Employment Taxes: Employees & Shares

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Contents

What, why and how

Some vocabulary

LTIP	Long Term Incentive Plan
Securities	Includes shares, debentures, loan notes, warrants, unit trust units
Options	A right to acquire a security on fixed terms in the future
ITEPA	Income Tax (Earnings & Pensions) Act 2003
Part 7	ITEPA, Part 7
Exit	An opportunity for shareholders to sell their shares (e.g. on a sale of the company)
Approved Scheme	One of the statutory share schemes
Unapproved	A share award granted outside the statutory framework, also a 'non-qualifying' award

Remuneration packages

For senior employees a remuneration package designed to have three objectives:

- meet the operational cost of employing the individual
  - Salary,
  - BIKs
- provide short-term incentives to meet operation goals
  - Variable remuneration,
  - Bonuses
- long-term incentives to meet strategic goals
  - Align managers with shareholders/owners

Designing an LTIP

Owners' emphasis

- Value for money
- Incentivise the right behaviours – discourage recklessness/short-termism
- Tie in employees for the long term
- In larger companies, investors and regulators' expectations/requirements
- In smaller companies, often aiming for an 'Exit'

Management emphasis

- Quantum – the rewards must be sufficiently valuable
- A share in the capital of the company
- Keep up with the market

Why not cash?

Using an LTIP to deliver cash has attractions:

- Simplicity
  - No new legal structures needed to make cash awards
  - There is no need for an ‘Exit’ to realise value
- Ease of communication
  - Value of the reward is clear
  - Everyone understands cash
- Flexibility
  - Fewer restrictions on using cash to pay bonuses

But:

- Cash LTIPs are taxed as salary and PAYE and NIC will apply – costly
- CT relief may not be available

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Example 1: Cash LTIP

Jane has been promised 5% of any proceeds in excess of £10m on the sale of the Company. The Company is sold for £20m:

- Jane's bonus promise is worth £500k (£20m - £10m x 5%)
- PAYE and NIC are withheld – a combined rate of 47% = £235k
- Jane's net benefit is £265k
- The Company pays ER NIC @ 13.8% = £69k
- The Company claims CT relief on bonus and ER NIC @ 20% = £113.8k
- Total cost to shareholders is £500k + £69k - £113.8k = £455.2k

The cost to shareholders of providing £1 of benefit is £1.72

Why shares?

Where it is possible to use shares, there are advantages:

- Clear alignment between shareholders and employees
- Regulatory/investor preferences
- Cash-flow
  - Often no immediate cash outlay required
  - Market may actually bear cash cost
- Statutory Corporation Tax relief for qualifying shares
- Potential for capital treatment
- Availability of statutory share schemes

Structuring an LTIP

Considering the form of award

Commonly encountered forms of award include:

- Options
  - Usually a right to buy shares at a fixed time and price in the future
  - Can be linked to performance conditions
- Share awards – shares immediately gifted to employees
  - Can be linked with forfeiture conditions if employees leave or don't perform
  - Possible for employees to benefit from capital treatment on growth
- Share promises
  - Shares are given to employees at a point in the future if conditions are met
- Restricted Stock Units
  - Usually granted by US corporations
  - Treated as a share promise

