Employee Ownership

An introduction to Employee Share Plans

And how we can tailor them to suit every business

> The concept of giving employees a direct stake in the business for which they work is gaining traction with many business owners, with the simplest method requiring the design and implementation of an employee share plan.

There are many reasons for a business to adopt this approach to a kinder, more inclusive capitalism, but chief amongst them is evidence that employee share plans improve motivation, increase productivity and strengthen loyalty.

Starting an employee share plan also has the added benefit that sharing in the success of their employer helps retain existing, valued team members, whilst proving an incentive to attract new talent to the business.

The reasons to consider an employee share plan are simple, but choosing the right plan, implementing it successfully and administering it compliantly and efficiently over its lifespan can be complex for the uninitiated, with potentially serious consequences for the unwary.

Before we look at the most popular employee share plans, it is important to understand that an Employee Ownership Trust (EOT) employee holds shares, indirectly, on behalf of all qualifying employees, whereas an employee share plan enables individual employees to become actual shareholders in the company.

Employee share plans can help deliver employee ownership in non-EOT companies, but they can also be used once a company has transitioned to EOT ownership to create a 'hybrid' ownership model.

“We decided that we needed a share scheme because we wanted our employees to be motivated to work as hard as possible to make the company succeed. RM2 were professional, informative, and highly communicative about the whole process, the work involved, and its progress over time. Highly experienced and adept in dealing with HMRC, RM2 was a pleasure to work with!

Employee share plans in non-EOT businesses

Introducing an employee share plan can be a valuable tool for incentivising and rewarding employees in the medium and long-term, ensuring they start to think about the success of the business, like owners not workers.

Owning shares directly can also deliver the following benefits:

- Dividend rights
- Voting rights
- The right to share in the proceeds of a sale of the company (including on a sale to an EOT)

There is significant flexibility as to which of these rights accrue to employees, and business owners can tailor their employee share plan to suit their business objectives.

Many private companies that establish share plans choose to create different classes of shares that only deliver some of these benefits, for example, a class of non-voting shares, which nonetheless confer economic rights.

However, using ‘employee shares’ with limited benefits may reduce the sense of ownership that can be created by shares with full rights. And if a company is considering transition to an EOT, using a different class of shares can make the sale to an EOT more challenging, or even impossible.

Employee share plans in EOT businesses

An EOT-owned business may also wish to operate direct share ownership arrangements, although sometimes for slightly different reasons than for a non-EOT business. For example, if a company is controlled by an EOT, voting rights attached to shares may be of limited value because it is the EOT that will make all the major shareholder decisions for the company.

Furthermore, the majority of EOT controlled companies will have moved to a long-term sustainable employee-owned business model, so that an exit event such as a company-wide onward sale may not be relevant. However, nobody can guarantee the future and it may be that one day a sale might be the best thing for the business.

In the absence of a company-wide exit event, directly owned shares in an EOT-owned business will need some sort of internal market in order to enable participating employees to realise the capital value in their shares.

If EOT trustees decide that an onward sale would be in the best interests of the employees in the business, then a sale could certainly happen. So direct employee shareholding may still give employees the opportunity to participate in the sale proceeds over and above any interest they might have in the EOT.

Direct employee shareholding can also deliver dividend payments in addition to any EOT tax-free bonus payments and profit-sharing, providing an additional reward for employees if the company is profitable.

How does an employee share plan work?

There are a number of different types of employee share plans and there are a few ways to compare them:

Tax advantaged share plans versus non-tax advantaged

- Tax advantaged plans are formally recognised by the government and tax authorities, and deliver specific tax benefits set out in legislation. These plans have to follow particular rules to benefit from the tax breaks.
- Non-tax advantaged plans are not specifically recognised or established in legislation. However, they are often structured to deliver tax advantages within the wider tax law framework or to ensure that any tax charges only arise when employees are in a financial position to cover the tax.

All employee plans versus discretionary plans

- Some tax advantaged plans must be offered to all employees in a company in order for the tax benefits to be delivered.
- Other plans can be offered only to specific employees, for example to recruit, retain and incentivise key personnel only.

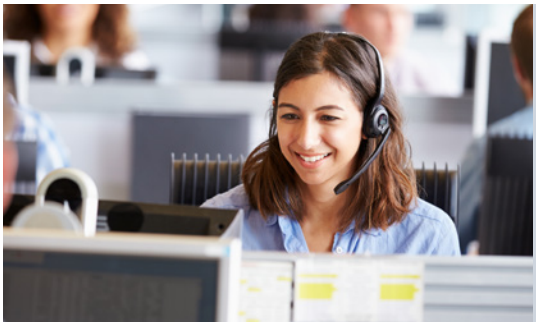
Share plans and option plans

- A share plan will usually enable employees to acquire shares directly and immediately, which will mean they benefit straight away from the applicable share rights (which might include votes or dividends) although they will usually have to pay for the shares upfront, agree to pay for the shares, or be taxed on any discount, to benefit in this way.
- An option plan enables employees to buy shares in the future at a price fixed at the time the option is granted - the exercise price. Typically, an option-holder will pay the exercise price after a certain time period, or after certain performance conditions have been met, at which point they will become shareholders. Option-holders don't benefit from any share rights (like dividends) until they have exercised their options. Some private companies will grant options that can only be exercised at the time the company achieves an exit, such as a sale of the business, at which point the employee will usually sell their shares immediately. That means that the employee will never have the right to votes or dividends, but they will share in the sale proceeds.

