Employee and Business Angel Shareholdings

Avoiding Income Tax Issues
Employee and Business Angel Shareholdings

Introduction

Private companies, particularly those in a start-up or early stage development phase, will find it difficult to compete on salaries and benefit packages with bigger, established businesses. A key means of attracting talented individuals to work for private companies is often to offer the individual the opportunity to acquire a meaningful stake in the ownership of the company, with the potential for this to turn into a substantial monetary sum on a future exit.

The benefit of selling a shareholding on an exit will be all the more material where capital gains tax (CGT) treatment is secured; but this tax treatment should not be assumed. Employee share ownership can all too easily be caught by tax legislation which is designed to prevent employees or directors being provided with share benefits without paying income tax and national insurance contributions. As will be seen below, these rules should be considered not only where an employee is recruited with a promise of shares or an existing employee is rewarded or incentivised by a share award, but also where founders establish a new company or where a business angel invests and is to be a non-executive director.

If income tax rules apply:

- income tax at rates of up to 50% will be payable;
- employee’s national insurance contributions (NICs) at 2% may also be payable (assuming the salary payable to the individual is in excess of the maximum figure at which the full 12% rate of employee NICs is payable);
- the company may also have to pay employer’s NICs (at 13.8%);
- income tax and NIC payments will often be payable by the employer company under the PAYE system (with a need for the company to have the means for collecting relevant liabilities from the employee shareholder).

If CGT treatment is applicable:

- a higher rate taxpayer pays CGT at 28% on the gain;
- if the shareholding represents at least 5% of the company’s share capital, there is the potential for securing a 10% tax rate (by means of entrepreneurs’ relief);
- if the shareholding is of 30% or less and held by investors who are not employees or executive directors, there is the potential for an exemption from CGT under the Enterprise Investment Scheme.
- a small amount of tax exempt gains can be secured through use of the annual exemption (potentially £10,600 of gains for the individual and a further £10,600 for his/her spouse/civil partner).

So there is every reason to seek to ensure that CGT treatment will apply. We often come across situations in which the founder shareholder(s) have promised equity to a key employee but have not done anything about implementing that promise; and when they come to do this the opportunities for avoiding income tax problems have been lost.

This note highlights some circumstances in which income tax liabilities can arise, either under general principles relating to the taxation of earnings or under the intricacies of the “employment related securities” (ERS) legislation. The ERS legislation is highly technical in nature and can all too easily
catch situations in which no obvious tax avoidance is involved. We also make some suggestions as to how to avoid difficulties.

We provide an overview of some commonly encountered issues in this important area but do not seek to summarise all circumstances in which tax liabilities may arise. Specific advice on the facts of any particular case should be sought and is commonly invaluable for early stage businesses. This note is based on the law in force on 1 December 2011 and refers to tax rates applicable in the tax year 2011/12.

Taxation of Earnings – General Principles

To set the potential tax issue in context; take the example of a key employee being recruited with a promise that he/she will be given a shareholding in the company. The employee’s opportunity to acquire the shares therefore arises from his/her employment. If, when the shares are acquired, they have a value greater than any amount the employee is required to pay (which may well be nil or nominal), then that difference will be treated as earnings for income tax purposes.

The problem can be all the more acute where the promise is not implemented at an early stage (when it might be that the shares have little or no value) but is only implemented after the company has grown and become more profitable.

Even though there may be no market for the shares and no exit in prospect at the time the shares are acquired, valuation methodologies can be applied to ascertain the value of a share in a private company and this will be a matter for negotiation with HM Revenue & Customs. In some cases there may be a clear indication of what that value should be; e.g. where an investor/business angel has recently acquired a small minority shareholding at a particular price. If no such indicators are present an appropriate valuation methodology will need to be identified and figures agreed with HMRC.

Employment Related Securities Legislation – Basic Scope

If a tax liability can be avoided under the general principles above, the potential for a charge under the ERS legislation must still be considered.

There are circumstances where it can be argued that the individual is acquiring shares in an entrepreneurial capacity or as a founder shareholder, rather than the opportunity to acquire the shares being offered in an employment capacity.

