

Your World First

C/M/S/

Law.Tax

Employee share schemes

5.6631

9.3334

4.25647

7.2235

Introduction

Employee share schemes were originally generally limited to listed companies. However, over the 20 years or so, tax and other developments have made these arrangements far more accessible to private companies as well.

Companies want to implement employee share schemes for a number of reasons. While each company is different, most wish to give employees some share in the growth in value of a company. This brochure sets out some common arrangements, most of which can be tailored to a company's individual needs.

Tax is never far from being an issue here and relevant points are dealt with throughout as well as summarised at the end of this brochure. Broadly, capital gains treatment leads to gains being taxed at no more than 20% (but they can be taxed at 10% or possibly not be taxed at all). This is in contrast to income tax treatment at rates of up to 45% with National Insurance contributions payable on top. This brochure therefore focuses on those arrangements which offer capital gains tax opportunities.

Despite the tax benefits on offer, some companies may be deterred from putting in place an employee share scheme by perceived difficulties such as continued control of the company and dilution, dealing with leavers, limiting the value to be shared with employees and lack of an available market to convert private company shares into cash. This brochure discusses some possible solutions here.

Share option schemes

Share option schemes remain the most commonly used type of employee share scheme for private companies.

Under these schemes the employee is given a right (the option) to buy shares at some time in the future. If the employee chooses to exercise that right, he will normally have to pay to do so (i.e. pay an exercise price); the price will have been fixed at the time the option was granted, and will usually be the market price of the shares at that time.

From the employee's point of view, an option has the advantage that although they will have the opportunity to participate fully in any growth in value of the shares, they are not exposed to any risk of loss while the option is unexercised.

From the employer's perspective, options are attractive because if employees leave before exercise, the options can simply lapse, so employers are spared from having to introduce some procedure to reclaim the shares. Optionholders have no dividend or voting rights until options are exercised. Options can also contain provisions which prevent exercise until performance targets are met.

The requirement to meet performance conditions before options can be exercised is a common feature of many option schemes. Another usual precondition is that the employee must be in employment at the time of exercise. Exceptions are often made for employees who leave through no fault of their own, e.g. death, injury, disability, redundancy, retirement or sale of the part of the business in which they have worked (so-called 'good' leavers).

Option schemes are either tax advantaged or not tax-advantaged. The most attractive arrangements are Enterprise Management Incentive Options (EMI), but other schemes are Company Share Option Plans (CSOP) and Save as You Earn Schemes (SAYE).

Following changes in April 2014, no scheme now has to be pre-approved by HMRC, which should help reduce the implementation costs and timetable.

Enterprise management incentive options

Enterprise Management Incentive (EMI) options enable trading companies (who are not controlled by another company, whose gross assets do not exceed £30 million and have fewer than 250 full time equivalent employees) to grant tax advantaged options to selected employees. EMI options over more than £3 million worth of shares (calculated at the date of each option grant) must not be outstanding at any one time.

The problem here is that many private companies may fail the first test of independence if they are private equity-owned but, if these and other conditions can be satisfied, an employee is able to hold options over shares worth up to £250,000 (calculated at the time of grant).

An employee can also only be granted an option if he is required to work for the company (or group) for at least 25 hours a week or, if less, 75 per cent of his working time. Companies may not grant EMI options if they engage in certain types of business, e.g. property, leasing or certain financial services.

If EMI options can be granted, there will normally be no income tax charge or NICs due when EMI options are exercised (however long the options have been held). However, it is possible to grant EMI options with an exercise price below the market value of the shares on the date of grant, when any discount will be subject to income tax (and possibly NICs) when the option is exercised.

When the shares are sold, the employee will have to pay capital gains tax on his gain. Capital gains tax is payable, broadly, at a rate of 10% (for basic rate taxpayers or 20% for taxpayers at higher rates). However, entrepreneurs' relief reduces the rate paid by higher/additional rate taxpayers to 10% where there is a sale of shares where the shares and/or option have collectively been held for 12 months or more at the time of sale (see the section on UK Tax in this brochure for more details).

