Sharing value

Employment Tax

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Janette Burns and *Caroline Butler* consider tax favoured share schemes for employees working in the UK and Ireland

Key Points

What is the issue?

Employee share ownership is a powerful way of encouraging key employees to think like owners, helping to make the business more productive, profitable and resilient.

What does it mean to me?

UK legislation offers four share schemes whose approved status confers certain tax advantages to both employees and employers. Each plan has its own inherent conditions and quirks.

What can I take away?

This article will provide an overview of the most favoured share schemes available under UK legislation to UK taxable employees, together with an overview of the new Key Employee Engagement Programme (KEEP), which was introduced by the Irish government in 2017 for employees working in Ireland.

Entrepreneurial companies wanting to recruit and retain high calibre staff are increasingly looking for simple and effective ways to offer share ownership. Employee share ownership is a powerful way of encouraging key employees to think like owners, helping to make the business more productive, profitable and resilient. This article will provide an overview of the most favoured share schemes available under UK legislation to UK taxable employees, together with an overview of the new Key Employee Engagement Programme (KEEP), which was introduced by the Irish government in 2017 for employees working in Ireland.

Equity rewards for UK employees

UK legislation offers four share schemes whose approved status confers certain tax advantages to both employees and employers. Each plan has its own inherent conditions and quirks. The Company Share Option Plan (CSOP), which can be found at ITEPA 2003 ss 521 to 526 and Sch 4 is a ‘discretionary’, as distinct from an ‘all employee’, type of scheme, allowing employers to select which of its employees can participate. Prior to 2000, the CSOP was the scheme of choice for many companies. However, it is now much less popular due to its lack of flexibility and the restrictive £30,000 limit on the value of shares, which is attributed to each participant. In contrast, the Save As You Earn scheme (SAYE) and Share Incentive Plan (SIP) are schemes which must be offered to ‘all employees’ on similar terms. The legislation relating to SAYE schemes can be found at ITEPA 2003 ss 516 to 519 and Sch 3; and for SIPs it may be found at ITEPA 2003 ss 488 to 515 and Sch 2. In general, such ‘all employee’ schemes have been popular only with very relatively large quoted companies that have a sufficently large share capital to satisfy employee demand. As a result, the number of companies in the UK using the CSOP, SAYE and SIP schemes has fallen over the last decade.

In contrast, the Enterprise Management Incentive scheme (EMI), which was introduced in the Finance Act 2000, has continued to grow in popularity and by 2017 accounted for 83% of all companies offering tax-advantaged schemes. HMRC share scheme statistics for 2016/ 17 suggest that employees received an estimated total of £920m in income tax and National Insurance relief across all four tax advantaged schemes. The number of companies offering EMIs continues to increase, reflecting the growing nature of the small and medium enterprises at which it is aimed. The EMI offers share options to help qualifying companies attract and retain the best people they need to grow and succeed. It enables many companies, both UK resident and non-UK resident, to grant eligible employees the opportunity to acquire shares in their employing company on advantageous terms.

From an employee’s perspective, the potential to share in the future capital growth of the company is a powerful incentive to remain focused on the goals and targets of the business and a chance to share in the rewards of their own efforts. For the employer, the alignment of the employee’s interests with those of the shareholders can only have a positive impact on employee motivation and loyalty. Where smaller businesses do not have the cash resources to provide competitive salaries and bonuses, the ability to offer tax efficient share-based remuneration has proven to be most successful in retaining those vital to the future of the company.

EMI schemes are open to qualifying companies or groups with gross assets not exceeding £30m. A company can select the employees it wants to join the scheme, provided the employee works for at least 25 hours a week and does not already own more than 30% of the equity in the company. The employee can be granted options to acquire shares in his employing company over a prescribed period. The price of the shares is agreed with HMRC when the options are granted and this price is fixed. Under the terms of the option agreement, the employee can exercise his option at a future date at the pre-agreed fixed price. There is no tax charge on the exercise of the option, providing it was granted at market value; and if the company has increased in value between the date of grant of the option and the date the employee exercises the option, then the uplift is received tax-free by the employee.

