AaronWallis™
Sales Recruitment

Incentivising your best people through Employee Share Schemes

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Introduction

The employment market in the UK and elsewhere is highly competitive. Fast-growing businesses need to offer attractive incentives to recruit and retain key staff. Granting shares is often considered an attractive benefit for senior employees.

This publication sets out the various schemes available and their advantages and disadvantages. It can only be a guide and professional advice must always be sought in individual cases. In this paper, the word 'employee' always includes director unless otherwise stated.

Many employers give employees the opportunity to acquire shares in their companies on advantageous terms. Their aim is to give a performance incentive and often a form of 'golden handcuff'. Share schemes offer employees a chance to benefit from the future growth of the company and encourage them to identify with it. Often the benefits are lost if the employee leaves. Employees are therefore more likely to be loyal to the company.

The Finance Act 2000 introduced two new schemes that benefit from significant tax advantages, reversing a trend against HM Revenue & Customs (HMRC) approved schemes. They took effect on 28 July 2000.

Despite the advantages of giving employees an interest in the company, employers should consider all the issues carefully before introducing a share scheme.

- Employers should remember that the value of shares can be affected by many issues apart from the efforts of the employees. For example, share values can rise and fall with economic and trading conditions generally. Where the shares are listed on a stock exchange, market fluctuations can have a major impact. As a result, some employees may become disenchanted with the arrangements;
- From the employer's point of view, 'golden handcuff' arrangements, which tie an employee to a company, can prove expensive if the employer wishes to end a contract prematurely;
- The shares must be easily disposable. This should be no problem for public companies, but could present difficulties for private companies;
- It is important to consider carefully how the arrangements will be taxed and to take capital gains tax into consideration which may compare favourably with income tax liability.
- Some approved schemes are costly for the employer to administer. This will generally restrict their suitability to larger companies. However, the rules for enterprise management incentive share options are designed to minimise administration costs.

Acquisition of Shares

Employees can acquire shares broadly in the following ways:

- By being issued with the shares for no consideration;
- By buying the shares either at full market value or at an undervalue;
- By being granted an option to buy shares at some future time, either at full market value or at an undervalue.

Approved schemes

Shares may be acquired through one of several share schemes approved by HMRC. These schemes generally ensure that any tax liability is deferred until the employee sells the shares and that the employee's liability is to capital gains tax rather than income tax. They also avoid national insurance contributions in those cases where such liability would arise. Capital gains tax has the following advantages:

- Tax liability is limited to 18% (from April 2008)
- The annual capital gains tax exemption can result in a tax saving – check with us for the latest figures.

It should be noted that approved schemes impose several stringent conditions.

Unapproved schemes

Where the employee's acquisition of shares is not under an approved scheme, tax charges can arise in the following circumstances.

- Where an employee acquires shares at less than their market value, there is an immediate income tax charge on the difference between the price paid for the shares and their market value. Where the shares are readily convertible assets, that is they can be sold on a stock exchange or there are arrangements in place that allow the employee to sell the shares for cash, national insurance is payable on the same amount. Attempts to make private company shares disposable, in

Tax simplification for employment-related securities/shares

The Chancellor announced in the Pre Budget 2008 that legislation will be introduced in Finance Bill 2009 to simplify certain tax rules that apply to employment-related securities or shares (ERS) acquired by employees for less than market value, as follows.

- Where an employee is paying for shares by instalments and sells them at no profit before completing the payments (provided the employee is not released from the obligation to pay the instalments.)
- Where an employee sells at no profit shares which are nil paid or partly paid on issue.
- Where a holder of employment related securities receives a scrip or bonus issue in certain circumstances - but the charge could arise under a proposed extension to another part of this legislation.

order to increase the attraction of a share scheme, may make them readily convertible assets. The tax and national insurance are collected through the PAYE system;

- Income tax and employer's national insurance are charged if the shares are acquired at their market value but payment for them is deferred. In effect, the deferred payment is treated as if it were a loan to the employee under the same benefit-in-kind rules as an actual loan. This charge does not apply to employees who earn at a rate of less than £8,500 a year and are not directors;
- If shares are acquired by the exercise of an option, the employee is liable to income tax when the option is exercised. The charge is on the difference between the market value of the shares when the option is exercised and the price paid for the shares, less any amount paid for the option. National insurance is charged where the shares are readily convertible assets;
- Where the option can be exercised more than ten years after it is granted, income tax may be charged on the grant of the option. The charge is on the market value of the shares at the date the option is granted, less the price to be paid for the shares on exercise and any amount paid for the option. Any income tax paid at this time can be deducted from the tax payable when the employee exercises the option. There is no charge if the option is granted at a price equal to the market value of the shares at the grant date. National insurance is charged if the shares are readily convertible assets;
- If the shares are subsequently sold at a profit, that profit is liable to capital gains tax. The base cost of the shares is the sum of:
  - The amount paid for the shares,
  - The amount paid for the option, and
  - Any amount taxed as income because the shares were bought for less than their market value.

