EMPLOYEE SHARE SCHEMES

A technical outline of the tax planning opportunities
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INDEX:

INTRODUCTION

This report will consider the various ways of providing shares to employees, comparing the advantages and disadvantages of each type of scheme.

This is not intended to be an exhaustive treatment of the subject but to highlight a number of issues that crop up in practice with suggested solutions where appropriate.

It is assumed that the basic rules are understood by practitioners but for completeness we have included extracts from HMRC manuals and legislation which practitioners may find useful. We have also included some commentary on the basic principles so that the later commentary can be more readily understood.

This is intended to focus on the types of scheme that are appropriate for smaller owner managed businesses and therefore only brief mention will be made of those schemes that are more appropriate for larger companies.

Statutory references are to ITEPA 2003 unless otherwise stated.

BASIC PRINCIPLES

1. Introduction

The tax legislation governing employee share schemes has evolved over the years and changes continue to be relatively frequent.

The last major rewrite took place in 2003 with FA 2003, Sch 22. A comment at the time was that Sch 22 was as long as an entire Finance Act of a generation ago! This substantially rewrote ITEPA 2003 Part 7 (ss417-554) making the original Part 7 some of the shortest lived legislation ever, being enacted on 6 March 2003 and replaced on 10 July 2003!

The reason for the amendments is that remunerating employees in a tax efficient way is always a high priority for employers and employee share schemes have often been exploited as a way of achieving that goal.

Although this is not intended to be a detailed explanation of the basic principles it is considered that a brief explanation of some of the more important points will assist.

2. By reason of employment

The employment related securities legislation applies “to securities, or an interest in securities, acquired by a person where the right or opportunity to acquire the securities or interest is available by reason of an employment of that person or any other person.” [s421B(1)].

Employment “includes a former or prospective employment” [s421B(2)(b)].

“A right or opportunity to acquire securities or an interest in securities made available by a person's employer, or by a person connected with a person's employer, is to be regarded for the purposes of subsection (1) as available by reason of an employment of that person unless–

(a) the person by whom the right or opportunity is made available is an individual, and
(b) the right or opportunity is made available in the normal course of the domestic, family or personal relationships of that person.” [s421B(3)]

Prior to 2003, it was often argued that shares given to an employee were given in another role, perhaps as a joint founder of a company. The main purpose of the legislation was to cut away such arguments. All shares provided by an employer or a person connected with the employer are caught subject to the exemptions provided by s421B(3).

This can have wide, and perhaps unintended, consequences.

For example a business angel might agree to lend money to a company on terms that allow him to convert the loan into shares based on the market value of the shares at the time the loan was provided. He might then be appointed as a non-executive director. The company is successful and he later converts the loan into shares when the company is about to be sold at a much higher value.

Based on the above definition the shares are employment related securities. At the time of conversion he is paying less than full market value for the shares and so the increase in value is liable to income tax.

Trap

Consider the terms of any outside investment into a company carefully to ensure that the employment related securities provisions cannot create unexpected income tax liabilities.

3. Shares vs options

There are a number of issues determining the choice between giving an employee shares immediately or issuing share options.

3.1 Convenience

This is the factor favouring options. There is no immediate requirement to issue shares and there is no need for mechanisms to recover shares if an employee leaves before being able to exercise his options.

3.2 Tax costs

Unless a share option scheme is approved, there is an income tax charge on the exercise of an option based on the difference between market value at the date of **exercise** and the price paid. This generally makes unapproved share options highly unattractive.

3.3 Dividends

Issuing shares immediately allows scope for payment of dividends to employees. This is usually seen as a national insurance saving device and is discussed more fully in the section DIVIDEND PLANNING.

3.4 Entrepreneur's relief

One of the requirements of entrepreneur's relief is that an employee must hold at least 5% of a company's shares for at least 12 months.

The old taper relief rules (up to 5 April 2008) required that an employee hold his shares for at least two years to qualify for the maximum level of taper relief. However, for share options issued under an Enterprise Management Incentive scheme, there was a special rule [TCGA 1992, Sch 7D, para 15] that deemed the holding period to start when options were **granted** rather than when exercised.

However, when entrepreneur's relief replaced taper relief, no equivalent rule was introduced.