However, the ERS legislation includes a somewhat blunt instrument, namely a provision which says that whenever shares are acquired by someone who is, or is to, be an employee or director, they are deemed to be acquired by reason of employment. This then means that the provisions of the ERS legislation which impose (higher) income tax charges are potentially applicable.

This blunt instrument will, for example, often catch a situation in which a business angel makes an investment and is to become a non-executive director. Founder shareholders – i.e. the entrepreneurs who establish the company and who will be directors – will also typically be within the ambit of the legislation.

This does not necessarily mean that liabilities will arise under the legislation; but the potential application of the charging provisions should at least be considered.
It should also be noted that the ERS legislation includes provisions which prevent an employee or director from avoiding charges by using a company or a trust to acquire the shares.

Some of the charging provisions most commonly encountered are identified below.

**Employment Related Securities Legislation – Less than Full Market Value Paid**

These provisions can apply where:

- the purchase price payable to acquire the shares is less than the full market value of the shares, but the tax charge under general principles does not arise (because the opportunity to acquire the shares did not in fact arise from employment but is deemed to do so under the blunt instrument referred to above); or

- there is a full market value purchase price, but payment is deferred (e.g. until the shares are sold – to avoid the employee having to fund payment).

- In any such case the undervalue or deferred amount is treated as an interest free loan, such that:
  - an annual tax liability on the notional interest free benefit may arise; and
  - in a case where the value of the shares at the date of acquisition exceeded the purchase price and no charge under general principles arises, the difference is treated as a earnings when the shares are sold, subject to income tax and national insurance contributions; and
  - in a case where a full market value purchase price was calculated but was deferred, but the company is not successful and the shares are sold for less than the purchase price or the company is liquidated and the employer company agrees to waive all or part of the outstanding purchase price, the amount waived is treated as taxable earnings.

**Employment Related Securities Legislation – Restricted Shares**

An employee shareholding will typically be subject to various restrictions; e.g. provisions which require shares to be transferred if the employee leaves employment and provisions which regulate the circumstances in which the shares can be transferred. This will usually mean that the ERS legislation treats the shares as “restricted shares”.

Complicated provisions can then apply to treat part of any proceeds realised on a sale of the shares as earnings subject to income tax and NICs. The usual way of avoiding this problem is for a specific form of election to be made by the employee at the time the shares are acquired. This election should eliminate a tax charge on sale of the shares under this part of the legislation. However, this election will lead to a tax charge on acquisition if the price payable to acquire the shares is less than the market value of the shares, ignoring, for valuation purposes, the existence of the restrictions (which might otherwise depress the value of the shares).

So, in summary, tax problems under the restricted shares provisions can be avoided if:
the appropriate election is signed at acquisition, electing to treat the shares as if they were “unrestricted” for tax purposes; and

- the price paid to acquire the shares is at least equal to the unrestricted market value of the shares (i.e. their value calculated as if the restrictions did not exist).

**Employment Related Securities Legislation – Other Heads of Charge**

Some of the other provisions under which the ERS legislation can result in income tax liabilities and NICs are as follows:

- If the employee/director is granted a share option under which he/she can acquire the shares at a future date (e.g. when the company is sold) - in such a case income tax and NICs will typically be payable on exercise of the option to the extent that the then value of the shares exceeds the price payable by the employee/director to acquire the shares. There are particular types of tax favoured options which do not always result in such liabilities (see further in “Practical Tips” below).

- If a special type of share is created which has restricted rights at the outset (e.g. to keep the initial value of the share low) but the share can be converted at a later date into a full ordinary share – in such a case the act of conversion can give rise to income tax liabilities and potentially NICs in relation to the enhanced value which is crystallised on conversion.

- Anti-avoidance rules exist to attack situations in which an employee shareholder receives benefits by virtue of the ownership of the shares. For example, bonus shares (if their value exceeds any loss in value of the original shareholding) could result in a tax charge; or if additional rights are created for the existing shares (e.g. by the employer making changes to the share rights in the Articles of Association) the enhancement in value could be taxed.

