STEVENS&BOLTON

SHARE INCENTIVES: COMPARISON OF ALTERNATIVE EMPLOYEE SHARE INCENTIVE STRUCTURES FOR SMES

The following provides a brief overview of the main features and tax treatment of various equity incentive arrangements available to small and medium sized enterprises. Please note it does not comment on the accounting treatment of any of the alternatives or issues of valuation. It is based on the laws and judicial interpretation in force at the date of writing and is therefore subject to any changes in applicable tax laws and HMRC interpretations occurring after the date of this document.

If, having considered this guide, you would like to know more or to discuss you own circumstances in greater detail, please speak to your usual contact at Stevens & Bolton or a contact listed at the end of this guide.

Definitions:

CGT	Capital Gains Tax	NIC	National Insurance Contributions
EBT	Employee Benefit Trust	PAYE	Pay As You Earn
HMRC	H M Revenue & Customs		

Enterprise Management Incentives ("EMI")

Key Features	Overview of Tax Treatment	Pros and Cons

• Tax favoured statutory option
• Employees may obtain up to £250,000 of shares (based on unrestricted value at date of grant)
• Overall scheme limit of £3 million
• Option term of 10 years
• Bespoke exercise trigger e.g. exit based (i.e. sale or listing) or performance related
• Issuing company must be qualifying at date of grant and vigilance required that option remains qualifying throughout the term:
  o Independent (not under the control of another corporate)
  o Gross assets of £30 million or less
  o No more than 250 full time employees (or part time equivalents)
  o All subsidiaries are at least 50%+1 owned
  o Less than 20% of the business activities are non-qualifying
• Employees are eligible if:
  o they work at least 25 hours per week or, if less, 75% of their working time on the business of the grantor company
  o hold 30% or less of the ordinary share capital
	Employer
	• If the exercise price is equal to the market value at the date of grant, employer NIC ought not to be due in respect of the award of shares
	• If the options are granted at less than the market value or if a 'disqualifying event' occurs during the option term, employer NIC liability may be passed to the employee with employee agreement
	• Employer is required to notify the grant of an option to HMRC within 92 days
	• Employer is required to make annual returns
	• Employer should (subject to statutory requirements) obtain a corporation tax deduction based on the option profit (market value of a share at date of exercise less exercise price of option) when the options are exercised
	Employee
	• If the exercise price is equal to the market value at the date of grant and no 'disqualifying event' occurs during the option term, no income tax/NIC will be due on exercise
	• If there is a 'disqualifying event' (e.g. employee leaves employment or a change in the company/share structure) and the option is exercised more than 90 days after that disqualifying event, an income tax charge (and potentially NIC) will arise on the increase in value of a share between the disqualifying event and exercise
	• On disposal of the resulting shares, if there is longer than 12 months between grant and disposal and the option holder remains in employment with the company, a reduced rate of CGT at 10% applies, otherwise normal CGT rates apply (10% or 20%)
		Pros
		• Potentially no income tax/NIC on increase in value of a share
		• HMRC will agree a market value of a share prior to grant
		• Potential valuable corporation tax deduction on exercise of option for employer company
		• Bespoke option which may be closely aligned with desired employee behaviours (e.g. exit)
		• Entrepreneurs' Relief potentially available to EMI option holders on the disposal of shares irrespective of size of shareholding
		• Well understood by employees and potential purchasers
		Cons
		• EMI must operate within legislative parameters i.e. qualifying issuing company, working commitment of employee
		• Possibility of post-grant disqualifying event

Growth shares

Key Features	Overview of Tax Treatment	Pros and Cons
• The existing share capital of the Company is reclassified into different classes of ordinary shares (e.g. A & B), with the A shares having the right to participate in the proceeds of any subsequent sale up to a set value of the company and the B shares only able to participate pro rata in the excess above this level • Employee acquires B shares for cash at the unrestricted market value at the point of acquisition • The unrestricted market value is the value of the shares if all restrictions attaching to the shares (such as forfeiture or compulsory transfer provisions on cessation of employment) are ignored • Acquisition can either be of new issued shares or shares held by an EBT • The company/EBT may provide a loan in order to fund the acquisition cost of the shares	*Employer* • No corporation tax deduction for the employer company as the employee will have paid full unrestricted market value of the shares at day 1 • If the employee pays the full unrestricted market value of the shares there will be no obligation on the employer to collect tax on the acquisition of the shares via PAYE • If a loan is made to fund the purchase price it may result in tax on any 'cheap loan' under the benefit in kind rules • Employer will need to report the acquisition through its online employment related securities return at the end of the relevant tax year *Employee* • So long as price paid represents unrestricted market value of the shares at the date of acquisition, and the appropriate tax election is entered into, there will be no income tax/NIC on the acquisition of the shares • Proceeds from the disposal of the shares will ordinarily be subject to the capital gains tax regime (if market value) • If a loan is made by the company (or EBT), it may give rise to a benefit in kind (as a cheap loan)	*Pros* • No upfront charge to income tax/NIC on acquisition of the shares • Total growth in share value will be subject to CGT • Structurally simple *Cons* • Specialist valuation advice required in order to ensure that the price paid represents the unrestricted market value • Total price for the shares must be provided upfront but may be loaned to employee • No corporation tax deduction for acquiring company • Employee acquires shares at day 1 so all restrictions (on cessation of employment, etc.) must be included in the company articles of association

Unapproved share option scheme

Key Features	Overview of Tax Treatment	Pros and Cons
• Options over either a new class of ordinary shares or exit based arrangements over a current class of ordinary shares • Usually open to any employee at the discretion of the directors/shareholders; may be extended to non-employees • Vesting dependant on the level of sale proceeds achieved • Flexibility on lapsing criteria, vesting criteria and performance conditions • UK market standard to grant options with a term of 10 years • No limit on individual participation • May be granted at less than market value but not less than nominal value if it is an option to acquire new shares • May be granted at less than nominal value if it is an option over existing shares held in an EBT	*Employer* • On exercise, the employer company should (subject to statutory requirements) obtain a corporation tax deduction equal to the difference between the exercise price under the option and the market value of a share at the date of exercise • Employer NIC may be due on the exercise of the option if the shares are readily convertible assets at that point • Subject to certain restrictions, employer NIC may be passed to the employee by agreement • PAYE to be operated on the exercise of the option if shares are readily convertible assets • Employer will need to report the acquisition of shares following exercise of the option through its online employment related securities return at the end of the relevant tax year *Employee:* • Income tax (and NIC via PAYE shares are readily convertible assets) payable on the difference between the exercise price and the market value at exercise; if shares are not readily convertible assets then income tax due via self-assessment • Any subsequent increase in value of the shares following exercise will be liable to CGT	*Pros* • No need for prior HMRC approval • Wide latitude on terms/conditions • No tax on grant of option • The holding of an option is risk free for an employee • Subsequent growth in value of a share following exercise will be subject to capital gains tax • Can aid employee retention *Cons* • Tax treatment – employee charged to income tax (and possibly NIC) on the difference between the exercise price of the option and the market value of a share at exercise

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FIND OUT MORE

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