There can be an income tax charge at other times:

- Under some arrangements, such as the removal or variation of a restriction or the creation or variation of a right, designed to boost artificially the value of the shares held by employees; or
- Where the shares are in a 51% subsidiary company that trades significantly with other group companies;
- Where the shareholder receives a special benefit.

Where shares are subject to forfeiture (for example, if performance targets are not achieved) or may be converted to another class (with a resultant increase in market value), income tax may be charged at the time when the risk of forfeiture is lifted or the shares are converted. The charge is on the amount (if any) by which the open market value of the original interest immediately after the event in question exceeds the sum of the amount paid for the shares and any amounts on which income tax was charged previously in respect of the shares.

Despite the tax charges, some companies have successfully operated unapproved employee share schemes for many years. Their main advantage is their flexibility, because they do not have to conform to the statutory conditions imposed upon approved schemes.

HMRC Approved Schemes

The tax pitfalls outlined above can be avoided to some extent under four types of HMRC approved share schemes. They are:

- The Share Incentive Plan;
- Enterprise Management Incentive Share Options;
- The Savings-Related Share Option Scheme;
- The Approved Company Share Option Plan.

These schemes can include employees of companies controlled by the company that established the scheme, as well as the company's own employees.

An employee may not participate in a savings-related share option scheme or all-employee share ownership plan if he or she, together with any associates, can directly or indirectly control 25% of the ordinary share capital of the company. The limit is 30% for enterprise management incentive share options and 25% for the approved share option scheme.

Approved schemes other than enterprise management incentives must have formal HMRC approval before the tax advantages are given. HMRC will only grant approval if the schemes adhere strictly to conditions laid down by statute. These are designed to prevent abuse of the tax advantages. The conditions include rules about who may participate, the shares that can form part of

Escaping income tax hikes through share schemes

Budget 2009 announced a new 50% tax rate for higher earners, the loss of the personal income tax allowance and increases in both employer and employee National Insurance. No surprise then that employers might look to share schemes to maximise tax benefits for employees.

Where qualifying conditions are met most share schemes are liable to capital gains tax at 18% rather than income tax at the proposed 50% for higher rate taxpayers. And remember that CGT is only payable for gains above the annual CGT threshold.

Share plans of interest may include:

The Company Share Option Plan - qualifying companies may grant their employees up to £30,000 worth of market value options.

The Enterprise Management Incentive - qualifying companies may offer key employees options over shares worth up to £120,000.

Growth Shares – unlisted companies may offer shares at a nominal value that may benefit from growth over market value at the date of acquisition.

Joint Ownership Plans – employees may acquire shares jointly with the trustee of an employee benefit trust and benefit from any growth in value. (The trustee owns the value at date of acquisition).

Share Incentive Plans – Up to £3,000 of free shares may be granted annually to each employee.

the scheme and the price to be paid for the shares.

The HMRC address for schemes is as follows:

Employee Share Schemes
Room 76, New Wing
Somerset House
London, WC2R 1LB

The Share Incentive Plan

The all-employee share ownership plan replaced the approved profit sharing scheme and has in common with it the requirement that shares are held in a trust for an initial period. Shares can be allocated to employees without payment or purchased by employees out of pre-tax salary.

Who may participate?

All UK full and part-time employees must be allowed to participate in the scheme on the same terms although benefits can, to a certain extent, be linked to salary, length of service or hours worked.

- The company may impose a qualifying period of employment of up to 18 months. This period cannot vary for different groups of employees;
- Employees are only allowed to have free shares in one such scheme and cannot be allocated any shares under an approved profit-sharing scheme in the same tax year as an award of free shares under an all-employee share ownership plan.

Qualifying conditions

Employees can acquire shares in four different ways:

- The company can give employees 'free shares' with a market value of up to £3,000 of shares each year. Some or all of these can be awarded to employees for reaching objective performance targets provided certain conditions of the scheme are satisfied;
- Employees can buy up to 10% of salary or a maximum of £1,500 a year of 'partnership shares' out of gross salary, before tax and national insurance;
- The company can give up to two 'matching shares' to the employee for each partnership share purchased. They are given free of cost and must be provided to all participants on exactly the same basis;
- Employees are allowed to reinvest up to £1,500 of dividends paid on shares within the scheme per year into further shares. Reinvestment must take place within 30 days of the trustees receiving the dividend.

