

Employee Share Incentives

Updating you on current issues



Welcome to the first issue of *Employee Share Incentives*, our newsletter to keep you updated on current issues in this area.

The impending introduction of an additional income tax rate of 50 per cent for higher earners on 6 April this year brings sharply into focus the need for tax efficient employee incentives. Our lead article considers some of the implications of this change for existing share schemes and the inevitable resurgence of interest in new tax efficient incentive schemes.

We are planning to issue our newsletter three times a year, sometimes linking publication dates to key events such as the Budget and sometimes simply offering a round up of recent newsworthy developments.

Please get in touch with your usual Mills & Reeve contact or anyone in the employee share incentives team if you have any feedback on the topics covered in this issue.

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The tax planning dimension

The current economic climate creates both challenges and opportunities for employee share incentives. In the quoted sector, executive remuneration is under scrutiny from regulators (in the process of implementing changes to the regulatory framework), shareholders (many still nursing losses and all facing uncertain prospects) and government (with the recent bankers' bonus tax). In the unquoted sector, cash is tight which makes equity incentives attractive to use but the prospects of realising value from an equity incentive at an exit event are thinner than usual. For all companies, finding a balance between motivating performance, managing risk and promoting long-term success is a key priority.

If this is the overall context, a specific issue in the forefront of many minds is tax efficiency. From 6 April 2010, the rate of income tax for high earners for taxable income over £150,000 will be 50 per cent and NIC increases are on their way too. Meanwhile, despite suggestions that the Chancellor might increase capital gains tax (CGT) rates, these remain at 18 per cent. Many companies and executives are considering how best to respond to this tax landscape.

1. Utilising the 40 per cent tax band while you can

High earners with "in the money" unapproved share options available to exercise should consider whether to do so before 6 April 2010. While this will accelerate a tax event and has financing implications (unless cashless exercise is available), it will limit income tax exposure to 40 per cent. Needless to say, such a decision will be influenced by an assessment of future prospects for share prices as well as tax considerations.

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In the unquoted sector, companies may wish to explore whether unapproved options which only become exercisable after 6 April 2010 could appropriately have their exercise dates brought forward. In the case of HMRC approved or Enterprise Management Incentives (EMI) options, caution is needed as such acceleration would generally be regarded as the grant of a brand new right to exercise and if so, would not attract tax privileges.

2. Tax-privileged schemes - now 25 per cent better!

Tax favoured share options, such as EMI options and HMRC approved Company Share Option Plans (CSOPs), are set to become more attractive to those high earners facing a 25 per cent increase in their marginal rate of tax from 6 April 2010.

- **EMI options**

For companies eligible to grant EMI options, these remain immensely attractive. Indeed, one leading adviser once described them as the "best tax shelter in the UK tax system". EMI options are tax privileged share options available to independent companies carrying on a qualifying trade with less than 250 employees and with gross assets of no more than £30 million.

An employee can be granted EMI options over shares with a maximum value of £120,000 at the date of grant (including the value of CSOP options also held). So long as the exercise price is no lower than the market value of the shares at the date of grant, and no disqualifying event occurs, employees can exercise options free of income tax and NICs. On the eventual disposal of the shares, normally only a CGT charge (currently at 18 per cent) will arise. For smaller trading companies, the simplicity and flexibility of EMI options, together with the individual limit of £120,000, makes them preferable to the use of CSOPs.

If the value of your company's shares has slumped, and you are looking to replace existing EMI options with new options at a lower exercise price, take care! There are a number of pitfalls and, in certain circumstances, replacement options may not be eligible for EMI status.

- **Company Share Option Plans (CSOPs)**

CSOPs are HMRC approved discretionary share option plans. For some unquoted companies, jumping through all the hoops to secure HMRC approval can be unappealing. For all companies, their impact is limited by the fact that an employee can only be granted CSOP options over shares worth up to £30,000 at the date of grant. However, CSOPs do offer an opportunity to pass value to employees free of income tax and NICs on exercise. In the right circumstances, a CSOP option granted subject to suitable performance conditions could be part of the remuneration mix for senior executives.

3. Capital vs income

There is considerable interest at present in methods to enable executives to benefit from growth in value of a company's shares and be taxed on that growth in value as a capital gain rather than income. There are a number of different ways to achieve this with minimal initial outlay of cash by the executive. Examples include:

- Nil-paid shares: Here the executive buys ordinary shares but on deferred payment terms;
- Flowering shares: Here the executive buys a special class of shares whose rights are carefully designed to minimise their current value

but to grow in value as the company grows in value;

- Joint share ownership plans: Here the executive and an employee benefit trust (EBT) buy ordinary shares jointly but their respective interests are different. Typically, the EBT buys almost all the current value and the right to, say, the first 5 per cent pa of future growth; meanwhile the executive buys little current value and the right to all future growth in excess of the first 5 per cent pa.