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The legislative background

Employment-related securities

Most employees and directors will be within the Part 7 rules

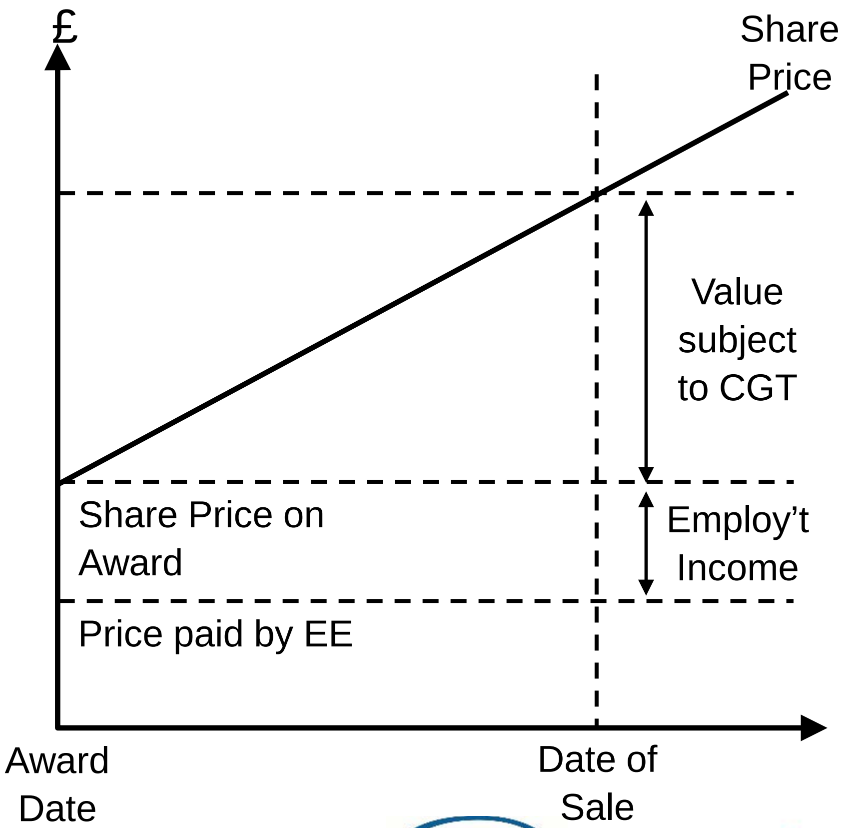
- Applies to a person who acquires securities by reason of their own employment or someone else's employment
- An employee or director acquiring shares in their employer company is deemed to have them by reason of employment
- Includes former or prospective employment

- A company founder who expects to take a seat on the board will be within the Part 7 regime

- Only exception is where shares are transferred among family members

An outline of the rules

- Value given away treated as earnings
  - shares given away for less than market value
  - 'things done' to increase value of shares
  - employees allowed to sell shares for more than market value
- Organic growth treated as capital
  - CGT rates lower than income tax rates
  - Entrepreneurs' relief can lower the tax rate to 10%



Example 2: Share Award

Wahida's employer has allowed her to buy shares in the company, Wahida has paid £2k to buy the shares, which are worth £200k; Wahida waits a year and sells the shares when they are worth £500k:

- Wahida's shares are employment-related securities, because the company is her employer company
- She is treated as having received taxable employment income on the value that she was given
- Wahida is treated as having received taxable employment income of £200k - £2k = £198k

- When Wahida sells her shares she will have made a gain of £500k - £200k = £300k
- This gain will be taxed under the CGT rules

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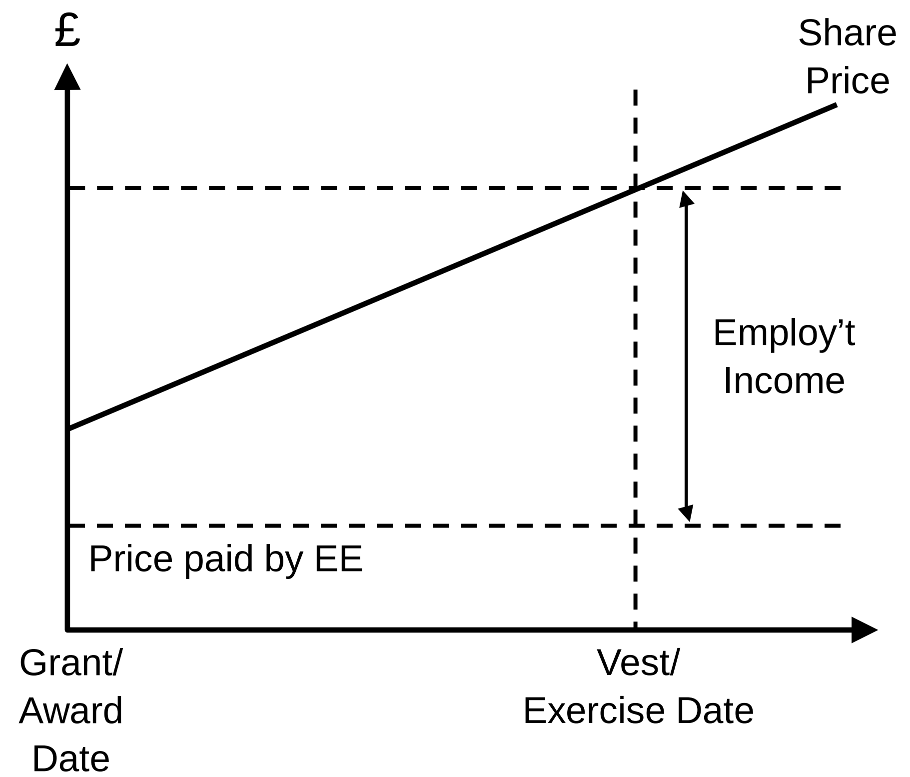
Exceptions – forfeiture & options

