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Board of Taxation Secretariat
Review of Small Business Taxation
Submission for Consideration:

This submission could be focusing on the end of a business; the retirement of a business owner, the closure of the doors; resulting in the end of a business that has been operating for 50 years, redundancy of 30 workers, the loss of skills and another nail in the coffin of manufacturing in Western Sydney, another business not meeting the needs of the retiring business owner.

Instead it is a story of a successful succession of a business to the employees. Ensuring the transfer business knowledge and the long term sustainability of that business.

It is important that we point out that this paper is much broader in its approach than just taxation issues for SME's, we apologise, but this process encompassed State legislation, Federal legislation , Company law and contract law. We are sure that there will be other issues associated with the operation of the co-operative that will come to light as we go forward.

Within the SME business community Mr Robert McMaster is indicative of the cohort that is confronting the challenge of succession and considering the following alternatives:

1. Close the business down; terminate all the employees then hopefully renting or selling assets.
2. Sell the business to an interested party (If one can be found)
3. Sell the business to a management team (MBO)
4. Transition the business within the family ,
5. Employing a CEO to run the business – not a long term solution or,
6. Sell/transition the business to the employees by way of a workers co-operative.

## Background information-Mr McMaster's Story:

Succession planning can be difficult for small business owners and if not done well can result in businesses closing leading to unemployment which erodes the tax base and increases the welfare burden of the Commonwealth. The consequence for the society and the economy, is, loss of skills, unemployment, low self-esteem, inability to meet financial obligations, family breakdown and a potential increase in undesirable social activity. Over the past 7 years this has weighed heavily on me - my concern for my business and my 30 employees.

My cohort of business owners have worked hard, built businesses and could generally be described as the follows, based on my experiences;

1. Baby boomers, now averaging 68 yrs., realising that their retirement asset is their property not their business. To retire they need to realise their property asset or receive a rental income.

2. Few investors want to buy manufacturing businesses, which generally have small or poor profitability, even though the business may have provided a good living to the baby boomer's family and staff. It becomes extremely difficult to sell the business and obtain any monetary value.
3. Closure of a business can be costly due to long service leave and redundancy entitlements flowing from long term employment and staff loyalty. This can mean existing owners, even after selling equipment assets, may have to raise funds to close. (Auction sales generally only realise 1/10th asset values). Consequently closing businesses is not a viable option.
4. Small business owners generally want to look after their staff, they have all worked together to build the business and their lives are enmeshed together, they are huge stakeholders however their jobs are not recognised as "skin in the game" by financial institutions.
5. Management staff may be able to raise funds to instigate a management buyout. However, only 20% of management buyouts are sustainable in the long-term (Many management buyout cash-out after a period of time), whereas 80% of employee buyouts are sustained well into the future.
6. ESOPs (Employee Share Ownership Plans) take time to implement. ESOP legislation is very complex and simple schemes are difficult and expensive to setup.
7. Transfer of ownership to staff is possible by setting up a worker's co-operative, however this is not as common a practice in Australia as it is in the UK, Europe, Canada and USA. These governments recognised the power of this model and have implemented incentives to encourage employee ownership. Australia on the other hand gives little attention to non-agricultural co-operatives and they face many hurdles and disincentives.
8. Employee ownership realises many well documented benefits to society and while the business is operating there is constant innovation happening.

After much consideration, research and expensive false starts Mr McMaster chose to pursue the path of an employee buyout via a workers co-operative model. This is not a very well understood model and we would like to present the issues that we encountered over two stages of our journey so far: the establishment of the co-operative and the operation of the co-operative after our first year.

