Employee share schemes

General
A company’s desire to give or sell shares to its employees may arise from a variety of objectives which can include:

• Incentivising employees to achieve better performance;
• Attracting and retaining staff, particularly in start-up situations where companies have insufficient funds to provide adequate salaries;
• Enhancing remuneration packages where this can be achieved tax efficiently;
• Succession planning for major shareholders;
• Raising equity funding, particularly in management/employee buy outs.

Why use a share scheme?
The outright gift of shares to an employee at less than market value constitutes taxable remuneration in the hands of the employee. The taxable amount is calculated as the difference between the market value of the company’s shares and the price (if any) paid for them and this will be subject to both PAYE and NIC if the shares are tradable.

This can mean that the employee has received shares on which he has to pay tax, but if he doesn’t have the cash to settle the tax liability he might have to sell some of his shares to do so.

A more tax efficient way of achieving the transfer of shares to employees is to use one of the four main types of share scheme:

1. Approved share option scheme (CSOP);
2. Unapproved share option scheme;
3. Enterprise management incentives (EMI);
4. Share incentive plans (SIPs).

The first three involve the use of share options. The fourth involves the employer giving a fixed number of shares free of tax and NIC.

What is a share option?
A share option is a right to buy:

• A set number of shares in a company;
• At a fixed price;
• During a set period of time.

Unapproved Share Option Schemes

Background
With an unapproved share option scheme, employees are given options to acquire a number of shares at a future date at any price specified by the company. Such schemes do not require HM Revenue & Customs (HMRC) approval, and the ability to exercise the options may be governed by performance targets.

Qualifying individuals
There is no requirement for all employees to be granted options and the scheme can be set up on a selective basis for certain individuals only.

Tax Treatment
As long as the option has to be exercised within 10 years of its grant, there will be no tax or national insurance charge when the option is granted.

On the exercise of the option there will be an income tax liability on the difference between the market value of the shares at that date, and the price paid for them.

On the disposal of the shares, the capital gain is calculated by comparing the disposal proceeds to the market value of the shares when the options were exercised.

There will be no national insurance charge on the grant or exercise of an option as long as the shares over which the options are granted, are not readily convertible into cash, which means there are no arrangements by which the shares’ value can be realised with certainty.

On exercise, the company will obtain a corporation tax deduction for the difference between the market value of the shares at that time less any amount paid by the employee for the shares.

Approved Share Option Scheme (CSOP)

Background
An approved, or “executive” share option scheme, as the name suggests, requires HMRC approval and as such, the rules of the scheme must fall within the HMRC guidelines. They are particularly suitable for family or owner-managed companies because only selected employees need be included.

These schemes operate by granting the participants options to purchase shares in the company at a later date, but with the price fixed at the outset, which is usually the market value of the shares at the date the options are granted.
The granting of options can be made dependent upon the achievement of specific performance targets, but the total value of share options held by a participant at any time cannot exceed £30,000 (based on the market value of the shares at the date the options were granted).

Options can be exercised at any time between three and ten years after they have been granted.

**Qualifying Individual**
An employee will be eligible to participate in an approved share option scheme if they work for at least 25 hours per week, and do not own more than 25% of the share capital.

**Tax Treatment**
There is no tax or national insurance charge on the grant of the share option or on its subsequent exercise.

On the disposal of the shares, the capital gain is calculated by comparing the disposal proceeds, to the price paid for the shares when the options were exercised.

On exercise, the company will obtain a corporation tax deduction for the difference between the market value of the shares at that time less any amount paid by the employee for the shares.

The main difference between the approved and unapproved schemes is that with an approved scheme there are no tax implications for the employee when the options are exercised – the tax charge is deferred until the shares are disposed of at which point the employee should have the cash to meet the tax liability.

**Enterprise Management Incentives**
**Background**
Enterprise Management Incentives (EMI) are intended to help smaller companies with potential for growth to recruit and retain high calibre employees and to reward employees for taking a risk by investing their time and skills in helping small companies to achieve their potential.

Available to small high risk independent trading companies which are not under the control of any other company, and whose gross assets do not exceed £30m.

There is no limit on the number of key employees that can be given options to acquire shares in the company, at, or less than, the market value of the shares at the date the options are given to them. The total value of the options given to each employee cannot exceed £250,000 (£120,000 up to 16 June 2012), with an overall total of £3,000,000; and they must be exercised within 10 years.

Voting restrictions can be placed over the shares subject to options to protect the owner-managers’ position.

The company can choose exactly who receives the option (subject to the material interest barrier) and they can be granted conditionally subject to performance criteria.

The company must notify HMRC within 92 days of the options being granted and the market value of the shares has to be agreed with the HMRC - Shares & Asset Valuation Division.

Formal HMRC approval is not required, but it is possible to obtain advance clearance that the company (not the employees) will meet the EMI qualifying requirements.

**Qualifying Individual**
An employee will be eligible for EMI options if they are employed by the company for at least 25 hours a week, or if less, for at least 75% of their working time, and do not own more than 30% of the share capital.

**Tax Treatment**
There is no tax or national insurance charge on the grant of the share option. Similarly, there will be no tax or national insurance charge on the exercise of an option unless the option was granted at less than market value, in which case there will be charge to income tax on the difference (collected through the PAYE system).

When the shares are sold, any capital gain arising will qualify for Entrepreneur’s Relief, provided the employee owns at least 5% of the issuing company’s share capital, and has done so for at least a year.

