Share ownership
The continued growth and success of your business can be dependent on your workforce. It is therefore important to ensure that you are recruiting, incentivising and retaining the right people. Operating a share based incentive scheme can help you achieve these goals.

Share incentive schemes can be divided into two categories:
• those which involve the company issuing shares to employees directly; and
• those that involve the company granting the employee the option to acquire shares in the future (commonly referred to as a ‘share options scheme’).

Existing shareholders will often prefer options to be granted, as their current holdings will not be diluted until such time as the options are exercised. Furthermore, options offer employees protection against any fall in value of their employer’s shares, as they will have significant flexibility to choose when they want to acquire their shares.

Direct share issue
The issue of shares to an employee will often give rise to an income tax charge on the employee at the date of gift. This follows the fundamental principle that giving an asset to an employee for less than it is worth gives rise to a taxable benefit. Therefore, should the employee wish to avoid an income tax charge, they will need to pay the full market value for the shares. This route may not be overly popular with employees as they will be required to fund the share purchase themselves.

Alternatively, the company could issue shares to the employee for their current market value, but the employee pays no cash for the shares immediately and instead leaves them as unpaid. If the directors prefer, the Articles of Association can state that only fully paid shares carry dividend and voting rights. At a future date, usually just before the sale of shares, the employees pay the company for the shares out of their sale proceeds.

The benefits of this are as follows:
• As the subscription price is equal to the current market value of the shares, there will be no undervalue and so no tax charge arises;
• The unpaid value of the shares will be treated as though it is a loan to the employee and an income tax charge would arise (calculated like an interest free loan). However, given that the ‘loan’ has been used to acquire shares, and tax relief is available for interest on loans to acquire shares in certain close companies; this often negates the tax charge.

However, it is important to remember the following:
• The employee will remain liable for the unpaid subscription price for the shares and this may be called, for example, when the company is in financial difficulties;
• It is possible to include forfeiture rights so as to put the company in a position where the shares can be returned in certain situations, for example, in the case of a ‘bad leaver’;
• The employee will be entitled to vote at general meetings and receive dividends; although, as mentioned above, a different share class could be used if required or, alternatively, dividend and voting rights could be limited to fully paid shares.

Employee Shareholder Scheme
In an effort to reduce regulatory burdens on businesses, the Government has introduced a new “Employee Shareholder” status for employees.

The legislation, effective from September 2013, gives employers the opportunity to offer tax efficient shares to employees in exchange for the surrender of certain employment rights.

Employees willing to accept this status can receive between £2,000 and £50,000 worth of shares in their employer company. As discussed above, should the employee wish to avoid an income tax charge on acquisition of these shares they will need to pay the full the market value when acquiring them. However, it should be noted that the Government has introduced a £2,000 deemed payment concept to the scheme. Therefore, should an employee receive the minimum share entitlement of £2,000, the taxable value of the shares will be nil as they will be deemed to have paid the full market value on acquisition (and it won’t cost the employee a penny).

Another advantage for employees accepting shares under the scheme is the capital gains tax exemption on the eventual disposal of
their shares. Ordinarily, an employee selling shares received in their employer company will face a charge to capital gains tax on the growth of the shares over and above the initial acquisition cost. Under the Employer Shareholder scheme, qualifying shares sold by the employee will be entirely exempt from capital gains tax.

It must however be borne in mind that in return for these tax breaks, the employee will be surrendering certain fundamental employment rights. These will include, inter alia:

- Statutory redundancy pay;
- Flexible working time;
- The right to claim unfair dismissal;
- The right to request employment training; and
- Flexibility concerning a return from maternity/adoption leave.

There are of course a number of qualifying factors that must also be met in order for the shares to qualify under the scheme. Importantly, the employee, or any associate of his, must not possess more than 25% of the voting rights of the employer company.

**Joint share ownership plan (“JSOP”)**

An alternative to the above direct share issues is a JSOP

A JSOP is an arrangement whereby an employee jointly acquires shares with a third party, usually an Employee Benefit Trust ("EBT"). The EBT will acquire the beneficial interest in the shares up to a specific value. The employee will acquire a restricted interest in the shares up to a specific value. Although the employee will pay for the interest acquired, there remains no income tax on the exercise of the options be granted at an exercise price below the current market value of the shares, there remains no income tax on the initial acquisition cost.

Providing the employee pays the market value price for the interest acquired, there should be no income tax implications on acquisition. The only tax charge to consider will be the capital gains tax charged on the growth of the shares over and above the initial acquisition cost.