- Tax arises in the future
- Securities forfeitable within 5 years of award – S425 ITEPA – tax on vesting
- Options – c.5 pt 7 ITEPA – tax on exercise
- CT relief follows income tax treatment – pt 12 CTA 2009



Other rules

Restricted securities – Chapter 2 of Part 7

- Applies where shares can be taken away from employees or the company can block the sale of shares
- Mainly affects private companies
- Reduces amount subject to tax on award, but means that income tax will arise when the shares are sold
- Can elect out of these rules s431 ITEPA
- Must always be considered if people acquire private company shares

Convertible securities – Chapter 3

- If securities of one sort are converted into more valuable securities, then the difference in their value will be treated as taxable employment income

Example 3: Restricted securities

- Ian and Will are both additional rate taxpayers and are both given shares in their employer worth £1,000.
- They are not allowed to sell the shares unless the whole company is sold – the value of this restriction is £300.
- Will makes a 431 election, Ian does not.
- The company is sold and both Will and Ian sell their shares for £100,000

Ian	Taxable £	Tax £
Taxable on award-45%	700	315
IT on sale-45%	30,000	13,500
CGT on sale–20%	69,300	13,860
Total Tax		27,675

Will	Taxable £	Tax £
Taxable on award-45%	1,000	450
IT on sale-45%	0	0
CGT on sale–20%	99,000	19,800
Total Tax		20,250

Company taxation

Corporation tax relief – Part 12 CTA 2009

Companies can claim CT relief on employee share awards if conditions are met:

- Shares must be fully paid, unredeemable ordinary shares
- Shares must be issued by employer company or parent of employer company
- Company issuing shares must be parent company or listed company

Where the conditions are met, the employer company can claim a deduction equal to the difference between the shares' market value at the date that the employee gets them and the price paid by the employee

PAYE & NIC

If there is a market in the securities, or they do not qualify for relief under Part 12 CTA 2009, the employer must operate PAYE on any tax charges; NIC will also be due.

In any other case, must go on the employees' self-assessment returns.

Valuation approach

The valuation standard

The valuation standard is set out in TCGA 1992, Part VIII

273 Unquoted shares and securities

(1) The provisions of subsection (3) below shall have effect in any case where, in relation to an asset to which this section applies, there falls to be determined by virtue of section 272(1) the price which the asset might reasonably be expected to fetch on a sale in the open market.

(2) The assets to which this section applies are shares and securities which are not [listed] on a recognised stock exchange at the time as at which their market value for the purposes of tax on chargeable gains falls to be determined.

(3) For the purposes of a determination falling within subsection (1) above, it shall be assumed that, in the open market which is postulated for the purposes of that determination, there is available to any prospective purchaser of the asset in question all the information which a prudent prospective purchaser of the asset might reasonably require if he were proposing to purchase it from a willing vendor by private treaty and at arm's length.

Valuation in practice

Is there a market in the shares:

- Is the company listed?
- Have there been recent transactions or offers for its shares?

What information would be available:

- Is the shareholding large enough for access to management information or just to public information?
- Is the public information old/stale?

What sort of company is the shareholding in:

- Property companies valued differently to insurance companies, for example
- Some industries have distinct valuation methods

How much of the company does the shareholding represent?

