Social Business Wales

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A guide to incentivised share plans

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Also available in Welsh. Also available in large print format.

A large number of employee owned companies operate some form of employee share scheme. Different companies will implement employee share schemes for different commercial or cultural reasons. Employee share schemes are normally implemented for the following reasons:

► Allowing employees to own shares gives tangible ownership in the company;

► Share ownership aligns the employees interests with that of the company;

► They encourage employees to think, feel and act like owners as they can create a link between better business outcomes and performance and increased share value and dividends for individuals;

► Employee share schemes might be used to attract, retain and motivate employees;

► They can provide significant tax savings for both company and employee whilst offering long term reward.

It's vital that you consider what you want to achieve before deciding on whether or not to implement an employee share scheme.

What options are open to me?

Once you've clarified why you want to implement an employee share scheme the next step is to consider the different incentive options available. Share schemes can be structured to incorporate all, or a mix, of the following three main aspects:

► *A gift of shares* – the employee immediately becomes a shareholder as a result of receiving shares, free of charge, in the company. As a shareholder the employee benefits from dividends and any increase in the share value. In most instances where an employee is given something of monetary value, such as shares, by their employer this will be treated as a benefit in kind and the employee will be subject to income tax and national insurance contributions and the company will be subject to employer's national insurance contributions.

► *Employee share purchase schemes* – employees buy shares from the company, Share Incentive Plan, or Employee Benefit Trust and can benefit from dividends and any increase in the share value.

► *Share options* – the employee has the right to purchase shares in the future at a predetermined price. There is little risk for the employee until the shares are bought. If the price increases the employee exercises the option, if the price decreases the employee can decide not to exercise the option.

The shares used in the above may come from existing owners either selling their shares or agreeing to make their shares available for an 'option', or as a result of the company issuing new shares subject to shareholder agreement at the time or at a later date.

There are a number of HMRC tax advantaged share schemes that incorporate the above options and make it easier for employees to acquire and own the company's shares, or be granted options for shares, in a tax effective manner.

Tax efficient share schemes

There are currently four HMRC approved tax advantaged share schemes that might be considered by a company:

► *Share Incentive Plan (SIP)* – offers tax and national insurance advantages for employee gifted and purchased shares.

► *Save as you earn share (SAYE) option scheme* – employee share ownership via options.

- *Enterprise Management Incentive (EMI)* – option scheme designed to help smaller companies retain talent.

- *Company Share option Plan (CSOP)* – Allows options to be granted to selected senior staff.

Share Incentive Plan

What does it do?

A HMRC approved Share Incentive Plan (SIP) aims to provide benefits to employees in the nature of shares in the company they work for. The SIP allows all employees to build up a personal stake in the company they work for over a period of time as a result of either buying shares from their gross salary, or as a result of being given shares free of charge and free of tax and national insurance (NI).

Who is it for?

Most independent companies will qualify to operate a SIP. The SIP is an all employee share scheme. That means all employees of the company that has established the scheme must be eligible to participate in the plan. The number of 'free shares' allocated to employees can vary on the grounds of remuneration, length of service or hours worked. Performance conditions are also possible so long as this complies with the SIP legislation.

It is possible to impose a qualifying period of up to 18 months employment before an employee becomes eligible to participate. Employees decide whether they wish to accept the invitation to participate.

Employees are debarred from participating if they have a 'material interest' in the company that established the plan – basically an interest of 25% or greater in the company counting together shares held by that employee and any associates of that employee such as a spouse, parent, son, etc.

How does it work?

First we have to consider how we get shares into the SIP:

- A SIP comprises a trust deed and rules (model deed and rules can be supplied by HMRC) and is managed by trustees.

- The trustees acquire shares in the company that has established the scheme. The Trustees are normally gifted or lent funds by the company in order to acquire the shares. These shares might be acquired from existing holders, or as a result of the company allotting shares.

- The shares used must be ordinary shares, although non-voting shares are permitted.

- These shares are then held by trustees on behalf of employees who will participate in the plan.

Now we'll look at the four main types of SIP awards that can be used:

- Free shares – employees can be gifted £3000 worth of shares each tax year without suffering tax and NI on the value at the time of the award.

