Ask an expert

Is the employee shareholder status scheme appropriate?

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Our client is an unlisted company that is looking to incentivise its key employees in the form of equity. The company understands that it is not eligible to grant enterprise management incentives options due to it being under the control of another company. However, the company has heard about the 'shares for rights' scheme and the significant CGT benefits that are available under it. The company wants to know whether it will be eligible to operate such a scheme and what the tax benefits would be.

Employee shareholder status (ESS) or 'shares for rights' as it is sometimes known, was introduced in September 2013 amidst a fair amount of controversy. The basic premise of ESS is that in return for giving up certain employment protection rights (including the right to claim unfair dismissal, the right to redundancy pay, the right to request flexible working or undertake study or training) an employee is issued shares with a minimum value of £2,000. However, the real attraction of ESS is that shares worth up to £50,000 will benefit from a capital gains tax exemption on sale. While the government's intention may have been for ESS to be used by small fast growing companies who wanted a more cost effective way to take on new employees, it has mainly been used as a tax efficient way of incentivising key executives and management, particularly in private equity portfolio companies.

What are the tax benefits?

Income tax: Income tax is only payable on the acquisition of ESS shares to the extent that their actual (restricted) market value (AMV) exceeds £2,000. Under ITEPA 2003 s 226A, the excess of AMV over £2,000 is treated as employment income. If the shares are subject to restrictions, then the usual rules in ITEPA 2003 Part 7 Chapter 2 will apply, so that a further income tax charge may arise when the restrictions fall away or the shares are sold. However, it is possible to make an election under ITEPA 2003 s 431(1) on the acquisition of ESS shares, such that the employee will be subject to income tax on acquisition only and by reference to the unrestricted market value of the shares (s 431(3)(aa)).

Therefore, it is likely that there will be an income tax charge at some point unless the ESS shares are not subject to any restrictions. If the ESS shares are readily convertible assets, then any income tax will be payable through PAYE and NICs will also be payable.

Capital gains tax: Any growth in value of ESS shares is exempt from capital gains tax if the value of the shares on acquisition is no more than £50,000 (TCGA 1992 ss 236B–236C). If the shares are worth more than £50,000 on acquisition, the CGT exemption will only apply to the first £50,000 worth of shares.

One of the conditions for both the beneficial income tax and capital gains tax treatment is that the shareholder does not have a material interest in the relevant company (ITEPA 2003 s 226D and TCGA 1992 s 236D). An individual will have a material interest if the individual and any connected persons hold at least 25% of the voting rights, or at least 25% of the assets on the winding up of a close company.

What are the key conditions?

There are a number of requirements in order to ensure that the tax benefits are available. Firstly, there must be no other consideration given for the shares other than entering into the ESS agreement (Employment Rights Act 1996 s 205A(1)(d)). The shares must also be in the employing company or a parent company and be newly issued and fully paid up (s 205A(1)(b)). However, there are no other restrictions on the type of shares that can be used, nor on the nature of the rights and restrictions that may attach to the shares. Given that the employee cannot pay for the shares, at least the nominal value of the shares will need to come from another source. This could be through a payment by another shareholder (such as an employee benefit trust) or through a capitalisation of reserves. The Department for Business, Innovation & Skills has indicated that treasury shares may also be used.

A written statement must be provided to the employee in advance of entering into the ESS agreement setting out details of the shares and a summary of the rights they carry (s 205A(1)(c)). The employee must also have received advice from a 'relevant independent adviser' and there must be a seven day 'cooling off' period before entering into the agreement (s 205A(6)).

How are the shares valued?

The valuation of the ESS shares is going to be key, both for ensuring that the shares are worth at least £2,000, and determining the amount of any tax liability. HMRC has established specific arrangements for agreeing ESS share valuations (a form VAL 232 will have to be completed). The requirement to achieve a minimum £2,000 value means that it may be necessary to adopt different valuation arguments with HMRC than is usually the case with employment related securities. However, even in the case of companies whose shares have zero or minimal value, it may be possible to put in place arrangements to increase the value to at least £2,000 (such as redemption and/or put option rights).

How can ESS shares be used most effectively?

For executives and senior management, the tax benefits of ESS shares make them an extremely effective incentivisation tool. Even though they may incur an income tax charge on acquisition, for companies that are expected to experience significant growth, the CGT saving can make ESS shares even more tax efficient than EMI options in some cases. The flexibility around how ESS shares can be structured also presents some further opportunities. For example, a company could award 'growth shares' under an ESS arrangement. These would typically be shares that have little or no value on acquisition but would allow holders to share in any increase in value above a certain threshold. Using growth shares can help to depress the market value on acquisition in order to minimise the income tax charge, and enable a greater number of shares to fall within the £50,000 CGT exemption.

Use it while you can

Both Labour and the Liberal Democrats have said that they would abolish ESS if they were in power after the May election. Therefore, companies looking to implement ESS should consider doing so sooner rather than later. ■