**Application of PAYE and Reporting Requirements**

Whenever income tax and national insurance liabilities arise the employer company must consider whether it is obliged to account for the liabilities under the PAYE system. Very broadly this will be the case where there are arrangements under which the shares can be sold (either at the relevant time or at a future date).

This obligation can arise even in circumstances where insufficient cash payments are being made by the employer company to the relevant employee from which it can make the PAYE deductions. It is therefore necessary to ensure that the position of the employer company is protected by ensuring that the employee shareholder is obliged to indemnify the company and to allow practical arrangements to be made to collect the tax.

Whenever shares are acquired in circumstances where the ERS legislation is applicable (whether or not tax liabilities arise) the company is obliged to make a return of that fact (before 7 July in the tax year following the year in which the acquisition took place).
Practical Tips

Some ways of addressing the issues identified above, and additional points to consider, are as follows:

- Founders and any other employee/director shareholders who will own at least 5% of the shares should consider eligibility for entrepreneurs’ relief, with a view to securing a 10% CGT rate on sale (for gains of not more than £10m – a lifetime limit for each individual). Business angels/non-executive director shareholders can consider the availability of relief under the enterprise investment scheme, potentially providing some income tax relief on money subscribed for the shares and a CGT exemption on a sale. However, in all of the above cases all or part of the benefit of these reliefs will be lost if ERS, and thus income tax charges, applies.

- Whenever possible issue shares (or consider the alternative of the grant of an enterprise management incentive (EMI) option – see below) at a time when they have little or no value – do not promise an employee or director shares and then do nothing about it until after the business has acquired meaningful value.

- If shares are to be issued, the founding or controlling shareholders will wish to retain control over those shares – e.g. by requiring a departing shareholder to sell the shares back at original cost if he/she leaves employment. This issue (i.e. retaining appropriate controls over shares and avoiding difficulties with minority shareholders) can all the more easily be secured if share options are used – perhaps options which are only exercisable on an exit. If so, consideration will need to be given to the use of a form of option (e.g. an EMI option) which can avoid income tax liabilities and NICs under the ERS legislation.

- Always consider the use of EMI options for employee shareholders. If relevant conditions can be satisfied, income tax liabilities can be avoided on exercise of an EMI option, with the CGT regime applying to profits realised on a sale of the option shares. A brief overview of the conditions to be satisfied is contained in the Appendix to this note. Under certain circumstances Entrepreneurs Relief can be used with an EMI scheme.

- An alternative to EMI options is an HMRC approved share option scheme (known as a company share option plan, or CSOP). However the value of shares which can be awarded under a CSOP (£30,000) is much lower than under EMI (£120,000), the form of a CSOP is much more restrictive and there is a need to secure prior HMRC approval. EMI is almost always the preferred means of securing tax efficiency for an option.

- What if there is material value in the shares at the time the share award is to be made and the employee cannot afford to pay this amount? Possible strategies include the following:

  - Use of EMI options – if the price payable to exercise the option is less than the market value at the date of grant of the option, that difference will be subject to income tax and NICs on exercise, but any growth in value of the shares should be subject to the CGT regime. (Note: It would not be possible to use a CSOP in this situation since CSOP rules require that the exercise price be no less than market value at the date of grant.)

  - Use of unapproved options – this avoids a tax charge at the outset (when there is no ability to sell the shares); instead the tax liabilities arise when the option is exercised, which would be timed to coincide with a situation when the shares can be sold. However, the full value at the time of exercise will be subject to income tax and NICs.
An arrangement under which the shares are acquired at the outset with a purchase price equal to the then market value of the shares; but this is left outstanding until the shares are sold. If arrangements are put in place to protect the employee should the value of the shares go down, income tax and national insurance liabilities could become payable (e.g. on any write off of the obligation to pay the purchase price) but this may be an acceptable risk. It will be necessary to consider how to deal with leavers.

A more sophisticated arrangement (and more aggressive and likely, therefore, to be subject to careful HMRC scrutiny and potential challenge) could be to have a special class of “flowering” or “growth” shares. The rights of these shares would be such that they arguably have little value at the outset but instead value accrues on future events, without any conversion of the shares into a different class of shares. The aim would be to enable the employee to acquire the shares for a modest market value figure, with the future growth in value being outside the charging provisions of the ERS legislation.