Other conditions are:

- Shares must be held within a trust established for the purpose. Partnership shares may be withdrawn at any time. Free and matching shares must be held within the trust during a minimum holding period set by the company, which must be between three and five years. The holding period for dividend shares must be three years;
- Shares must come out of the trust when an employee leaves. The company can require forfeiture of free and matching shares if an employee leaves the company before the end of a specified period, which may not be more than three years from the date the shares are appropriated. Shares cannot be forfeited where the employment ends because of injury or disability, redundancy, retirement, death or certain changes in control of the company;
- A plan cannot be established by a company whose business consists substantially of providing services to an associated company or to persons who control the company. This excludes, for example, service companies formed by accountants' and solicitors' partnerships;
- There can be no loans to employees associated with the plan;
- The rules governing the type of share that can be acquired are broadly similar to those under savings-related schemes.

Tax considerations

- There is no income tax liability when shares up to the specified value are appropriated to an employee;
- If free or matching shares are withdrawn during the first three years after appropriation, income tax is charged on the market value of the shares at the time of withdrawal. In the case of partnership shares, the charge is reduced by the amount paid for the shares;
- If free or matching shares are withdrawn between three and five years from appropriation, income tax is payable on the lower of the market value at appropriation and the market value at withdrawal. No charge can arise on the withdrawal of partnership shares in these circumstances;
- The withdrawal of dividend shares within three years from the date of acquisition will result in an income tax charge on the original dividend for the

tax year in which the shares are withdrawn;

- Shares can be withdrawn free of income tax after five years;
- Capital gains tax is charged only on any increase in value of the shares after they come out of the plan. Employees who leave their shares in the plan until they want to sell them will have no capital gains tax to pay. Disposals are charged capital gains tax at the flat rate of 18% on any gain;
- Shares can be transferred directly into the stocks and shares component of an ISA within 90 days of coming out of the plan, subject to the normal ISA subscription limits. It is also possible to transfer shares into a stakeholder pension;
- The company's costs of operating the plan are tax-deductible. In addition, the company can deduct the market value of free and matching shares in calculating its taxable profits in the period in which the shares are appropriated.

Comment

The administration of such schemes can be complex and burdensome. The employees are entitled to have and exercise all the rights of the shares allocated to them. Trustees are therefore obliged to ensure that the participants are informed of rights and scrip issues, takeovers, etc.

Acquisition of shares by the trustees

Two special reliefs are available where shares are transferred to a trust set up under an employee share ownership plan. They enable the trustees to acquire shares without the company having continually to issue new shares to support the plan.

- Individuals can claim a form of capital gains tax rollover relief on a transfer of shares to a trust set up under a share ownership plan, subject to meeting a number of conditions;
- Shares held by a qualifying employee share ownership trust (QUEST) on 21 March 2000 can be transferred to a trust under an all-employee share ownership plan without any income tax liability on leaving the QUEST.

Enterprise Management Incentive Share Options

Enterprise management incentives allow a company to grant qualifying options to key employees[1]. Unlike the other share schemes, it does not require advance HMRC approval and is a great deal more flexible than a company share option plan.

Employees are granted options to acquire shares with no restriction on the exercise price. The options must be capable of being exercised within ten years of their grant.

Qualifying small higher-risk companies can offer key employees options over shares worth up to £120,000 (at the time of grant). Employees who are prepared to move from secure jobs and speculate their time and effort in high-risk but high-prospect businesses[2] could be rewarded with equity worth up to £120,000. The aim of the scheme is to encourage the best managers to join these businesses and to take equity as part of their remuneration package.

Example

An employee is granted an EMI option over 100,000 shares when the market value is £1 a share.

The employee exercises the option 3 years later when the shares are worth £3 each, making a gain of £200,000.

No income tax or NICs will be payable on the gain of £200,000.

The employee decides to sell the shares 2 years later when they are worth £500,000 (a gain of £400,000).

The employee will have a capital gains tax bill of £400,000 * 18% = £72,000.

(This example presumes the employee has already used up their annual CGT allowance).

Summary

The Enterprise Management Incentive is an option or right to purchase a stated number of shares in a company.

Employees are granted these options under separate option agreements - the market value of the shares at the time of the grant must not exceed £120,000 (from 6 April 2008) for each employee.

There is no ceiling on the number of employees that can be granted Enterprise Management Incentive options. However, the total aggregate value of shares over which options can be granted under Enterprise Management Incentive options must not exceed £3 million for the company.