This is generally seen as the most favourable/risk-free scheme available with employees being able to receive capital gains tax treatment yet often not acquire their shares until just before an exit. Companies also receive corporation tax relief against their profits for any gains which employees make on exercise of their options.

Company share option plans

Under a Company Share Option Plan (CSOP), an employee is granted an option to acquire shares with an exercise price at or above the market value at the date of grant. The maximum value of the shares under CSOP options for any one employee is £30,000, which means that such options alone are rarely sufficiently motivating for senior executives. EMI options will almost always be preferable if they can be granted, and the CSOP, like EMI, requires the company not to be controlled by another company, which makes many private-equity owned companies ineligible for the scheme.

The company has discretion to select which employees may participate and may impose performance conditions which must be met before options can be exercised.

There is no tax or NIC charge on exercise of a CSOP option, provided the option has been held for three years or is being exercised by a 'good' leaver or on a cash takeover. On sale of the option shares, there will be a capital gains tax charge on the amount by which the sale proceeds exceed the exercise price. The capital gains tax treatment for CSOP options is the same as for an EMI option except that there is no relaxing of the qualifying requirements for entrepreneurs' relief in the case of CSOP options.

SAYE schemes

Under a save-as-you-earn ('SAYE' or 'Sharesave') scheme, an employee is granted an option to acquire shares in the company at a discount of up to 20 per cent of the market value of the shares at the date of grant. Once again, though, companies in which the options are granted cannot be owned by another company, which means that many private equity-owned companies cannot use this scheme.

Unlike EMIs and CSOPs, participation under an SAYE scheme must be available to all employees, subject to a qualifying period of service which cannot be more than five years. The grant of the option is conditional on the employee taking out a linked savings arrangement with a bank or building society to save the option exercise price. Option holders save up to £500 per month from salary. Options are normally exercisable for six months after three or five years after grant.

There is no tax liability on the exercise of an SAYE option if it is exercised more than three years after the date of grant. Broadly, there is no tax liability if an SAYE option is exercised within three years of grant because the option holder is a 'good' leaver or in the event of a cash takeover. Further, because of the smaller gains which are typically realised on SAYE options and the fact that most employees will not have other capital gains, the annual capital gains tax exemption means that many employees pay no tax at all on SAYE option gains.

Savings have to be kept in the interim by a bank or building society and the administration costs of this scheme, as well as the company independence requirement, make these schemes generally unappealing for privately-owned companies.

Non-tax advantaged share option schemes

If options are granted under a non-tax advantaged scheme, none of the restrictions above will apply (shares can even be awarded for free), but the employee will suffer an income tax and NIC charge on exercise on the market value of the shares acquired less the exercise price.

No tax-free exercise is possible and the income tax due will probably have to be paid by the employer to the HMRC under PAYE. It is normal for shares to be sold to meet this liability and for the scheme rules to provide that this will automatically happen so that the employer is not left with an unfunded liability. Accordingly, given that the employee is likely to have to sell shares to pay his exercise price and the income tax and NICs due, a large percentage of the shares under option will usually have to be sold, but that presupposes that there is a buyer for the shares. On a sale of the company that may not be a problem, but in other cases, the need to find tax as well as an exercise price is frequently a deterrent to using this type of arrangement.

Unlike in the case of a tax-advantaged scheme, NICs will usually be payable on the gain on exercise. Employers can however require employees to bear the employers' NICs.

The ultimate sale of the shares may lead to a charge to capital gains tax, subject to the availability of the annual exemption. The gain will be the amount by which the sale proceeds exceed the market value of the shares at exercise. Accordingly, if the shares are sold at or shortly after exercise there is unlikely to be a capital gains tax charge.