Statutory share schemes

Overview

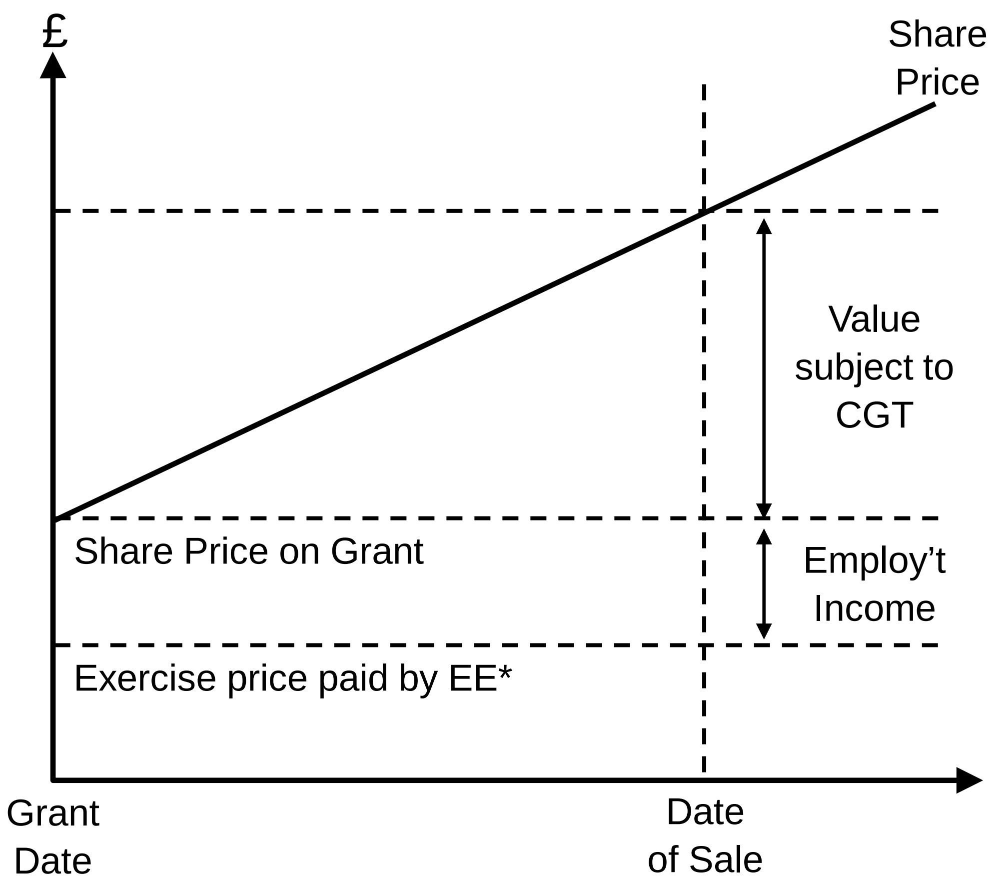
ITEPA makes provision for a number of statutory share schemes

Tax advantaged schemes are set out in the legislation – allow employees to benefit from capital treatment or, in some cases, complete exemption from tax

The older schemes were known as ‘approved schemes’ because they used to need HMRC approval – requirement now abolished

Option plans	Award plans	All employee schemes
EMI	ESS	SIP
CSOP		SAYE

Tax relief – Statutory option plans



Option plans:

- Tax point – date of exercise
- Effectively tax as if shares acquired on grant date
- Growth in value falls into CGT
- Additional relief for EMI shares
- CT relief ignores statutory status

*NB - CSOP must have MV ex. price;
SAYE limits discount to 20% but gives income tax relief

EMI – the better option

		EMI Options	Non-qualifying Options
Value at grant	A	100,000	100,000
Exercise Price	B	50,000	50,000
Value at exercise/sale	C	500,000	500,000
PAYE & NIC • (A-B) x 47% • (C-B) x 47%	D	23,500	211,500
CGT • (C-A) x 10% • (C-C) x 20%	E	40,000	0
Net value to employee C – (D+E+B)	F	386,500	238,500
Employer NIC • (A-B) x 13.8% • (C-B) x 13.8%	G	6,900	62,100
CT Relief (C+G-B) x 20%	H	91,380	102,420
Total Cost to Shareholders C+G-(B+H)	I	365,520	409,680
Benefit: cost ratio F/I x100		106%	58%

