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Application and Professional Skills

Human Capital Taxes

Suggested solution

REPORT TO WILLIAM EDWARDS ON PROPOSED REMUNERATION SCHEMES

INTRODUCTION

As requested in your e-mail of 2 November 2019, this report considers the two suggestions proposed by your HR consultant for your management team being an Enterprise Management Incentive Scheme and a Flexible Cash Award Scheme.

The objective is to

a) Encourage managers to remain with the company until a proposed sale in three years' time, and
b) Motivate managers to grow the business substantially.

Our report is prepared for ASU Ltd and no third party may rely on it without our consent.

Our report is based on the legislation in force on [date] and so if there is a material delay in implementing a scheme it will be necessary to consider whether there have been any changes which affect our advice. It is also possible that future legislative changes may affect any scheme already in place.

EXECUTIVE SUMMARY

The EMI scheme appears to meet both of your objectives.

It is tax effective when eligibility conditions are met and it allows the business to retain its cash funds to invest. You could tailor exercise requirements for each employee to maximise the incentive.

It would be possible for all dilution to be borne by you either by giving you and Petra separate classes of share (and granting options over new shares of your class) or by you personally granting options.

There will be extra administrative expense incurred if you intend to include new joiners. Plus, as the company grows it is possible that ASU Ltd may become ineligible for EMI status.

The rate of capital gains tax on the sale of shares will only be ten percent if the shares represent a 5% holding and the option has been held for at least one year. If these conditions do not apply then the rate for higher rate taxpayers will be 20% of any gain on sale.

It is important to consider whether the prospect of a sale is sufficiently imminent and realistic to give those participating in the scheme the desired level of motivation.

The cash award scheme is less tax and cost effective and because interim payments are made, it may be less effective than an EMI at retaining staff. On the other hand, if employees perceive the chances of sale as vague, they may prefer the certainty of a regular cash award.

A cash award scheme is also cheaper and simpler to set up and administer than an EMI scheme which requires registration with HMRC and annual return. It is also more flexible and may therefore be easier for future hires.

Overall, an EMI scheme is recommended. Since the objective is to reward future growth in the value of the company rather than historic value, the exercise price of options should be their "Actual Market Value" on the date of grant.

If individuals are ineligible for the EMI tax advantages, options will still be commercially effective for them due to the growth in value of the shares. However, the cost to the company of the employers NIC on exercise could be considerable and the tax for the employee would be substantially greater. It may be possible to make changes to their working arrangements to get round this issue.

ENTERPRISE MANAGEMENT INCENTIVE SCHEME

Introduction

This is an extremely flexible scheme which allows you to select employees who would be granted the option to purchase a number of shares in ASU Ltd at a future date at a price fixed today. The option would only be exercisable in the event of an actual or anticipated sale of the company. Only employees who are still in employment at that date will be eligible to exercise their options.

Once the sale is agreed, employees will exercise their options and acquire shares in ASU Ltd. These shares will then be sold to your purchaser along with the shares held by yourself and Petra.

The key decisions to make are:

a) Who is to receive options
b) How many shares the options are to be over for each employee (they need not be the same).
c) The price at which the options may be exercised

Whilst some companies will grant options to every employee, generally it is better to limit options to the key individuals who are critical to the business and its objectives. You have already identified the senior management team as the group to receive options. It is possible to grant further options should the need arise in the future, although the tax benefits for them may be reduced.

You may wish to consider whether all senior managers should receive an equal number of shares or whether there should be some variation. If you wished, it would be possible to also provide each manager with personal targets so that the right to exercise options varies according to performance. For example, you could grant an option over 10 shares, but of these 5 will only become exercisable if they have achieved “x” in the period to exercise.

The price at which the options may be exercised may be dictated by your objectives in implementing the scheme: three alternatives might be:

You could make this a ‘nil’ option where the employees would pay nothing for their shares, which would give the biggest reward to employees. However, it has tax implications (see below) and also you would in effect be giving them value you have created rather than value they are to create. Furthermore, there are some practical implications in that you cannot issue shares at less than their nominal value. This is currently £1 per share, although it may reduce if you choose to subdivide the shares to manage dilution (see section on share dilution below). Whilst we can work around this by channelling shares through an employee benefit trust, this is complex and can be expensive. We would ultimately recommend setting the exercise price as at least nominal value if new issue shares are being used.

You could grant options at market value and can agree a value with HMRC in this regard (we can assist with this). The value you will agree with HMRC will be the “Actual Market Value” of the shares being issued, which is not the same as the current market value pro-rated by the number of shares held. Since the shares involved will represent a small proportion of the company, the Actual Market Value will include a significant discount (typically 75%). The result of this is that even if the company is sold for its current market value, the employees will get an automatic profit.