These plans have no tax advantage over cash payments, but still have many of the badges of a share scheme and so can be attractive on that basis alone.

Share arrangements

Unlike the previous arrangements which involve employees being granted rights to acquire shares rather than shares themselves, the following arrangements involve employees owning shares or part interests in shares from the outset.

Outright share ownership

There is much to be said for the simplicity of arrangements where employees just acquire shares outright without any special terms, though few companies would not want leaver terms and employees might need reassurance that they will be able to sell shares if they are to make a substantial investment. These share arrangements could include a separate class of shares, which would probably require the articles of association of the company to be amended. These will set out any voting, income, capital and other rights attaching to the shares. For tax reasons these terms need to be set out in the articles rather than a side agreement.

In order to avoid leaver issues, employees will normally be required to transfer their shares (for example, to an employee benefit trust or other shareholder) if they leave employment. The price leavers receive will normally depend on whether the employee is a 'good' leaver or a 'bad' leaver.

Most companies who wish to explore employee share schemes want more structured arrangements, however.

Nominee arrangements

The common concerns of having numerous individual employee shareholders affecting dilution and control and creating potential issues on an exit, as well as many of the administrative and other problems in the event of leaving employment, can all be addressed by having nominee arrangements in place.

Under nominee arrangements, employees own the shares and pay to acquire them but the legal title to the shares is held by a nominee chosen by the company (often the trustee of an employee benefit trust). The benefit of this approach is that it enables employees to be awarded shares upfront, thereby allowing gains on shares within the capital gains tax regime, including the

possibility of entrepreneurs' relief. It also enables the company to retain a degree of control and avoid administrative difficulties mentioned above as the nominee will often have the powers such as voting rights as well as the power to sell the shares and sign documentation without having to consult employees at the time of sale.

Growth share arrangements

Growth share arrangements are designed to enable employees to receive capital gains tax rather than income tax treatment on any share gains for a very small upfront outlay. They have become popular over the last few years and have a number of different names – including 'hurdle shares' or 'flowering shares'.

In most circumstances, the arrangements need a new class of shares which are issued to employees. Typically these allow the employee on an exit to receive the increase in the value of the shares after they have been issued (rather than a pro-rata share of the company's value at that point, as would normally be the case). For example, if the growth shares are issued when the company's other shares are worth 10p and the company is sold when those shares are worth 60p, the growth shares would only receive 50p per share.

To avoid an up-front income tax and NIC charge, employees will need to pay full market value for their shares. Determining the market value of the shares at acquisition is therefore very important. Growth shares will often have a relatively low market value on acquisition because the value of the company must increase, possibly above pre-determined thresholds, for the growth shares to have any value. The value of the growth shares may only be agreed with HMRC some time after they have been acquired. To prevent surprises, companies often consult professional valuers in advance.

Joint share ownership arrangements

This is mostly for quoted companies, where EMI option tax treatment cannot be obtained and where a separate class of growth shares is not possible. In economic terms, the arrangements are similar to a market value option or growth shares described above, with the employee receiving just the growth in value of the shares.

Under this arrangement the employee jointly acquires shares with an employee benefit trust. The employee trust is entitled on sale of the shares to the value of the shares at the time they were jointly acquired (plus a small annual increase) with the employee being entitled to the subsequent growth in value of the shares. For example, say the value of a share at the outset was 10p and the value at the time of sale was 60p, then the trust would receive 10p (plus a small amount) and the employee would receive 50p (less a small amount). The employee must pay for his interest but given that his interest is all hope value this up-front payment will often be relatively low while the potential gains can be significant and, most importantly, subject to capital gains tax.

There is no limit on the size of an individual award under a joint share ownership plan or the collective number of awards that can be made. The plan can be implemented on its own or in conjunction with other arrangements. For example, it can be used as a way of providing annual bonuses in a more tax efficient manner.