The EMI is a great deal more flexible than other approved schemes and it is possible to adjust the scheme and tailor it to the specific requirements of the company. The options must be granted over Ordinary Shares that are fully paid and not redeemable, and each option must be capable of being exercised within 10 years. Also, the total market value of shares subject to an unexercised EMI option at any time cannot exceed £250,000 and any options granted under a CSOP scheme also count towards this limit.

For companies to qualify, the value of the company’s gross assets must not exceed £30m at the date the option is granted. The company must be independent, have fewer than 250 employees, carry out a qualifying trade on a commercial, profit making basis, which does not to any substantial extent include certain excluded trading activities, and have a permanent establishment in the UK.

The EMI is a creative method of remunerating employees, planning for succession and providing employees who fall within the scope of UK tax the opportunity to avail themselves of generous tax benefits. This tax plan has indeed been a resounding success with the number of companies offering the opportunity to their employees increasing year after year.

Equity rewards for Irish employees

The KEEP scheme was first introduced in Budget 2017 after substantial lobbying from the SME sector, the Irish Tax Institute and the Law Society.

The scheme was viewed as essential for SMEs to become more attractive and retain key employees by permitting such employees to participate in the growth of their employing company. This is especially relevant for smaller companies which do not have sufficient cash resources at their growth stage to offer competitive salary packages to employees in comparison with established multinationals.

The major difference in the KEEP scheme and existing share schemes available in Ireland for Irish employees, is that on the exercise of a KEEP share, there is no income tax charge but rather the tax liability is triggered on the future disposal of the KEEP share. Any gain is then subsequently subject to capital gains tax.

As such, any tax liability is therefore deferred and also reduced, with the rate of CGT in Ireland currently at 33%, substantially lower than the marginal rates of income tax of 52%. Historically with existing share schemes, the triggering of a tax charge on the exercise of a share option presented a cash flow difficulty to employees, as they had a tax liability and no cash to meet their tax obligations.

There are several qualifying conditions that a company, an employee and the share option must meet to qualify for the KEEP scheme. The company granting the share option must be a ‘qualifying company’ for the purpose of the relief. A qualifying company must have been incorporated in Ireland/EEA or carry on a business in Ireland through a branch or agency. The company must be carrying on a trade; however, certain trades are prohibited. These include companies dealing in or developing land, professional service companies and financial activities, for example fintech companies. Furthermore, the company must be unquoted and meet the definition of an SME.

For an individual to qualify, the following conditions should be met:

- The individual must be a full-time employee/director working at least 30 hours per week for the qualifying company.
- The employment held must be capable of being held for at least a further 12 months from the date the option is granted.
- The employee must not acquire or be connected to a person who controls more than 15% of the ordinary share capital of the company during option period.
- The individual must hold the option for a minimum of 12 months prior to the exercise.

To qualify for CGT treatment under the KEEP scheme, the share option must be over new ordinary fully paid shares in a qualifying company. It must have an exercise price that is not less than the market value of the underlying shares on the date the option is granted. In addition, a written contract must be in place setting out the number and type of shares, option price and exercise period. The share option granted to any individual employee in any year cannot be valued at more than 100% of the employee’s salary and the overall value of the share options that can be granted to employees in the lifetime of the scheme is €300,000. Finally, the share option must be held for a minimum of 12 months and a maximum of 10 years.

The uptake of the KEEP scheme has been very disappointing, and this was acknowledged by the Minister for Finance in his Budget 2019 speech. Revenue has stated that around 30 companies have commenced the scheme, but no employee has received a KEEP share to date. Commentators on the scheme have pointed out the limitations of the scheme; namely, the exclusion of certain companies, the valuation cap of €3m and no mention of safe harbour around valuing a company. For example, if you consider that a typical share option pool often represents 10% to 15% of a company, the KEEP scheme would not work for companies with valuations in excess of €30m, such as growth/highly valued technology companies. Finally, the requirement for an employee to ‘work a minimum of 30 hours per week’ does not reflect the reality of start-ups that usually rely on the input of a number of employees or consultants at the development stage, which are closed out of the scheme as a result of this condition.

Nevertheless, the introduction of the KEEP scheme is still regarded as a positive step. It is, at its best, an acknowledgement that share option schemes can contribute to the SME sector. Industry experts are now calling for the scheme to reflect more of the relaxed conditions pertaining to the EMI scheme if it is to gain the same popularity and success as its counterpart in the UK.