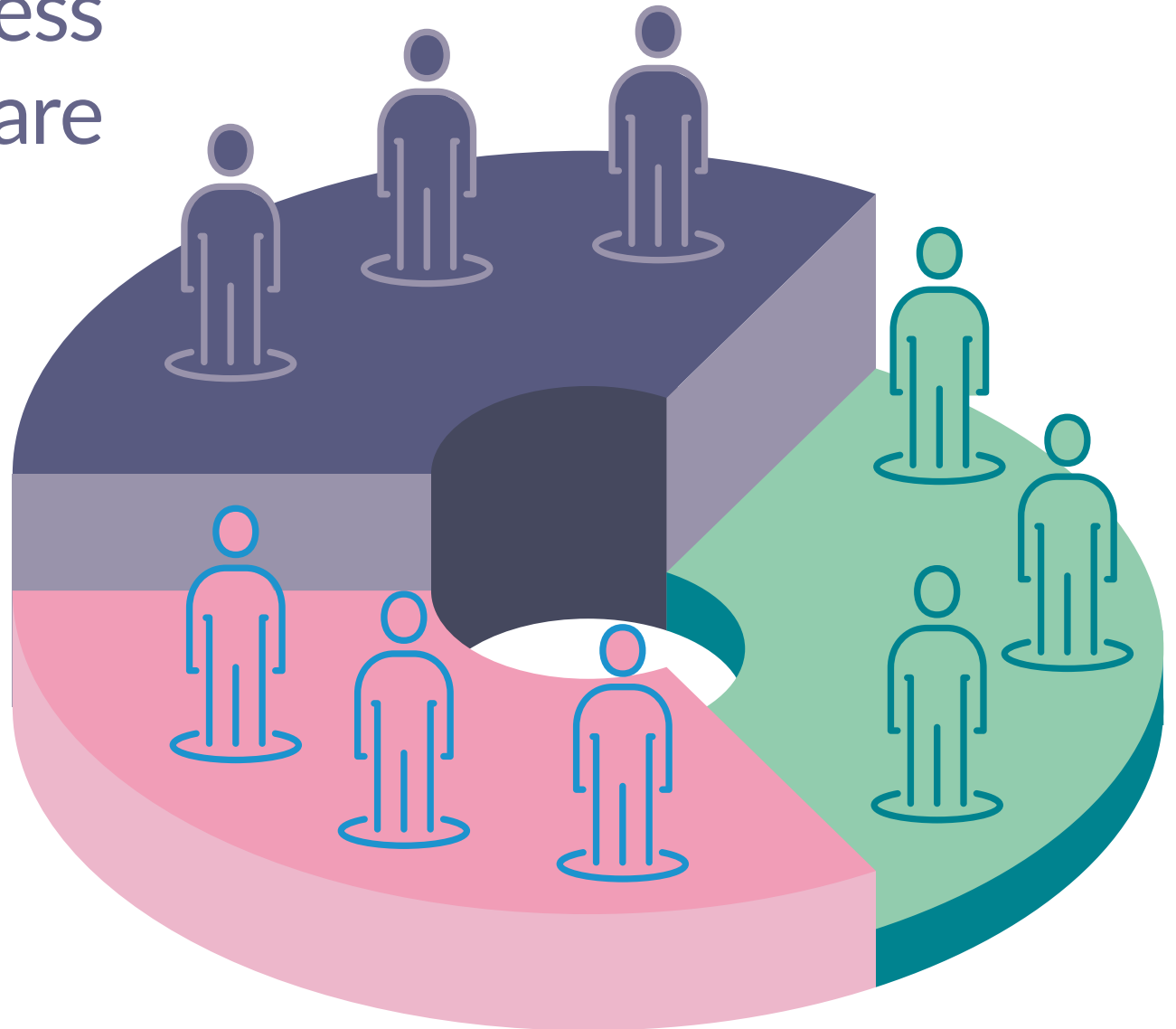


How can a business use employee share schemes?

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Companies use employee share schemes primarily to enhance remuneration packages in order to attract and retain the best talent, and to incentivise that talent to grow and develop the business (often to an exit). They can also be an effective way of raising equity funding and for planning for succession of major stakeholders.

Since employee share schemes do not require an immediate outlay of cash, for example a salary or bonus payment, they can be useful for start-up companies, or other companies where cash flow is limited.