Under taper relief, an EMI option holder could delay exercising options until immediately prior to a sale and still claim maximum taper relief. Under entrepreneur's relief, an option holder must exercise options over at least 5% of a company's shares (assuming he does not already own at least 5%) at least 12 months prior to a sale.

With the capital gains tax rate at 18%, this was not a major burden. But with the increase in the capital gains tax to 28% from 23 June 2010, the attraction of EMI share options dropped even further.

3.5 Corporation tax relief

A company is entitled to claim corporation tax relief for the benefit provided to an employee when he acquires shares [CTA 2009 Part 12]. Under a share option, this benefit is provided at a much later date and so the available corporation tax relief will be significantly greater assuming the company has grown in value.

For an unapproved share option, the employee will suffer income tax on the same value for which corporation tax relief is available. However, under an approved share option such as the Enterprise Management Incentive scheme, the employee will not normally suffer any income tax and so the additional corporation tax relief is particularly attractive.

4. Share valuation

To determine the tax consequences of any proposed grant of shares or share options, it is usually necessary to determine the market value of the shares at the date of grant.

Because one is dealing with minority shareholdings, it is important to be aware of the different methods of share valuation.

For the purposes of the share scheme legislation in Part 7, market value is defined by s421. This imports the definition found in the capital gains tax legislation, in particular TCGA 1992 s273. S273(3) requires that “there is available to any prospective purchaser of the asset in question all the information which a prudent prospective purchaser of the asset might reasonably require if he were proposing to purchase it from a willing vendor by private treaty and at arm's length.”

On the other hand, a simple transfer of shares is governed by s62. This does not use the capital gains tax definition but is simply “money’s worth”.

The key difference is that money’s worth can bring into account information known to the employee receiving the shares. If the employee is senior, he is likely to have more up-to-date information than is available in the public domain. On the other hand, for minority holdings unless of very substantial value, s273 will generally only allow information in the public domain to be considered. This will, of course, include published accounts but could include press releases.

Thus, in some circumstances, the two methods of valuation can produce quite different answers.

HMRC’s commentary on this issue can be found in the Shares Valuation manual at:

http://www.hmrc.gov.uk/manuals/svmanualnew/svm109030.htm
http://www.hmrc.gov.uk/manuals/svmanualnew/svm109040.htm

Thus consider a company that has been making losses but has very recently become profitable. Latest published accounts only show losses. The valuation for Part 7 purposes may thus be very low whereas a money's worth valuation may be substantially higher. Equally a company that has historically made good profits may have started making losses and therefore the Part 7 valuation might be higher.

Therefore it may be worth considering the method of providing shares in the light of possible differences in valuation.

Where the money's worth value is high and the Part 7 value is low, two approaches are possible:

a. Use an Enterprise Management Incentive option scheme even if the intention is to exercise options quickly (perhaps because of a wish to pay dividends on shares).
b. Provide shares but make an election to use unrestricted market value under s431 (see paragraph 4 below under Share Schemes). This brings Part 7 into play.

If the Part 7 value is higher than the money's worth value the simplest approach may be to delay providing the shares until the next accounts are published at which time the Part 7 value is likely to drop.

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SHARE OPTION SCHEMES

1. Introduction

Generally share options are unattractive from a tax viewpoint unless they are granted under an approved scheme. This is because an income tax charge arises on unapproved options at the point options are exercised based on the difference between market value at the date of **exercise** and the price paid, if any. Thus if, as is often the case for unquoted companies, options are only exercised immediately prior to the sale of a company, virtually the whole profit is liable to income tax.

In contrast, under an approved scheme, there is generally no tax charge on exercise and only capital gains tax is paid when shares are sold

2. Types of approved scheme

There are three types of approved share option scheme:

a. SAYE share option schemes
b. Company share option plans
c. Enterprise Management Incentive schemes

3. SAYE share option schemes

These are not attractive for companies other than large quoted companies.

The reasons are that the scheme must be open to all employees with at least 5 years' service and the amounts of shares that can be acquired are modest.

Essentially they require that an employee saves an amount of between £5 and £250 a month in an approved account for a period of 3, 5 or 7 years at the end of which the funds can be used to exercise share options.

