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EMPLOYEE SHAREHOLDER SCHEME ("ESS")

Introduction

The Employee Shareholder provisions were introduced in the 2013 Finance Act amid much debate as to whether or not employees and employers would make use of the new rules.

In essence shares are given to employees in return for them giving up certain employment rights. Many employees and their employers are waking up to the fact that the new rules give very generous tax reliefs if the various conditions are met.

Overview

Where an employee is granted shares in consideration for entering into an employee shareholder agreement the first £2,000 worth of shares will be free from Income Tax (and National Insurance if applicable) as the shareholder will be treated as having made a payment of £2,000 for the shares. The normal tax rules will apply to the value of any shares received in excess of £2,000 thus giving the individual a tax liability.

An exemption from Capital Gains Tax ("CGT") will be available on any gain realised on the disposal of Employee Shareholder shares. The exemption applies to the disposal of the first £50,000 worth of shares (valued at the day the shares were acquired).

For example, assume an employee is granted Employee Shareholder shares worth £50,000. After 3 years the shares are sold for £300,000. The realised gain is £250,000, and assuming all the conditions are satisfied this gain would be exempt from CGT. There would be an Income Tax charge at the time of grant on £48,000 (i.e. the value of the award less the first £2,000 which is exempt).

Valuation of the shares

The valuation of the shares issued to the Employee Shareholder is critical to the success of any Employee Shareholder arrangement. The shares awarded must have a value of at least £2,000 for the arrangement to be effective. The company must consider the actual market value of the shares at the date of issue, i.e. the value should take into account any restrictions applicable to the shares. Employers are likely to want to impose restrictions on any employee shares, for example to prevent the employees from selling their shares to third parties. When calculating the number of shares that can be issued to an employee it will be the unrestricted market value which is used (i.e. the value ignoring any contractual restrictions on the shares).

If the restricted value of the shares is below £2,000, the ESS cannot be used. However, if the value of the shares is over £2,000, Income Tax (and potentially National Insurance contributions) will be payable on the excess.

The Employee Shareholder must receive £2,000 worth of shares in a single allocation. An issue of employee shares cannot be staggered, nor can an initial award of shares be "augmented" with a further award if the valuation shows that an initial award was below £2,000.

An ESS cannot therefore be used where performance targets may dictate the number of shares to be awarded.

In view of the importance of issuing shares with a value over £2,000 agreeing the valuation with HMRC in advance of any award is prudent. Once HMRC approval is received there can then be no doubt that the tax exemptions are available to the Employee Shareholders.

Dilution

With an ESS the share valuation is crucial and this can lead to some unforeseen consequences. For instance, the lower the value of the shares, the more shares an employer will need to issue to meet the £2,000 threshold. This in turn could lead to a material dilution of value for the company's other shareholders. Companies will therefore have to balance any dilution risk against ensuring a realistic valuation for the shares to be awarded.

One solution could be to create a new class of shares for the £2,000 worth of Employee Shareholder shares. The rights and restrictions on these shares could be changed with a consequential effect on the value. This gives companies considerable flexibility when it comes to designing a scheme which is appropriate for their business.

Who are employee shares suitable for?

To benefit under the ESS rules an individual has to be an employee of the company awarding the shares or a subsidiary company. However, unlike with Enterprise Management Incentive ("EMI") options there is no working time requirement. This means that individuals who would not qualify for EMI could qualify for Employee Shareholder shares. The simple test is that an individual must be an employee who is able to give up certain employment rights.

Another condition is that the employee does not control more than 25% of the company either on his own or when looking at the total shareholding percentage of the individual and of those connected with him.

Any company can issue Employee Shareholder shares – there are no restrictions, as there are with other tax favoured arrangements, which limit participation by reference to the activities undertaken by the company.

If the employee ceases to be employed he is still regarded as an Employee Shareholder which means that the £50,000 exemption continues to apply. This is not the case with EMI options where the tax benefits lapse 40 days after ceasing to be employed.

Employee Shareholder shares can be voting and dividend bearing which can be attractive when looking at aligning the management team with the position of shareholders. Employee Shareholder shares can be subject to the usual shareholder protections such as drag along and tag along rights.

The drawbacks

The major element of the new legislation is that employees have to give up certain employment rights in return for their shares. Perhaps the most important right to be given up would be the right to claim unfair dismissal.

An employee is required to obtain independent legal advice relating to the rights given up. This legal advice must be paid for by the employer.

This initiative could be very attractive for senior executives who may feel less exposed or concerned about the risks associated with giving up employment rights.

New start-ups may struggle with this initiative because the Employee Shareholder shares must have an unrestricted tax market value of at least £2,000.

Independent legal advice

The employee must obtain independent legal advice on the terms and effects of the Employee Shareholder agreement before entering into it. The employee must follow a specific process; taking seven calendar days to consider the advice before the employee can enter into the shareholder agreement. This process is likely to be time consuming and potentially expensive for the employer who must meet the reasonable cost of the advice being provided. The employer should be vigilant as the only advice which can be paid for by the employer on a tax-free basis is in connection with: the terms and effect of the Employee Shareholder agreement and general advice explaining how Employee Shareholder arrangements are taxed.

Other matters

In order to ensure that any future increase in the value of the Employee Shareholder shares is not inadvertently subject to Income Tax the employee will need to sign 'Section 431 election'. This election is a joint election signed by the company as well and ensures that all future growth is subject to CGT and not Income Tax which means that in the case of the ESS no further tax liabilities will arise.

The ESS rules are clear in that the Employee Shareholder must not give any consideration for the shares they are given. Thus, employers and employees should be mindful of, and hopefully avoid, any transactions which could be construed by HMRC as the Employee Shareholder giving consideration.

Conclusion

The ESS provisions give the opportunity for employers to provide employees with a significant tax break. Many may view the giving up of employment rights as a small price to pay for a tax-free capital gain.

The most important elements with the ESS rules is the share valuation and also ensuring that the proper procedures are followed through before the shares are issued.

Please contact Simon Littlejohns, Tax Partner, for any further detail on how to design and implement an ESS.

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