Always ensure that PAYE issues are addressed through appropriate documentation. If national insurance liabilities may arise, consider whether this is a case where the law allows for the employer’s NICs to be borne by the employee and, if so, whether provision to this effect should be made in the documentation.

Summary

The following examples illustrate the range of after tax returns which might be achieved when a shareholding is sold, by reference to circumstances of different categories of shareholder (as described in the first column below).

<table>
<thead>
<tr>
<th>Description of Shareholder</th>
<th>Net after tax proceeds of sale, assuming £5m taxable profit¹</th>
<th>EIS relief applies</th>
<th>Entrepreneurs’ relief applies</th>
<th>Full rates apply²</th>
<th>Employment related securities provisions apply³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor with shareholding of less than 30% who is not an employee or director</td>
<td>£5m</td>
<td>N/A</td>
<td>£3.6m</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Investor with shareholding of less than 30% who is a non-executive director</td>
<td>£5m</td>
<td>£4.5m</td>
<td>£3.6m</td>
<td>£2.4m</td>
<td></td>
</tr>
<tr>
<td>Management/employee shareholder with shareholding of at least 5%</td>
<td>N/A</td>
<td>£4.5m</td>
<td>£3.6m</td>
<td>£2.4m</td>
<td></td>
</tr>
<tr>
<td>Management/employee shareholder with shareholding of less than 5%</td>
<td>N/A</td>
<td>N/A</td>
<td>£3.6m</td>
<td>£2.4m</td>
<td></td>
</tr>
</tbody>
</table>
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These crude examples illustrate that there is much to play for. Advice should be sought before the shares are allocated.

Notes:

1. Taxable profit: Proceeds of sale less deductible costs and less any available annual exemption.

2. The figures in this column assume the shareholder has income and gains such that the top CGT rate of 28% applies.

3. If ERS legislation applies part of the gain could be taxed at 52% (50% income tax + 2% employee’s national insurance). The £2.4m figure is a worst case figure (but ignoring the impact of employer’s national insurance) based on the whole gain being taxed at 52%, which would be unusual. Income tax and national insurance liabilities could also arise on the acquisition of the shares.

Further Advice

This Briefing summarises some of the main features of ERS rules, based on the law in force on 1 December 2011. The relevant legislation is lengthy and detailed, and this Briefing does not refer to all the provisions under which tax liabilities can arise. Specific advice should be sought in relation to the facts of any particular case.

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Appendix

Share Options Qualifying as Enterprise Management Incentives

Some key features and eligibility requirements of EMI options are as follows:

- Trading companies with gross assets of no more than £30 million can have an EMI scheme. Certain trades will not qualify.
- The company must be independent – not under the control of another company. It (or a trading subsidiary) must have a UK permanent establishment.
- Only companies with fewer than 250 employees can grant EMI options.
- An employee can hold unexercised EMI options over shares worth up to £120,000 (calculating the value of the shares at the date of grant of the option).
- With care, employees can be granted EMI options over shares worth £239,999 in a three-year period.
- There is a £3 million overall limit on the value of shares (valued at the date of grant) that can be made the subject of unexercised EMI options.
- To be eligible an employee must spend on average at least 25 hours a week, on the business of the EMI company (special rules apply for employees who work less hours but who work wholly or mainly for the EMI company); the employee must not have an interest of 30% or more in the shares of the company.
- No income tax or NICs on option exercise if the exercise price is at least equal to the market value of the shares at grant.
- The exercise price of EMI options can be set at less than market value (this “discount” will be subject to income tax and potentially NICs on exercise).
- No need to get HMRC approval in advance. Each option must be notified to HMRC within 92 days of grant.
- There is no need to adopt a formal set of EMI share option plan rules. Each EMI option takes the form of a stand-alone agreement. Great flexibility as to terms of the options.
Disclaimer

We have written these materials to help you, but no article can address all the issues. The benefit of using an experienced lawyer is that they ask the right questions and build the solution around you. Please therefore note that these materials only provide you with general information and should not be regarded as a substitute for taking legal advice.

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