We have divided this presentation into five parts;

1. The reason we chose the employee succession option,
2. The challenges that we faced along the way,
3. The challenges that we perceive in the future.
4. Our Learnings
5. Our Recommendations

## Why the employee succession option?

It took 7 years of consideration and evaluation of succession options, diligent study, discussion and negotiation to complete the transaction. The employee buyout model was seen as the best socially responsible model, a model to provide for the retiring owner and reward and to encourage the often neglected key stakeholders in the business, the employees. Many employees had been part of the organisation for up to 30 years. A sale to an external party would have resulted in the termination of current and long-term valuable employees. This was seen as an untenable situation by the owners.

The transition to the employees owning the business was negotiated with the employees in a collaborative manner to arrive at a price for the business and the process of transfer. It was also decided that the employee co-operative model was the most suitable model from the perspective of equity, cost effectiveness and longevity of the business.

All were attracted by the 7 principles surrounding the formation of worker co-operatives and we adapted them to reflect the co-operatives name;

1. **Voluntary and open membership** - C-Mac Industries (Aust) Co-operative Ltd is open to all who are willing to accept the responsibilities of membership, without discrimination.
2. **Democratic member control** - C-Mac Industries (Aust) Co-operative is democratic organisation controlled by our members, who actively participate in the setting of C-Mac policies and decision-making. C-Mac members have equal voting rights (one member, one vote).
3. **Member economic participatio**n - C-Mac members contribute equally to the funds of the co-operative and control the allocation of surplus C-Mac funds
4. **Autonomy and independence** - C-Mac Industries Co-operative is an independent organisation controlled by members. Any agreements entered into with other organisations must ensure democratic control by members and C-Mac Industries (Aust) Co-operative has independence.
5. **Education, training and information** - C-Mac Industries (Aust) Co-operative provides education and training for members, elected representatives, managers, and employees so they can contribute effectively to the development of the C-Mac Co-operative. C-Mac informs the public about the nature and benefits of co-operation.
6. **Co-operation among co-operatives** - Co-operatives serve their members most effectively and strengthen the co-operative movement by working together.
7. **Concern for community** - C-Mac Co-operative works for the sustainable development of our community through policies approved by C-Mac members.

These principles, we thought would aid the long-term survival of C-Mac and contribute to the maintenance of manufacturing jobs and expertise in Western Sydney. By operating within these principles we felt that the co-operative represented a business model which refuses to "divorce economic activity from its societal consequences", that is it was good for the members and a good corporate citizen.

**At the core of these principles is the focus of the co-operative to maximise benefits for its members, the employees/owners.**

## The challenges that we faced along the way,

The purchasers of the business are employees and as such they do not have access to large sums of capital. It was the aim of this process to give access to the business on the basis of a walk in walk out deal. Presenting no major shocks to the cash flow to ensure the business would survive.

To this end 3 actions were taken:

1. **C-Mac Pty Ltd paid for the process** - We were at all times breaking new ground and very aware of the cost of professional advice plus our awareness that the process could not be rushed, we had to build up the skills of the new General Manager, build governance skills in the employees, draw up

our rules as a co-operative, ensure that the business was viable going forward and establish our viability in the eyes of a financial institution. This training and development was financed from operating funds and paid as and when they occurred. Always being sure that at all times the business was running profitably and had a positive cash flow. Being the first to go down this path we faced challenges in our dealings with the Dept. of Fair Trading, they were learning the ropes too.

2. **The McMasters kept the facility in place** - We needed to have a financial institution/facility in place; this was one of the points agreed with the employees. Financial institutions were constantly rejecting us and it looked like we were going to find ourselves factoring our debtors to survive. A facility was negotiated with Scottish Pacific, a very expensive exercise. However we held off signing thanks to the McMasters who kept the overdraft facility in place with a deadline of 31st March 2018. On the 18th April we established a facility with the Commonwealth Bank of Australia who supplied us with and overdraft facility of $250K with no bricks and mortar security or Directors personal guarantees. This was a long drawn out process as the bank didn't understand the legalities and co-op rules protecting the members, it did not fit into the financiers' conventional business models or the traditional risk profiles utilised by the financial institutions analysists.
3. **Patient Capital established** - The walk in walk out element of the transaction proved to be a little problematic as C-Mac Pty Ltd owed the McMaster Approx $250K in rent and other expenses paid for by the family. This was agreed to be patient capital and would be paid back over a 5 year period at no interest.