- Partnership shares – eligible employees may authorise deductions to be made out of their gross salary (that is before tax and NI) of up to £1800 (or 10% of salary whichever is lower) to be used to acquire partnership shares

- Matching shares – trustees can give matching shares at a ratio of up to 2 matching shares for each 1 partnership share bought by the employee;

► Dividend shares – dividends from the shares already held by the employee can be reinvested to buy further shares in the company each tax year.

All the shares are normally held in trust for at least three years, but more often for five years as this provides more tax effectiveness. Shares may then be withdrawn and employees will pay tax only on the lower cost of the market cost or original value. After five years, the entire value of the shares is free of tax.

If an employee leaves voluntarily (or is sacked with good cause) within three years of an award of shares the company can require that any Free or Matching shares be forfeited. If any employee leaves voluntarily (or is sacked with good cause) within three years of purchasing Partnership shares they will incur tax and national insurance contributions.

Is it expensive to operate the SIP after installation?

Not in most circumstances. As the SIP is designed by HMRC there is a lot of information available relating to how the plan must be operated and what information is required by HMRC annually. Most companies will be able to operate a SIP without the need for outside help and thus costs should be limited.

Any benefits to the company?

The company can benefit in a number of ways. The company will be entitled to a corporation tax deduction for the cost of establishing and operating the plan.

The company doesn't have to pay employer's National Insurance contributions on any pay used by employees to buy Partnership Shares so long as they are then left in trust for the full five years – saving the company up to £128 for every £1,000 invested by employees.

Why should we choose it?

Choose the SIP if you want employees to own shares rather than options. Whilst shares may need to be held in the plan for a number of years there are clear tax savings for both the employee and company regardless of whether shares are gifted or purchased.

Does this create immediate ownership?

Yes. As shareholders employees will immediately benefit from dividends.

The tangible nature of shares means that employees have clear ownership in the business from the moment they become a shareholder.

The shares held in the SIP are allocated to specific employees even though they are held in a trust.

Save As You Earn Share Option Scheme

What does it do?

A HMRC approved Save as you Earn scheme is a tax advantaged scheme for all employees and directors. It allows participants to save up to £500 per month to acquire shares at the end of a three or five year period. Shares are acquired upon the exercise of an option that is funded from the proceeds of a special certified SAYE savings arrangement - Employees have money deducted from their salary and put into a special savings account.

Who is it for?

Most companies will qualify to operate a SAYE scheme. SAYE is an all employee plan and this means you must invite all employees to participate. However, the company can specify that employees need to have worked for the company for a minimum period which can be set at up to five years. Employees decide whether they wish to accept the invitation to participate.

How does it work?

Under Approved SAYE schemes the company grants employees an option to use the proceeds of their SAYE Share Scheme, including tax-free bonuses, to purchase company shares when their savings contracts mature in either three or five years time.

Employees agree to save a given sum of money each month with a bank or building society for the three or five year period. The maximum amount that can be saved is £500 per month under an approved scheme. Employees will receive a tax free bonus after fixed periods of time. The bonus rates currently (May 2012) are:

► The three year bonus is equal to 0.0 monthly contributions;

► The five year bonus is equal to 0.0 monthly contributions;

The bonus rates in force when an employee enters the contract are included in the invitation document and apply for the entire contract period.

The rates of bonus are determined by HMRC and are linked to swap rates quoted in the Financial Times. As a comparison the bonus rates in September 2008 were 2.4 and 7.0 respectively for a three or five year savings contract.

Employees can exercise their option during the 6 months after the three or five year savings contract has been completed.

Let's consider an example:

► *Today ABC Ltd decides to offer each of its employees a share option. This will allow employees, after a fixed period of time has passed, to buy a fixed number of shares at today's share price of £1 per share or at a discount of up to 20% on that price 80p per share. ABC Ltd decides to grant the option with a 80p exercise price;*

► *Employees will only be granted the options so long as they agree to save a fixed amount per month, up to a maximum of £500 per month, for a minimum of three years. Therefore the total of their savings and interest will provide enough money for them to exercise their options at the end of the saving plan term;*

► *Bob, one of ABC's employees decides to save £50 per month for five years. After five years, this will give him £3,000 plus a tax free interest bonus of £0 (current rate = 0.0 x £50), giving Bob a total £3,000.*

► *Bob is granted an option to buy 3,750 shares.*

► *Seven years later the share price has increased to £2.50. Bob uses his savings to exercise his option in full paying £3,000 for shares that are now worth £9,375. Bob makes a gain of £6,375.*

If Bob had used an option that didn't benefit from HMRC approval he would have to pay income tax and possibly NI on this benefit (even though it may only be a paper gain if he hasn't yet sold the shares). However, because this option is a HMRC approved SAYE option, he doesn't have to do so.