At the time of exercise of the option, even though the share value at that time may be much greater than the option price, no income tax will be payable - instead, employees will pay capital gains tax when the shares are sold.

The original March 1999 proposals had a maximum number of participating employees of 6, and this was increased - first to 10, then to 15 and finally (in the, the March 2001 Budget) with no limit on the number of employees. It has also been made clear that this is a share option scheme. The scheme is designed specifically for the needs of unquoted companies, although it is also available to smaller quoted companies.

The key features of the scheme are as follows:

- Options over shares worth up to £120,000 (from 6 April 2008) at the date of grant can be awarded to key executives (the limit of 15 employees was removed by the Finance Act 2001). The "fair value" of the shares at the date of grant must be agreed with the Shares Valuation Division of HMRC;
- The shares must be ordinary shares (not preference shares or redeemable shares);
- The shares can be voting or non-voting shares;
- There is no income tax on the grant or exercise of the option;
- There is no national insurance (employer or employee) on the grant or exercise of the option;
- Options can be exercised at any time within 10 years of the date of grant. Unlike the Approved Share Option plan, there is no 3-year minimum exercise period;
- If the shares acquired through the option are sold, capital gains tax is payable. Disposals are charged capital gains tax at the flat rate of 18% on any gain;
- There is no need to obtain prior HMRC approval before establishing a scheme although the fair value of the shares must be agreed (see above). Red tape is reduced as there is no scheme approvals procedure - companies will enter into individual EMI share option agreements with each employee, which will be notified to HMRC;
- Schemes can be set up quickly but companies operating schemes must meet detailed conditions and make annual returns and schemes are subject to inspection by HMRC.

Who may participate?

- Employees who work for the company for at least 25 hours a week or, if less, at least 75% of the employee's working time must be spent on the business of the company.

Qualifying conditions

Options must be granted for commercial reasons in order to recruit or retain a key employee and not for the purpose of tax avoidance. This purpose test is likely to limit options to more senior technical or managerial staff.

The company must satisfy several conditions:

- It must not be a 51% subsidiary of another company or otherwise under the control of another company and must not itself have any subsidiaries other than 50% ones (75% for options granted before 17 March 2004). In addition, it must not have a property managing subsidiary which is not a 90% subsidiary of the company.
- Its gross assets must not have a balance sheet value of more than £30 million.
- It must exist wholly to carry on one or more qualifying trades and must either be carrying on such a trade or be preparing to do so.

A trade qualifies if it:

- Is carried on wholly or mainly in the UK,
- Is conducted on a commercial basis and
- Does not consist of excluded activities.

Excluded activities include:

- Dealing in land or shares;
- Banking, insurance or other financial activities;
- Most leasing activities;
- Providing legal or accountancy services;
- Property development;
- Farming, market gardening or forestry; and
- Operating or managing hotels, nursing homes or residential care homes.

See our Information Publication *400 – Enterprise Management Incentive* for a more detailed account of the qualifying conditions.

The shares must be ordinary shares that are fully paid up and not redeemable. They can be subject to restrictions and be subject to risk of forfeiture if, for example, performance conditions are not met.

Major reform of Capital Gains Tax hits employee share schemes

From 6 April 2008, taper relief and indexation allowance will be withdrawn to be replaced by a single rate of capital gains tax of 18 per cent for disposals on or after that date. The annual exempt amount (£9,600 for 2008/09) will remain in place and the current rules will continue to apply to disposals before this date.

But this may not be good news for the 1.7m investors who hold employer shares through over 950 approved employee "Save as you earn" share schemes in the UK. Higher rate taxpayers participating in an SAYE employee share scheme could be 8 per cent worse off than before and basic rate taxpayers could be 13 per cent worse off.

Previously, where an employee held shares through an eligible SAYE scheme, taper relief for capital gains tax started on the date of exercise of the option. This meant that if the shares were disposed of after two years, the effective rate of tax would be only 10% for higher rate tax payers and 5% for basic rate taxpayers. Now the capital gains tax rate will be 18% for all taxpayers.

Other employee share schemes will also be affected. For example, EMIs will be particularly hit as taper relief begins when the option is granted rather than when it is exercised.

An employee may hold unexercised qualifying options up to a value of £120,000 (from 6 April 2008), calculated by reference to the market value of the shares at the time the option is granted. An employee who has reached this limit may exercise some and then be granted further options, but these further options will not qualify if they are granted within three years of the previous grant of qualifying options. Unexercised options under a company share option plan must be counted in determining whether this limit has been exceeded.