The position taken by the McMaster family may not be one available to many other families and bridging this gap, were all the parties are willing and the business is viable an there is an opportunity for government to intervene and assist in the establishment to workers co-operatives as viable succession strategies.

## The challenges that we perceive in the future.

We are entering unchartered waters and while we have the facility in place with the bank, have maintained and built great relationships with our clients we are now facing the actual operation of the Workers Co-operative as a business entity. We now must continue to remain viable and encourage more into the co-operative sector of the economy.

## Our learnings.

In our process of learning about the transfer of businesses to employees we read widely. One of the documents that we read was the Nuttall Report, which was prepared by Graham Nuttall OBE. He has highlighted the importance of employee ownership trusts and identified the various challenges confronted by the employee ownership model and co-operatives.

In the UK the transition to employee ownership is also encouraged through the taxation system by allowing capital gains tax relief on sales to certain employee ownership structures, and ability to pay bonuses of up to £3,600 per employee free of income tax for certain employee ownership structures and the ability to allocate shares through a share incentive plan.

Mr Nuttall also felt that employee engagement and employee ownership are interlinked, to expect one without the other was unrealistic. Ownership is not just a legal or management structure it will not happen without engagement and vis versa. This needs to be underpinned by employees having a meaningful financial stake in the business.

Employee ownership, in Mr Nuttall's opinion, is great for succession and very effective for assisting ailing businesses. However business advisors are ready to propose the orderly sale of a business that includes; Management Buy Out, trade sale or listing as a complete list of exit solutions without considering employee ownership, there are many business owners who find these alternatives unattractive. Because of loss of identity of the business, not wanting to sell to a lifelong competitor, why see something that you have built up dissipated or lose its independence, it's vital that employee ownership be considered. One of the practical advantages is timing; you can choose when you allow your employees to succeed to your business, you are not dictated to by market forces or private equity or what a competitor's business plan might say.

**Providing that there is a viable business** employee ownership can be very viable; employment terms and conditions can be restructured, a long-term innovation strategy can be developed and the employees quite often understand actions that can be taken to improve the business, the success rate of businesses overseas which have followed this strategy has been impressive.

## *Recommendation 1*

That Business Owners, Business Professional and Financial Institutions be educated in the implications, operation and advantages of the Worker Co-operative as an alternative model for business succession or a start-up, two critical stages in the life cycle of a business.

**Why?** Because ignorance of this model is denying employees of the opportunity to save their jobs, destroying skills, breaking up families and removing from the mix a solution that has demonstrated its viability around the world.

## *Recommendation 2*

That the Federal Government establishes a **Co-operative Business Development Fund** to assist business owners and employees in the establishment of Workers Co-operatives as a viable business succession alternative. This funding, we envisage, would take the form of patient capital, not a cash grant. Patient capital is the equity normally provided by business owners who are willing to balance the current return on their investment against long-term value and the continuation of a family business. This patient capital is paid back over 5 years at a concessional interest rate, providing the Co-operative with assistance to get the first years of operation under the businesses belt plus brings in the financier to the table as a key stakeholder with financial, management and business connections. Examples from around the world demonstrate that worker co-operatives are slow to start but survive economic fluctuation better, tend to be more innovative and operate debt free.

The idea would be that the **Co-operative Business Development Fund** is a financial institution which focuses on the workers co-operative management and business model, its establishment and operation. The challenge is that there is no entrepreneurial rent, this is the name given to the bonus extracted by entrepreneurs to justify them or executives/directors taking on the liability of personal guarantees. Worker co-operatives on the other hand tend to be risk averse. Therefore we need financial institutions in the early days that are comfortable to operate without guarantees and accept that "the most skin that you can have in the game" is your job.