What happens if the value of shares doesn't increase?

There is no obligation on the employees to exercise their option and instead they could simple keep their savings and any bonus.

If the share price were to remain static or fall in value the employees would probably decide not to exercise their options as there would be little benefit in doing so.

Any benefits to the company?

Yes. The employer should be able to make a corporation tax deduction for any gains made when the options are exercised by employees.

Why should we choose it?

The SAYE scheme can help to align employee and company interests as the employees have a vested interest in the company doing well over the period of their savings plan and the longer term. From the employees perspective they carry little risk until they exercise the option as should the share value decrease they can decline to exercise the option and instead remove their cash from the savings plan.

Does this create immediate ownership?

No, the SAYE option may never be exercised and until the point that it is the employee doesn't become a shareholder, benefit from dividends, or have a tangible stake in the business.

Enterprise Management Incentive Options

What does it do?

HMRC approved Enterprise Management Incentive (EMIs) options are tax advantaged share options. They are designed to help small, higher risk companies recruit and retain employees who have the skills to help the company grow and succeed. They are also a way of rewarding employees for taking a risk by investing their time and skills to help small companies achieve their potential.

Who is it for?

EMI is intended for smaller companies only and there are a number of restrictions that companies need to be aware of.

To qualify companies must have gross assets of no more than £30 million, fewer than 250 full time employees and have a permanent establishment in the UK.

Certain types of businesses are excluded including dealing in land, financial trading, leasing and property development amongst others. Also the company must be independent - it must not be a subsidiary of or controlled by another company.

An EMI is intended to allow the company to provide key employees with the opportunity to participate although this can be widened to all employees provided that the scheme's various rules are complied with.

To be eligible to participate as an employee they must work for the company for at least 25 hours a week, or if less, for at least 75% of their working time.

Anyone holding 30% or more of the company's ordinary shares won't be eligible to participate.

How does it work?

There is a company limit of £3million on the total value of shares (as at the grant date) that may be available under EMI options at any given time. There is also an individual limit of £250,000 on the value of shares (as at the grant date) that any one employee may hold under the EMI option.

Although prior HRMC approval is not needed to grant EMI options, it will need notified of any such grants within 92 days of the grant.

Employees are selected at the discretion of the employer. These employees are granted an option to purchase company shares worth up to £250,000. Employees pay a fixed price per share if they decide to exercise the option and buy the shares. Normally an employee would have to pay income tax and possibly NI on any gain made between the granting of and exercising of the option - even though it may only be a paper gain if the employee hasn't yet sold the shares. However with an EMI no income tax or NICs will be payable when an employee exercises the share option.

The EMI share option will rise in value if the share value rises above the price set when the option is granted. Employees must be able to exercise EMI share options within 10 years.

When shares acquired through exercise of EMI options are eventually sold, capital gains tax (CGT) will be due on the option gains (the amount by which the sale price exceeds the exercise price). CGT is normally payable at 18% or 28% but if certain criteria are met it may be possible to qualify for Entrepreneurs' Relief on this gain and be taxed at a flat rate of 10%.

It is possible to structure the EMI so that specific performance criteria must be achieved in order for the option to be exercised.

What happens if the value of shares doesn't increase?

There is no obligation on the employees to exercise their option.

If the share price were to remain static or fall in value the employees would probably decide not to exercise their option as there would be little benefit in doing so.

Any benefits to the company?

Yes. The employer should be able to make a corporation tax deduction for any gains made when the options are exercised by employees.

Why should we choose it?

An EMI can provide your key employees with a financial reward where value is directly determined by business success and which may be taxed at a significantly lower rate than a cash bonus would be.

