

International Business Review

Employee share schemes for inward investors

Employee share schemes have long been recognised as having the potential to motivate employees and help retain key staff. A considerable body of research has established a positive connection between long term capital growth of a company and the existence of equity incentive schemes within a business.

In addition, at certain points in the life of a business, it may be appropriate to award shares or incentivise staff by granting options to be triggered by a key event (e.g. an initial public offering (IPO) or sale of the company).

The general rule in the UK is that shares awarded to employees are treated as a benefit from their employment – no tax is payable when an option is granted. However, when the option is exercised, a taxable amount is likely to arise; the taxable amount is the difference between the option price paid and the market value of the share when the option is exercised (the “option gain”).

Where listed shares are awarded, or there are arrangements in place to sell the shares, payroll taxes (i.e. income tax and national insurance contributions) are required to be applied to the option gain. In the case of such tradeable shares, income tax and the employee’s national insurance contributions are required to be deducted from the award to the employee, and the employer’s national insurance contributions must be charged (at 13.8% of the option gain). By prior agreement,

the employer’s national insurance contributions - in part or in their entirety - can be transferred to the employee. Even if the company’s shares are not currently listed, it is advisable to consider the possible incidence of payroll taxes, as an exercise opportunity may be triggered by sale or IPO of the company when a market in the shares does exist.

When the shares are sold by the employee, the sale will be subject to capital gains tax (CGT). In order to eliminate double taxation, the amount already taxed as the option gain can be offset against the proceeds of sale, reducing the CGT payable.

CGT on disposal of the shares will be payable at 18-28%, depending on the individual’s tax rate, on the difference between sales proceeds and cost. However, where a director or employee of a trading company (or holding company of a trading group) has held at least 5% shares and voting rights for at least a year, they should qualify for entrepreneurs’ relief for disposals from 6 April 2008. The effect of the relief is to tax the first £5m of gains on disposal at 10%.

CASE STUDY

A client in the mobile telecommunications business came to us with an already established US style stock option agreement. In order to attract and retain three employees in the UK, including CEO and Sales Director, we were asked to determine whether a tax favoured scheme could be implemented for them. After a careful review of the client’s business and the existing scheme we advised that the proposed incentive arrangement could be accommodated within a UK qualifying scheme.

The scheme rules state that options can be exercised on sale of the business or IPO. At that point, the UK employees will realise their option gain free of income tax and national insurance, and at a low rate of capital gains tax.

For accounting periods ending after 1 January 2003, any exercise of share options which is accompanied by an option gain will permit the UK employing company to claim a tax deductible amount, equivalent to the amount of the employees' option gain. The tax relief applies whether the option gain is taxable under an unapproved scheme, or exempt under tax favoured arrangements.

Within the EU, the UK boasts one of the most attractive regimes for tax favoured share arrangements and some of these schemes listed below may be suitable for inward investors to the UK.

The UK's tax favoured share schemes effectively eliminate the income tax charge on the option gain. The arrangements of most relevance to inward investors, with their key tax benefits and requirements, are shown below:

Enterprise management incentive scheme (EMI)

- Up to £120,000 market value of option shares may be held under the scheme per individual, up to a maximum of £3,000,000 of options granted by the company. The £120,000 limit is set at the option price when the option is granted.
- The scheme is suitable for small or medium sized independent companies with no more than 250 employees. Typically the scheme provides that the options would be exercised just before a change of control.
- Companies (or if part of a group, the group) must have a trade wholly or mainly in the UK.
- Options cannot be awarded over subsidiary companies' shares.

- EMI can be used to award shares to individuals with up to 30% shares in a company.
- The scheme permits the option gain to be realised free of income tax.
- Gains may be eligible for entrepreneurs' relief (see above), otherwise taxable at 18-28%.
- Participants must generally be full time employees.
- It is very often possible to adapt an overseas stock option plan to a UK qualifying plan.

Company share option plan

- Up to £30,000 market value of option shares may be held under the scheme per individual. The £30,000 limit is set at the option price when the option is granted.
- The scheme is suitable for listed companies.
- Options cannot be exercised before three years from the date of grant.
- Gains may be eligible for entrepreneurs' relief (see above) otherwise taxed at 18-28%.
- It is very often possible to adapt an overseas stock option plan into a UK approved plan.

Both schemes are relatively straightforward to set up. Either can be used in conjunction with non-tax favoured arrangements, with the UK approved element "shadowing" the main share option plan.

In the first instance, please contact:

Nilesh Shah

Telephone: +44 (0)20 7544 8866

Email: nilesh.shah@blickrothenberg.com

12 York Gate
Regent's Park
London NW1 4QS
United Kingdom

Tel: +44 (0)20 7486 0111
Fax: +44 (0)20 7935 6852