On exercise, the company will obtain a corporation tax deduction for the difference between the market value of the shares at that time less any amount paid by the employee for the shares.
Share Incentive Plans

Background
A Share Incentive Plan (SIP) is designed to be flexible so that all employees can participate and employers can reward specific performance. Shares acquired under the plan have to be held in a UK resident trust to ensure the independent legal ownership of the shares.

Employers can give employees up to £3,000 of shares each year free of tax and national insurance ("free" shares). Some or all can be awarded based on performance targets.

Employees can buy up to £1,500 of shares out of their pre-tax and pre-NIC salary ("partnership" shares).

Employers will be able to match partnership shares by giving employees up to two further free shares for each partnership share ("matching" shares) up to a maximum of £3,000.

Up to £1,500 of dividends may be reinvested in shares tax-free each year.

Shares must leave the plan when the employees leave their job. The company can decide whether employees lose their free shares if they leave within 3 years.

The company will obtain corporation tax relief for the costs they incur in providing shares and also for the market value of the free and any matching shares given to the employee.

Qualifying individual
The company must offer all employees the opportunity to participate in the plan whether they work full or part-time, although a minimum period of employment can be specified before an employee can qualify (this cannot exceed 18 months).

Tax Treatment
Employees who keep their shares in the plan until they are sold will have no capital gains tax to pay on sale. If they take the shares out and sell them later then there will only be a charge to capital gains tax on any increase in the value of the shares after they have been taken out of the plan.

Which Scheme?
Because HMRC approval is not required, Unapproved Share Option Schemes provide maximum flexibility along with the ability to individually tailor the rules of the scheme to meet the company’s particular requirements; the exercise price can be set below the market value of the shares, which gives immediate value to the option. There is, however, an income tax liability when the option is exercised, which may mean the employee has to sell some of the shares just acquired in order to meet this liability; although in some cases, the employer will pay the employee a bonus sufficient to fund the income tax liability.

By way of contrast, Approved Share Option Schemes are much less flexible because they have to meet certain statutory requirement. The exercise price of the shares cannot be less than the market value and there is a £30,000 limit on the value of the options that can be held by an individual at any one time. The main advantage of approved schemes is that there is no tax charge when the option is exercised – the only tax charge arises when the share are sold which means the employee will have cash to meet the tax liability.

Also, the increase in value of the shares between the granting and exercise of the option, which is subject to an immediate income tax charge with an unapproved scheme, is effectively taxed as a capital gain when the shares are sold, against which the individual can utilise his annual capital gains tax exemption.

The Enterprise Management Incentive Scheme (EMI) is highly tax advantageous because there is no tax or national insurance when the share options are granted or exercised. Capital gains on EMI option shares are likely to incur a maximum Capital Gains Tax (CGT) rate of 28% (after deducting the annual exemption). The lower 18% CGT rate would only apply if the employee has not used their basic rate income tax band (unless the employee holds at least 5% of the issuing company’s share capital and does so for at least a year, they will not benefit from the 10% Entrepreneur’s Relief CGT).
However an exit rate of 28%/18% is still considerably cheaper than the combined income tax/NIC on a cash-based employee bonus. In particular, with an EMI, the exercise price can be less than market value, which means options can be issued at the discounting, giving them immediate value.

This is not possible under an approved scheme, and means the share options granted under an EMI enjoy some of the tax reliefs associated with an approved scheme but some of the flexibility associated with an unapproved scheme. The EMI scheme, while highly attractive, is limited to selected employees.

For those companies that want to involve all employees in share ownership a Share Incentive Plan would be more appropriate. Under previous tax approved all employee share schemes, share awards had to be on a similar basis to all employees. The advantage of this scheme is that companies have flexibility in the way they reward employees with free shares in return for achieving performance targets, however because they do require considerable administration, such schemes have tended to be used mainly by quoted companies.

What if a share scheme is not appropriate?
Share option schemes are often more suitable for dynamic companies which are likely to be sold at some point in the future – employees who are offered options in family or owner-managed companies may not consider them to be of any real value if the business is simply to be passed on to the next generation; and existing shareholders may resist a fragmented share ownership. There is also the very real risk of falling share values.

Companies that decide that employee share ownership is not right for them might instead choose to set up a **phantom share options scheme** where employees are paid cash bonuses linked to increases in the company’s share value. The employees will however miss out on tax benefits associated with the approved and unapproved schemes, but this may be the only option where the owners do not want wider employee share ownership.

Long-Term Incentive Plan (L-TIP) alternative
Under traditional share option schemes, employees are given options to acquire shares at a certain price, and the benefit to them is the increase in share price over the option period. Under an L-TIP, shares are appropriated to employees at nil or nominal cost, but are held in reserve, usually in a trust, until satisfaction of certain performance targets at which point employer will take full ownership. The employee therefore benefits from the full value of the shares rather than the growth over the option period.

There is no income tax chargeable on the shares initially appropriated, because the employee does not take ownership of them, but there will be charge based on the market value of the shares as soon as the conditions are met and the shares are released to employees. There are no real tax advantages to an L-TIP but they do provide a strong incentive for employees to remain with the company.

How can we help?
Scott-Moncrieff can assist with initial advice on appropriate share schemes, agreeing of share valuations and registering of the shares with HM Revenue & Customs.

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