SCOTT-MONCRIEFF

EDINBURGH AND GLASGOW

# Employee share incentives

Employee share incentives can be a valuable tool in motivating, rewarding and retaining employees. They can also be tax-efficient, with gains liable to capital gains tax (generally at 18% but possibly at 10%) compared with an income tax rate of 50% (from 6 April 2010) and no national insurance contributions. However, there are a number of alternatives and, in a complex area, it is easy to make expensive mistakes.

**No tax or national insurance contributions are payable when the option is exercised, provided the option has been held for at least three years.**

### What are the alternatives?

The principal alternatives involving the issue of options to employees are as follows:

- Enterprise Management Incentives;
- Company Share Ownership Plan;
- Save as You Earn Option Scheme; and
- an unapproved share option scheme.

### The principal alternatives which do not involve options are as follows:

- an issue of shares, possibly nil paid; and
- an Approved Share Incentive Plan.

### Enterprise Management Incentives ('EMI')

EMI options are by far the most attractive of the tax-favoured option schemes. The key features are:

- an individual limit to the value of options of £120,000 (including the value of CSOP options; see below);
- a company limit to the value of options of £3 million;
- the company must be independent and cannot have gross assets exceeding £30 million, or more than 249 full-time employees; and
- no income tax or national insurance contributions are payable if the exercise price is not less than market value at the date of grant.

A company cannot grant EMI options if it is carrying on an excluded trade. Excluded trades include dealing in land or shares, banking and insurance and property development.

EMI options are extremely flexible. For example, exercise can be made conditional on exit (i.e. the sale of the company) or the achievement of performance criteria. They are ideal for young, growing businesses.

### Company Share Option Plan ('CSOP')

Employees are granted options to acquire shares at their market value at the date of grant. There is an individual limit to the value of options of £30,000, but no company limit. No tax or national insurance contributions are payable when the option is exercised, provided the option has been held for at least three years.

### Save as You Earn ('SAYE') Option Scheme

An SAYE option scheme has to be open to all eligible employees, subject to a qualifying employment period of up to five years. Accordingly, it is more likely to be of interest to quoted companies where there is a market for the shares.

At the start of the savings contract, employees are granted options over shares at a discount of up to 20% of the market value. They can save a fixed monthly amount of between £5 and £250 for 3, 5 or 7 years. At the end of the savings contract a tax-free bonus is payable. Employees use the proceeds of the savings contract, including the bonus, if they want to exercise the option. If they do not, the proceeds are paid in cash, tax-free. There is no tax or national insurance when the option is exercised.

### Unapproved Share Option Scheme

Unapproved share option schemes are very unattractive from a tax perspective. An employee is liable to income tax on the gain realised on exercise, the gain being calculated as the difference between the market value of the shares acquired and the amount paid for them and for the option itself. Income tax is payable whether or not the shares have been sold. If the shares are Readily Convertible Assets (broadly, if there is a market in them or they are shares in a company which is a subsidiary) the income tax is payable under PAYE, together with national insurance contributions.

However, unapproved share options can be attractive commercially when the shares which are to be subject to option have a low market value.

### Issue of shares

Potentially a simple issue of shares to employees is the most straightforward alternative. However, the employee generally has to fund the acquisition of shares at the outset. In addition, the employing company will have an increased number of shareholders to which to send accounts, invite to General Meetings etc. One way of reducing the compliance burden in respect of the employee owned shares is to create a new class of shares with reduced rights e.g. they could be non-voting.

If the company is 'close' (broadly, if it is controlled by five or fewer shareholders) and the individual either:

(i) is a senior employee or director involved in running the business; and/or

(ii) controls more than 5% of the ordinary share capital of the company

the shares could be issued nil paid, thus overcoming the funding issue. Normally the issue of shares nil paid would give rise to a taxable benefit in kind but not where the above conditions are met. The nil paid shares should also be uncalled to avoid adverse tax implications for the company.

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## Approved Share Incentive Plan ('SIP')

A SIP has attractive tax benefits. However, because it has to be open to all eligible employees (subject to a qualifying period of up to eight months) it is more likely to be of interest to quoted companies where there is a market for the shares.

A SIP has three core elements which can be combined by a company depending on its needs:

- free shares up to a limit of £3,000 in any tax year;
- partnership shares (purchased out of pre-tax and NIC salary) up to £1,500 in any tax year (or 10% of overall salary, whichever is less); and
- matching shares provided by the company to match employees' purchase of partnership shares up to a limit of two for each partnership share purchased.

There has to be a holding period of between three and five years for free and matching shares. Shares may be dividend shares and the company may choose to make dividend re-investment compulsory or optional. Total dividend reinvestment for any participant must not exceed £1,500 in a tax year. The holding period for dividend shares is three years. Shares have to come out of the plan when employees leave their job. Companies can decide that employees lose their free or matching shares if they leave within three years, and that employees who leave have to sell their shares.

Employees who keep their shares in the plan for five years will pay no income tax or national insurance contributions.

Employees who keep their shares in the plan for three years will pay income tax and national insurance contributions on the initial value of the shares; any increase in value of the shares will be tax-free.

Employees who keep their shares in the plan until they sell will have no capital gains tax to pay. If they take them out and sell later, they will pay capital gains tax only on any increase in value after the shares come out of the plan.

## Anti-avoidance provisions

There are extensive anti-avoidance provisions which make it essential to take advice before providing share incentives to employees or changing the rights of options and shares held by employees. The circumstances in which a liability to income tax and, potentially, national insurance contributions arise include:

- the acquisition of shares at a discount to their market value;
- the acquisition of shares on deferred payment terms (subject to the close company exception referred to above);
- an increase in the value of shares due to the removal of restrictions;
- the conversion of shares or securities;
- events related to shares with an artificially depressed market value;
- artificially increasing the market value of shares;
- the disposal of shares for an amount in excess of market value; and
- the receipt of benefits in connection with the shares.

## Corporation tax relief

Specific statutory provision is made for tax relief for the costs of setting up SAYE, CSOP and SIP schemes. It is clear that, at the time that the EMI scheme was introduced, it was considered that relief would be available for set up costs. Whilst there is no statutory provision to this effect, and the Small Companies Enterprise Centre has suggested that set up costs are not deductible on the grounds that they constitute capital expenditure, in practice relief is often allowed by local inspectors. HMRC generally argues that the set up costs of other share incentive arrangements are capital and therefore not deductible.

Ongoing costs for all share incentives are generally allowable as revenue expenditure incurred for the purposes of the employing company's business. In addition, specific statutory provision is made for relief for costs incurred in connection with the acquisition of shares by employees.

These include relief for notional costs, such as the difference between the market value of shares at the date they are acquired and the subscription price.

## Accounting and other issues

The focus of this factsheet is on the tax issues arising in connection with employee share incentives. It is important to bear in mind that there will also be accounting issues on which advice should be taken. In addition, quoted companies may need to take into account listing obligations and the requirements of institutional investors.

## Who to contact

The foregoing is a summary of the key issues relating to employee share incentives and advice should be taken before implementing such arrangements.

For further information please contact your usual Scott-Moncrieff partner. ■

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