



employee share incentives

New companies with ambitions to become successful high-growth enterprises need to recruit and retain key individuals to build the business. High quality managerial, financial and technical personnel are essential. For many businesses, building a partnership with all employees is critical to loyalty, sustained performance and customer care. For these reasons, share-based incentives can play an important role in the remuneration and motivation policies of start-up companies.

Types of incentive

Employees can be given a route to participation in the growth in value of the share capital of a start-up company through three basic methods.

Options: employees can be given an option to buy shares at some point in the future, perhaps dependent on attainment of performance targets, but at a price fixed when the option is granted. This is a one-way bet for the employee because he is not obliged to invest his own cash, but if shares rise in value, he can buy shares at an attractive price.

Shares: employees can be given the opportunity to buy shares in the company. These might be shares of the same class as founder shareholders or, possibly, a special class of employee shares.

Phantom schemes: these schemes involve the payment of a cash bonus which is calculated by reference to the value of the shares in the company. For a start-up company where share valuation is difficult and cash often scarce, a phantom scheme would be rare unless “dilution” of share ownership must be avoided. Naturally, bonus arrangements linked to profit or turnover (rather than share value) are possible at any stage in the lifecycle of a company.

Issues to watch

Several issues need to be addressed when considering what share-based incentives, if any, to make available in a start-up company but four issues which regularly call for close attention are detailed below.

- o **Control:** many founder shareholders do not wish shares to be held by ex-employees or non-employees. Accordingly, it is important to include provisions in the company’s articles ensuring that employee shares cannot be transferred to non-employees and that departing employees must offer their shares for sale. In fact, it can often be simpler to avoid having employee shareholders altogether during a company’s growth phase. One common approach to achieve this result, while providing an equity incentive, is to grant employees “exit-only” options, that is, options which can only be exercised on a sale or listing of the company. Such an approach focuses everybody’s attention on working towards exit, avoids the need to set up or implement share buy-back mechanics for leavers, and means fewer signatures need to be collected on an investment round.
- o **Marketability:** ultimately, options or shares have little or no value to an employee unless he can sell them for cash at some point. One natural occasion for realising the value of options or shares is the sale or flotation of the company. However, if a market for the shares is needed sooner rather than later as part of

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the remuneration policy, special arrangements are necessary. It may be possible to establish an employee benefit trust which can operate, among other things, as a buyer and seller of employee shares.

- o Tax: tax issues need to be considered carefully both for employees and for the company itself. Broadly speaking, share incentive arrangements fall into two categories: HM Revenue & Customs approved arrangements, offering tax benefits but less flexibility, and “unapproved” arrangements, offering more flexibility but at the cost of tax disadvantages.

Where capital gains tax treatment applies on a disposal of shares, a tax rate of 18 per cent will generally apply to basic rate income tax payers and a rate of 28 per cent to higher and additional income tax rate payers. In some cases, entrepreneurs’ relief will apply to reduce the capital gains tax rate to 10 per cent on the first £10 million of qualifying capital gains made by an individual during his lifetime. This relief is available to employees/directors on disposals of shares in a trading company (or the holding company of a trading group) provided that, throughout a one-year qualifying period, the employee/director owns at least 5 per cent of the ordinary share capital of the company and can exercise at least 5 per cent of the voting rights in the company. In addition, entrepreneurs’ relief is available to employees who acquire their shares on the exercise of an Enterprise Management Incentives (EMI) option provided certain conditions are fulfilled including, in particular, that the shares are sold at least one year after the date of grant of the EMI option.

However, employee-held shares can give rise to income tax, PAYE and national insurance contributions (NICs) in a range of circumstances (whether on acquisition, disposal or otherwise). It may be appropriate within 14 days of the acquisition of shares by an employee for the employee and the employer to sign a “section 431 election” for the purposes of the “restricted securities” regime. On a more positive note, companies are generally entitled to a corporation tax deduction equal to the value of shares awarded to employees, whether directly or following the exercise of a share option, less any price paid by the employees.