Other conditions are:

- The company must give notice to the HMRC within 92 days of the grant of any option. The notice must contain a declaration that the requirements of the enterprise management incentive scheme are met;
- Where the company or the individual breaks the conditions of the scheme, for example, the employee leaves, the option is disqualified unless it is exercised within 40 days of the disqualifying event. An option will also be disqualified if the employee is granted options under a company share option plan such that the total options held then exceeds £120,000 (from 6 April 2008);
- There are provisions for replacement options to be issued following a takeover, but only if the acquiring company can satisfy certain conditions of the scheme.

Tax considerations

- No tax is charged on the grant of a qualifying option even if it is capable of being exercised more than ten years after the grant.
- On exercise of a qualifying option, income tax is charged only on any amount by which the exercise price is less than the market value of the shares at the date the option was granted. HMRC has a procedure for agreeing market value at the time the option is granted.
- Any gain on the eventual disposal of the shares is subject to capital gains tax, allowing use of the annual exemption. The base cost of the shares is the amount paid for them under the option plus any amount on which income tax was charged when the option was exercised.
- Disposals are charged capital gains tax at the flat rate of 18% on any gain;
- If an option is disqualified, any increase in market value of the shares between the dates of grant and disqualification of the option remains exempt from income tax.
- The costs of setting up a scheme are tax deductible.

Approved Savings-Related Share Option Schemes

The approved savings-related share option scheme allows employees to be granted a number of options to acquire shares linked to a Save As You Earn (SAYE) contract. They can exercise the options, under certain conditions, when they have saved enough funds. The employee is not obliged to take up the options and can simply withdraw tax-free the proceeds of the savings contract, with a bonus, at the end of the contract.

Who may participate?

All full and part-time employees must be allowed to participate in the scheme on similar terms, except that part-time directors may be excluded. The company is allowed to impose a qualifying period of employment of up to five years.

Qualifying conditions

- Employees must save between £5 and £250 a month under an approved SAYE contract with a bank, building society or other authorised financial institution;
- The price at which shares may be acquired must be stated when the option is granted. It must not be less than 80% of the market value of the shares at the time of the grant;
- Options cannot normally be exercised before the bonus date under the SAYE scheme. Schemes are for three or five years, with the option in respect of the five-year contracts to extend to seven years;
- Options may be exercised early where the employee dies or where employment ends because of injury, disability, redundancy or retirement. The option must be exercised within six months or, in the case of death, within twelve months;
- Options must normally lapse where the employee leaves the employment within three years, except in the circumstances described in the paragraph immediately above. Schemes can allow employees to exercise options within six months, if the part of the business where the employee works leaves the group or company operating the scheme;

If the employment ends after three years, the scheme may allow the employee six months in which to exercise the options. Schemes may also allow employees to exercise options within six months after the bonus date if the employee remains employed by a company associated with the one that set up the scheme;

- Schemes can provide for options to be exchanged where the granting company is taken over;
- The shares must be fully paid, irredeemable and not subject to any restrictions. They must be quoted shares, or unquoted shares in a company not controlled by any other company, unless that other company is a quoted non-close company. A close company is basically one controlled by five or fewer people.

Tax considerations

- No income tax liability arises on the grant of the option, or when the option is exercised, provided it is not exercised within three years of the option being granted. No tax is charged on any increase in the value of the shares between the date the option was granted and the date it was exercised;
- Once the shares are acquired, their base cost when calculating capital gains tax on any future disposal is the amount paid for the shares under the option plus the amount paid for the option. Market value is not substituted;
- Disposals are charged capital gains tax at the flat rate of 18% on any gain;
- Interest and bonuses earned under the SAYE contract are tax-free.

Bonuses

If an employee decides to withdraw their money at the end of the contract they will receive a bonus. Bonus rates are set by a mechanism agreed with the savings providers.

The rates for 3, 5 and 7 year SAYE contracts are adjusted automatically by linking them to 3, 5 and 7 year market swap rates.

The bonus rates are adjusted to maintain the following gaps under the market reference swap rates:

Contract type	Basis point margin under market swap rate
3 year	2.05% under 3 year market reference swap rate
5 year	1.75% under 5 year market reference swap rate
7 year	1.65% under 7 year market reference swap rate

The mechanism allows for bonus rates to be adjusted if the market reference swap rates move more than a certain amount. This adjustment is triggered if the three or five year swap rates (measured as an average over a rolling 20 working day period), are equal to or greater than 0.5 per cent below or above the levels used in setting the previous rates.

If this trigger condition is met, the bonus rates are reset to maintain the 2.05 per cent, 1.75 per cent and 1.65 per cent gaps under the new reference swap rate as appropriate, which is the average swap rate over the last ten working days of the 20-day period. These bonus rates will then apply until the market reference swap rates move far enough for the trigger condition to be met again.