The key tax considerations with employee share schemes

The key tax considerations are usually:

- Minimising or deferring the tax liabilities arising on the acquisition of the shares; and
- Minimising the tax liabilities on a sale of those shares.

Tax issues on acquisition of shares by employees

A difference between the market value of the shares at the date of acquisition by an employee, and the price paid for the shares by the employee, can result in an employment tax charge. This is akin to a non-cash bonus. The tax charge is therefore 'dry', as the employee will not have received any cash from which they can settle the tax due.

To mitigate this employment tax risk, certain employee share schemes look to reduce the market value of the shares at the date of acquisition (for example, through growth share arrangements).

Other employee share schemes use option arrangements to defer such employment tax charges. Under option arrangements, there will generally be no employment tax charge until the option is exercised in the future. If the options can only be exercised at the point of exit, the employment tax charge can be deferred until a future sale of the company, for example, and can therefore be funded by the employee from the proceeds of sale of their shares. However, unlike holding shares from the outset, share options do not give any entitlement to dividends or right to vote in shareholder decisions.

Tax liabilities on the sale of shares by employees

The use of HMRC approved employee share schemes can have significant tax advantages for both employees and the employing company. Under approved schemes, any growth in value tends to attract capital gains tax (CGT), rather than higher rates of income tax. The main rate of CGT is currently 20% (falling to 10% where Business Asset Disposal Relief (BADR) applies). This compares to the higher and additional income tax rates of 40 and 45%. If the shares received are also considered 'readily convertible' (into cash), then employee and employer national insurance contributions will also apply, in addition to income tax.

There has been recent speculation as to whether the government will look to increase CGT rates to align with the higher income tax rates, and whilst it hasn't happened yet, this could happen at some stage in the future. However, irrespective of the final tax treatment, it is important that directors of companies looking to incentivise employees do not lose sight of the commercial benefits of these employee share schemes to motivate, incentivise and retain key employees. Concerns over possible future increases to tax rates should not normally be a reason to deter from implementing an employee share scheme.

Whilst approved schemes can provide significant tax breaks, they may not be as flexible as unapproved schemes, due to the rules with which they must comply.

Approved equity incentive schemes include the Enterprise Management Incentive (EMI) Scheme and Company Share Option Plan (CSOP), used for rewarding specific key employees, as well as the Share Incentive Plan (SIP) and Save As You Earn (SAYE), all-employee schemes.

Enterprise Management Incentives

With their flexibility and advantageous tax breaks, EMI options are still the 'gold standard' for share rewards. Often, other share rewards are only used where EMI is unavailable, for example when the conditions cannot be met.

Key features

- An individual can be granted options valued at up to £250,000 in total;
- Options can be granted at a discount to market value (but income tax will be due at exercise on the value of the discount); and
- For BADR purposes, the qualifying holding period for EMI options commences at the date of grant of the option.

Limits on EMI

- The value of shares over which there are unexercised options is limited to £3 million (determined at the time of grant);
- At the time of the grant of the options, the company must be independent, have gross assets of less than £30 million and have less than 250 full-time equivalent employees;
- Companies carrying on certain excluded trades cannot grant EMI options. Excluded trades include dealing in land or shares, banking and insurance, property development and farming.

Company Share Option Plans

Unlike with EMI schemes, with CSOPs, there are no limits on company size or number of employees, allowing larger companies and listed organisations to participate. Similarly, there are not the same trade restrictions for CSOPs as there are for EMI schemes.

A CSOP is, however, a more restrictive regime than EMI in that:

- Options must be granted at market value;
- Each employee can only be granted options valued at up to £30,000; and
- The option cannot be exercised for at least three years following grant, for any gain to be exempt from income tax.

CSOPs are therefore popular with larger corporates and can be used by UK subsidiaries of overseas corporate groups.

Unapproved options

As with approved options, there is no initial upfront tax cost. Any gains arising on exercise of the options will be taxed as employment income and these are typically used as top-ups to approved schemes.

Approved all-employee schemes

There are two all-employee approved share ownership plans; the Share Incentive Plan (SIP) and the Save As You Earn (SAYE) scheme.

SIPs allow employees to acquire shares in the employing company from their pre-tax income, with employers able to top up these awards. The shares are then held in trust for a minimum period and, when taken out after the required holding period, can be sold or retained without an income tax charge arising. If shares remain in the plan until the point at which they are sold, then there is also the benefit of no CGT being due.

