

Who Shares Wins

With the involvement that results from your staff owning shares in the company for which they work comes ownership of quality, delivery, cost control and performance. Employee share ownership creates a real partnership between you, as business owners or investors, and your teams. This is particularly important in the times of increased competition resulting from economic instability that we are now facing.

Teacher Stern has a range of employee share incentive services to achieve the results you want in this area, and provides tailored solutions to delivering and managing share-based incentives.

The aim of this, the first edition of a new bi-annual newsletter, will be to give you updates in relation to this fast-moving market, share our experience and give you an insight into the support and services we can provide.

EMI Update

Currently, one of the most tax-advantaged share option scheme approved by HM Revenue & Customs (**HMRC**) is the Enterprise Management Incentive (**EMI**) scheme originally introduced in July 2000. It is designed to help small companies, with gross assets not exceeding £30m, to attract and retain staff. Under the scheme, each employee can be granted options over shares worth up to £120,000. There is an upper limit of £3million on the total value of options which may be offered and EMI is available only to companies with fewer than 250 full-time employees.

One of the most attractive features of EMI shares was that they attracted business asset taper relief. The rate of capital gains tax (**CGT**) payable on any gain realised on ultimate disposal of the shares began to taper down as soon as the options were granted. Prior to 6 April 2008, this meant that many option holders paid CGT at a maximum effective rate of 10%. This made the EMI scheme significantly more tax-efficient than other HMRC approved share option schemes.

Since 6 April 2008, business asset taper relief has been scrapped and replaced with a flat CGT rate of 18%. Notwithstanding this, EMI remains a good method for incentivising employees. The income tax relief on any increase in the market value of the option shares between grant and exercise of the option, national insurance contribution (**NIC**) relief for both employer and employee, and the availability to the employer of corporation tax relief, still make EMI one of the

most attractive schemes available. In addition, the blow of the increase in minimum CGT rate has been softened by the introduction of entrepreneurs' relief which will enable the first £1 million of gains made by an individual who qualifies for relief to reduce the maximum effective CGT rate to 10%.

In any event, many schemes are structured on the basis that options are only exercisable on a trade sale or flotation, subject to the 10 year exercise limit imposed by the rules. When this is the case, it is likely that an option holder will sell his or her shares immediately following exercise, paying CGT based on the increase in value of the shares between the date of grant and the date of exercise of the options. If the options have been structured and valued correctly, the option holder should pay no income tax or NICs. When considering how best to implement new EMI schemes, employers should always consider this method in order both to maximise the ongoing incentive for employees to commit to the growth of the business right up to exit and to ensure that potential option holders (and the employing company) are given the most tax-efficient structure possible.

Nil Paid Share Schemes

Normally shares are issued fully paid, giving the issuing company working capital for trading purposes. However, it is lawful for shares to be issued part or nil paid. This mechanism can be used to provide employee incentives as no upfront payment is required from the employee, whilst giving potential tax benefits which are not available to unapproved option holders. In particular, issuing shares nil paid can take the shareholder out of the income tax regime, avoiding liability to income tax and NICs. Typically, the scheme may be structured so that the shares are acquired by the employee at their full unrestricted value but are not paid for until an exit event – such as a trade sale or flotation – takes place. Any gain on sale would be subject to CGT at 18%, unless mitigated by entrepreneurs' relief which, as mentioned above, can deliver a maximum effective CGT rate of 10%. A nil paid share scheme may, therefore, be worth investigating, for example where EMI is not available for some reason.

However, it is important to bear in mind that the shares will need to be paid up at some point to avoid a tax charge and, in a worst case scenario - insolvency - the liquidator would almost certainly seek to recover the outstanding monies from the relevant shareholder, notwithstanding that the shares no longer have any value. Nevertheless, this does have the benefit of aligning the employee shareholders' interests directly with those of the founder shareholders which, after all, is one of the principal objectives of share incentives generally. In addition, there is anti-avoidance legislation in place to ensure that nil paid schemes which have the avoidance of tax as their primary purpose can be attacked: In particular, issuing shares nil paid can be treated by certain tax legislation as creating an interest-free loan to the employee. So, notwithstanding that nil paid share schemes can be an effective share incentive tool, such schemes are not always appropriate and it is vital that you receive expert tax and company law advice in order to use

such schemes effectively.

Growth Share Plans

This is an area which has seen a lot of growth (no pun intended), and in relation to which Teacher Stern advises an increasing number of clients. Like most good ideas, the principles underpinning growth plans are quite simple.

Under a growth share plan employees acquire a new class of shares in the company. The new class is only entitled to participate in any future increase in the value of the business. Because at the outset these shares are worth very little, the employee should only pay a small amount to acquire the shares (and should therefore have only a minimal tax liability in connection with their acquisition). Employees like growth plans because there is minimal risk for them. If the share price falls they will have lost very little but if share price rises they may make substantial gains. Again, growth share plans are not HMRC approved but any gain made on the sale of the shares by the employees may be taxed at a maximum effective rate as low as 10% (depending on the availability of entrepreneurs' relief).

Sharing Works

There is a vast number of ways in which you can seek to retain and incentivise your employees, of which the arrangements described above form only a small, but popular, part. The most important question, however, is, "Does share incentivisation work?" And the answer, assuming you choose the right scheme and have the necessary professional support, is an unequivocal "yes". As research [1] has shown:

- There is a current acceleration in corporate interest in shared compensation practices, now embraced by over 50 per cent of UK businesses;
- Employees who have the benefit of shared compensation practices are more likely to be productive;
- Shared compensation results in a lower turnover of staff and reinforcement of the corporate "glue" that bonds employer and employee together.

In short, Who Shares Wins.

[1] Freeman and Vanyon (2001)

If you would like to discuss any share incentive issues with us, why not contact **James McVeigh** on 020 7242 3191

This article should not be relied upon as a substitute for legal advice as to any particular matter. If you would like specific advice please contact the persons stated above.