If the trigger condition is met, the Early Leavers' Rate is also changed in order to ensure that it gives a fair return to those who do not wish to or are unable to carry on for a three-year period, and so do not qualify for the standard scheme bonuses and benefits, while maintaining an effective incentive for continued participation in the scheme.

Approved Company Share Option Plans

The approved company share option plan, a flexible type of scheme, was very popular until the Finance Act 1996 imposed a limit of £30,000 on the value of shares that can be placed under option for any individual. It is likely to be of less interest than enterprise management incentive share options in those companies that qualify for the scheme. Employees are granted options to acquire shares at their market value at the date the option is granted. The options may be exercised, and shares acquired, between three and ten years after their grant.

Change in Bonus Rates for SAYE Share Option Schemes

Changes are being made to bonus rates for Save As You Earn (SAYE) Share Option Schemes (sometimes referred to as 'Sharesave') that will maintain them in line with other interest rates. The bonus rates were last changed on 17 February 2009.

The new bonus rates effective from 29 May 2009 are:

- **3 yr contract** 0.3 x monthly payments, AER 0.54%
- **5 yr contract** 2.2 x monthly payments, AER 1.42%
- **7 yr contract** 5.2 x monthly payments, AER 1.84%

The Early Leavers' Rate will change from 0.5% to 0.36%.

Employees who are already saving under existing SAYE contracts are not affected by these rate changes.

Who may participate

This scheme does not have to be open to all employees. In general, companies have used this scheme to reward directors and senior employees.

- The scheme cannot include part-time directors. A part-time director is one who works less than 25 hours a week for the company, excluding meal breaks;
- Part-time employees are excluded from schemes approved before 1 May 1995, unless the scheme's rules have been amended since then to include them.

Qualifying conditions

- Options cannot be exercised within three years of their grant, except on the death of the option holder;
- Unexercised options lapse after ten years;
- An individual cannot exercise options more than once every three years, and keep the tax advantages of the scheme;
- The value of shares over which options may be held cannot exceed £30,000. Before 30 April 1996, the limit was the greater of £100,000 and four times salary, excluding benefits, of the year of assessment or the previous year, whichever was the greater. Options granted before 17 July 1995 continue to benefit from tax exemption, but those granted between 17 July 1995 and 29 April 1996 only benefit from the tax exemption if they also satisfy the new restriction;
- The price at which shares can be acquired must be fixed at the time the option is granted and must not be less than the market value of shares of the same class at that time. Before 30 April 1996, options could be granted in some circumstances at a discount of up to 15% of market value. Options granted between 17 July 1995 and 29 April 1996 only benefit from tax exemption if they also satisfy the new restriction;
- The rules governing the type of share that can be acquired are broadly similar to those under savings-related schemes.

Tax considerations

- No tax is charged on the grant of the option, except where exceptionally the option price turns out to be less than the market value at the date of grant.
- No tax is charged on the exercise of the option or on any increase in the value of the shares between the date the option was granted and the date it was exercised.
- Any gain on the eventual disposal of the shares is subject to capital gains tax, allowing use of the annual exemption. The base cost of the shares is the amount paid for them under the option plus the amount paid for the option. Disposals are charged capital gains tax at the flat rate of 18% on any gain.
- The costs of setting up a scheme are tax deductible.

Alternatives to Share Schemes

Phantom Arrangements

As an alternative to providing shares, a scheme could be structured to give employees a cash payment geared to any increase in value of the company shares. Such schemes, known as 'phantom' share schemes, enable employees to participate without actually owning shares. Income tax and national insurance contributions are charged when the employee receives the cash.

Such arrangements free the employer from much of the administrative burden imposed by the approved share schemes. However, employees forgo the advantages of capital gains tax rather than income tax, and the wholly tax-free uplift in the value of shares held in the all-employee share ownership plan. The employer also has to pay national insurance.

Employee Benefit Trusts

Employee Benefit Trusts ("EBTs") have been in use in the United Kingdom for over fifty years. They have no legislative basis and rely for their effectiveness on general tax principles and the common law relating to trusts. The UK HMRC is familiar with such structures and generally accepts EBTs that have been correctly structured. Most EBTs have been established offshore, partly for tax planning reasons, as they serve both domestic and international employees, but mostly because the technical expertise for administering such schemes lies in offshore trust companies.

Different Strategies

In order to attract and retain the highest calibre of staff in today's competitive environment, companies must offer more sophisticated incentives. Outlined overleaf are brief details on each of the five strategies, which can of course be tailored to different circumstances.

