INNOVATIVE TAX TECHNIQUES FOR EMPLOYEE SHARE SCHEMES

David Craddock, Founder & Director, David Craddock Consultancy Services

Webinar

Monday 11 October 2021 15:00 BST

FS Club

A Word From Today's Chairman

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Today's Agenda

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- 15:00 – 15:05 Chairman's Introduction
- 15:05 – 15:25 Keynote Presentation – David Craddock
- 15:25 – 15:45 Questions & Answers

Today’s Speaker

EsopCentre

David Craddock

Founder and Director

David Craddock Consultancy Services

d.craddock@dcconsultancyservices.com

David Craddock Consultancy Services

Specialist in Employee Share Ownership and Reward Management,
Share Valuation, Management Buyouts,
Employee Ownership Trusts (EOT)
& Investment Education

Founder, Principal and Director:
David Craddock, MA(Oxon)
Consultant and Lecturer
Author of **"Tolley's Guide to Employee Share Schemes"**

★ *Expertise and Experience* ★

Innovative Tax Techniques for Employee Share Schemes

Why is there the need for Innovative Tax Techniques?

In the UK, there are four so-called tax-advantageous employee share schemes, historically known as the tax-approved schemes:

- The Savings-Related Share Option Scheme
- The Company Share Option Scheme
- The Share Incentive Plan
- The Enterprise Management Incentives Employee Share Scheme

These schemes operate with limitations that are built into the legislation. Also, it may be that a company's structure may not allow the introduction of one of these schemes.

However, it is possible to develop a commercially-effective, tax-efficient employee share scheme using the general legislation, notably from the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003") and the Taxation of Chargeable Gains Act 1992 ("TCGA 1992").

ITEPA 2003 includes the Section 431 Tax Election regime that, when properly implemented for shares to which restrictions are attached, can protect future gain from income tax, subject instead to the less punitive capital gains tax regime.

TCGA 1992 includes Section 272 that, when harnessed to the share valuation case law, enables share values to be established that can be relied upon in employee share schemes whether developed from the bespoke employee share schemes legislation or the general legislation.

The General Share Option Scheme (Unapproved Share Option Scheme): An Example

This example is designed to illustrate how the introduction of a discount in the calculation of the option price at the time the option is granted can compensate for tax that is subsequently payable on the exercise of the option.

Suppose that a tax-approved CSOP option is granted at an option price of £5.
The £5 in this example represents the market value of the shares at the time the option is granted.

Suppose that a tax-unapproved share option is granted at an option price of £1.
The £1 in this example represents the market value of the shares at the time the option is granted of £5 less a discount of £4.

Some years later the employee exercises both options.

The income gain that arises at exercise is gross/net of £5 under the tax-approved CSOP arrangement and a net of £5.40 under the tax-unapproved share option arrangement.

In this example the discount at grant has more than compensated for the anticipated income tax charge arising at exercise.

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Tax-Approved CSOP	**The Income Tax Effect**	Tax-Unapproved Share Option
	Exercise	
£10	Market Value = £10	£10
Gross Gain = £5 **Net Gain = £5**		**Net Gain = £5.40** Gross Gain = £9
£5 At Market Value	Grant	£1 At Market Value Less Discount of £4

<u>The Phantom Share Option Scheme: An Example</u>

Suppose a phantom option is granted over a <u>notional</u> number of 5,000 shares and suppose also that the option price is set at £1.

The £1 in this example represents the market value of the shares at the time the option is granted.

Some years later the employee exercises the option, or more precisely exercises his right to call upon the company for a sum of money that is calculated on the basis of the rise in the share price from the date of grant to the date of exercise. The market value of the shares at the time of exercise is £5.

The gross sum of money that the employee is entitled to is calculated as follows:-

5,000 shares × (£5 - £1) = <u>£20,000</u>

The £20,000 is subject to income tax and National Insurance Contributions, payable through the PAYE system and subject to a corporation tax deduction as taxable emoluments.

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<u>"Exercise"</u> <u>Right to Call</u>	**<u>The Income Tax Effect</u>** Market Value £5	
		Taxable Increase in Value = £4 **Income Tax to Employee** **Corporation Tax Deduction for Employer**
<u>Grant</u>	Market Value £1	

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The Long-Term Incentive Plan - An Example: Whether or not to link the L-TIP to EMI

Suppose that an employee is allocated 1,000 shares and the employee pays 40% income tax.

