Employee Shares

Don’t lose up to £900,000 in entrepreneur’s relief
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Introduction

Failure to plan ahead to take advantage of entrepreneurs' relief could cost up to £900,000 in additional capital gains tax. This article explains how to ensure that your employee share schemes are tax efficient.

Offering shares to employees can be an important part of the armoury to incentivise employees. In designing such a scheme, don't forget to consider the qualification requirements for entrepreneurs' relief as this can have a significant impact upon the tax that your employee would be required to pay. Bryan Rickman explains how to ensure that share scheme incentives are optimised.

Entrepreneur’s relief

When you sell capital assets such as shares, capital gains tax is charged on any gain, less allowable costs and your annual exemption if available.

Since 23 June 2010, the capital gains tax rates payable by an individual are:

- 18% - if your combined income and taxable gains (after deducting any available tax-free allowances and reliefs) are at or below the basic rate band upper limit (currently £37,400); and
- 28% - for gains exceeding that limit.

Entrepreneurs' relief reduces both these rates to 10% on the first £5 million of gains, the current lifetime limit, providing certain conditions are met. This is a valuable tax break. For a higher rate tax payer making a £5 million net gain, qualifying for entrepreneurs' relief means a reduction of 18% capital gains tax, equating to a significant tax saving of £900,000.

Entrepreneurs' relief is available on the sale of shares in a company provided that, throughout the period of one year ending on the date of disposal, all of the following conditions are met:

- the company is a trading company or the holding company of a trading group;
- the shareholder owns at least 5% of the company's ordinary share capital and can exercise at least 5% of the voting rights; and
- the shareholder is an officer or employee (full or part time) of the company or another company within the trading group.

Typical share scheme requirements and their impact on entrepreneurs' relief

If you are considering offering shares or shares options to employees or others, the starting point in every case is to identify your objectives and to design the scheme around that. Generally speaking, tax efficiency can reduce the flexibility of your scheme. However, given the clear advantage of reliefs such as entrepreneurs' relief, this is often a price worth paying.

Let's consider some of the pitfalls:
Limiting employee share ownership

Clearly the percentage of shares offered to employees will depend upon a number of factors. These include the size of the company, the number of employees, employee performance and future investment and recruitment plans.

However, if you propose to allocate say 4.5% to a particular employee you may want to consider increasing that to the magic 5% figure. It would be a shame if a relatively small increase in shares to an employee could have avoided a significant increase in their capital gains tax liability.

Future share issues will also need to be kept under review, as this might dilute existing employees' shareholdings to below 5%.

Non-voting shares

Employers often allocate shares to employees, to enable them to participate in a future company sale and perhaps receive dividends.

At the same time, you may be reluctant to give employees voting rights for fear that they may block future shareholder decisions. It is not uncommon, therefore, to offer employees a separate class of non-voting ordinary shares.

Assuming all other requirements for entrepreneurs' relief have been met, you may want to ensure the employee retains at least 5% of the voting rights. Otherwise, the relief will not apply.

Exit-only share option schemes

Many share option schemes are structured as exit-only schemes. This means the options can only be exercised at the point of sale of the company or other exit. These schemes are popular as they enable employees to participate in a future exit without having to fund their share acquisition. They also avoid having to compulsorily purchase back the shares of an employee who, having exercised their share option, then leaves prior to the exit.

The requirement for entrepreneurs' relief is that the employee actually holds 5% of the ordinary shares throughout the one year qualifying period. As long as that is the case and the other qualification requirements are met, additional shares held by that employee for a shorter period will also qualify for entrepreneurs' relief. For example, this will include share options exercised immediately before sale. If, however, an employee only holds an option to acquire 5% or more of the enlarged ordinary shares, he would have to exercise that share option at least one year prior to sale to qualify for entrepreneurs' relief.

You should therefore consider carefully whether an exit-only scheme is the right type of share option scheme, if it would otherwise mean failing the one year period of ownership requirement.
Role of shareholders

There are no specific rules regarding either working hours or the level of remuneration. The condition is simply that the individual should be an officer or employee throughout the one year qualifying period.

It can have tax advantages to transfer shares between husband and wife or civil partners. A transfer won’t trigger a taxable gain and each party is entitled to their own £5 million lifetime limit for entrepreneurs’ relief. Just remember to ensure that at least 5% of the ordinary voting shares are transferred and that the spouse or civil partner is made an officer or employee at the earliest possible date.

If you would like further guidance on any of this, we will be pleased to talk you through the issues.

Bryan Rickman is a highly experienced corporate and commercial lawyer, handling the full range of corporate transactions including M&A, private equity, corporate restructures and joint ventures. He is also an employee share schemes specialist.

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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.

Would you like to know more?

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