These strategies, developed by leading regional law firm DMH Stallard[3], incorporate appropriate employee share schemes, pensions, employment contracts and tax schemes for the particular needs of a company. DMH Stallard's contact details are provided on the penultimate page of this publication.

1. The All Employee Strategy

Employee Share Schemes

(One of the following):

- All Share Incentive Plan
- Save As You Earn Scheme
- Unapproved All Employee Share Scheme
- Shadow Share/Cash Bonus Plan

Pension

(One of the following):

- Money Purchase Scheme (COMP)
- Final Salary Scheme (FSS)
- Group Personal Pension Plan (GPPP)
- Stakeholder Scheme

Employment Benefits

Contract of employment to deal with all benefits to be provided under employment.

Tax Considerations

Obtaining exemptions from Income Tax, NICs and CGT relief under the Approved Employee Share Schemes.

2. The Selected Employee Strategy

Employee Share Schemes

(One of the following):

- Company Share Option Plan
- Unapproved Share Option Scheme
- Shadow Share/Cash Bonus Plan
- Employee Benefit Trust

Pension

- Group Personal Pension Plan (GPPP)
- Stakeholder Pension Scheme

Employment Benefits

Contract of employment to deal with relevant benefits, e.g. company car/allowance, bonus, and private medical insurance, etc.

Tax Considerations

Obtaining exemptions from Income Tax, NICs and CGT relief under the Approved Employee Share Schemes and the setting up of a UK/Offshore Employee Benefit Trust as a mechanism to minimise tax.

3. The Executive's Strategy

Employee Share Schemes

(One of the following):

- Enterprise Management Incentive Scheme
- Company Share Option Plan
- Unapproved Share Option Scheme
- Employee Benefit Trust

Pension

(One of the following):

- Executive Pension Plan (EPP)
- Employer Financed Retirement Benefit Schemes (EFRBS)
- Self-Invested Personal Pension Plan (SIPP)
- Small Self-Administered Scheme (SSAS)
- Stakeholder Pension Scheme
- Unfunded Unapproved Retirement Benefit Scheme (UURBS)

Employment Benefit

A service agreement to deal with benefits to executives, e.g. company car/allowance, bonus, private medical insurance etc.

Tax Considerations

Obtaining exemptions from Income Tax, NICs and CGT relief under the Approved Employee Share Schemes and the setting up of a UK/Offshore Employee Benefit Trust as a mechanism to minimise tax.

4. The Business Owners Manager's Strategy

Employee Share Schemes

- Unapproved Shadow Share/Cash Bonus Plan
- Employee Benefit Trust

Pension

(One of the following):

- Executive Pension Plan (EPP)
- Funded Unapproved Retirement Benefit Scheme (FURBS)
- Group Personal Pension Plan (GPPP)

- Self-Invested Personal Pension Plan (SIPP)
- Small Self Administered Scheme (SSAS)
- Stakeholder Pension Scheme
- Unfunded Unapproved Retirement Benefit Scheme (UURBS)

Other Considerations

- Company or partnership
- Limited Liability Partnership or company
- Subsidiary companies
- Partnership agreements
- Shareholders agreements
- Assurance and insurance

Tax Considerations

Careful tax planning of chosen entity and business formation and the setting up of a UK/Offshore Employee Benefit trust as a mechanism to minimise tax.

Employment Benefit

A service agreement to deal with benefits to executives, e.g. company car/allowance, bonus, private medical insurance etc.

5. The Self-Employed Consultant's Strategy

Relevant Legal Considerations

- Supply Agreements through Personal Service Companies
- Direct Use of Self-Employed Consultants
- Employment Agencies and Business Arrangement
- Agreements for the Provision of Services

Pension

(One of the following):

- Group Personal Pension Plan (GPPP)
- Personal Pension Plan (PPP)
- Self-Invested Personal Pension Plan (SIPP)
- Stakeholder Pension Plan

Tax Considerations

Tax planning for personal service companies and the applications of the IR35 rules.

Ancillary Matters

Tax Returns

All events that give rise to income tax liability must be shown on the share schemes pages of the self-assessment personal tax return. There are comprehensive notes to aid completion. There are also help sheets and leaflets from HMRC that give more detailed information as follows:

- IR177: Share Incentive Plan and your entitlement to benefits;
- IR216: Shares as benefits;
- IR217: Shares acquired: post-acquisition charges;
- IR218: Shares acquired: operation of Pay As You Earn (PAYE);
- IR219: Securities acquired from your employment:
- IR287: Employee share schemes and Capital Gains Tax.

National insurance Contributions (NICs)

The benefits derived from approved share schemes are excluded from earnings when calculating national insurance contributions.