"Without hesitation I would instantly recommend The RM2 Partnership... It's a fact that people buy people - these people are worth investing in!

What share plans are available?

Below we have detailed some of the key employee share plans that are available for private companies and when they might be used.



Enterprise Management Incentives (EMI)

This is a discretionary, tax advantaged, share option plan. It is the best choice for companies that carry out certain trades and employ fewer than 250 full-time equivalent people. It is the most popular share option plan in the UK and is very often used for companies wishing to incentivise key, senior staff (although it can be used for all employees, with different levels of award). An EMI plan allows companies to grant to each individual options with a value (at date of grant) of up to £250,000, but each company is limited to total option grants of £3M.

Company Share Option Plan (CSOP)

This is a discretionary, tax advantaged, share option plan. Companies that don't qualify for EMI (for example, because they have 250 or more full-time equivalent employees) will often use CSOP as the next best option. CSOP has a lower individual limit than EMI, up to £60,000 (measured at date of grant) for each individual, but there is no company limit and qualification is easier to establish and maintain than under EMI. Traditionally used for senior executives, some companies now use it to reward all of their employees.

Share Incentive Plan (SIP)

This is an all employee, tax advantaged, share plan. A SIP must be offered to all employees in the company. It allows employees to buy shares out of pre-tax salary and/or to be given free shares, without any tax arising on the gift. Employees can also be given two extra free shares for each share they buy. Shares are held on behalf of employees in a trust, but employees can still benefit from dividends on the shares that they have been awarded. The SIP is very tax efficient and can deliver zero tax rates for employees, provided the shares are held in the trust for at least five years.

Partly paid shares

This is a discretionary, non-tax advantaged, share plan. It is a plan typically used when a company, or its employees, will not qualify for one of the tax-advantaged plans – for example, subsidiary company shares cannot be used for EMI, CSOP, SIP or SAYE plans. Employees buy shares at the outset but the majority of the outlay is left outstanding and is paid at a point in the future – sometimes out of dividends, sometimes when a sale occurs and employees can afford the delayed payment. Like a growth share plan, this arrangement can deliver voting rights and dividends, and is tax efficient under general tax law rather than any specific tax-advantaged share plan rules.

Direct share acquisition/non-tax advantaged options

It is perfectly possible to set up a more straightforward share plan or option plan for employees, including having employees subscribing directly for shares, and paying full market value at that time. These plans can ensure employees have real "skin in the game", with risk and return on the same basis as any other investor. Such arrangements can be particularly helpful for subsidiary companies where tax advantaged plans cannot be used. Alternatively, non-tax advantaged share options could be granted, offering commercial flexibility but no tax breaks.

Growth Share Plan (GSP)

This is a discretionary, non-tax advantaged, share plan. This plan is typically used to ring-fence existing value in a company for the founding shareholders, with employees sharing only in the growth above a financial hurdle. A new class of 'growth shares' is created with the 'hurdle' attached - for example, if the company is worth £4m at the time of award, the hurdle might be set at £5m. On sale of the business the founder shares will receive the first £5m of value; the growth shares will share in the value beyond £5m. Growth shares usually have a lower value at the outset, because they will not be 'worth' anything unless a sale is achieved at or above the hurdle level, which means they can be affordable for employees. Growth shares can carry voting rights and dividends, and are tax efficient under general tax law rather than any specific tax-advantaged share plan rules.

Sharesave/Save As Your Earn (SAYE)

This is an all employee, tax advantaged, share options plan. An SAYE must be offered to all employees in the company. Employees are granted an option over shares, and set up a savings plan which enables them to save up to £500 each month over a 3 (or 5) year period. Options can be granted with a 20% discount on the initial market value of the shares. At the end of the savings period, the employees can either use their savings to exercise their options tax efficiently or they can simply take their savings (potentially with interest and a tax-free bonus payment). SAYE is more popular with larger listed companies than with private companies, because a savings account has to be set up and administered, which can make SAYE costly for smaller businesses.

Shares	Options
SIP, GSP, Partly Paid	SAYE, CSOP, EMI

All employee	Discretionary
SIP, SAYE	GSP, Partly Paid, CSOP, EMI

Non tax advantaged	Tax advantaged
GSP, Partly Paid	SIP, SAYE, CSOP, EMI

What share plan is right for me and my business?

This information is just a brief summary of some of the more popular share plans available. If you are considering sharing the success of your business with some or all of your employees, there is a lot of detail still to cover to ensure the final plan is tailored to your needs. This is where the advice of our experienced specialists can save you a lot of time, stress and money, as we help you design and implement the best plan to achieve your desired outcome.

The rules regulating the various share plans and how they must be administered can be complicated, particularly those relating to the tax advantages, which may be lost if mistakes are made.

We know we can help you as we have hundreds before you, so please get in touch today, for a no-obligation, in-depth discussion about your business and your specific needs and objectives.