RECRUITMENT

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EMPLOYEE SHARE SCHEMES - TAX BENEFITS

How can an employee share scheme benefit your business?

Employee share schemes have become a popular way for employees to be given a stake in the business for which they work and benefit from the growth in the company to which they contribute. If the company succeeds, and the value of the shares increases, the employees gain from their own efforts.

It is believed that productivity levels increase because employees have a vested interest in ensuring that their company succeeds. Share schemes have a positive effect on staff retention by providing employees with a longer-term focus on the company's future performance. They are generally more engaged, increasing performance and job satisfaction, and reducing absenteeism.

An employee share scheme is an additional form of remuneration without involving an immediate outflow of cash, and can be tax-efficient. Share schemes are at their most effective, where the value of the company rises. Given these advantages, schemes can also help with recruitment as an extra form of enticement.

Although there are benefits to having an employee share scheme, they can be more complex to administer than cash incentive schemes and therefore more costly to set up and run. Additionally, not all companies can predict growth, which means that it is not always possible for employees to benefit from shares schemes offered by their employers. That said, share schemes are nearly all, at worst, offered on an economically neutral basis for employees if the company fails to progress.

TAXATION OF SHARE SCHEMES

There are four common forms of tax favoured share schemes. We outline these schemes and highlight the main tax benefits each one can provide. We then highlight one further tax attractive scheme, which has so far proved less popular.

1. Enterprise Management Incentive Scheme

Of the tax favoured schemes, Enterprise Management Incentive (EMI) schemes offer the most flexibility for both the employer and the employee. The scheme involves the grant by the employer of options over shares, which may be exercised at a designated time or at trigger points, such as performance conditions, over a period. There is no holding period, unless set down in the option plan. The plan can also be designed so that options over shares can vest at various points. This could usefully delay the point of exercise.

When options are granted, there is no tax to pay. When options are exercised and shares awarded, there is no tax to pay on exercise; provided the exercise price is not less than the open market value at the date of grant. Tax, charged at Capital Gains Tax (CGT) rates, only becomes payable by the employee when the shares are sold. If options are held for more than 12 months, and the other conditions are satisfied, the taxpayer may be eligible for Entrepreneurs' Relief, which reduces the tax rate to 10%.

HMRC will give advance assurance that the company carries on a qualifying trade for EMI purposes, and will also give advance clearance on the open market value at the date the options are granted. Specific conditions must be satisfied by the company, and by the option holder, and certain events can disqualify the scheme once in place.

Careful consideration of these conditions and disqualifying events needs to be taken before opting for this scheme. We would therefore recommend that you speak to one of our share scheme experts so that we can advise you as to whether or not your company qualifies under the EMI arrangements. We can also help you to devise the EMI option plan and manage the necessary online tax and statutory filings on your behalf.

2. Share Incentive Plans

A company can offer shares through a Share Incentive Plan (SIP) on an all-employee basis. If the employee keeps their shares in the plan for five years, there is no Income Tax or National Insurance (NIC) to pay on their value. Further, there is no CGT to pay on the sale of the shares if they are kept in the SIP until they are sold.

SIPs provide the flexibility to tailor the plan to meet the company's business needs. There are four ways in which shares are awarded under SIPs:

i. Free shares

The employer can give the employee up to £3,600 of free shares in any tax year.

It is important to carefully consider which employee share scheme is most suited to your company and its individual needs.

For further information about employee share schemes and guidance on which best suits your business, please contact:

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ii. Partnership shares

An employee can buy shares out of his salary before tax deductions. There is a limit on how much an employee can spend on the shares; either £1,800 or 10% of income for the tax year, whichever is lower.

iii. Matching shares

The employer can award the employee with up to two free matching shares for each partnership share that the employee buys.

iv. Dividend shares

An employee may be able to buy more shares with the dividends derived from the free, partnership or matching shares (where the employer's scheme allows it). There is no Income Tax to pay if the dividend shares are retained for at least three years.

We can help you design your company's SIP using key components set out above.

3. Save As You Earn scheme

This is an all-employee savings-related share scheme in which employees can buy shares with their savings for a fixed price. Employees can save up to £500 a month under the Save As You Earn (SAYE) scheme and can use these savings to buy shares at the end of the savings contract, which can be three or five years.

The interest and any bonus at the end of the scheme is tax-free and no Income Tax or NIC is applicable on the difference between what is paid for the shares and what they are worth.

CGT becomes payable if the employee sells their shares, unless they are transferred into an Individual Savings Account (ISA) or pension as soon as they are purchased.

4. Company Share Option Plan

Company Share Option Plans (CSOPs) can be operated either on an all-employee or a discretionary basis. They enable a company to grant share options to selected directors and employees over shares with a maximum value, per individual, of £30,000 at the date of the grant. The acquisition of shares on the exercise of the option three or more years after the date of the grant will be free of Income Tax and NICs.

If and when the shares are sold by the employee, normal CGT rules will apply if there has been an increase in the market value of the shares between the time the share option was exercised and when the shares were disposed of.

Where share options are exercised within three years of the date of grant, other than in the specified circumstances above, Income Tax will be due on any increase in value between the market value of the shares at the date they are acquired and the exercise price. This may be collected under Pay As You Earn (PAYE) arrangements if the shares are 'readily convertible assets' at the time, in which case NICs (including employer NICs) will also be due.

One drawback to CSOPs is that there is a limit on approval status based on the value of options held. An individual can hold CSOP options over shares with a value of up to £30,000, based on the market value at the date of the grant, at any one time. Any options granted above this limit will be unapproved, ie. unable to benefit from tax-favoured treatment.

5. An alternative share scheme

It may be worth exploring a less popular employee share scheme that is offered in particular by start-up companies with a low initial value and substantial growth prospects. Such a scheme might be compared and contrasted with the EMI arrangement set out above. Here, shares are offered immediately.

The shares are treated as having a value of at least £2,000 at the time the employee acquires the shares. If the shares are worth more than this, the excess may be subject to an immediate Income Tax charge.

Each employee shareholder may acquire up to £50,000 of employee shares, with the advantage that there may be no CGT on their sale.

Such a scheme will need to be offered in return for the employee shareholder giving up certain statutory rights as an employee; including:

- no right to claim unfair dismissal (except where the law otherwise requires it, or for reasons that relate to discrimination, or in some health and safety cases); and
- no right to statutory redundancy pay.

THE NEXT STEP

Careful consideration is required in order to understand which share scheme is most suited to your company and its business needs. In addition to assisting you with this decision process, we can also help you with the following:

- how to tailor your scheme so that tax approval status is made available;
- how to tailor your scheme so that your employees must meet performance conditions;
- how to tailor a scheme in circumstances where you do not meet the conditions for tax approval;
- valuation aspects surrounding share arrangements;
- the accounting aspects of granting options and awarding shares; and
- general company law aspects.