**Share options**

The alternative, and perhaps more traditional, way of providing shares to employees is by way of a share option scheme. Broadly speaking, this is a mechanism that allows an employee to acquire shares at some point in the future by exercising the option at a price determined at the date of grant. The ability to exercise the option may be contingent on a future event, such as a sale, or the employee meeting certain performance targets.

Share schemes can be split into those that have been approved by HMRC, thereby receiving favourable tax treatment, and unapproved schemes.

The tax position on the acquisition of shares provided under such a scheme will vary depending on which type of scheme is adopted. This publication will focus on two key approved schemes – EMI & CSOP – as well as providing a brief overview of unapproved schemes.

**Enterprise management incentives (“EMI”)**

EMIs are tax advantaged share options. Under the plan, employees are given (granted) the option to acquire shares in their employer company within a specified time period and at a fixed price.

If options are granted under an EMI scheme, such that the exercise price is at least equal to the market value of the shares when the options are granted, then no income tax will be payable on either the grant of the options or on the exercise of the options. It is possible to obtain agreement to the value of the shares in advance of the grant of the options and we would recommend that one obtain this, as it gives certainty that no income tax charge will arise. Should the options be granted at an exercise price below the current market value of the shares, there remains no income tax on the grant of the options, but income tax will be payable on the exercise of the options. Income tax will be charged on the lower of the market value of the option shares at the date of grant or the date of exercise, less the total price actually paid for the shares.

There will also be a capital gains tax charge when the employee eventually sells the shares. The capital gain is simply calculated as the difference between the sale proceeds and the cost. The cost is the amount actually paid for the shares, plus any amount charged to income tax on exercise (only applicable if the options were issued at a discount).

However, it doesn’t end there, as the Government has enhanced the tax advantages of the EMI scheme by allowing gains made on shares acquired through exercising EMI qualifying options on or after 6 April 2012 to be eligible for Entrepreneurs' Relief (ER). Unlike shares acquired under other circumstances, holdings of less than 5% can qualify for ER. The change, made in 2012, still requires that the shares are owned for at least 12 months. However, the 12 month ‘waiting period’ for entrepreneurs’ relief starts when the options are granted, not when they are exercised. Therefore, shares acquired when options are exercised on a sale can now qualify, providing the employee has held the option and the shares for a combined period of 12 months or more.

There is great flexibility as to when the employee may exercise the option and acquire the shares, though one must agree these before the grant of the options and one must specify them in an Option Agreement. They can vest immediately or after a certain period, perhaps after certain performance conditions are met. A common and popular condition is that they only vest immediately before a sale or float of the company. Though, as mentioned above, it should be noted that ER will not be available where the employee has held their shares for less than 12 months.

There are however, limits as to the amount of EMI options the company can grant. The total value of shares over which there are unexercised options granted by the company cannot exceed £3 million. An individual employee cannot hold unexercised EMI options over shares with a total value over £250,000.

The employee and company must meet a number of conditions for the options to qualify.

The employee or officer must work for the company for 25 hours or more a week; or, if less, 75% of the employee’s working time.

Also, the employee or officer cannot own or control more than 30% of the ordinary share capital of the company or, in the case of most privately owned companies, be entitled to 30% or more of the assets on winding
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up. In determining this, one must include holdings in the company of relatives, commercial partners and associated trusts.

The company must meet a long list of conditions:

- Firstly, another company cannot control the company. Therefore, in the case of a group, only a holding company can grant EMI options;
- Any subsidiaries must be 51% subsidiaries (i.e. the company must own more than 50% of the ordinary share capital of any subsidiary);
- The company or group cannot have gross assets of more than £30 million;
- The company or group must have employees numbering less than 250;
- In the case of a single company, it must exist wholly for carrying out one or more qualifying trades or is preparing to do so. In the case of a group at least one of the companies in the group must do so and the business of the group as a whole cannot consist (wholly or as to a substantial part) in carrying on non-qualifying activities. Non-qualifying activities are any other activities other than trading and any trade that is an excluded activity. Such excluded trades include property development, dealing, farming, legal and accountancy services etc.

Company share option plans ("CSOP")

An alternative to the EMI is to grant options under a CSOP. Finance Bill 2014 is set to substantially change the way in which a CSOP scheme is registered and maintained. From the 6 April 2014 employers will be required to self-certify that their scheme meets the qualifying conditions of a CSOP and register the scheme online for the purpose of submitting annual returns.

It is hoped this will reduce the administrative burden previously associated with establishing and operating a COSP.