A possible source of funds for this institution could be unutilised franking credits, on businesses with turnover of under $100M, that have folded with franking credits not claimed, these funds are already allocated to business and could be utilised for the good of the economy.

**Why?** Because it is much easier to continue an existing viable business than it is to start a new one and having people in jobs is much better that having them on the dole. Losing jobs means lost training, lost knowledge, lost efficiencies and the loss of decades of experience.

## *Recommendation 3:*

That the Federal Government finances the establishment of a **Co-operatives and Collaboration Pilot Programme** in Western Sydney. This would be a pilot program along the lines of the $14.1M Agriculturally focused Farm Co-operatives and Collaboration Pilot Programme (Farming Together). This program has proved to be very effective and has set in place a model that could be replicated in promoting and establishing the non-agricultural co-operative model. This could be termed the **Working Together Program** and the pilot program could comprises of three phases to better support individual business owners, Considering the establishment of succession and business owner groups or clusters who develop tailored advice to meet their needs, this would develop in time;

- **Knowledge Base**: providing legacy resources to business owners considering succession through access to quality and relevant information to assist decision-making.
- **Expert Support**: enable business owners to access expert advice about co-operative structures, collective bargaining and other forms of collaboration.
- **Cluster/Group Projects**: provide funding to help groups or clusters of businesses move towards implementation of new collaborative business approaches.

This program has proved to be very effective in the agricultural environment and the lessons learnt here could be transferred to the non-agricultural segment of the economy.

## *Recommendation 4:*

To allow **franking credits** in the old structure to be refunded to the new workers co-operative to provide immediate much needed working capital for the new entity.

In the normal cause of events these franking credits would have been available to the owners and they would have been available to use them had they drawn down dividends. In many cases these credits are not drawn down when a business is sold/becomes a co-operative. Business owners who are passing on a business to the workers in the form of workers co-operative should be able to pass these credits to the "new" company. This acknowledges the stake that the previous owners have in the success of the business going forward.

## *Recommendation 5.*

**Share structure**; this requires some explanation - trading forward the C-Mac co-operative has followed the principles as outlined in the Mondragon model (Europe) utilising internal capital accounts.

Each individual bought into the workers co-operative by purchasing a member share, these are characterised by:

- being at a fixed dollar amount, this formed their capital contribution to the co-operative,
- being something which can only be owned by a worker (satisfying the active member test – 8 hours per week),
- being fully refundable when they leave employment,
- entitling the member to one vote,
- entitling them to an internal capital account,

- being non-transferable

In a worker co-operative, ownership and control of the business is derived from working in the business, rather than simply investing financial capital in it. A central element of this business structure is that the labour employs the capital, rather than capital employing the labour. In this way, workers co-operatives are structured to provide a stable source of profitable work for the worker – owners, instead of profitable return for the shareholder – owners.

The way we have structured our capital differs substantially from the capital structure in a conventional business corporation. The net worth of a conventional corporation is reflected in the shares. If the company succeeds then it retains earnings, the net worth of the company (and thus the value of the shares) increases over time. If a co-operative records its value in the price of a share, then the appreciated value of these shares might make them too expensive for new members to purchase to become a worker co-operative members, this has in the past provided an incentive for demutualisation. Historically, use of such capital shares has led to the demise of this democratic structure in a variety of employee-owned firms. To counter this C-Mac is employing "internal capital accounts" and cost of a membership share of the co-operative is kept at an agreed amount and the business value increases and decreases are reflected in the individual's internal capital account.

To this end internal capital accounts are generated in the worker co-operative which reflect the return accruing to the individual member based on their contribution as an active member of the co-operative. An active member of the co-operative in the C-Mac case is determined by someone who works 8 hours a week or more.