NOT USING EMI **TOTAL TAX = £0 + £4,000 = £0 = £4,000**

Year 3 Sale Sale Value = £10

Uplift in Market Value from Maturity to Sale = [£10 - £10] x 1,000 = £0

Capital Gains Tax = **£0**

Year 3 Maturity Market Value = £10

Uplift from Allocation Value to Market Value = [£10 - £0] x 1,000 shares = £10,000

Income Tax = £10,000 x 40% = **£4,000**

Year 0 Allocation

Allocation Value = **£0**

USING EMI **TOTAL TAX = £1,200 + £0 + £1,400 = £2,800**

Year 3 Sale Sale Value = £10

Uplift in Market Value from Grant to Sale = [£10 - £3] x 1,000 = £7,000

Capital Gains Tax = £7,000 x 20% = **£1,400**

Year 3 Maturity = EMI Exercise Market Value = £10

Increase in Market Value from Grant to Exercise = [£10 - £3] x 1,000 shares

Income Tax = **£0**

Year 0 EMI Grant Market Value = £3; Option Price = £0

Discounted at Grant = £3 x 1,000 shares = £3,000

Income Tax = £3,000 x 40% = **£1,200**

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The Employee Share Trust: The Classic Model

This explanation is designed to demonstrate the movement of cash and the movement of shares in as tax-efficient a way as possible within an employee share scheme arrangement.

The structural steps are as follows:

Step 1: The company makes a cash contribution to the offshore trust.

Step 2: The trust uses the cash to purchase shares from the existing shareholders.

Step 3: The trust transfers the shares to the employees, either to satisfy the exercise of options or to meet some other obligation arising from employee rights to shares or the company's resolve to dispense free shares to the employees.

The consequences of this arrangement are as follows:

- Cash is transferred from company to existing shareholders **via the offshore trust**.
- Shares are transferred from existing shareholders to employees **via the offshore trust**.

The arrangement will offer the possibility of efficient tax treatment as follows:

- Corporation tax relief for the company independent of the trust.
- Capital gains tax treatment for the existing shareholders.
- Income tax reliefs for the employees independent of the trust.
- No capital gains charge for the trust, given the offshore status.

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The Share Purchase Scheme

The approach is to arrange for the employee to make an immediate purchase of shares through the payment of monies that are funded by a non-contractual bonus. The payment back into the company by the employee of the net bonus monies represents the subscription for the shares, giving the employee immediate ownership of the shares, thereby allowing payment of dividends. Indeed, this approach to pay a bonus alongside an invitation to participate in an employee share scheme provides the basis for one of the forms in which the Restricted Share Plan is introduced in the USA.

The financial modelling using discounted cash flow techniques demonstrates significant tax benefits to the company and to the employee arising from funding the purchase of shares through bonus monies. For this type of share purchase scheme to be effective in terms of tax-efficiencies for the employee and in terms of the motivational impact on the employee, the scheme should be structured in one of the following two ways:

- The scheme may provide the employee will net bonus monies (after applying PAYE) to fund the purchase of the shares at their full market value, in which case no liability to income tax or National Insurance Contributions will arises on the actual purchase of the shares.

- The scheme may fund the employee with net bonus monies (after applying PAYE) that enable the employee to pay the liability to income tax and National Insurance Contributions that arise on the purchase of the shares at a discount on full market value. This funding by the company to the employee to pay the tax liability on the discount is an alternative to the funding of the full market value.

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The Share Loan Scheme

The share loan scheme arrangement is most appropriate in circumstances where a director is expected to meet share ownership targets soon after joining the company or within a short timescale, say, typically, within one year of joining.

Where these targets are set, the company expectation will usually be for the director to acquire at least some of the shares at current market value as a straight purchase, quite apart from any shares that he or she may expect to purchase later through involvement in the company's bona fide employee share schemes. However, it is often the case that the director does not have the readily disposable funds available to make the investment.

The legislation enables the company to provide the funding to the director in the form of a loan so that he or she can make the investment. The director is thereby enabled to become an actual shareholder from the outset of the arrangement with no upfront cost from his or her own resources.

There are for the director key tax advantages as this structure establishes a position whereby all growth in the value of the shares is captured within the CGT regime rather than the more punitive income tax regime and there is no charge to tax at all at the date of acquisition. The potential downside for the director is that the director is at risk of exposure to loan repayment without available resources in the event of a falling share price.