Share incentive plan

This scheme is a bit of a hybrid. A share incentive plan (SIP) offers employees the opportunity to acquire shares outright (and so it is not an option scheme). This is also an 'all-employee' scheme, and so it cannot be established on a selective basis (although a qualifying period of employment can be imposed). Companies are also not able to establish a SIP if they are under the control of another company, and SIPs are expensive to run, not least because they need to comply with relatively detailed HMRC requirements.

Four types of share award can be made to employees under a SIP, in each case free of tax and NICs on acquisition:

- Up to £3,600 per annum worth of 'free shares' can be given to employees.
- Employees can buy up to £1,800 per annum of 'partnership shares' out of their pre-tax salary.
- Employers can give up to two free 'matching shares' for each partnership share which an employee buys.
- Dividends received on shares in the plan are tax-free if those dividends are used to acquire additional 'dividend shares'.

Shares received under a SIP will usually only be totally tax-free if they are held in the plan for at least five years. If the shares cease to be subject to the plan at an earlier date (and they will do so automatically if the employee leaves), there will usually be a tax charge unless the employee is a 'good' leaver. The amount taxable will depend upon the date of withdrawal. PAYE may have to be operated and NICs paid.

So, while the scheme offers good tax breaks, it may not be available to many private-equity owned companies and the need to offer it on an all-employee basis and the cost of doing so will also be discouraging factors.

UK tax

Employee taxation

Broadly, there are two regimes to consider for employees – income tax and NICs on the one hand and capital gains tax on the other.

Income tax and NICs

Gains on the exercise of share options and gifts of free or discounted shares are subject to income tax (at 20%, 40% or 45% depending on whether the employee is a basic rate, higher rate or additional rate taxpayer) unless acquired under a tax advantaged scheme. Accordingly, where an employee acquires shares, it will be necessary to check that he is not paying less than market value for those shares. Equally where shares are sold, no more than market value must be received. Valuation advice will therefore often be needed (if income tax and NIC is to be avoided).

Income tax generally has to be accounted for and paid over by the employer to HMRC under PAYE.

Where an income tax liability arises, there will generally also be a liability to NICs, although these will usually be avoided under tax advantaged schemes. Two types of NICs are payable:

- Employees' NICs are deducted from remuneration. NICs are payable at 12% on earnings at the basic rate while all earnings above the basic rate are subject to a 2% rate.
- Employer's NICs are payable by the employing company at a rate of 13.8%. Companies with sufficiently large payrolls will also have to pay a 0.5% apprenticeship levy.

The above assumes that the shares concerned can be traded or that trading arrangements are likely to come into existence for the shares in due course. Where this is not the case, it may be the responsibility of the employee rather than the employer to account for any income tax due (and no NICs may be payable by either employee or employer).

Capital gains tax

A gain on the sale of a share will usually not be subject to income tax but instead to capital gains tax on the difference between the sale proceeds and the acquisition price. Capital gains tax is payable at a rate of 10% or 20% depending on whether the individual is a basic rate or a higher/additional rate taxpayer. The rate paid by higher/additional rate taxpayers can be reduced to 10% in cases where the individual qualifies for entrepreneurs' relief.

Entrepreneurs' relief applies where an employee or director of a trading company has owned at least 5% of the voting rights and nominal value of a company's shares for at least a year (though where the shares result from EMI options, there is no minimum shareholding requirement and the 12 month qualifying period relates to holding the option and/or the shares).

Other reductions are also available including an annual exemption of £11,300 (for the 2017-18 tax year) and tax-neutral transfers of shares to spouses who may then realise gains at a lower tax rate or shelter gains using their annual exemption.

All in all, this makes capital gains tax a far more favourable regime than income tax.