National insurance arises on unapproved share option schemes where the shares are readily convertible assets. Since 19 May 2000, it has been possible for the company and employee to agree that the employee will meet some or all of the employer’s liability on a gain arising after 27 July 2000 on any unapproved share option granted on or after 6 April 1999. Where this occurs, the amount on which the employee is liable to income tax in respect of the share option gain is reduced by the national insurance passed on.

The Companies Acts

The company must ensure that the proposed scheme is within the provisions of its Memorandum and Articles of Association. Loans can be made to employees, but not directors, so that they can participate in employee share schemes, subject to the conditions laid down by the Companies Acts.

Financial Services & Markets Act

The scope of the Financial Services & Market Act 2000 is wide. A company that is not authorised under the Act could breach its provisions by recommending the acquisition of its shares as an investment. Expert advice should be sought with regard to the literature to be distributed to employees.

Stock Exchange rules and Investment Committee guidelines

If the company or its holding company is listed on the Stock Exchange, the Stock Exchange Yellow Book will lay down rules that schemes must comply with. It will also generally require approval of the scheme in general meeting.

For quoted companies, the Investment Committees, which consist of some major institutional investors, also set several constraints on employee share schemes, aimed partly at preventing their investments from being diluted by employee shareholdings. Companies need only comply with the guidelines where they have significant investors that are members of the various Investment Committees, who might otherwise refuse to approve the scheme.

Corporation Tax and Employee Share Schemes

A statutory Corporation Tax (CT) deduction for the costs of providing shares for employee share schemes is available for accounting periods starting on or after 1 January 2003.

Under the previous system, employers were not guaranteed a CT deduction for the costs of share schemes. A company could often obtain a deduction if it followed complex procedures involving the use of trusts. The mixture of complexity and uncertainty deterred many, especially small companies, from operating employee share schemes.

The current relief extends to all employee share schemes that offer employees a real stake in the company or group they work for. To qualify for the relief, shares need to be:

- Fully paid-up;
- Non-redeemable; and
- Form part of the ordinary share capital of a qualifying company.

The relief applies to shares acquired by employees in accounting periods starting on or after 1 January 2003 irrespective of when the share option was granted or the shares awarded.

The deduction is based on the market value of the shares at the date the employee is taxed on the acquisition less any contribution payable in respect of the acquisition of those shares. The company's costs of operating the plan are tax-deductible. In addition, where a company provides shares through a share incentive plan the company can deduct the market value of free and matching shares in calculating its taxable profits in the period in which the shares are appropriated.

The employing company will be eligible to obtain the relief though the shares acquired by the employee can be in another company. This provides a clear link between the relief and employee remuneration. If the shares acquired are in a company other than the employing company then the legislation will define a qualifying company whose shares can used. A qualifying company is, broadly, the employing company, a company that controls the employing company or a member of a consortium that owns such a company.

The CT relief does not apply to expenses incurred in establishing, administering or borrowing for the purposes of an employee share scheme. The availability of a CT deduction for such expenditure continues to follow normal rules for computing company profits for tax purposes.

The Finance Act 2006 amended the rules to ensure that the intended relief is given for shares acquired under the EMI share option provisions.

Conclusion

With the variety of schemes available, it is important to seek professional advice when setting up a scheme. In this way, the envisaged aims can be met, and both the employer and employees can benefit.

Further Information

This publication sets out the various schemes available and their advantages and disadvantages. It can only be a guide and professional advice must always be sought in individual cases. In this publication, the word 'employee' always includes director unless otherwise stated.

We believe that the facts are correct as at the date of publication but there might be certain errors and omissions for which we cannot be responsible.

Further information can be obtained from the HMRC web site which can be found at www.hmrc.gov.uk/shareschemes

If you would like to receive further information about this subject or other publications, please call us – see our contact details on the next page.

References:

[1] The Enterprise Management Incentive is an option or right to purchase a stated number of shares in a company. Employees are granted these options under separate option agreements - the market value of the shares at the time of the grant must not exceed £100,000 (£120,000 from 6 April 2008) for each employee. There is no ceiling on the number of employees that can be granted Enterprise Management Incentive options. However, the total aggregate value of shares over which options can be granted under Enterprise Management Incentive options must not exceed £3 million for the company.

[2] These businesses are broadly those meeting the criteria for the Enterprise Investment Scheme and Venture Capital Trusts.

[3] The contact details for DMH Stallard are: DMH Stallard, Solicitors, 100 Queens Road, Brighton, East Sussex, BN1 3YB, UK. Website: www.dmhstallard.co.uk. Tel: 01273 329833

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