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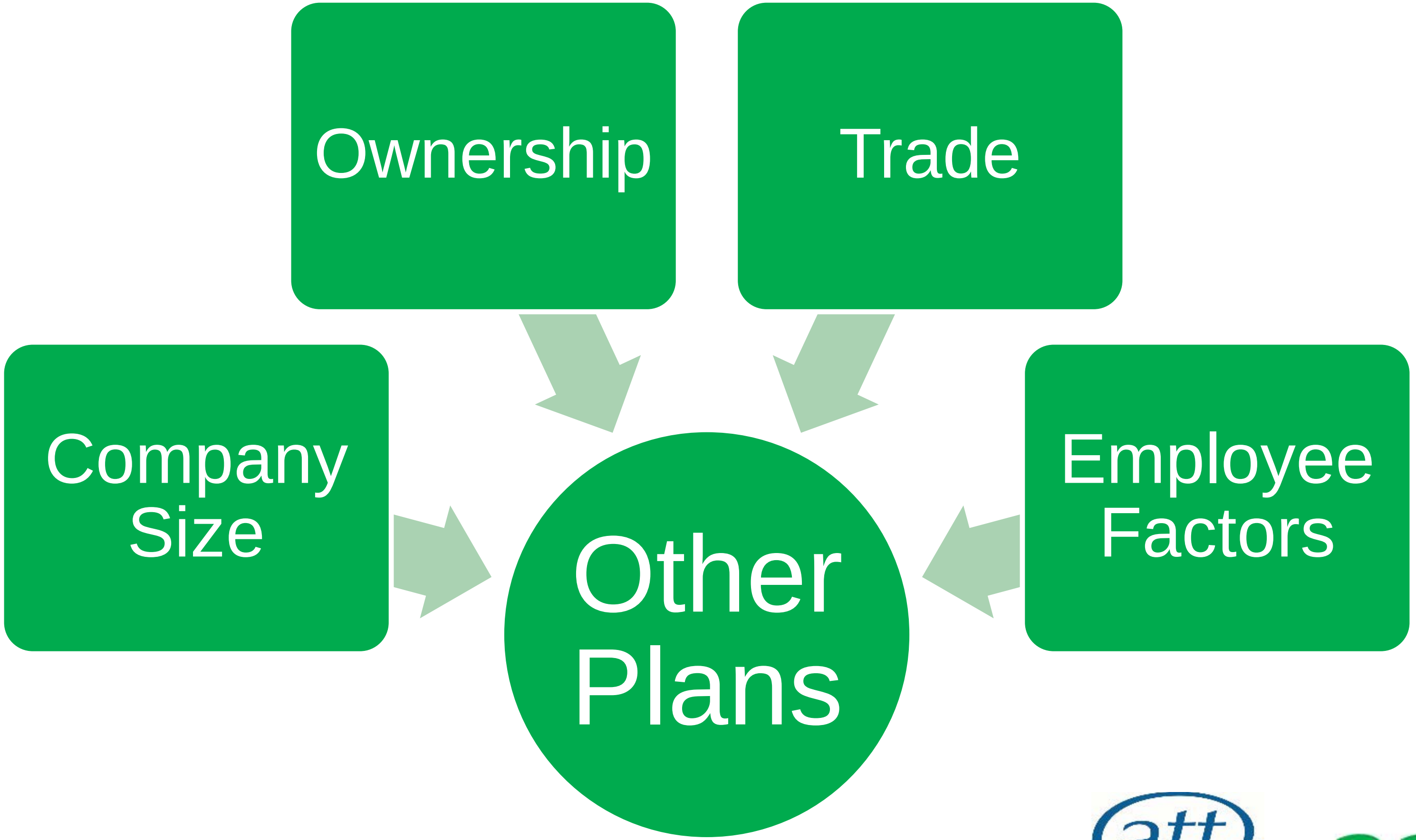
Why consider anything else?



The other statutory share schemes (1)

CSOP
- No size limit on companies
- Bring growth in value within CGT
- Less flexible and less generous than EMI