These internal capital account accruals in other parts of the world are termed "patronage dividends" rather than capital dividends. They differ from capital dividends in a number of ways:

1. They are not paid in cash
2. They represent a return on labour patronage rather than a return of capital investment. Traditional firms are subject to taxation at both the firm and the ownership level. We are arguing that the firm is a collective agent of the members and that the income only becomes taxable when it is in the hands of the members when they leave the business.
3. The co-operative allocates the patronage dividend entirely on paper and retains the profit for the use for any co-operative purpose. This addresses one of the major challenges faced by co-operatives, raising equity capital.
4. The co-operative pays out to the member each year interest, at a rate determined by the Board, for the co-operatives use of their patronage dividend.

Matters to be resolved:

1. The "patronage dividend", is the balance in their personal internal capital accounts which is paid to the member only when they leave the co-operative.
2. Because they are dividends retained by the company to build up working capital, when paid they should be franked at the company's taxation rate.
3. The interest paid on the "patronage dividend", which is paid to the members of the co-operative annually is 100% tax-deductible when accrued and as it is a payment to the individual for their personal contribution to the company there should be an afforded the opportunity for it to be paid directly to superannuation by way of salary sacrifice.

### *Recommendation 6*

Workers Co-operatives need to be actively supported by the Government.

The worker co-operative business structure has become very strong and well regarded overseas for the following reasons:

1. Government wanted to make businesses more resilient to recessions. The majority of companies in the UK are the one type, which exposed the UK economy to weakness.
2. The UK government wanted to find a way to ensure long term growth and a more evenly balanced future for mainstream business as well as create a more diversified and balanced economy
3. UK clamoured for a more responsible capitalism. The economy desperately needed an injection of responsibility, greater checks on unaccountable power and power placed in more hands. It's not enough to talk about a new kind of capitalism: more balanced, more sustainable, fairer. We need to roll up our sleeves and build it. We must also ensure that we emerge from this treacherous period with an economy that is not only bigger, but better. We need economic repair - but we need economic reform too. And that's where greater employee ownership comes in.
   *Nick Clegg, Deputy Prime Minister*

Specifically, to encourage co-operatives to further develop in Australia retiring business owners and employees need education and some small tax incentives to focus the professional accountants on this alternative socially responsible way of succession planning.

The following are some suggested ways:

- No capital gains tax applicable on transfer to co-operative
- No Stamp Duty – C-Mac's was sent to a specialist assessor based in Wollongong as it was outside of the "box". It shouldn't be outside the box!
- Payroll tax (if applicable) removed for <u>100% owned worker co-operatives on the basis that they are akin to partnerships and the payment is a split of after tax profits rather than wages.</u>
- Another proposal as has been adopted by countries in the Europe to kick start co-operatives in a bid to develop a better economy:
  - 100% Worker owned Co-ops are exempted from income tax for non-agricultural activities
  - Capital equipment purchases for co-ops to have a higher depreciation rate

## *Recommendation 7*

**Employee Ownership Trusts**; that the Government enact legislation that identifies a particular form of Discretionary trust - Employee Ownership Trusts, EOT as another business succession vehicle.

These trusts are specialised trusts which are established to transition the ownership of the business and are designed for transactions other than a direct sale. This innovation was introduced in the UK Finance Act 2014. While we are not lawyers an overview of this process as outlined in his documentation can be found at;

Chapter 5 reducing the complexity of employee ownership page 58 of this document:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31706/12-933-sharing-success-nuttall-review-employee-ownership.pdf

The findings of this report resulted in a process which very much simplifies the path that we followed in the establishment of the C-Mac workers co-operative - At the centre of the simplified process was a special Discretionary Trust termed an "employee ownership trust".

The employee ownership trust is designed to facilitate the transition from the existing owners of the company to the new employee owners. The trust sits between the old company structure/ownership and the new company structure/ownership. The beauty of this structure is its simplicity. Each trust deed is drawn up and establishes a clear set of rules for the transition of ownership and the payment for said ownership. These trust rules will establish clear guidelines around how the owners are to receive payment for their shares and how the shares will be managed in the hands of the new owners. These rules are established in open facilitated dialogue between the parties.