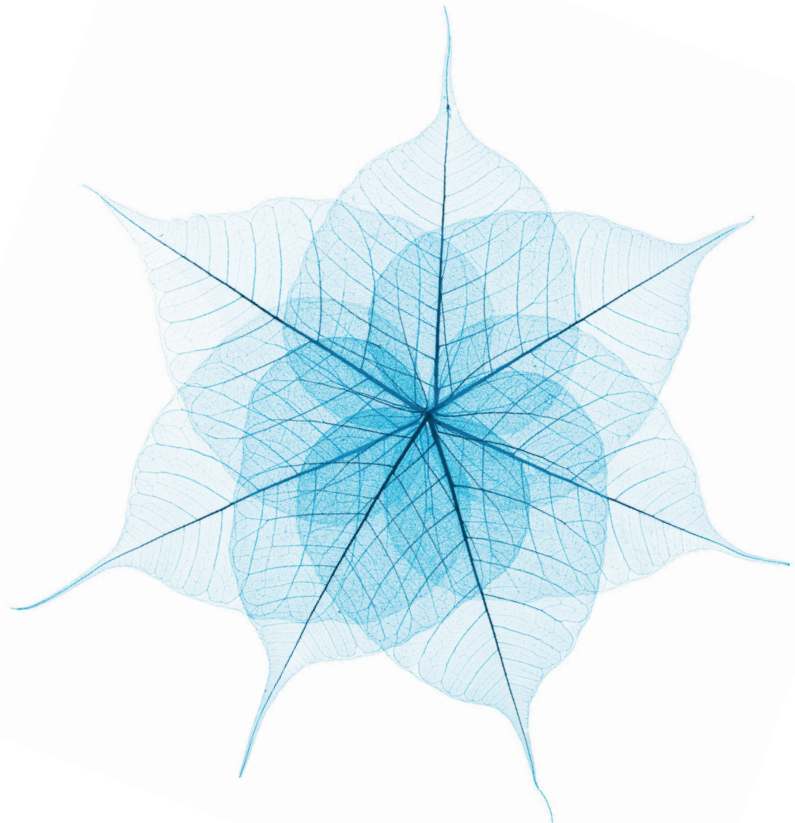
Company taxation

Where an income tax charge arises on exercise of an option, the employing company will normally have to pay employer's NICs on the taxable amount. Currently, employer's NICs are payable at 13.8%. Companies with sufficiently large payrolls will also have to pay a 0.5% apprenticeship levy. However, an employer can, with the agreement of the employee transfer the employer's NICs liability to the employee. Tax-advantaged and capital gains schemes generally avoid this charge, which can make them very cost-effective.

Companies are also able to obtain a tax deduction for some employee share schemes. The employing company can receive a deduction equal to the gain made by the employee on the exercise of a share option. A deduction is also available for shares awarded under SIPs, but the tax relief is limited to the value of the shares at the time those shares are put into the SIP trust. A deduction is not available in other schemes. Given the gains that can arise on some employee share schemes, this can be a very valuable benefit for the company.

Accounting implications

This is not strictly tax, and the details of the relevant reporting standards are beyond the scope of this brochure, but companies will need to consider the accounting issues further when implementing employee share schemes.



Other points to consider

Employee trusts

There are several reasons for using an employee trust:

- It may be used to acquire shares from other shareholders and make those shares available to employees rather than issuing new shares, thereby avoiding the dilution of existing shareholders' interests.
- An employee trust may also effectively act as a market maker in shares and give liquidity. This is particularly valuable for a private company, where there is no ready market in which the employees are able to dispose of their shares. The trust can also act as a "warehouse", holding shares which may be allocated to employees in the future.
- Trusts are also necessary for some schemes to operate – e.g. jointly owned share arrangements and SIPs.

Trusts may be funded by a mixture of gifts and loans from employing companies. Loans are commonly interest-free, but on terms that the trusts waive dividends on shares they hold.

Other than where a trust is required in connection with a SIP, employee trusts are normally located for tax purposes outside the UK, usually in the Channel Islands or in another low or no-tax jurisdiction. This is to avoid capital gains tax arising on the trustees' disposal of shares. Professional trustee companies are usually used. Whilst the trustees are independent, and have complete discretion as to how to act, they in practice take account of employing companies' wishes.

