Share Option White paper briefing

Vfdnet Share Option Schemes

Vfdnet regularly implements Share Option Schemes, and this Share Option White paper briefing is the first step in the vfdnet streamlined process:

1) **Share Option White paper briefing**
2) Design of bespoke scheme
3) Implement scheme
4) Communicate scheme benefits

Why consider Share Options?

The first question to ask is what are your goals in offering share options? Broadly there are generally three reasons why you might want to consider a share scheme:-

a) to allow employees to acquire shares in a tax-effective way over a period of time: this can increase motivation and improve team performance. But ask yourself whether you are happy to share ownership and if this will work in terms of remuneration and dividend policy. Once the option is exercised the employee becomes a co-owner and their rights must be respected.

b) to lock-in the employee until the point of a sale (or IPO) or until a key milestone is achieved. Translating what would otherwise be cash benefits into future share rewards can be very beneficial for an early stage or fast growing company.

c) to reward past loyalty ahead of a sale: it is quite common for owner-managers thinking of a sale to want to ensure that key employees who have contributed to the value creation share in sale proceeds.

Locking in key employees can save considerable management time, business interruption and costs involved in having to replace a senior manager. Can this be done without losing control of your business? Also can it be done in a tax efficient way? How do you protect the business should it become necessary to part company with the key employee? A well designed Share Option Scheme will answer all these questions but it does pay to have an experienced 'hand on the tiller' to guide you through the maze of alternatives.

What are Share Options?

A Share Option is when an individual is granted the Option of buy Shares in a company at a future time at a share price agreed when the Option is granted.

How can you maintain Company Control?

Business Owners may wish to incentivise senior employees but will also wish to protect the business by retaining control. Share Options provide a means of allowing senior managers to participate in the capital growth of the business, however this needs to be accompanied by careful drafting of the Share Option Rules and also amending the legal Articles of Association. The legal documents need to be drafted so that differing outcomes can be anticipated and planned for. For example a senior employee who leaves to join a competitor (a bad leaver) should lose any entitlement to purchase Shares and also be required to sell back any Shares that he or she had acquired. On the other hand a senior employee who holds Share Options who dies (a good leaver) perhaps ought to be allowed to purchase shares for the benefit of their spouse or estate.

In addition careful legal drafting is required to protect the business owner's interests in a business sale situation, so that should the main shareholder chose to sell any smaller employee shareholders or option holders are required to sell (so called Drag Along provisions).

<u>How flexible are Share Option Schemes?</u>

Share Option schemes can be very flexible in how they are developed, which provides benefits in being able to more closely match the objectives of the business owner. However this can present more confusion and complexity at the outset, hence using an experienced guide should Fastrack this process.

In designing the right Share Option scheme for your company you will need to address several questions:

1. **Objectives**: What are the objectives of the Share Option Scheme? Are they to lock in senior employees until the business owners sell the business? Or is it to provide the senior employees with loyalty bonuses after long service? Alternatively it is to provide employees with the chance to invest in the equity of the business?
2. **Participants**: Who will be invited to enter into the Share Option Scheme? How much equity do you wish allow them to purchase? It makes sense to do some approximate business valuation calculations to evaluate the amount and impact of the options on the motivation of senior employees.
3. **Entitlement**: How will senior employees become entitled to purchase Shares? Will there be a qualifying service period? Alternatively would you wish to apply performance criteria to the Share Options eg. If the company exceeds £1.5m sales then the senior employee is entitled to purchase shares.
4. **Share Rights**: What rights do you wish the new Shares to have? It may be that the Shares would be non-voting. Would the Shares be Dividend earning at any time in the future?
5. **Leaver's rights**: What rights should leavers have? What qualifies as a 'Good Leaver' or 'Bad Leaver'?

We have a detailed meeting to discuss all these key questions so that the Owner Managers can settle on the best choice of decisions for their particular circumstances. This decision process enables the following legal process to be streamlined.