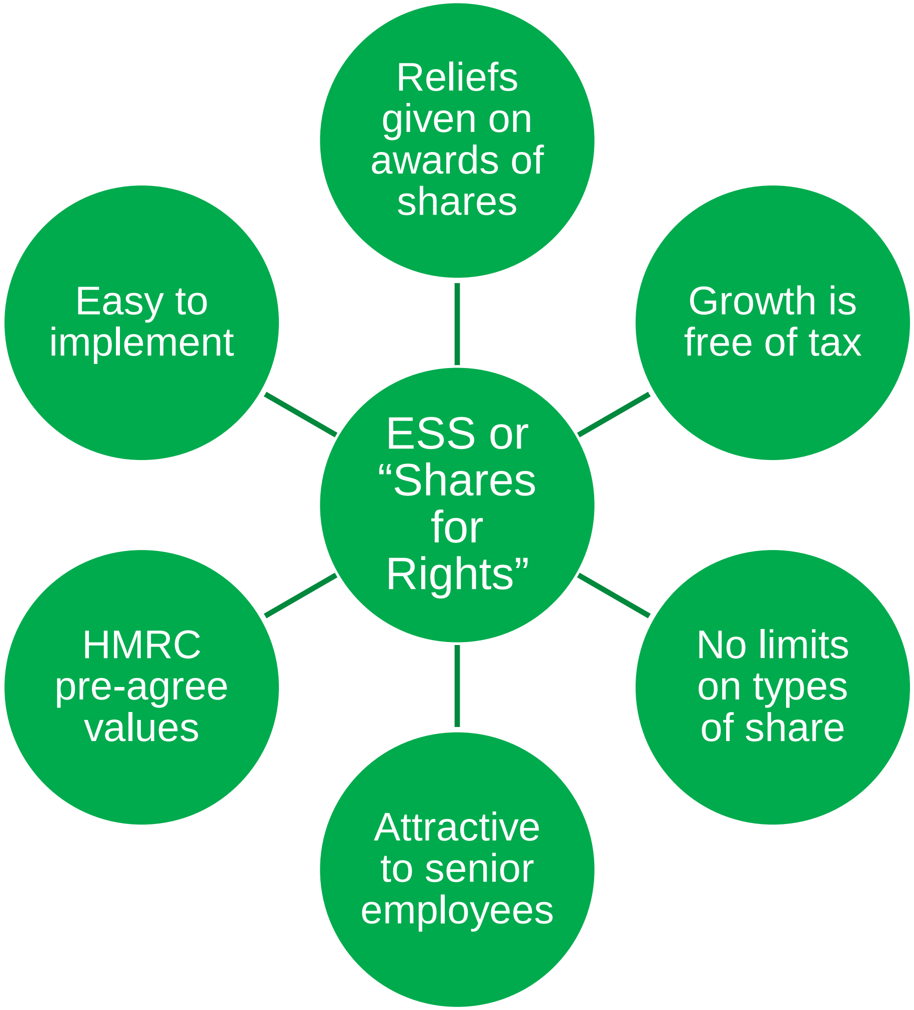
SAYE
- Regular savings by employees
- Bring growth in value within CGT
- Geared to companies with marketed shares

The other statutory share schemes (2)

Share Incentive Plan

- "Wrapper" around variety of awards
- Potentially tax-free
- Could be used to structure business investment
- Less dependent on market for shares
- Perceived complexity

Employee Shareholder Status



- Minimum £2,000 award
- Tax charge can arise on award
- Good for high-growth businesses
- Can choose to limit share rights
- Senior employees have better contractual rights

Other approaches

An overview

NQ Options — Share options without tax advantages

- Easy to implement
- Taxed as employment income

Share Awards — Simply awarding shares to employees

- Easy to implement, but company law issues to consider
- Initial award taxed as income, growth in CGT

Partly Paid Shares — Employee agrees to pay market value for shares in future

- More complex to implement and company law issues remain
- Can be BIK charges to consider, growth in CGT

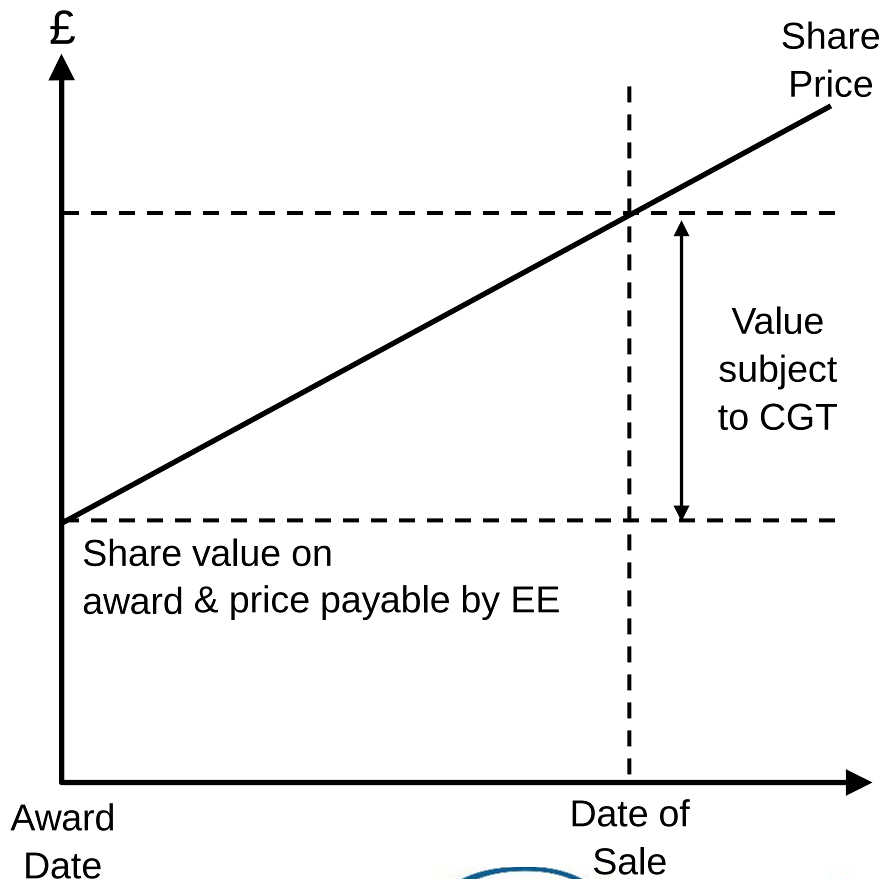
Growth Interests — Share awards with low initial value