4. Company share option plans

These were the forerunner of the Enterprise Management Incentive schemes. Originally they allowed options to be granted to selected employees with an upper limit based on the market value of shares at the time options were granted of the higher of £100,000 or 4 times an employee's pay. However, with effect from 17 July 1995, the limit was reduced to £30,000.

Thus this type of scheme has been largely overtaken by the Enterprise Management Incentive scheme and remains useful only where a company cannot use the EMI, perhaps because its trade does not qualify. Even then the low limit is likely to mean that it is useful only to slightly larger companies that may wish to offer options to middle ranking employees.

5. Enterprise Management Incentive ("EMI") schemes

These are now generally the share option scheme of choice for small companies.

The cap on the value of options is set at £120,000 – four times the limit in a Company Share Option Plan.

The main restriction for EMI options is that the company cannot be carrying on an “excluded activity”. The list of excluded activities is found at Sch 5 para 16. It is the same list that restricts the use of the Enterprise Investment Scheme, i.e. primarily types of businesses perceived as low risk such as a range of financial activities (e.g. banks and accountancy services) and property backed trades (e.g. farming and operating hotels).

One difference between an EMI option and other approved options is that the exercise price can be set at any figure. If below market value at the date the option is granted, the difference is liable to income tax but only at the time the option is exercised.

SHARE SCHEMES

1. Introduction

Since, for reasons explained in the Basic Principles section in paragraph 3.4 above, the Enterprise Management Incentive scheme is now much less useful than it was, it is necessary to consider the alternatives.

In order to achieve eligibility for entrepreneur's relief on a disposal, an employee must hold at least 5% of the company's shares for at least 12 months [TCGA 1992 s169I(6)].

Of course, as already mentioned, if an employee already owns 5%, the need to provide shares immediately is reduced. Alternatively a combination is possible whereby an employee is provided 5% immediately with the balance by share options. However, it is probably simpler and cheaper to provide all shares by a single method.

Thus, based on the principle of qualifying for entrepreneur's relief, the requirements for an effective share scheme are:

a. Shares are acquired at an early stage.
b. No substantial upfront payment for the shares is required from the employee.
c. No income tax charges are triggered.

Below are some suggestions that satisfy these requirements.

2. Nil paid shares

2.1 Outline

i. The company issues ordinary shares to an employee that are nil paid, i.e. the employee is not required to pay for them until the company makes a call. Making the call can be delayed as long as desired. Typically it would be made immediately prior to a sale.
ii. The price is full market value at date of issue.
iii. The shares are the same class as existing, fully paid, ordinary shares.
iv. The Articles are amended, if required, to cover the rights of shares that remain unpaid, e.g. entitlement to votes, dividends, etc.
v. The Articles provide for the employee to sell the shares if he leaves employment (including a provision to sell at original issue price if still unpaid if desired).

2.2 Tax consequences

i. As the shares are issued at full market value there is no tax charge for an issue at an undervalue.
ii. Until the employee pays for the shares there is an income tax charge based on a notional loan equal to the amount unpaid under ITEPA 2003 s446Q. However, under s446S(3), no charge will arise

provided the company is a close company but not a close investment holding company.

iii. No charge arises under CTA 2010 s455 (loans to participators) until the company issues a call for the shares to be paid up.

iv. Even though the shares may be unpaid, providing they carry at least 5% of the company's voting rights (note this means that voting rights should not be completely restricted whilst the shares remain unpaid), the required holding period of one year for entrepreneur's relief purposes will start to run immediately.

2.3 Disadvantages

i. The main disadvantage of this scheme is that, if the company fails, the employee will remain liable to pay for the shares.

3. Growth shares

3.1 Outline

i. A new class of share is created that has no value at the outset but is expected to grow in value over time. There are various ways this can be structured and this is considered in paragraph 3.4 below.

ii. The Articles set out the rights of these shares but, for entrepreneur's relief purposes, it is necessary that any employee's holding confers at least 5% of the votes.

iii. The shares are issued to the employee at full market value and paid for in full. If structured correctly market value will be a nominal amount.

iv. The Articles provide a requirement to sell the shares on cessation of employment and can provide for the price to be nominal under certain conditions.

3.2 Tax consequences

i. As the shares are issued at full market value there is no tax charge for an issue at an undervalue.

ii. Provided the shares represent at least 5% of the ordinary share capital and carry at least 5% of the votes, they will qualify for entrepreneur's relief after being held for one year.

