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Employee Share Schemes

Employee Share Schemes can be a valuable tool in motivating, rewarding and retaining key employees. They can also be tax-efficient, with gains liable to lower capital gains tax (CGT) rates rather than income tax, and free of national insurance contributions.

There are a number of schemes, and with the complexity in this area, it is easy for businesses to make expensive mistakes. This factsheet considers the key options for employee share schemes and give a broad overview of the schemes.

What options are available?

The principal schemes involving the grant of options to employees are as follows:

+ Enterprise Management Incentive (EMI); and
+ Company Share Option Plan (CSOP);

The principal scheme which does not involve options is:

+ An Approved Share Incentive Plan.

The unapproved alternatives include:

+ Unapproved Share Option Scheme, including hurdle shares; and
+ Issue of shares, possibly at nil value.

Approved Schemes

Enterprise Management Incentive (EMI)

The EMI scheme is a highly tax-efficient method for providing targeted incentives to key employees or employee groups. The employee is granted the right to purchase company shares in the future at a price set at the date of grant. The employee gains when the value of the shares rises above the purchase (exercise) price.

To meet the EMI scheme requirements, a growing quoted or unquoted company must:

+ Be independent;
+ Have fewer than 250 employees; and
+ Gross assets not exceeding £30 million at the date of the grant.

Each employee can hold options over shares worth £250,000 at the date of grant - this is an all-time limit for unexercised options, not per grant. The employee should work at least 25 hours a week or 75% of their working time for the Company and cannot hold a "material interest" of more than 30% of the share capital.

The shares used must be non-redeemable, may be of any class of Ordinary Share (with or without restriction) and may be non-voting. An overall limit is imposed regarding the value of the shares of £3 million per company and options must be capable of being exercised within 10 years from the date of the grant.

The employer is able to set the EMI option exercise price, with no income tax or national insurance contributions being payable, either on the grant or the exercise of the option, provided 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, which includes the dealing in land or shares, banking and insurance, farming and property development.

Exercise can be made conditional on exit (i.e. the sale of the company) or the achievement of performance criteria.

Company Share Option Plan (CSOP)

The CSOP is a fantastic means of motivating staff to work beyond short term goals. It is a discretionary plan allowing for performance conditions to be created.

The CSOP scheme is tax efficient with:

+ No income tax or NICs on grant; and
+ Provided options are exercised more than 3 years after the date of grant, there is no income tax or NICs on exercise. Further gains following exercise are subject to Capital Gains Tax (CGT).

From 6 April 2023, the individual limit has doubled from £30,000 to £60,000 and there is no overall scheme limit.

Companies using the CSOP must be independent and options must be granted at Market Value, however, the company can be of any size and in any sector, unlike the EMI scheme.

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 18 months) it is more likely to be of interest to quoted companies where there is a market for the shares.

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

+ Free shares up to a limit of £3,600 in any tax year;
+ Partnership shares (purchased out of pre-tax and NIC salary) up to £1,800 in any tax year (or 10% of overall salary, whichever is less);
+ Matching shares provided by the company to match employees' purchase of partnership shares up to a limit of two for each partnership share purchased; and
+ Dividend shares can be purchased using the dividends received on free, partnership or matching shares, but only if the scheme allows it.

Employees who keep their shares in the plan for five years will pay no income tax or national insurance contributions in relation to the acquisition of the shares. Employees who keep their shares in the plan for at least three years, but less than five years, will pay income tax and national insurance contributions on whichever is the lower, the initial value of the shares or the value at the time the shares are taken out of the plan.

If shares are taken out before three years have elapsed, income tax and national insurance will be charged on the market value of the shares at that time. Slightly different rules apply to dividend shares.

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

EMI / CSOP / SIP - creating an internal market

Many private companies will wish to ensure that employees can convert their shares into cash without the company having to be sold or floated. This can be done through the creation of an internal market, effectively provided by the employer.

An Employee Benefit Trust (EBT) is a trust into which a company can place shares or other assets for the benefit of employees, under the separate legal ownership of trustees. Legislation was introduced to curtail the use of trusts for tax avoidance, which had previously been widespread. However, these trusts may still be used in conjunction with tax advantaged share schemes such as EMI, CSOP or SIP which are recognised by HMRC.

Unapproved Schemes

Unapproved Share Option Scheme

Unapproved share option schemes can be attractive commercially when the shares which are to be subject to option have a low market value which is expected to increase over time, and none of the approved share plans are available or appropriate.

Unapproved Share Option Schemes therefore have their place in reward planning despite them being less advantageous from a tax perspective. There is normally no tax or national insurance charge on the grant of the option, but an employee is liable to income tax on the gain realised on exercise, that gain being calculated as the difference between the market value of the shares acquired and the amount actually paid, whether for the shares or for the option itself.

Income tax is payable whether or not the shares have been sold. If the shares are *'readily convertible assets'* (generally, if there is a market in them or they are shares in a company which is a subsidiary) the income tax must be accounted for by the employer under PAYE, together with National Insurance Contributions.

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);
- An increase in the value of shares due to the removal of restrictions;
- The conversion of shares or securities;
- Events related to the 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.

Employee Related Securities Reporting

Regardless of the scheme used, there is a requirement for companies to notify HMRC of any grant of options to employees by 6 July each year for transactions in the year ended 5 April.

Next step

This factsheet is only a summary of the key issues relating to employee share incentives, and advice should be taken before implementing any such arrangements.

Why not speak to one of our specialists to see how we can help you achieve your goals?

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