You could however choose to set the exercise price at pro-rata the full value of the company which would mean they would only share in the increase in whole company value.

These are only suggestions: you are free to set the price at any value you wish. In a situation such as yours, it is common for options to be granted at Actual Market Value as that avoids adverse tax consequences (see below) and provides a good balance between incentive to grow and to achieve a sale and retaining value for the founders.

Employee Tax Position

There is no income tax or NIC on the grant of the option.

There will be no income tax or NIC when the option is exercised unless the option price is less than the Actual Market Value of the shares on the date it was granted. Thus, if you choose to set the exercise price at nil as discussed above, this provision will apply and tax and NIC will be due on the difference between the Actual Market Value at the date the options were granted and the amount paid to acquire the shares (nil in this example).

In the context of an exercise when a sale has been agreed, any tax and NIC will need to be collected via the RTI system. The PAYE/NIC will normally be collected by deducting it from the proceeds they will receive on the sale of their shares.

When the company is sold, the difference between the sales proceeds received and the amount paid for the shares (or charged to Income Tax on exercise) will be charged to Capital Gains Tax.

Once employees have held the options for 12 months [note – candidates may refer to 24 months] they should qualify for entrepreneurs' relief which would reduce the rate of tax on their capital gain from 20% to 10%.

Company Tax Position

If the option price is no lower than Actual Market Value on the date of grant there will be no RTI requirements and no employer NIC to pay. However as discussed above if you use a nil option price, PAYE and NIC will need to be calculated on the difference between the option price and the market value of the shares over which the option was granted on the date of grant.

ASU Ltd will be eligible to claim a corporation tax deduction for the difference between the market value of the shares on the date of exercise and the price paid for the shares by the employee.

Practicalities/Administration

Grants of EMI options must be notified to HMRC online within 92 days. If notification is not made the option will not qualify for the tax benefits expected. It is also important that the terms of the option are in writing and that the option agreement meets the requirements of the legislation: we can review draft documentation for you.

You should also get HMRC agreement of the value of the shares at the grant of the option. If you do not get HMRC approval and they later disagree with the value used there is a risk that the tax advantages of the EMI scheme will be less than you had originally planned.

Annual returns (due 6 July following the end of the tax year) must be submitted to HMRC for each tax year during which unexercised options exist.

If you allow new joiners to enter the scheme after the initial options have been granted you will need to agree a new share valuation with HMRC. If at the time the scheme is being implemented any of your planned new hires has an agreed start date it may be preferable to wait until they have joined the company to reduce the number of times you will incur additional valuation fees. However, any delay has to be balanced against the potential increase in value of the shares and the consequential reduction in tax savings (which are limited to the growth above the market value at the date of grant).

Sale of ASU Ltd

A purchaser will want to acquire the entire capital of the company and therefore you will want options to be exercisable on or just in advance of a proposed sale and for any options not so exercised to lapse.

You will also want to ensure that all shareholders must sell when you sell. The usual way of achieving this is to have “drag along” provisions in your Articles. Similarly, for the protection of minority shareholders, you will want “tag along” provisions in your Articles which give them the right to sell on the same terms. If these provisions are not already in your Articles, we would therefore recommend that they be included.

You may wish to consider whether you will facilitate the exercise of the options and subsequent sale of the shares to assist the relevant employees with any cash flow issues. In other words, instead of collecting in the option price on exercise you would deduct this from any subsequent proceeds due to the employee on the sale of the shares. This will make it easier for your employees to participate. This will not be an issue if you choose to set the option price at nil as there would then be no monies to collect on exercise.

As the corporation tax deduction on exercise of the EMI options will only be received in the accounting period in which the options are exercised the value of this deduction and corresponding reduction in corporation tax payable should be taken into account when setting the sale price with the purchaser. If the sale takes place partway through an accounting period the completion accounts should be prepared in such a way as to ensure that the benefit of the deduction is allocated to you.

Should you ultimately decide to sell the trade and assets of ASU Ltd rather than the shares you should take advice on the timing of all of the relevant actions. The sale of the trade would trigger the end of an accounting period. It is important that the options are exercised before this takes place so that you can get the benefit of the corporation tax deduction. We would be happy to advise further at the time should this become likely.

EMI Scheme Requirements

There are a number of conditions that must be satisfied by the company and by employees in order to benefit from the tax advantages.

The employer must:

- Be independent (i.e. not controlled by another company)
- Have gross assets of less than £30 million.
- Have less than 250 full time equivalent employees
- Carry on a qualifying trade. Investment income from the rental of the excess office space is less than 20% of the total income and therefore not considered substantial.

The company meets these requirements.

As you are expecting to grow the business significantly the requirement to have less than 250 full-time equivalent employees may cause a problem in the future. This will prevent further options having EMI status, but will not affect options already granted.

