The government has recently announced plans to promote employee ownership of businesses. For employees, the ability to participate in the equity of a business can be an important part of their reward package. For private companies the two most efficient methods of giving equity stakes to employees are Enterprise Management Incentives (EMI) scheme; and an outright transfer of shares (including partly paid shares). But in considering whether to implement such schemes, businesses should also give thought to the potential downside. Depending on the type of scheme, where ownership schemes are implemented there will be particular issues that arise on leaving the business, such as potential disputes surrounding ‘good and bad leaver’ provisions where the amount (if any) which is paid for a shareholding, and the right or obligation to sell it, depends on the circumstances of departure. Similarly, it is common for share options to vest over time with unvested options at the time of leaving the company lapsing.

**What is the real aim?**

The government has recently announced plans to promote employee ownership of businesses to aim for a ‘John Lewis’ society. This might well sound like a good idea in theory, but what are the legal, practical and tax issues which businesses face with such co-ownership schemes in practice?

In many ways, minority shareholdings in private companies have limited value – there is no immediate market to sell them and unless the directors (in some cases) use their discretion to declare dividends, shareholders may derive no income from the shares they own either. But it is the intangible, psychological feeling of being part of something which, rightly or wrongly, makes people want to participate in share ownership or option-based structures.

However, if the tax and legal issues are not dealt with correctly from the outset the gains on an exit are likely to be taxed as employment income and the employees will not have the benefit of CGT rates and in some cases these can be deal breakers when it comes to a sale of the business.

For private companies the two most efficient methods of giving equity stakes to employees are:

- Enterprise Management Incentives (EMI) scheme; and
- An outright transfer of shares (including shares).

There are other methods and approved schemes but these are not considered in this article as they are not commonly used by private companies.

**EMI options**

The flexibility of EMI makes it popular with employers (ITEPA 2003 Sch 5 & Part 9 Chapter 7). The tax benefit to an employee, assuming that the option is exercised, is that any growth in value of the shares from the grant is taxed as a capital gain. For the employer the benefit is that the exercise date can be delayed to an exit (if within ten years) so if an employee leaves the employment the option will simply lapse. This contrasts to the scenario where an employee has shares and wishes to leave the company.

The main conditions for an EMI are:

- The shares must be in an independent trading company or the holding company of a trading group.
- The company/group’s gross assets cannot exceed £30m and the employee number must be less than 250.
- The trade cannot be an excluded trade (ITEPA 2003 Sch 5 para 16).
- The maximum value of shares under option at any point is £3m. This is based on the unrestricted value.
- No prior approval from HMRC is required but options must be notified to HMRC within 92 days of grant.
- There is a £120,000 limit per employee.
- Employees have to work 25 hours a week or 75% of their working time and must not hold a material (30%) interest.

The benefits of using an EMI share scheme are:

- If the exercise price is equal to the market value as at the date of grant, there is no income tax or NIC charge at exercise;
- The company will get a corporation tax deduction for the growth in value between grant and exercise;
- No complications where the shares are restricted provided actual market value (AMV) at grant is paid on exercise;
- HMRC will usually agree the share value prior to the grant of the option;
- Individual EMI agreements can be written including specific performance criteria.

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**SPEED READ**

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**Private co. incentives:**

**shares v EMI options**

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Shares held outright

An alternative to options is for the employee to subscribe for shares or acquire existing shares. If the employee pays market value for the shares, there should be no income tax liability under employment-related securities (ERS) legislation. However, the value of the shares cannot usually be agreed with HMRC in advance. Where the tax has to be deducted under PAYE, HMRC will provide a PAYE ‘healthcheck’ but neither HMRC nor the employee is obliged to accept that valuation when working out the final liability.

If the individual borrows money to buy the shares loan interest relief may be available if the company is close or an employee controlled company.

Where the shares are acquired at an undervalue an income tax and in some cases a NIC charge will arise on the difference between the market value of the shares and the price paid for those shares. Where the shares are not readily convertible assets (RCAs) the employee accounts for the tax via self-assessment and there is no NIC. However where the shares are RCAs there is NIC and the tax and NIC is deducted under PAYE. Where there is a PAYE liability the employee must make good that amount within 90 days, otherwise the PAYE will be treated as additional net pay. This is the case even where the employer has failed to operate PAYE. Shares will be RCAs where there are trading arrangements in place or where the company is not entitled to a corporation tax deduction. The latter is a pitfall for private companies where the shares are issued in a subsidiary.

Partly paid shares

The use of partly paid shares is another way to minimise the tax charges on acquisition.

The employee is issued with shares at full market value and only part of the share price is called up. The uncalled amount is treated as a notional loan under ITEPA 2003 Part VII Chapter 3C and a benefit in kind (BIK) is calculated in accordance with ITEPA 2003 s 173. With the current beneficial rate of interest of 4% this results in a yearly charge of 1.6% for a 40% taxpayer or 2% for a 50% taxpayer. A class 1A NIC charge is payable by the employer. However, these charges can be avoided if interest relief would have been allowed under ITA 2007 s 383 had a loan been taken out to acquire the shares. This includes interest on loans to acquire an interest in a close company or an employee-controlled company.

As this relief cancels out the BIK charges the amounts can be called up over a few years and the employee can use dividends to pay up calls – depending on the timing.

Where shares are partly paid there is no corporation tax relief so this would cause a problem where shares are partly paid and the employee does not pay full value for the shares. This would trigger the PAYE rules.