- An individual cannot hold unexercised CSOP options or shares with a total value over £30,000 (significantly less than EMI). The options must be granted with an exercise price approximately equal to the market value of the shares on the grant of the option (so they are less flexible than EMI);
- CSOP options have the same advantages as EMI in that, on exercise of the option, no income tax will arise;
- To obtain the tax relief the individual must be a full time officer or employee of the company and cannot have more than 25% of the share capital of the company or be entitled to more than 25% of the assets on winding-up;
- The options cannot generally be exercisable within the first 3 years of grant, but must be exercised within 10 years of grant if an income tax charge is to be avoided. The option holder will therefore have a 7 year window in which to acquire their shares (so, again, considerably less flexible than an EMI scheme). It will also, therefore, be important to ensure that options are granted at least 3 years before any sale or float of the company;
- Assuming the employee exercises the option without triggering an income tax charge, the only tax to be charged will be capital gains tax when the employee decides to sell the shares. To calculate the capital gain, one simply takes the sale proceeds of the shares and deducts the purchase cost;
- Generally, CSOP options are not used where EMI is available, as they are more costly, less flexible and less attractive from a tax point of view.

Unapproved employee share option schemes

An unapproved option scheme is any scheme involving the granting of share options to employees that does not meet the qualifying conditions of one of the HMRC approved schemes.

There is usually no charge to income tax on the grant of an option under an unapproved share option scheme, however there will always be a charge on the exercise of those options. To summarise the tax treatment:

- On the exercise of an unapproved option, the employee will face an income tax charge based on the market value of the shares at the time of exercise, less any amount paid for the options and on exercise (if anything);
- In contrast with an approved scheme, the tax charge arises in the year of exercise of an option and not on the subsequent disposal of the shares. This means that the employee may not have the funds to pay the income tax liability arising;
- If the amount paid on exercise of the option is at least equal to the then market value of the shares (less the amount paid on the grant) there is no tax charge, since full value will have been paid;
- In any event, paying full market value on exercise means that the employee only benefits from any subsequent increase in value of the shares after the exercise of the option and not on any increase in value during the period between the grant and exercise date;
- An employee will usually be subject to capital gains tax on the disposal of the shares in the normal way. The amount of the chargeable gain is the difference between the disposal proceeds and the price paid or, if greater, the market value used in calculating the income tax charge on exercise.

National Insurance Contributions and PAYE

So far we have only considered the income tax and capital gains tax implications of providing shares to employees. However, it should be noted that there may be National Insurance Contributions ("NICs") to consider, as well as an obligation for the employer to collect any income tax due via the PAYE scheme (as opposed to through the self-assessment regime).

Whether NICs are payable and income tax needs to be collected via PAYE will be dependent on whether the shares in question represent 'readily convertible assets'. Readily convertible means that it is easy for the employee to turn these assets into cash overnight. For shares, this will usually mean that a market exists for the shares, i.e. the employee could quickly sell them if they so wished.

When shares which are readily convertible assets (or treated as such) are gifted by a company to one of its employees, the market value of the shares is treated as PAYE income from the employment at the date of the gift. This amount is entered on
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to the PAYE deductions working sheet by the employer.

As for PAYE, if the shares are readily convertible assets they will be regarded as earnings for Class 1 NICs purposes so the employee will be liable for Class 1 primary NICs. Any employee NICs due in respect of the shares should be deducted from cash payments to the employee in the same month. If there is insufficient cash pay, the NICs due can be collected from subsequent cash payments made in the same or the following tax year. Similarly, payment in the form of a readily convertible asset will also constitute earnings for Class 1 secondary NICs purposes (employers’ NICs). There will always be a Class 1 secondary NICs charge on the employer at the full rate because there is no reduced rate for employers’ contributions. An award of unquoted shares which are not readily convertible assets will not be regarded as earnings for NICs purposes and will not give rise to a Class 1 NICs charge in the hands of either the employee or the employer.

**Accounting treatment and corporation tax deduction**
The granting of an option will give rise to a charge to the profit and loss account. The value of the options (not the shares) on grant will need to be valued using an option pricing model. The value of the options is then charged to the profit and loss account over the period of the likely vesting period. There is, however, no further charge to the profit and loss account on the exercise of the option.

The corporation tax position is somewhat different. On the exercise of the options (be they approved or unapproved) there will generally be a corporation tax deduction on the difference between the market value on exercise and the amount paid for the shares. This corporation tax deduction is also available where shares are directly issued to an employee or director at an undervalue, without using an option mechanism. However, it should be noted that there are detailed conditions that need to be met to obtain the corporation tax relief.

There are complex tax rules that apply to share incentives and there are important company law requirements to observe. The above notes are intended to only be a summary of the main alternatives available. Further, more detailed advice will always be required before implementing any form of share incentive.

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