The technical details of these arrangements can be complicated, and each has its own advantages and disadvantages. All have in common the fact that, unusually, the company does not benefit from any corporation tax deduction. In effect, under these awards tax costs are passed from the executive to the company. However, in certain circumstances, that will be little disadvantage (eg if the company has substantial carried forward losses) or a price worth paying (eg to recruit a key individual or really motivate an executive team to pursue performance which will underpin share price growth). One area of uncertainty is the risk that HMRC might introduce anti-avoidance legislation to target one or more of these incentive structures.

In the quoted sector, the tax treatment is only one consideration, and the Association of British Insurers (ABI) has produced guidance saying "Remuneration structures that seek to increase tax efficiency should not result in additional costs to the company or an increase in its own tax bill. Remuneration Committees should be aware of the potential damage to the company's and shareholders' reputations from implementing such schemes." Any quoted company considering introducing such a tax structured scheme will need thorough consultation with its shareholders to ensure the proposal will attract shareholder support.

2009 Pre-Budget Report (PBR)

The PBR in December included the following items relevant employee share incentives:

- The previously announced increase of 0.5 per cent in both employee's and employer's National Insurance Contributions from April 2011 will now rise by a further 0.5 per cent. For an additional rate taxpayer, this will lead to an effective rate of tax on a fully taxable share scheme (assuming the employee also bears the employer's NICs) of an eye-watering 58.9 per cent!
- New draft legislation has been published to extend the Disclosure of Tax Avoidance Schemes (DOTAS) regime. Details of tax avoidance arrangements must be notified to HM Revenue & Customs if, amongst other criteria, they possess certain "hallmarks". A number of new "hallmarks" are proposed, including one which targets schemes aimed at reducing or deferring employment income and one aimed at schemes that convert what would otherwise be employment income into capital gains. Consultation on the draft legislation runs until 19 February 2010.



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Relaxation of the Enterprise Management Incentives (EMI) rules

The current EMI rules require a qualifying company's trade to be carried on "wholly or mainly in the UK". With effect from 6 April this year, this rule is being relaxed so that the company will only be required to have a "permanent establishment" in the UK. This change will allow companies based in the UK which carry out considerable overseas activity to grant EMI options to UK based staff. It will also allow UK tax paying staff of overseas companies with a



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permanent establishment in the UK to benefit from EMI.

This amendment appears to have been conceded by the Government in order to secure approval from the European Commission that EMI options are consistent with the EU rules on long term State Aid. The Commission has now agreed to grant EMI State Aid approval until April 2018.

Wicks

Corporate governance and directors' remuneration

In December 2009 the Financial Reporting Council (FRC) published its consultation draft of a revised Combined Code on corporate governance (to be renamed the UK Corporate Governance Code).

Proposed changes to the provisions on directors' remuneration include:

- a stronger supporting principle on performance related remuneration requiring "stretching" incentive performance conditions related to the "long-term success of the company";
- a recommendation that non-executive directors' remuneration should include neither share options nor (which is new) "other performance related elements";
- a new statement aimed at linking incentive schemes to the risk profile of the company and discouraging excessive risk taking;
- a recommendation that consideration should be given to the inclusion of clawback provisions in executive incentives for "exceptional circumstances of misstatement and misconduct";
- the deletion of the current code's recommendation of performance conditions based on comparative total shareholder return.

Whilst the revised code will be of most relevance to listed companies, it will nevertheless be influential for other companies, especially AIM companies.

The final report of the Walker review of corporate governance in UK banks and other financial institutions also made recommendations relating to the remuneration of board directors and other "high end" employees in the financial sector. These included emphasis on deferral incentive payments to align rewards with sustainable performance; the extension of the remuneration committee's responsibilities to include firm-wide remuneration policy and oversight of the remuneration packages of "high end" employees who are outside the board; and the disclosure in bands of information relating to the remuneration of "high end" employees.

Also in December:

- The Association of British Insurers (ABI) issued updated ABI guidelines on executive remuneration reflecting some of the FRC and Walker recommendations.
- The London Stock Exchange proposed changes to the AIM rules requiring disclosure of directors remuneration (including share options and other long term incentive plans) in the annual audited accounts of AIM companies for financial years ending on or after 31 March 2010.



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Shortcut - more information

For more information on the services offered by Mills & Reeve in relation to Employee Share Incentives, please click [here](#).

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