The employee tax consequences of an unapproved share option granted by the company are as follows:

- o When the option is granted: no tax or NICs arise.
- o When the option is exercised: income tax is payable on any gain calculated as the difference between the market value of the shares at the time of exercise and the price paid for those shares by the employee. The company may also have a PAYE and NIC liability and needs to ensure that, as regards PAYE and employee’s NICs, the company will obtain full reimbursement of any such tax costs from the employee. Employer’s NICs (currently charged at 13.8 per cent) can also be (and generally should be) made the employee’s responsibility. These tax costs can be avoided if the company grants enterprise management incentives (EMI) options. EMI options are tax-privileged options specially designed for use by startup and early stage independent trading companies.
- o Exit: care is needed when designing the terms governing optionholders’ rights on the sale or flotation of the company. If a sale occurs, provisions should be included in the articles to ensure that employees are obliged to sell their shares and cannot stall completion.

HM Revenue & Customs approved schemes

There are a number of tax-advantaged employee share schemes namely:

- o Enterprise management incentives (EMI) under which employees in independent trading companies with

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fewer than 250 employees and gross assets not exceeding £30 million can each be given tax advantaged options over shares worth up to £250,000 at the time of grant. The tax privileges of EMI options are very substantial and the legislation provides considerable flexibility for a company to design tailor-made options to fit the specific business situation. EMI options are explained in more detail in the next section and further information is available at the HM Revenue & Customs website at www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm.

- o A company share option scheme (CSOP): options are awarded to employees selected at the discretion of the directors of the company. Provided the scheme maintains approved status, option exercise is tax-free if exercise occurs at least three years after grant or in “good leaver” circumstances.
- o The share incentive plan (SIP), which was originally known as the new all-employee share ownership plan, has been described by the HM Revenue & Customs as “the most tax-advantaged all-employee share plan ever introduced in the UK”. Employees may, for example, purchase up to £1,500 of “partnership shares” each year; alternatively a company may award up to £3,000 p.a. of free shares subject, if appropriate, to reaching agreed performance targets.
- o A savings-related share option scheme (Sharesave): options are offered to all employees of the company who must enter into a savings contract with an approved institution. In practice, this scheme is not suitable for start-up companies.

Normally, early stage companies have found the qualifying conditions for SIPs, Sharesave schemes and even CSOPs too cumbersome to be practical. However, changes made by the Finance Act 2013 have made CSOPs more flexible and take up may increase among companies which cannot, for some reason, grant EMI options.

Since September 2013, it has been possible for companies to invite employees to become ‘employee shareholders’ by giving up certain statutory employment rights in exchange for receiving at least £2,000 worth of shares. For the employee, the tax benefits are that, first, the first £2,000 worth of shares are tax-free on receipt and, secondly, any shares so received (up to a maximum value on receipt of £50,000) are exempt from capital gains tax on sale. However, the general consensus, is that the ‘employee shareholder’ scheme is, for various technical and practical reasons, too complex to be suitable for most early stage companies.

Unapproved share incentives

Unapproved arrangements can take literally any form. It may be impossible to grant EMI options, for example, because the company is treated as being under the “control” of its principal corporate investor(s) or the proposed optionholder is a non-executive director. In these circumstances, unapproved options can be granted but the effective rate of tax on exercise for the optionholder may be over 50 per cent (if he or she is made responsible for employer’s NICs). For this reason, or out of a preference for providing employees with equity now, shares rather than share options might be appropriate. If so, “unapproved” employee share schemes permit maximum flexibility when designing the rights and restrictions attached to the shares. But advice should be taken to avoid or minimise the impact of rules which could impose income tax, PAYE and NICs on future growth in the value of the shares.

Using an employee benefit trust

An employee benefit trust (EBT) is a “vehicle” through which shares may be held by trustees for the benefit of employees. The trustees may be individuals but, more typically, a subsidiary company will perform this function. An EBT, funded by the company or possibly with external finance, can subscribe for shares or buy shares from selling shareholders. Thereafter the EBT can sell shares, or award options, or transfer shares free of charge to employees. An EBT can serve as a “warehouse” for shares intended to be made available to employees at a future date, or operate effectively as an “internal market” for shares. In some circumstances an EBT’s role of providing

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incentives and rewards to employees to assist the trading performance of the company will result in increased ownership of shares by the “next generation” of managers, and, incidentally, facilitate long-term “succession” planning. Thus, an EBT has wide-ranging potential to assist with employee share ownership arrangements but, whatever your commercial strategy, advice on a range of legal and tax issues should always be taken in order to avoid pitfalls for the unwary.

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