- More complex to implement
- Growth in CGT

Cost effectiveness

Broadly two approaches:

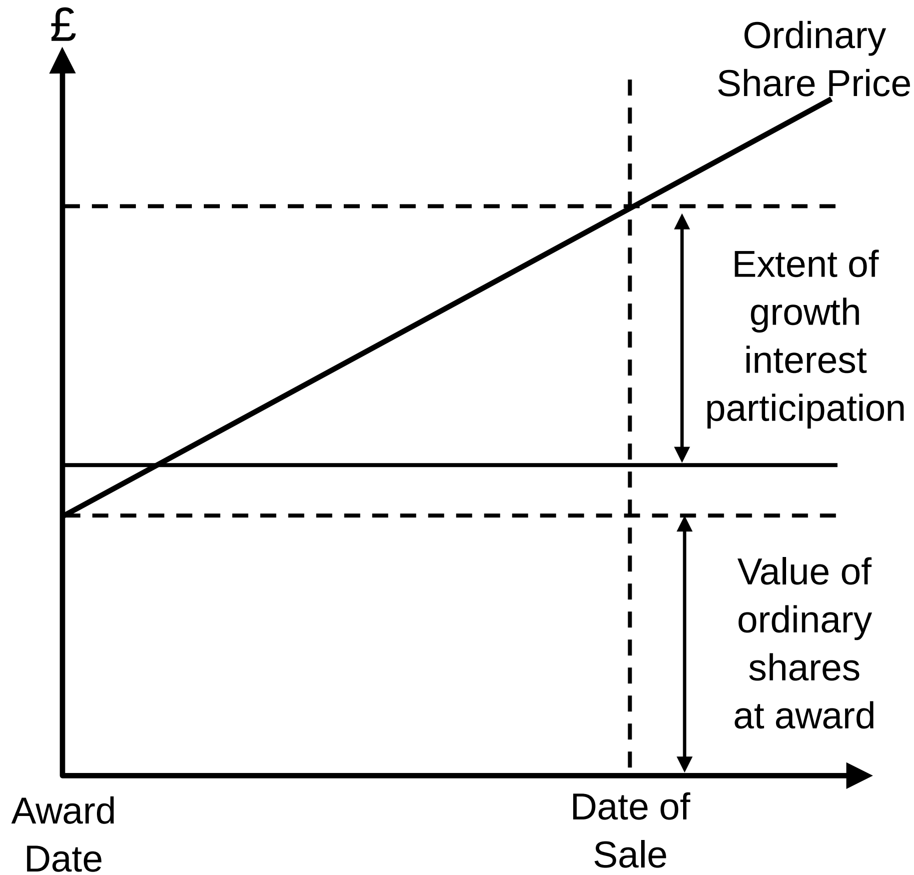
- Partly paid/deferred consideration – employee contracts to pay market value for the shares, but payment is deferred;



Cost effectiveness

Broadly two approaches:

- Partly paid/deferred consideration – employee contracts to pay market value for the shares, but payment is deferred;
- Growth interests – employees only share in growth in value, not in current value.



Questions

Thank you

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