Say it with shares

OMB

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Peter Rayney lets us in on a technical conversation with an (anonymised) OMB client about its proposed share options

Key Points

What is the issue?

OMB wishes to grant employee share options but exceeds the ‘250 employees’ limit

What does it mean for me?

Understand the considerations facing OMBs wishing to implement employee share options where an EMI scheme is not possible

What can I take away?

Appreciation of many key areas affecting employee share schemes

In 2014, the ATT sponsored the Tax Writer of the Year category at the LexisNexis Taxation awards which was won by Peter Rayney. Peter has agreed to write this article on a subject suggested by ATT's technical committee.

Sebastian, known to his colleagues as 'Seb', is the finance director of a successful IT company, Phoebe IT Ltd, which is a close company for tax purposes. He was reflecting over the previous day's board meeting at which it was proposed to grant a further series of share options to some of its senior IT specialists and managers. Seb was tasked to explore the most tax-efficient way to achieve this.

'It's a pity that we can't grant any more options under our enterprise management incentives (EMI) scheme – we exceeded the 250 employee headcount limit last year,' he mused. 'It seems that we are going to have to issue *unapproved* share options, so I'd better check how these would work.' At moments like these, Seb would seek inspiration from the company's tax adviser, Joshua – so he phoned him.

'Hi Joshua, I was looking for some "quick" advice about share options. The board needs to grant some more options and, as you know, we are over the 250-employee limit, so we can't use the EMI scheme. I've done some quick "calcs" and most of our individual options would represent about 0.5% of our share capital on a "fully diluted" basis. I know that we would want to steer clear of these new fangled employee shareholder share arrangements since our IT specialists will not want to give up any employment rights. Plus, we want to use options. What would you advise us to do?'

'Well, Seb, there are a number of choices. Leaving aside the approved company share option plan (or CSOP) – we'll come back to that later – perhaps the most straightforward one is to grant unapproved share options. There is no tax charge on the grant but, unlike your EMI options, employees would suffer an income tax charge when they exercised them. This would be based on the market value of the shares at that point.

Seb interrupted: ‘So the charge is based on an “unrealised profit” and they won’t receive any cash when they exercise? Blimey, they won’t like that, especially when they know that our EMI options don’t incur any income tax charge on exercise. Do we have to tax that under PAYE and are NICs due?’

Income tax on exercise

‘It all depends,’ which was one of Joshua’s typical replies. ‘I don’t think PAYE or NICs would be due in your case. This only occurs if the shares are readily marketable – strictly known as “readily convertible assets”. This might happen where, for example, the shares are about to be sold and can be realised into cash. So, provided there is no impending sale of the company when the options are exercised, any tax charge is reportable on the employee’s tax return, with the income tax being paid through the self-assessment system, generally by 31 January after the end-of-the-tax-year of exercise.

‘The tax shouldn’t be that scary since we are talking about valuing very small minority holdings that are going to be heavily discounted for fiscal valuation purposes. The discount could be as much as a 80% reduction on the straight pro rata value of the shareholding.

‘Let’s try to put some numbers around this. Let’s assume that Phoebe IT Ltd was worth £7 million when the options were exercised and that we are valuing a shareholding stake of 0.5%. The value we might agree with HMRC would be somewhere in the region of £7,000 – that is £7 million x 0.5% = £35,000 less (80% discount x £35,000) = £7,000. This would be taxed at (say) 40% – £2,800 in the employee’s hands.

‘That’s not a bad result, but the problem is that, if these unapproved options are exercised shortly before a sale (like our EMI ones), we would hardly have any discount and virtually all the sale value would be subject to full PAYE and NICs. It would therefore be much better if the employees were able to exercise their options freely within two or three years and before any prospect of a sale, since the value can then be based on heavily discounted minority holdings. The company could also provide interest-free loans to the employees to enable them to acquire the shares.

These loans would not count as a taxable benefit since any interest charge would be tax deductible.

‘You could also make the options conditional on pre-agreed performance criteria. Yes, there would be a small amount of income tax to pay but the company may be able to assist with that.’

Seb responded: ‘That should all be manageable, Joshua. I’m sure we could help them out on the tax front. Anything else to consider?’

Section 431 elections

‘Well, I always advise my clients to make a section 431 election on all employee share purchases. Strictly, these elections are only required for “restricted shares” – that is where the shares are subject to certain restrictions which reduce their value. For example, if an employee has to sell back their shares to the company at their original purchase price when they leave as a “bad leaver”. The problem is we cannot say for certain whether standard ordinary shares like yours, with pre-emption restrictions and the like, are likely to be restricted. Assuming the company continues to grow in value, I’ve always felt that it’s not worth taking the downside tax risk if HMRC subsequently succeeded in arguing they were “restricted”.’

‘Why is that?’ asked Seb.

