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Alternatives to HMRC approved share incentives

Introduction

Employee engagement is a much discussed topic in the business community for a good reason. Your employees are the lifeblood of your business and losing key employees or not attracting new talent can cause significant disruption and financial loss.

There are many ways to incentivise management and employees and the best way will depend on your business.

Employee share incentives are a popular way for companies to recruit and retain key staff. Discretionary awards to chosen employees under the HMRC approved Enterprise Management Incentives (EMI), or Company Share Ownership Plans (CSOP) where EMI options are not available, are an incredibly effective way to motivate, retain and reward your team, giving them a sense of ownership and a financial stake in the future of the company. Where the incentive is to be provided to all employees, the HMRC approved share incentive plan (SIP) and save as you earn (SAYE) scheme should be considered.

Approved schemes provide generous tax advantages, however various qualifying requirements for both employees and employers must be satisfied in order to access the potential tax advantages.

It may therefore not be possible or appropriate for the business to grant EMI or CSOP share options or operate a SIP or SAYE scheme. Where this is the case, an 'unapproved' employee share incentive could achieve the commercial objectives of the business.

What are the alternatives to HMRC approved share incentives?

Unapproved incentives can broadly be divided into incentives where the employee makes an acquisition of shares and incentives where the employee is granted an option to acquire shares in the future.

Share acquisition

There are many ways such an unapproved share incentive may be structured, for example by way of a simple share acquisition, the issue of growth (or hurdle) shares, the issue of part paid shares or the acquisition of an interest in a jointly owned share.

Growth shares are a common incentive structure and enable employees to participate in the future growth of the company above an equity hurdle (but not below it). A growth share incentive involves a separate class of share being created in the company that only has a right to share in capital and/or dividends above a certain value hurdle. The hurdle will usually be set at a value in excess of the current market value of the company on the date the hurdle shares are issued. As a result, the value of the growth shares when they are issued is likely to be low and the cost to acquire the shares for the employees should not be significant. A growth share incentive is therefore relatively low risk from the employee's perspective.

You can cherry pick the employees who will acquire shares under an unapproved incentive, set your own performance criteria that are required to be met before the incentive shares vest, and withdraw shares from employees who leave.

Share options

A share option is a right to acquire a specified number of shares in a company at a future date for a pre-determined price.

Unapproved share option incentives can be used very flexibly. As with unapproved share acquisitions, you can choose the employees to be given options, set your own performance criteria that are required to be met before they can be exercised, and withdraw options from employees who leave.

Who are they for?

Unapproved employee share incentives may be suitable for companies that do not satisfy the various conditions needed to provide incentives under HMRC approved arrangements, such as EMI or CSOPs. For example, where the company exceeds the EMI size limits for gross assets or number of employees or where the company wishes to incentivise employees or directors who be "connected" with the company for EMI or CSOP purposes.

Growth shares are most commonly used by private companies, such as start-up and private equity backed companies, where substantial growth is anticipated. Care is, however, required if it is intended to issue growth shares in companies that have raised funds under the Enterprise Investment Scheme (EIS), to ensure that the growth shares do not adversely impact on the availability of EIS tax reliefs for EIS investors.

What are the benefits?

Share acquisition

An acquisition of shares (including growth shares) will attract an income tax charge (and National Insurance contributions if the shares are readily convertible assets at acquisition) on the difference between the acquisition cost and the market value of the shares on the date they are acquired.

However, the future increase in value of the shares will, generally, be treated as a capital gain and charged to capital gains tax, the current top rate of which is 20%, on the sale of the shares. This is more attractive than a cash bonus which would be taxed as employment income in the usual manner, or unapproved share options which would be subject to income tax (and National Insurance contributions where the option shares are readily convertible assets).

Where employee shares are ‘restricted securities,’ income tax may arise at a later date when the restrictions attaching to those shares fall away or when the shares are sold. It is therefore usual to make a protective ‘s431 election’ within 14 days of such securities being acquired (either by direct acquisition or after exercising a share option) to prevent such additional charges arising.

On acquisition of the shares, the company can usually obtain a corporation tax deduction based on the market value of the shares at that time (although not for part paid shares and usually not for growth shares given the low initial value of growth shares).

Share options

There is no income tax charge on the grant of an unapproved share option to a UK resident employee.

Options can be granted with an exercise price which is at a discount to the market value of the option shares when the option is granted, but income tax of up to 45% under current rates (plus potentially employee and employer National Insurance contributions) will be due on the difference between the option exercise price and market value of the shares on the date they are exercised.

Any growth in the value of the shares between acquisition and ultimate sale of the shares is charged to tax at capital gains tax rates. The current top rate of capital gains tax is 20% but can be as low as 10% if the various conditions for claiming Business Asset Disposal Relief are satisfied, such as the shares being held for more than two years after the option is exercised.

On exercise of the share option, the company can usually obtain a corporation tax deduction based on the market value of the shares at that time.

Design

Unapproved employee share incentives are very flexible as there is no need to satisfy the various requirements associated with approved incentives.

The design of the incentive can therefore be tailored to your circumstances and commercial objectives.

There is flexibility regarding when options can be exercised by an employee, although the majority of options are exercisable only a sale or winding up of the company (an ‘exit only’ option). Factors such as vesting, and performance criteria will need to be considered when designing the incentive. As with all employee share incentives, a detailed review of the impact of the incentive on the other stakeholders in the business should be done prior to the incentive being implemented.

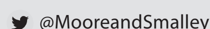
Exit only options are particularly attractive to both the employee and the company because if the employee leaves, no money has changed hands at that point, and the share option will simply lapse.

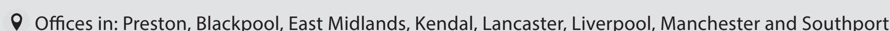
It is not possible to agree share valuations for unapproved employee share incentives with HMRC. Where employees acquire shares under the incentive it is therefore key that a robust valuation of those shares is prepared to ensure that the employer and employee can fulfil their tax obligations regarding the incentive accurately.

Unapproved employee share incentives should be reported to HMRC on or before 6 July following the tax year in which they are implemented. There are also annual reporting requirements thereafter.

Want to find out more?

Please email Hasan Hashmi or contact a member of the tax advisory department at MHA Moore and Smalley on 0161 519 5050.





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