Cash schemes

Finally, in some cases, a share scheme is simply not available and cash is the only answer to a company's incentivisation needs. This may include where the implementation costs of a scheme are too high or employees will not pay anything for their shares.

A phantom share arrangement is a cash bonus tied to an increase in the value of shares in the company, without giving the employee an interest in any actual shares.

None of the tax benefits of tax advantaged schemes are available for phantom schemes and the cash payment is subject to deduction of income tax and NICs under the PAYE system (although a corporation tax deduction will normally be available for the cash paid).

Our experience

The team has extensive experience of devising and delivering the most attractive schemes to ensure effective reward and retention, for example, setting up or changing the terms of share schemes including share option schemes, long term incentive plans, bonus plans and other bespoke tailored arrangements.

Our core team is:



Nicholas Stretch

Partner

T +44 (0)20 7367 2862

E nicholas.stretch@cms-cmno.com



The 'personable' Nicholas Stretch is consistently praised for his technical expertise.

[The Legal 500](#)



Graham Muir

Partner

T +44 (0)20 7524 6917

E graham.muir@cms-cmno.com



Graham Muir has 'excellent knowledge' of share schemes and their tax implications.

[Chambers and Partners](#)



Andrew Quayle

Partner

T +44 (0)20 7067 3739

E andrew.quayle@cms-cmno.com



Andrew has a 'wealth of experience of implementing employee share incentive plans'.

[The Legal 500](#)



Catherine Merry

Of Counsel

T +44 (0)20 7067 3363

E catherine.merry@cms-cmno.com



The Employee Share Schemes team at CMS has the technical expertise as well as the commercial and practical experience to handle all employee incentives related matters.



Law . Tax

Your free online legal information service.

A subscription service for legal articles
on a variety of topics delivered by email.
cms-lawnow.com



Law . Tax

Your expert legal publications online.

In-depth international legal research
and insights that can be personalised.
eguides.cmslegal.com

CMS Cameron McKenna Nabarro Olswang LLP
Cannon Place
78 Cannon Street
London EC4N 6AF

T +44 (0)20 7367 3000
F +44 (0)20 7367 2000

The information held in this publication is for general purposes and guidance only and does not purport to constitute legal or professional advice.

CMS Cameron McKenna Nabarro Olswang LLP is a limited liability partnership registered in England and Wales with registration number OC310335. It is a body corporate which uses the word "partner" to refer to a member, or an employee or consultant with equivalent standing and qualifications. It is authorised and regulated by the Solicitors Regulation Authority of England and Wales with SRA number 423370 and by the Law Society of Scotland with registered number 47313. It is able to provide international legal services to clients utilising, where appropriate, the services of its associated international offices. The associated international offices of CMS Cameron McKenna Nabarro Olswang LLP are separate and distinct from it. A list of members and their professional qualifications is open to inspection at the registered office, Cannon Place, 78 Cannon Street, London EC4N 6AF. Members are either solicitors or registered foreign lawyers. VAT registration number: 974 899 925. Further information about the firm can be found at cms.law

© CMS Cameron McKenna Nabarro Olswang LLP

CMS Cameron McKenna Nabarro Olswang LLP is a member of CMS Legal Services EEIG (CMS EEIG), a European Economic Interest Grouping that coordinates an organisation of independent law firms. CMS EEIG provides no client services. Such services are solely provided by CMS EEIG's member firms in their respective jurisdictions. CMS EEIG and each of its member firms are separate and legally distinct entities, and no such entity has any authority to bind any other. CMS EEIG and each member firm are liable only for their own acts or omissions and not those of each other. The brand name "CMS" and the term "firm" are used to refer to some or all of the member firms or their offices. Further information can be found at cms.law