<u>How are Share Options Taxed?</u>

The taxation of Shares and Dividends is subject to change in each government Budget, and so up to date Tax advice should be sought during the scheme design process.

Shares issued as part of an Enterprise Management Incentive Scheme (EMI) are taxed as a Capital Gain (and potentially as low as 10%) or a 'deemed Dividend' and not normally subject to income tax and national insurance. Shares issued outside this specific scheme are at risk of heavy taxes being levied; the Government has passed certain anti-avoidance legislation so that giving shares to employees can be a taxable benefit in kind on which tax and national insurance is payable, often meaning that the employee (or more likely the Company) ends up with a large unexpected Tax bill of several thousand pounds. So if the options enable the employee to buy shares at a price below the current share value (for example par value) then the employee suffers 2 taxes:

a) On exercise the employee will pay income tax on the difference between the market value at date of grant and the price paid and
b) when the employee eventually sells the shares they will pay capital gains tax (or tax on a 'deemed Dividend') on the difference between the market value at date of grant and the proceeds of selling the shares.

If however Share Options are issued, via an EMI approved Share Option scheme, at a value at or above the Revenue deemed 'Share Valuation' then no such income tax or national insurance is payable and it is only the

increase in Value of Shares which is taxed as a Capital Gain (or Deemed Dividend). This means that the increase in Share Value is taxed at either:

- Capital Gains tax rates (currently 0% up to £11,100 Capital Gain, thereafter 18% or 28% for higher rate taxpayers) – when Shares have been held for 5 years or more NB. As from April 2013 EMI Shares sold on a business sale are be able to be taxed under the Lifetime Entrepreneurs Relief scheme at 10%.
- Deemed Dividend rate (currently 30%) – when Shares are held for less than 5 years.

<u>The Tax Advantage of EMI Share Option Schemes</u>

The Government have made allowance for a scheme called an Enterprise Management Incentive (EMI) Scheme which is tax effective. Under this scheme there is no income tax or NIC payable on qualifying share options either on the date they are given to the employee or on the date they are exercised.

The scheme enables the value of the shares to be agreed with the Revenue in advance of granting each option. If the options enable the employee to buy shares at no less than the current share value then when the employee eventually sells the shares they will only pay capital gains tax on the difference between the amount paid and the proceeds of selling the shares.

For an EMI Share Option Scheme to be set up, certain qualifying criteria need to be met:

- The Company must be a ‘Qualifying Company’
- The Employee must be a ‘Qualifying Employee’

Again our detailed planning meeting will identify whether the company can set up a scheme and which employees can qualify.

The value agreed with HM Revenue and Customs is discounted from the full value because employee shareholders typically have very few shares so no effective power and because of the difficulty of selling shares in unquoted trading companies. (This is called minority interest discount).

Decide what value you place on the company and its shares now. Valuing shares, especially small minority shareholdings in a private company, is a very subjective business. With the right advisers this can give you plenty of latitude to achieve your goals.

It is not strictly necessary to agree a share price for the EMI options with HM Revenue & Customs. However, it is a very good idea to do so. That way you know that you are within the relevant limits (£250,000 value of shares at grant per employee and £3million in total for all option holders). Also if you want to grant options at below market value (which you can do) the amount of income tax to be paid on exercise of the option is known.

This is useful information for your employees and it can also be very important for you to know. This is because if the shares are what HMRC call "readily convertible assets" at the time the shares are acquired (e.g. because the company is to be sold), then the Company may have to pay PAYE.

So if you grant options at less than market value and they are exercised at the point the company is sold, PAYE will need to be paid on that undervalue.

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Streamlined Process
Our vfdnet streamlined process delivers bespoke Share Option Schemes that achieve the business owner's objectives, in a cost effective way through:

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3) Implement scheme
4) Communicate scheme benefits

To talk to us about designing and implementing a bespoke scheme for you, please email me at james@vfdnet.com or call 01865 78 40 60.