the issue of "chocolate bonds" - entitling bondholders to a return payable in cash and chocolate. In 2012 the boutique hotel guide and booking business Mr & Mrs Smith raised £2m through a bond offering 7.5% return, or a 9.5% return if the return was taken in credits to be spent through the company. The restaurant chain Leon went further, in July 2012, and issued a bond which offered no cash return but paid between a 10% - 15% return in discounts to eat at Leon restaurants. More recently, in September 2013 Naked Wines raised £5m from an oversubscribed issue of a fine wine bond paying gross interest of 7%, or 10% if taken as wine credits. At the most extreme end of the scale, companies which have a genuinely innovative product have raised money on a purely rewards basis - the most well-known recent example being a US company Pebble Technology which raised over $10 million against forward sales of its smartwatch.

The decision to raise money independently in this way is not to be taken lightly. Any form of crowdfunding needs a very significant contribution of time and will mean that the company will need to make public certain details of its business, making maximum use of social media. Equally, where a company issues mini-bonds, the money which is saved on traditional borrowing costs will be partially offset by increased professional fees and (probably) a higher rate of return payable to investors. However if some of the return is rewards-based (ie paid in the company's products) the costs start to look more attractive. There are other advantages too. Unlike a conventional issue of equity, the issue of mini-bonds has no dilutive effect on ownership. A successful campaign is certain to raise brand awareness, and can help to lock in customer loyalty. Alternative finance can also help to leverage additional conventional finance and since mini-bonds are generally unsecured there is no need to give security over additional assets. However, while brand awareness is bound to soar for a successful campaign there may be a risk of considerable reputational damage if the fundraising is poorly handled or the company is unable to meet its obligations to bondholders so companies need to act prudently.

The decision to go it alone and pursue an alternative form of finance is a bold one and not without risk, but it may be of interest to businesses with a strong brand and loyal customer base. Moreover, while interest rates remain low, mini-bonds will continue to attract attention and may open the door to a significant new source of finance.

Recent research

Finally, a couple of pieces of research have been published recently which may be of interest.

Institute for Family Business

In June last year the IFB Research Foundation, in conjunction with UCG Report, published a report into "people capital" in family businesses. By people capital, the report means "the strength of knowledge, skills, behaviours, energy, loyalty and commitment which exist within non-family members of a family business". The report notes that the quality of the people working in a business can create a vital competitive edge and that family businesses need to compete for the best talent. Among the findings of the report are that, in comparison to non-family businesses, employees in owner-managed family businesses see management as more responsive and reliable and report greater loyalty, job satisfaction and a greater sense of job security. Conversely, the report finds that owner-managed businesses tend to provide less time off for training than non-family businesses and are less likely to implement new HR strategies to improve people capital. The report draws a distinction between family businesses where the family are still actively involved in management

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and those where they are not and concludes that as family businesses grow and family members cease to be involved in day to day management it becomes necessary to adopt more formal HR practices to improve financial performance. The report points to evidence that the adoption of specific HR best practices (which it calls "high performance work practices", some of which are listed in the appendix to the report) can significantly affect the financial performance of a business.

Burges Salmon comment

Any growing business needs to assess whether its systems are appropriate to reflect the size and complexity of the business. Understandably, this can take a low priority when all attention is on growing the business, but if it is not done the business may become less efficient as a result. The process of "professionalising" the business as it moves from early stage to an established business is one that owners should assess periodically. We regularly advise on implementing best practice HR and other policies and would be happy to help.

Insider South West

A survey of family businesses in the south west of England, carried out by Insider magazine in October 2013 found that the vast majority of family business who responded confirmed that their aim was to build value for the long term benefit of all of those involved (family, employees and community). 64% of respondents said that planning and implementing a tax-efficient succession plan was a concern. However, despite the fact that most of the respondents expected a change of ownership or control within the next five years, approximately 70% said that they had no formal succession plan in place.

Burges Salmon comment

In some family businesses it may be obvious who will take over the reins but this doesn't reduce the need to plan for succession well in advance. Assuming that there is no uncertainty about who will take over (and very often there is considerable uncertainty, which needs to be resolved), failure to plan ahead can lead to serious financial issues. For example, will the retiring family member have sufficient finances for retirement (if not, how will he or she take money from the business and how secure is that income stream?). Another key area is to consider is the effects of inheritance tax, which can cripple a business if it not planned for. Equally, any successor must be properly prepared to take over the business so that performance is maintained. If ownership is to be shared thought needs to be give to how decisions will be made, and what each shareholder expects from the business (for example will some expect a regular dividend?). The important thing is to start thinking about succession as early as possible. The conclusions which you reach may change the way in which you need to develop the business. Succession planning need not be daunting but it does need to be given proper attention.

If any of the information above is of interest please contact Doug Streatfeild-James or Jim Aveline.

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Our Family Business team

Burges Salmon are unusual in being a leading commercial firm that also specialise in private client issues. We combine our business and family expertise to advise family businesses of all sizes through our specialist Family Business team - a group of experienced advisers dedicated to advising family businesses of all sizes across range of sectors.

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