Tax Connect - Share Incentives Toolbox

As the economy recovers there is an increasing expectation, particularly in the technological sectors, that to attract and retain the best staff you need to offer share incentives. Tax advantaged share plans work well by providing tax-efficient ways for individual employees to acquire and dispose of shares.

For most companies, the first item in the toolkit should be the Enterprise Management Incentive (EMI) plan. EMI options give employees the single most tax advantaged form of remuneration and, if structured correctly, can result in a tax charge as low as 10%.

Unfortunately, there are a number of qualifying criteria for EMI plans, which a company or a specific employee may not meet. The most common problems are where gross assets exceed £30 million, companies have more than 250 full-time-equivalent employees and where employees do not work sufficient hours at the company or group to be eligible for EMI.

The good news is that if EMI is not possible, there are a number of alternatives.

Company Share Option Plan (CSOP)

The CSOP regime also allows share options to be granted to chosen employees, and although it does not have the size limits of the EMI it is less flexible and less generous. Options must be granted with a market value option price and the employee normally has to wait three years before exercising. Even then the best tax rate they can hope for is likely to be 28%. Furthermore an employee may only hold options on up to £30,000 worth of shares at the time of grant, compared to £250,000 under EMI.

Share Incentive Plan (SIP)

This HMRC-approved share plan must be offered to all eligible employees of a company on broadly the same terms. Shares are awarded to employees, which are then held on their behalf within a SIP trust. They can be awarded in a combination of ways, including free, purchased and matching shares.

The maximum that an employee may receive per tax year is £9,000. Once an award has been made, the SIP trustees will hold the shares until the employee wishes to release them. If the shares are withdrawn from the trust after five years, there is no income tax or NIC on the value of the shares given. If they are then sold on the same day, they will be exempt from capital gains tax.

Employee Shareholder Status (ESS)

In September 2013 an entirely new share ownership regime came into force, which allows employees to trade a limited number of their statutory employment rights for shares in their employer. The rights to be surrendered include the right to request flexible working, the right to request training and the right not to be unfairly dismissed. Senior employees are unlikely to place much value on these rights, so ESS could prove useful for attracting key executives. However, the shares must be given to the employee for no consideration and they must have a minimum market value of £2,000. Although there is no income tax or NIC on the first £2,000 it does apply to any amounts above this level and is payable at the time the employee receives the award.

When the employee eventually disposes of the shares, the first £50,000 will be exempt from CGT. Importantly, the calculation is based on the value of the shares when they are awarded. So if shares were worth £10,000 on the date they were awarded to an employee and were eventually sold for £500,000, they would be totally exempt from CGT.

So where initial share values are low and there is an appetite for risk, ESS could be seen as more favourable than EMI because of the scope for unlimited tax-free growth.

Growth Shares

Employees can be awarded shares that have no interest in the current value of the company, but have an interest in its growth potential. This means that the value of the growth shares acquired by employees is initially low, but there is potential for capital growth, assuming that nothing is done to trigger a charge under any of the anti-avoidance provisions.

The simplest way to structure a growth interest is to create a new class of shares, often referred to as hurdle shares. For example, if the company is currently worth £1 million, the hurdle above which the growth shares would participate would be set at a premium to that value, say £1.2 million. On the sale of the company, if the exit valued the company at £1.1 million the growth shares would not participate in the proceeds. But if the exit valued the company at £1.5 million, the growth shares would participate in a proportion of £300,000.

Nil-paid or partly paid shares

The final tool in the toolbox is to agree with the employee that he or she will pay full market value for the shares and to issue the shares to them unpaid, that is, the employee has an obligation to pay the price of the shares at a point in the future, typically before the sale of the shares.

While the employee holds the shares and the consideration remains outstanding, they will be treated as having an employment-related cheap loan and will be subject to an annual tax charge on the benefit of the loan at the current rate of 3.25%, but there are a number of reliefs available against this charge which may result in the deemed indebtedness being exempt from tax. The proceeds from the disposal of the shares should be taxable under the normal CGT rules, which may allow Entrepreneurs' Relief to be claimed in certain circumstances.

Conclusion

EMI is rightfully seen as a straightforward and advantageous way to structure employee share awards in smaller companies, but there are viable alternatives to the EMI if a company does not qualify or an individual employee does not meet the criteria to participate.

As always, if you are considering a Share Incentive Scheme, using options, purchase or gift of shares, then we recommend you talk to our share incentives experts in our Share Ownership and Equity Rewards team to consider the best approach.

Further information

Please contact your usual Menzies team representative or e-mail taxconnect@menzies.co.uk