3.3 Disadvantages

i. By introducing a new class of share, this brings an added level of complexity to the company's affairs.

3.4 Structure of growth shares

There are limitless possibilities in how the growth shares are structured.

An extreme example is to give 100% of growth from date of issue to the shares. This could be achieved by stating that dividends and assets on a winding up available to the old shares are capped at a set value. This value should be no less than the current market value of the company if the growth shares are to be considered to have minimal value.

A less extreme example is to give the growth shares entitlement to dividends and assets on a winding up based on a percentage of the entitlement of the existing ordinary shares. This percentage would start at nil but would increase as certain criteria, typically based on turnover and/or profit levels, are achieved.

4. Restricted shares

It may be that a share scheme is contemplated at a time, perhaps near the beginning of a company's life, when the share value is very low. In this case, the need for nil paid shares or growth shares is unnecessary.

However, the owner may be reluctant to give employees shares outright before they have proved their abilities to contribute to the growth of the company.

In such circumstances, a possible solution is to provide employees with shares subject to certain restrictions.

Such restrictions can include forfeiture if an employee leaves within a set period or if certain performance targets are not achieved.

The taxation of restricted securities is dealt with in Part 7, Chapter 2. The rules are complex and it is not intended to cover these in detail. Applying these to the scenario above, provided the price paid by the employee for the shares when issued is at least the market value ignoring any restrictions ("UMV" or unrestricted market value) then no income tax charges apply on a later removal of restrictions or sale of shares.

The potential for income tax charges arise where the shares are provided free or at a price less than UMV. In such cases an election should be made under s431 to disapply the restricted securities rules. This will mean an immediate income tax charge arises on the difference between the price paid, if any, and UMV. But, assuming UMV is small, the absolute size of this tax cost will be modest. Going forward any profit on later sale will only be subject to capital gains tax.

Failure to make the election means that the initial income tax charge is limited to the difference between price paid and actual market value. However, if, for example, actual market value was 60% of UMV because of the restrictions, then 40% of any uplift in value either when restrictions are removed or on a sale would be liable to income tax rather than capital gains tax. Thus potentially a small extra income tax cost now can save a very large amount of tax in the future.

The time limit for making an election under s431 is only 14 days from date of grant. Where the time limit has been missed, it may be beneficial to consider removing or modifying a restriction and making an election under s430 to ignore all remaining restrictions. If done at a stage when the share value has not increased significantly, the tax cost should be modest.

DIVIDEND PLANNING

1. Introduction

A possible purpose of providing shares to employees is to allow payment of dividends in lieu of salary or bonuses. The reason is to save national insurance.

The savings are substantial.

For example, an employee on a salary of £50,000 takes home £35,610 after tax and national insurance based on 2011/12 tax rates. If, instead, his employer paid him a salary of £7,072 (the secondary threshold) and a dividend of £39,082 then, based on a corporation tax rate of 20%, the after tax cost to the company is identical. However, the employee's net income becomes £44,389, an increase of £8,780.

If the company's corporation tax rate is in the marginal band (an effective rate of 27.5% in the year to 31 March 2012), the saving in this example is still £6,032.

Note that the National Minimum Wage rules may prevent reduction of salary as low as £7,072. This issue is considered in more depth in the report [Tax Planning for Couples].

If only bonuses are converted, the savings are still significant. If a £50,000 bonus is converted into a dividend, i.e. at the same after tax cost to the company, and assuming that the employee already receives a salary in excess of the upper earnings limit, then the boost to the employee's net income is as follows (depending on the employee's marginal tax rate and the company's corporation tax rate):

Marginal income tax rate	40%	50%
Small co rate (20%)	5,140	5,082
Full rate (26%)	2,580	2,901
Marginal rate (27.5%)	1,939	2,356

2. Artificial arrangements

It is common to encounter arrangements where a company's share structure is arranged to allow dividends to be paid to employees without conferring any real ownership in the company itself.

At the most extreme these may take the form of issuing single shares each of a different class (typically A, B, C, etc thus commonly referred to as alphabet shares) to each employee that have no votes or entitlement to assets on a winding up but are entitled to dividends. As each share is unique, dividends can be voted of any amount (subject to availability of reserves) without reference to levels of dividends voted on other shares.