The SAYE scheme is a savings plan where employees can purchase shares in the employing company, at a discount of up to 20%, using funds paid into the savings plan over a three or five-year period, without an income tax charge arising from the acquisition.

The all-employee nature of these plans can make them difficult to implement, but they too have a good track record of incentivising and retaining staff.

Direct share acquisition

Where an employee acquires shares in the company directly, any future increase in value will, in most cases, be treated as a capital gain.

However, if market value is not paid on acquisition, the discount received will be treated as a taxable amount, subject to income tax. If the shares are not considered readily convertible at acquisition, the discount received will not be subject to PAYE/NICs but will instead be taxable via self-assessment, unless the company is under the control of another company.

Shares are often acquired directly where the voting rights are highly valued and where there is a likelihood of future dividend payment.

Care needs to be taken where the shares acquired are restricted in some way, as additional income tax charges may arise later, when any restrictions lapse or fall away. Restrictions may be deemed to have fallen away at the point of sale.

Growth shares

A new class of shares can be created, where the shareholders are only entitled to a distribution of capital on a sale once a particular financial hurdle has been achieved. Where this hurdle is considered a stretching target, it allows a significant discount to be applied to the initial market value of the shares, which is then typically reduced to a nominal value. Any future increase in value will then be taxed as a capital gain.

Setting an appropriate hurdle and valuing the new class of shares can be complex. As this hurdle will be an inherent characteristic of the share class, it will also need to be included in the company's articles.

Once created, the new class of shares can be used for share option awards, such as under an EMI scheme.

Growth shares are typically used in companies where the acquisition price of ordinary shares is relatively high, and so can make better use of the limits under approved schemes.

Jointly owned shares

Jointly owned shares are an alternative to growth shares and are generally used by listed companies and companies where it is not possible to create a new class of shares. This involves an employee and an Employee Benefit Trust (EBT) jointly owning a share. The trust is entitled to the initial value and bears the administrative costs attributable to the running of the trust (the 'carry costs'). The employee is entitled to most of the future growth in value. This is a complex arrangement that requires a detailed legal agreement and valuation work in determining the appropriate hurdle and carry cost levels and their impact on tax valuation, as well as the setting up of an EBT.

However, it does allow the employee to acquire an interest in the business for a low cost and have the future increase in value taxed as a capital gain on exit, without creating a new class of shares.

Employee Ownership Trusts

An Employee Ownership Trust (EOT) goes even further than most of the planning described above and gives the employees a controlling interest in the company through a trust-based arrangement. This is very efficient for succession planning, as the departing shareholders can sell their shares to the trust and have no CGT liability, while the employees can acquire an interest indirectly, without having to use their own funds. Once set up, the company can pay tax-free bonuses to employees of up to £3,600 a year.

Other considerations

Business Asset Disposal Relief

Where an employee owns at least 5% of the share capital (by voting rights, number of shares, dividend rights and entitlement to disposal proceeds), providing they own the shares for at least two years prior to sale, they should qualify for BADR. Under BADR, any gains arising on a disposal of shares should attract a lower 10% rate of CGT.

Whilst for unapproved options and CSOPs this would require the employee to exercise the options two years before any sale, there are special rules for EMI options that treat the qualifying holding period as commencing from the date of grant of the option, so the employee can exercise the option immediately prior to sale of the shares and qualify for BADR and the lower rate of CGT.

Share valuations

As well as the tax and commercial aspects of employee share schemes, the valuation of the company shares is also an important consideration. The choice of employee share scheme can be driven by the current market value of the shares, as this will tend to determine the tax risk. Lower company valuations can therefore make employee share schemes more attractive for both employee and employer.

Share valuation can be difficult, and subject to scrutiny by HMRC. That difficulty can be exacerbated by uncertainty created by factors including the impact of the Coronavirus pandemic and the current situation in Ukraine. It is therefore important to use a firm with extensive share valuation experience.

About Saffery Champness

How can Saffery Champness help

Saffery Champness has extensive experience in helping clients to design employee share schemes to meet specific objectives for attracting, incentivising and retaining key employees to grow and develop businesses. That is often with a view to an exit strategy, to raise equity funding or to plan for succession of major stakeholders.

To find out how we can help you, please get in touch with:



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About Saffery Champness

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