The advantage of the partly paid share route is that the employee has a real share with entitlement to dividends and eligibility to entrepreneurs’ relief where applicable. There is a commercial risk for the employee as the uncalled amounts can be called up in the event the company is liquidated.

Restricted shares

Where there are restrictions attaching to the shares some of the growth in value could be taxed as income unless a s 431 election is entered into by the employer and the employee within 14 days of the share issue. The election will increase the upfront tax cost but it does ensure that the future growth is taxed as capital instead of income. See the Table below.

Some legal and practical issues

A number of the best performing businesses do have day-to-day working practices which are

<table>
<thead>
<tr>
<th>Comparison of EMI versus outright transfer of shares</th>
<th>EMI</th>
<th>Outright transfer of shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax charges on acquisition of the shares</td>
<td>There are no tax charges on the grant of an option.</td>
<td>Where the shares are acquired at an undervalue there is a tax charge on the undervalue. This can be avoided by using partly paid shares.</td>
</tr>
<tr>
<td></td>
<td>On exercise a tax charge is only triggered if the employee does not pay the market value as at the date of grant. If market value at grant is not paid on exercise then the tax charge is limited to the difference between the amount paid on exercise and the market value on exercise.</td>
<td></td>
</tr>
<tr>
<td>Need for a s 431 election</td>
<td>Where AMV on grant is the exercise price there is a deemed election which does not trigger a tax charge.</td>
<td>An election will ensure that the future growth is charged to capital gains tax when the shares are eventually sold.</td>
</tr>
<tr>
<td></td>
<td>Where exercise price is less than AMV at grant a s431 election is usually entered but the tax charged is limited to the lesser of the unrestricted market value (UMV) at exercise and the AMV at grant minus the exercise price.</td>
<td>The election will increase the tax charge on acquisition. AMV on acquisition 80p UMV on acquisition £1</td>
</tr>
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<td></td>
<td>Employee does not pay for the shares.</td>
<td>Employee does not pay for the shares.</td>
</tr>
<tr>
<td></td>
<td>No election – employee taxed on 80p and 20% of future growth charged to income tax with 80% charged to CGT.</td>
<td>With election – employee taxed on £1 and all future growth charged to CGT.</td>
</tr>
<tr>
<td>Corporate tax deduction (subject to the rules in CTA 2009 ss 1006–1038 being met)</td>
<td>Tax deduction for the company on the difference between the AMV and the price paid by the employee. Where a s 431 election (deemed or otherwise) the UMV is used.</td>
<td>The company gets a deduction against its taxable profits for the amount on which the employee is taxed.</td>
</tr>
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</table>
genuinely based on collaboration and working together, consistent with their shared legal ownership structures. But in considering whether to implement such schemes, businesses should also give thought to the potential downside. Depending on the type of scheme, where ownership schemes are implemented there will be particular issues that arise on leaving the business, such as potential disputes surrounding ‘good and bad leaver’ provisions where the amount (if any) which is paid for a shareholding, and the right or obligation to sell it, depends on the circumstances of departure. Similarly, it is common for share options to vest over time with unvested options at the time of leaving the company lapsing. The rationale behind this is to keep people incentivised right up until the point of a sale or flotation with a loss of financial return for those who do not last the course.

**Shares: The companies’ legislation and most companies’ articles (and any shareholders’ agreements) require shareholders to approve the allotment and issue of new shares. Existing shareholders will almost always have pre-emption rights in respect of any new shares (to allow them to maintain their proportionate shareholding and not to be diluted), so these need to be disapproved to allow any issue to take place. This generally requires the approval of not less than 75% of the shareholders voting at a meeting or by them signing a written resolution. There may however be additional consents required, for example, a particular majority shareholder may have a veto right or the approval of separate classes of shareholders may be needed.

The directors also need to be authorised to allot and issue ‘relevant securities’ and the maximum duration of any such authority is five years, so this too needs to be checked.

**Options:** The establishment of a share option plan does not of itself usually require the express approval of shareholders – this is something within the directors’ powers. But the creation of a share option pool (which is typically between 7.5% and 20% of the overall share capital ‘fully diluted’ – ie, as if all options, warrants and other share rights are exercised) does require shareholder approval. In legal terms, this is simply a disapplication of the pre-emption rights referred to above for a specific number of shares – the option pool – usually linked expressly in the shareholders’ resolutions to the allotment and issue of shares pursuant to the grant and exercise of options under the company’s share option plans which exist from time to time.

The authority to allot and issue the subject shares upon the exercise of options is not required at the time of grant. But the company is likely to be in breach of the option documents if it does not obtain this approval from shareholders. It is usual for the directors alone to determine the allocation of options without reference back to the shareholders.

Finally, companies should take care of informal agreements to give a new joiner ‘x% of the company’ if he or she joins. This can result in a binding obligation on the company which it cannot easily or cheaply get out of if the relationship turns sour.

While retention of employees does assist with business stability, longer service also leads to greater costs. Severance negotiations may be more difficult where an employee is also facing the prospect of losing the value embedded in his or her share options. The articles and shareholders’ agreements also need to link in properly with any share option agreement or plan rules, so if a leaver is allowed to exercise his options, he must still be compelled to sell them under the articles if that is what is intended.

While certain benefits may seem outwardly attractive, companies should always be given to the particular circumstances and requirements of the enterprise in question. Lawyers, accountants and tax advisers ought to be able to add value in this area in terms of offering advice on balanced structures which are appealing to all parties. It is also possible to do this in a way which allows any potential new shareholders to time their decision to join at a later date with a minimal amount of additional business structure work being required.