What a gift!

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Naomi Nesbit and Matthew Hall explain the employee shareholder scheme

Key Points

What is the issue?

The government introduced the concept of the employee shareholder in September 2013 allowing employers to award tax-advantaged shares to key employees in return for the forfeiture of some statutory employment rights

What does it mean for me?

For the right company, the scheme can provide a genuine opportunity to recruit, retain and motivate key employees in a tax-efficient way; offering shares with a potential exemption from capital gains tax on sale

What can I take away?

It is important to understand the key objectives of a company to ensure that any share scheme, including the award of ESS shares, is the right fit for their needs

The ‘employee shareholder’ concept was introduced as the flagship announcement in the chancellor’s speech at the Conservative party conference in 2012. Initially dubbed ‘shares for rights’, it is fair to say that it had a rocky start, with the policy widely criticised and being defeated in the House of Lords in March 2013. However, the chancellor persevered and, after a five-month delay, the employee shareholder status (ESS) was born with employers having the right to offer shares to employees from 1 September 2013. Now, there appears to be considerable interest in the scheme and the Shares and Assets Valuation department is apparently dealing with a ‘significant number’ of valuations requested for the purpose of share awards under employee shareholder agreements.

Employee shareholder status defined

ESS is an entirely new employment status involving employee shareholder employment contracts. The employer company (or its parent) must give shares with an actual market value of at least £2,000 to an employee while the employee foregoes some statutory employment rights. This concept is unique in that the tax legislation is taking a large step on to the toes of employment law.

Although there is a minimum value requirement (£2,000) on shares to be provided to the employee shareholder, there is no minimum percentage requirement. The shares to be given to the employee can be of a new class with particular rights and restrictions. For example, the employee may be entitled to participate in future company growth only, or the shares may carry no voting rights, or contain good and bad leaver forfeiture provisions.

There is no set upper value to the shares that can be issued, although a share value in excess of £50,000 will have an impact on the calculation of capital gains tax exemption available to the employee. It should be noted, however, that an employee shareholder must hold less than 25% of the share capital (with reference to voting rights and rights to assets on a winding-up).

Shares can be issued to an employee in tranches and there is no minimum holding period for the capital gains tax exemption to apply.

There is no requirement for the issuing company to be independent and there are no restrictions in terms of the size or trading type of the companies that can award employee shareholder shares.

The effect on income tax

In principle, when shares are issued to an employee the award is subject to income tax based on the value of the shares at issue minus any price the employee paid for them. In some circumstances, the award may also be subject to NICs.

However, ESS deems the first £2,000 of shares issued to an employee shareholder to be free from income tax and NICs. Therefore, it is only any value received by the employee in excess of this that will be subject to a charge under the employment related securities rules (see ***Example 1***).

Example 1 - effect on income tax

Mr Wilkins acquires employee shareholder shares with a total unrestricted market value at award date of £10,000, in exchange for entering into an agreement to become an employee shareholder. Mr Wilkins elects to be taxed on the unrestricted market value. The first £2,000 is treated as ‘deemed consideration’ and an employment income charge arises on the balance of £8,000.

The company receives corporation tax relief based on the market value of the shares. If NICs apply, there will also be employers’ NIC, albeit tax-deductible itself for the company.

The effect on capital gains tax

The major tax advantage for an employee shareholder is that the first £50,000-worth of shares received by the employee under ESS will be exempt from capital gains tax on a future sale. There is no set limit on the value of the gain which is exempt (see ***Example 2*** and ***Example 3***).

Example 2 - Effect on capital gains tax

Miss Kennedy enters into an employee shareholder agreement with her employer, Z Ltd. This is her only ESS agreement. Neither Miss Kennedy nor anyone connected with her has or has had a material interest in Z Ltd. In consideration of the agreement, she acquires shares in Z Ltd with an unrestricted value on acquisition of £50,000.

Three years later, the company is sold and Miss Kennedy receives proceeds of £500,000. The entire gain of £450,000 is exempt from CGT because the initial acquisition had a value that did not exceed £50,000.

Example 3 - Effect on capital gains tax

Imagine instead that Miss Kennedy enters into an agreement with Z Ltd, whereby she acquires over time three successive tranches of shares in the company. Tranche 1 has a value on issue of £10,000; tranche 2 of £20,000; and tranche 3 of £30,000.

The shares in tranches 1 and 2 are exempt ESS shares because they fall within the £50,000 limit. Two-thirds of the shares in tranche 3 are also exempt from capital gains tax because this takes the total value received on share issue to £50,000, leaving one-third subject to the applicable capital gains tax rate on sale.

Qualifying conditions

There are conditions to be satisfied in order to qualify as an employee shareholder and benefit from the tax advantages. The main ones are:

- The employer must give the individual fully paid-up shares in the employer’s company or the employer’s parent company, and they must be worth at least £2,000.
- The employee must forego some statutory rights.
- The shares must be fully paid-up shares, and the accounts must demonstrate this.
- The individual must not pay for the shares in any way.
- The employer must give the individual a written statement of the particulars of the status of employee shareholder.
- The individual must obtain advice from a relevant independent adviser on the terms and effect of the written statement. The company is required to pay for that advice whether or not the individual accepts the employee shareholder agreement.
- The individual cannot accept or agree to an employee shareholder agreement until seven days have passed after receiving the independent advice.
- The employee shareholder (and/or persons connected with them) must not have a material interest in the company in order to be able to benefit from the tax advantages.

Statutory rights to be sacrificed

To become an employee shareholder, the individual is required to forego some statutory rights. These include:

- Unfair dismissal rights, except on the ground of discrimination and in relation to health and safety;
- The right to statutory redundancy pay;
- The right to request flexible working, except in the two-week period after a return from parental leave;
- some statutory rights to request time off to train; and
- an employee shareholder will have to give 16 weeks’ notice (an increase from the normal statutory notice) to the employer if they intend to return early from maternity leave, additional paternity leave, or adoption leave.

Conclusion

By awarding employees with shares, the goals of those individuals should be aligned with the goals of the company. Employee shareholder status, therefore, can be used as a tool for recruitment, retention and motivation of employees in any sector. The significant capital gains tax exemption available on ESS shares makes it particularly attractive to employees. Unsurprisingly, there appears to be particular interest in ESS from certain groups of employers, including those that are:

- fast-growing SMEs;
- companies with highly skilled employees who are mobile in the jobs market;
- companies working towards an exit, such as a sale or a management buyout;
- subsidiaries within groups where offering shares in the holding company would be inappropriate; and
- companies within sectors excluded by some other share schemes, such as financial activities or property development.

Although the announcement of ‘shares for rights’ was met initially with much scepticism, it appears that there is a place in UK business for a scheme that is both flexible and generous in awarding shares to key employees.