### *Recommendation 8*

That we consider the Nuttall plan and the UK Finance Act 2014 and consider legislation which would encourage use of employee ownership trusts to simplify, guide and encourage the process of establishing employee ownership.

To Summarise;

**Graeme Nuttall identified three barriers to the adoption of Employee Ownership:**

1. Lack of awareness of the concept within the business community and the professional community
2. Lack of resources to support employee ownership
3. The perception of complexity in employee ownership arrangements

**He saw the essential elements to successful employee ownership as:**

**Financial participation** – you need to get something out of the employee ownership model that employees would not get in another business model, more than just job security and the potential of an additional financial reward

**Individual voice** – it is important that the employee feel that they have a say individually in how the business is run and so that there are the appropriate engagement mechanisms in place.

**Collective voice** - employees need to feel that they have a meaningful stake in that business and a real sense of the direction of that business

1. A real sense or ethos of mutual purpose behind the employee owned business
2. A fairness in pay
3. A great contribution to the local community

## The new start

After our first 12 months of trading we have seen the impact that employee ownership has had on this business. Plus we have established our bona fides with the Commonwealth Bank of Australia and now have in place an overdraft of $250,000 secured without bricks and mortar or directors guarantees. This is just the start, this model for business and the ethics that it represents will make for valued members of the community, well run and professional companies with a long tem focus on value and job creation. Co-op members need to be encouraged as a group and supported for the long-term impact that they will have on the economy.

To quote Ann Apps talking about the co-operative model;

The co-operative is a distinctive type of corporate business model that offers an alternative to the profit-driven company. Rather than seeking to maximise profit, the co-operative seeks to maximise the value of membership by advancing the interests of its owner-members. The members of a co-operative are also stakeholders who transact with the business. In a producer or workers' co-operative, the members are the suppliers of one or more of its non-capital inputs, for example labour or raw materials. In a consumer co-operative, the members are also the consumers of its goods or services. The achievement of a co-operative's business objectives requires balancing financial returns with non-financial or social returns that are also valued by its members, for example the provision of additional member services. The liberty to pursue non-financial goals has contributed not only to the resilience and longevity of the model, but also to its ability to innovate and adapt to its changing member needs.[i]Ann Apps

## In Conclusion

There are many businesses in the same situation as C-Mac found its self in, with no viable succession plan and many jobs at risk. The Workers Co-operative is one model for transition and not a very common one in Australia, in the case of C-Mac this proved to be the best model. There are many businesses out there who are unaware of the power of this model and the implications that it has for their business, hence the need for education.

Not every business will have owners with the will or the way to finance the co-operative in its early stages, hence the need for the Co-operative Business Development Fund.

C-Mac was a proof of concept - a concept that has been demonstrated all around the world. We are calling for a commitment from the Government to establish a Co-operative and Collaborative Pilot Program in Western Sydney.

This model calls for some thinking outside the square and giving life to old Franking credits, looking at share structure in co-operatives and accounting for them in a different way.

We are calling for Government assistance, not in the form of grants but by way of patent capital that can assist Worker Co-operative's over their first couple of years of operation until our financial institutions can come to grips with the new business model.

Simplification of the process through the introduction of special discretionary trusts styled Employee Ownership Trusts that have clear rules to aid the succession of a business.

**At the core of the submission is the need for a better model for business one that more equally distributes the return in a business between capital and labour.**

**Contributors to this submission:**

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Robert McMaster Director C-Mac Industries (Aust) Co-operative Ltd

George Pagnan CA

Graeme Nuttall OBE

C-Mac Industries (Aust) Co-operative Ltd - Case study

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Legislating for co-operative identity: The new co-operatives national law in Australia
Ann Apps*[i]
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31706/12-933-sharing-success-nuttall-review-employee-ownership.pdf