Less extreme arrangements might give these shares a full range of rights relying on the main shareholder's majority holding of voting power to avoid problems.

Less aggressive still is to have a single class of share but for the majority shareholders to waive part of their dividends to allow larger dividends to go to the minority shareholders. HMRC regard this with more hostility if there are insufficient reserves to pay the dividend in full without the waiver. However, in absence of this issue, waivers should not be regarded as safe.

More complex variations have been devised, for example setting up a separate company in which employees hold shares.

3. Anti-avoidance

Such artificial arrangements to pay dividends are vulnerable to challenge under the provisions of s447 (benefits received from securities). F(No2)A 2005 introduced a motive test with effect from 2 December 2004. This means that the old defence that the dividends were liable to income tax and therefore could not also be charged to PAYE can no longer be used in cases of schemes to avoid tax or national insurance.

It is worth reading the commentary in HMRC manuals.

See in particular
http://www.hmrc.gov.uk/manuals/ersmmanual/ERSM90060.htm and
http://www.hmrc.gov.uk/manuals/ersmmanual/ersm90210.htm .

The difficult question is whether HMRC will actually invoke s447 to challenge the types of scheme discussed in the previous section. It would appear that, at present, HMRC is not highly active in issuing challenges and so use of such schemes, at least the less aggressive arrangements, are relatively safe for the time being. However, this attitude could change at any time and PAYE and national insurance sought for at least the past 4 years and more likely 6 years.

It should be noted that it is not wholly clear that, where shares are acquired after 2 December 2004, that a simple arrangement of a single class of shares with no dividend waivers allows dividends to be paid in lieu of salaries. The statements in ERSM90060 referred to above give some reassurance but not complete comfort. But it should be noted that such an arrangement is at the bottom end of the aggression scale and so is likely to be safe.

COMPLIANCE ISSUES

1. Share valuation for Enterprise Management Incentive schemes

It is possible to agree a share valuation for the purposes of issuing EMI share options.

The procedure is to complete and submit a form VAL231 available from http://www.hmrc.gov.uk/shareschemes/val231.pdf

Any valuation is usually binding for a period of 60 days.

2. Notification of share option schemes

2.1 SAYE schemes

SAYE schemes must be approved in advance by HMRC. For details see http://www.hmrc.gov.uk/manuals/essum/ESSUM37200.htm

2.2 Company share option plan

Company share option plans must be approved in advance by HMRC. For details see
http://www.hmrc.gov.uk/manuals/essum/ESSUM46200.htm

2.3 Enterprise Management Incentive scheme

All grants of EMI options must be notified to HMRC within 92 days of the date of grant using form EMI 1.
- http://www.hmrc.gov.uk/shareschemes/emi/emi-10-09.pdf

2.4 Unapproved share options

These must be notified using the annual return form 42 – see below.

3. Annual returns for share schemes

3.1 SAYE schemes

It must be submitted by the date given on the notice issued or within 3 months from date of issue. Use form 34.
- http://www.hmrc.gov.uk/shareschemes/form34-2011.pdf

3.2 Company share option plan

It must be submitted by the date given on the notice issued or within 3 months from date of issue. Use form 35.
- http://www.hmrc.gov.uk/shareschemes/csop-form35-2011.pdf

3.3 Enterprise Management Incentive scheme

It must be submitted by 7 July following the end of the tax year. Use form EMI 40 - http://www.hmrc.gov.uk/shareschemes/emi/emi40-2011.pdf

3.4 Employment-related securities

Used to notify grants of shares or unapproved options during a tax year. It must be submitted by 6 July following the end of the tax year. Use form 42 - http://www.hmrc.gov.uk/shareschemes/form42-2011.pdf

4. Election to use unrestricted market value ("UMV")

This is the election to tax grants of shares based on UMV rather than actual market value under s431. There is a similar provision in s430 to ignore outstanding restrictions.

The election does not need to be submitted to HMRC.

The election is made jointly by the employer and employee, is irrevocable and must be made within 14 days of the grant of the shares.

The format of the election is available at
http://www.hmrc.gov.uk/manuals/ersmmanual/ERSM30450.htm