The EMI can encourage commitment from your key employees as you can ensure they may only exercise their option if they stay with the company.

From the employee perspective there is little risk until they exercise the option.

Does this create immediate ownership?

No. The option might not be exercised due to no real increase in value, or due to the performance targets not being met. As a result the employee wouldn't be a shareholder.

Company Share Option Plan

What does it do?

An HMRC approved Company Share Option Plan (CSOP) allows companies to grant share options to selected executive directors and employees. It is possible to grant an option with a maximum value per individual of £30,000 at the date of the grant. The benefit for employees is that the CSOP allows them to participate in share options without having to pay income tax and national insurance on their option gains.

Who is it for?

Companies must either be a listed company or, if unlisted, must be independent and not controlled by another company. The shares issued under that option must also fulfil certain conditions, including that they must form part of the ordinary share capital of the company; be fully paid up and not redeemable; and not be subject to restrictions other than those attaching to all shares of the same class, or certain restrictions limited to the disposal of the shares following the end of the participant's employment with the company.

A CSOP is a discretionary plan and this allows the company to select individual executive directors and employees to benefit. Whilst the CSOP may not have been designed to benefit all employees it is still possible to grant options to all employees.

To be eligible to participate executive directors must work for the company for at least 25 hours a week. There is no working time requirement for employees who aren't directors.

Employees and/or directors are debarred from participating if they have a 'material interest' in the company that established the plan – basically an interest of 30% or greater in the company counting together shares held by that employee and any associates of that employee such as a spouse, parent, son, etc.

How does it work?

Employees are selected to benefit from the CSOP at the discretion of the employer.

These employees are granted an option to purchase company shares worth up to £30,000 per employee. The options must be awarded with an exercise price equal to fair market value. It is not allowable to grant discounted options under the CSOP.

Normally an employee would have to pay income tax and possibly NI on any gain made between the granting of and exercising of the option - even though it may only be a paper gain if the employee hasn't yet sold the shares. However with a CSOP no income tax or NICs will be payable when an employee exercises the share option so long as at least three years and no more than ten years has passed.

When shares acquired through exercise of CSOP options are eventually sold, capital gains tax (CGT) will be due on the option gains (the amount by which the sale price exceeds the exercise price). CGT is normally payable at 18% or 28%

It is possible to structure the CSOP so that it can only be exercised assuming specific performance targets are achieved.

What happens if the value of shares doesn't increase?

There is no obligation on the employees to exercise their option

If the share price were to remain static or fall in value the employees would probably decide not to exercise their option as there would be little benefit in doing so.

Any benefits to the company?

Yes. The employer should be able to make a corporation tax deduction for any gains made when employees exercise the options.

Why should we choose it?

A CSOP can provide your key employees with a financial reward where value is directly determined by business success and which may be taxed at a significantly lower rate than a cash bonus would be.

A CSOP may be a suitable alternative for companies who do not qualify for EMI schemes.

From the employee perspective there is little risk until they exercise the option.

Does this create immediate ownership?

No. The CSOP option might not be exercised either due to no rise in the share value, or due to performance targets not being met.

Summary

There is likely to be a tax advantaged share scheme suitable for your business. If you want employees to immediately become shareholders then the SIP may be the most appropriate solution. If you want to offer options to all employees then a SAYE scheme may be the solution. If you are looking for share schemes to benefit specific key individuals then an EMI or CSOP could be considered.

One important point to make is that it is quite possible to operate these share schemes alongside each other. For example you could operate an EMI to incentivise your key managers, whilst operating a SIP to incentivise all employees.

Social Business Wales can help you to seek professional guidance before you make a final decision on a share scheme for your business.

Further Information

The guide has been produced for the Social Business Wales project. Social Business Wales is funded by the European Regional Development Fund and Welsh Government. It is delivered by the Wales Co-operative Centre and is part of the Business Wales service.

Social Business Wales aims to support social businesses with aspirations to grow. For further assistance, please contact:

Business Wales: http://businesswales.gov.wales/ Tel: 03000 6 03000

Or visit the online toolkit http://businesswales.gov.wales/socialbusinesswales/

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