A Form of Growth Shares Model: Based on a Share Reclassification and Value Freeze

The principle behind growth shares is that a separate new class of shares is created that has no dividend rights and no voting rights but has full capital rights in the event of a takeover of the company, a sale of trade and assets of the company, the admission of the company to a recognised stock exchange or a winding-up of the company. The operation of this form of growth shares model relies upon the share reorganisation principles working in combination with share valuation principles to orchestrate the value freeze.

Using the share reclassification technique, at the date of creation of the new class of shares their value is no more than their nominal value, say £0.01 or maybe even less. The reason for this low value is that as part of a reclassification of the share capital the other new class of shares that is created is given very substantial rights and is classified as a class of preference shares. The rights for the preference shares include full voting rights, full dividend rights and full capital rights.

The values attached to the dividend rights and the capital rights are enshrined in the Articles of Association at the date of the reclassification. It is from these rights that it is established that the full value of the company at the date of the reclassification, the value freeze, is attributable to the preference shares. However, the preference shares will never be more than the value attributed to them at the date of the reclassification so that all future growth in the value of the company from the date of the reclassification attaches to the new ordinary shares that are called, therefore, 'the growth shares'.

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The Comparison with the Joint Share Ownership Plan ("JSOP")

By comparison with the reclassification growth shares scheme, for the JSOP, a joint owner is required with the employee for the same shares. The joint owner is usually an employee share trust to solidify the initial market value in the way that the existing whole company value is frozen in the cumulative non-redeemable preference shares in the growth shares model.

For the growth shares model, the freezing technique facilitates all future value to attach to the growth shares whereas, for the JSOP, the role of the employee share trust allows the bulk of the future value to attach to the employee's separate interest in the shares.

The point is that the JSOP operates with two separate interests – the interest of the employee and the interest of the employee share trust – in the same shares. The employee share trust does not benefit from any future gain which accrues to the employee's interest.

Unlike the growth shares model described previously, where it is possible to grant an Enterprise Management Incentives ("EMI") share option over the individual employee's allocation of ordinary shares, it is not possible within the JSOP arrangement to grant an EMI option over the individual employee's interest in the share. This is for the reason that the EMI legislation does not envisage the acquisition of an interest in shares, only an actual acquisition of shares. Furthermore, the EMI legislation does not envisage ownership by two parties of the same share.

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The Tracker Shares Concept

The Tracker Share represents a class of shares that is created at holding company level specifically to track the developing value of a subsidiary company's business. The value of the subsidiary company is captured in the Tracker Share which can then be used for employee share scheme purposes as part of a scheme arrangement for the involvement of the employees of the subsidiary company.

The technique ensures that the employees can be participants in an employee share scheme that is based on a holding company share that represents the subsidiary company to which they are directly adding value rather than based on a holding company share to which the employees from throughout the whole group are adding value.

Subsidiary Company Employee Share Schemes

Finance Act 2003 abolished "the dependent subsidiaries legislation", thereby enabling from henceforth for an employee share scheme to be introduced in the subsidiary which, when linked to the Section 431 Tax Election, allows for the realised gain on the sale of the shares to be taxed under the capital gains tax regime.

Typically, the employee share scheme is based on a new class of shares that is structured to have low value at the inception of the employee share scheme.