‘By making a section 431 election, the employee agrees to base their “up-front” income tax charge on the option exercise on the value of the shares *ignoring the impact of the restrictions* – that is known as their “unrestricted value”. Let’s assume that the restrictions devalue the shares by 10%. By making the election the employee agrees to pay tax on that higher unrestricted value – so there may be a very small additional income tax liability on the exercise. The important point is that this ensures that all future growth in the value of the shares will be subject to CGT. Now this would be beneficial so long as CGT rates remain below income tax rates, which we would expect to be the case. On the other hand, if no section 431 election is made, we can say that if the company was eventually sold employees with unapproved shares would be exposed to an income tax charge of some 10% of their sale proceeds – with employee and employer’s NICs on top of that. The 10% is obtained by taking the proportion of the unrestricted value that was not taxed on exercise. It’s all quite complex really, but does that make sense?’

‘Yes ... it seems the key to avoid incurring substantial income tax charges later on is to enter into a section 431 election with the employee. Do we send that to the HMRC?’ asked Seb.

‘No. The election must be made within 14 days and is retained by the company. HMRC may ask to see the section 431 elections during an enquiry or to ensure that there is no income tax charge arising on a later sale. So you should keep them in a safe place. You should also ensure that you pick up the company’s tax relief when the employee exercises their share option.’

‘Run that by me again!’ It didn’t occur to Seb that the company might obtain tax relief when the employee share options were exercised.

Corporation tax deduction for employee shares

‘Yes, the tax legislation, CTA 2009 Pt 12 to be exact, provides that the company is entitled to a corporation tax “trading” deduction equal to the amount that is subject to income tax in the employee’s hands. You might therefore consider obtaining an appropriate share valuation when the options are about to be exercised. This will ensure consistency – both the company and the employee would use the same value. I understand that HMRC will often seek to ensure that “matching” values are used.’

‘There’s a lot to this isn’t there, Joshua? What about our EMI options? Presumably as the employees do not suffer any tax charge on exercise, there is nothing for the company to claim relief on.’

‘I’m glad we’re having this conversation,’ said Joshua with a little excitement. ‘That’s the good bit. The company will be able to claim tax relief when the EMI options are exercised even though there is no income tax charge for the employee. It’s a good thing that none of your EMI options have been exercised yet since you might have missed this.

‘Broadly, the company can claim tax relief based on the difference between the share value on exercise less the exercise price. As your EMI options are “exit-based” – they are only exercisable shortly before a sale – the market value of the shares will be near to the actual sale price. The value of this tax relief is likely to be a very significant asset on any future sale and you should try to retain as much of it as possible when negotiating the sale consideration. And don’t forget all your EMI option holders are now likely to benefit from the 10% entrepreneurs' relief (ER) CGT rate on sale, even though they would not have held the shares for the required 12-month period.'

'Wow, fantastic!' exclaimed Seb.

'Wait until I tell the board. You always give me a few surprises, don't you? You mentioned something about CSOPs. Could they help us?'

Company share option plans (CSOPs)

'In some ways CSOP options work in a similar way to EMI options,' said Joshua. 'But they are not subject to any employee headcount restrictions. Broadly, this means that all of the employee's profit should fall within the more beneficial capital gains regime, but they are unlikely to benefit from the 10% ER rate.

'The exercise price for a CSOP option shares must not be manifestly less than their market value at the date the option is granted. This market value, as at the date of grant, must not exceed £30,000 per employee. Based on the numbers we were looking at earlier, you should easily be able accommodate them within the CSOP rules – all your IT specialists and managers would meet the "full-time working" condition. Generally the main restriction is that CSOP options can only be exercised after the third anniversary of the grant. If you go down the CSOP route, you will have to draw up formal scheme rules, but it is no longer necessary for them to be pre-approved by HMRC. However, to qualify for the favourable tax treatment, CSOP options must be notified electronically to HMRC.

'You can make the exercise of CSOP options conditional on specified performance targets. Once more, as with your EMI scheme, the company obtains corporation tax relief on the excess of the market value on exercise less the exercise price – even though this amount is not subject to income tax in the employee's hands. If you want to pursue the CSOP route, I would be happy to come along to your next board meeting to run through the details.'

'I'll take you up on that, Joshua. I can see that there are some attractions of going down the CSOP route. All the planned options for our guys would easily fall within the £30,000 limit due to the heavy valuation discount. And they should avoid any income tax on exercise I like that. Joshua, can you take this forward for me? I'll give you a list of prospective option grants and perhaps you could prepare a briefing note for the next board meeting showing how this would shape up under a CSOP. And we’ll compare that with the likely tax costs of going down the unapproved share option route. Thanks for your input – you’ve been most thankful as always.’

‘No problems. One last point – don’t forget that all your employee share returns must now be filed online – so you should arrange to get the company registered for e-filing as soon as you can.’

‘Thanks Joshua – will do.’

As so often happened after speaking with Joshua, a warm glow came over Seb content in the knowledge that he had the makings of a sound plan to put to ‘his’ board.