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Employee Share Schemes

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Questions And Answers

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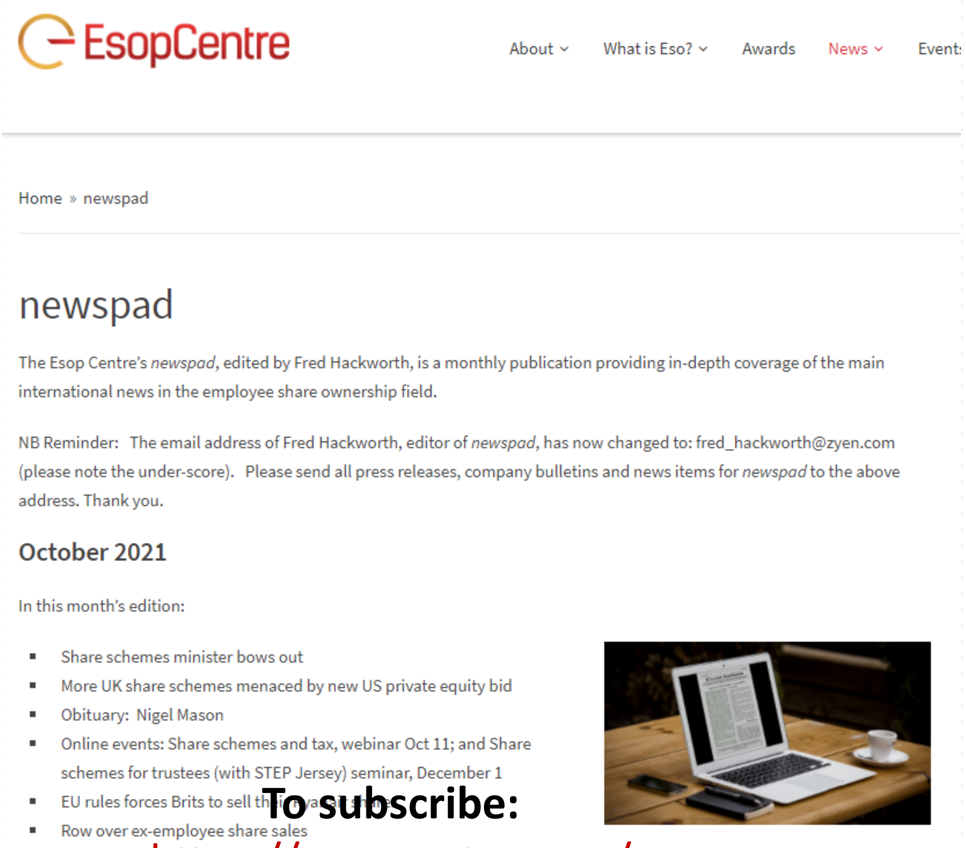
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The Esop Centre's *newspad*, edited by Fred Hackworth, is a monthly publication providing in-depth coverage of the main international news in the employee share ownership field.

NB Reminder: The email address of Fred Hackworth, editor of *newspad*, has now changed to: fred_hackworth@zyen.com (please note the under-score). Please send all press releases, company bulletins and news items for *newspad* to the above address. Thank you.

October 2021

In this month's edition:

- Share schemes minister bows out
- More UK share schemes menaced by new US private equity bid
- Obituary: Nigel Mason
- Online events: Share schemes and tax, webinar Oct 11; and Share schemes for trustees (with STEP Jersey) seminar, December 1
- EU rules forces Brits to sell their private equity...
- Row over ex-employee share sales

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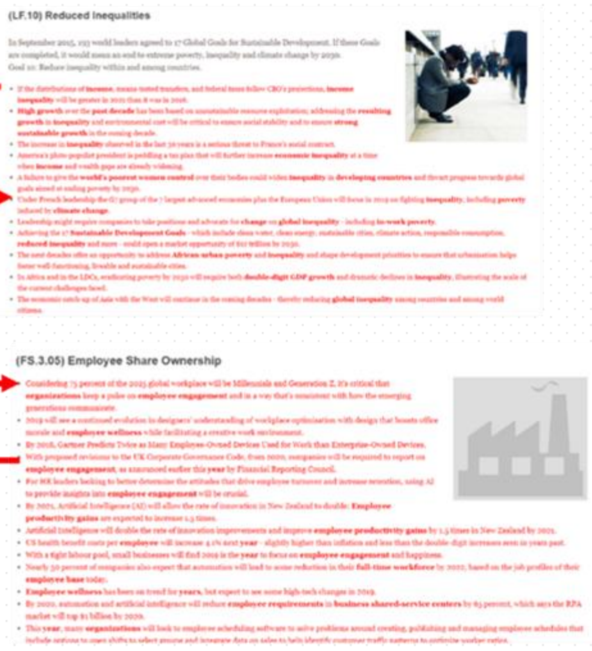

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Forthcoming Events

- Wednesday 13 Oct (15:00) Practical Examples At The Cutting Edge Of Natural Language Processing (HybridNL)
- Thursday 14 Oct (15:00) Asynchronicity & The Future Of The Workplace
- Wednesday 20 Oct (09:00) Launch Of Global Green Finance Index 8
- Thursday 21 Oct (10:00) Escape From Model Land: The Dangers Of Over-Confidence In Mathematical Models And How To Avoid It
- Monday 25 Oct (16:00) Privacy By Design Is Essential To Complementing Regulatory Compliance: Privacy Laws Are No Longer Sufficient

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