Employees to be granted options must not have a material interest in the company (a 30% shareholding) and must work for the company either for least 25 hours a week or at least 75% of their working time.

Frances is eligible to participate, but as Harry only works for ASU Ltd three days a week, he may be below the 25 hours a week requirement for automatic employee eligibility. Therefore, to participate in the scheme 75% of his total working time must be for ASU Ltd. When total working time is considered for this test it includes both time worked as an employee and also as a self-employed individual.

If you are to implement this scheme we recommend you confirm this and ask him to sign a working time declaration confirming his eligibility under the 75% test before he is granted any options. It would be our recommendation as good practice to have all the employees to be granted options sign a such a declaration to confirm their eligibility.

The position would need to be assessed for your team leaders and for any new recruits.

Individuals who will not be eligible for the UK EMI tax benefits can still be granted share options. However there would be an Income Tax charge on the share exercise. Additionally, as the shares will only become exercisable in the event of a company sale, they will be "readily convertible assets" because there would be an arrangement in place enabling the shares to be sold. The result of this is that in addition to Income Tax there would also be both an employee and employer Class 1 NIC charge on the exercise.

Share Dilution

In your letter you stated that you will bear the impact of any share value dilution caused by the implementation of the option scheme. It will be important to structure the option scheme carefully to ensure that this end result is achieved.

One option would be for you to restructure your and Petra's shareholdings into different classes and then grant the options over your class of shares, by re-designating each of your holdings. Your new shares will take on the base cost of your old shares for any future disposal.

The alternative would be for you personally to grant the options. The tax consequences for the individuals and the company would be the same. You would however make a disposal of these shares for CGT purposes. Assuming that market value is used as the exercise price, you would pay CGT on the difference between the exercise price (and amount received for the shares from the employees) and your base cost of £1 per share.

Given the relatively small number of shares in issue and the likely options to be awarded, it may be necessary to sub-divide the existing share capital into shares of say £0.01 each.

I would also recommend you take legal advice to confirm that the current Articles of Association give you the authority to take these actions. If they do not, they may need to be amended as necessary.

Business Objectives

Since options will only be exercisable on sale if employees are still with the company, provided employees have confidence that there will be a sale it should act as an incentive to remain.

As the "profit" they make when the company is sold is based on the value of the company at that time and they will acquire the shares at their current value, there is an incentive for them to work to grow the company.

FLEXIBLE CASH AWARD SCHEME

Introduction

ASU Ltd will make cash awards to employees based on the growth in the value of the company over the relevant financial year. While this is relatively straightforward you will need to have a clear method to calculate the award so staff included in the scheme can see how their efforts to improve business performance will translate into their cash award. One option would be to dedicate a set percentage of annual profits to the award pool.

The scheme is very flexible as you can set whatever parameters you like and it is cheap to set up and administer.

Employee Tax Position

Income tax and employee NIC will be withheld via the payroll in the year the cash is received.

Company Tax Position

Any payments will go through the payroll in the same way as salary with PAYE and Class 1 NIC due on the awards.

The value of cash award paid out plus the employer NIC contributions will be deductible for corporation tax together with the costs of setting up and running the scheme.

Sale of ASU Ltd

It may not be desirable for the company to commit to paying out large cash amounts in the run up to the sale. Additionally, the measure by which the quantum of bonuses is determined would have to be carefully chosen to remove the risk of the company being required to pay out more in cash bonuses than their available funds.

Business Objectives

No payment would be made to employees if they leave the company and so there is an element of retention incentive, but the interim payments may mean there is less incentive to stay until after the sale.

As the awards are based on the value of the company, there would be an incentive to work to grow the company.

Both objectives can be met. However, I note that you had stated that you would like any share value dilution as a result of the implementation of either scheme to only impact your holding. The effect of a cash bonus scheme is that the value of each of your share holdings is affected.

FINANCIAL COMPARISON OF SCHEMES

Beyond the consideration as to which scheme meets your business objectives, it is important to also consider the financial implications of each scheme. If we assume growth is created which delivers a gross sum of £100,000 for each employee, an EMI scheme based on non-discounted options may deliver post-tax income of £90,000 compared to just £53,000 for a cash award scheme (Appendix A). Furthermore, the EMI scheme will be substantially more cost effective for the Company. Although, more professional fees are required to set it up and administer it, the value flows from the sale proceeds (coming from the purchaser) rather than the company itself.

Appendix A: Model Calculations comparing each scheme

Estimated after tax income for the employee				
Cash Bonus	**£**		**EMI Share Options**	**£**
			MV of shares on exercise	200,000
			Less option price paid	(100,000)
Gross bonus	**100,000**		**Gross income on exercise**	**100,000**
Less income tax @ 45%*	(45,000)		Less income tax @ 0%	-
Less employee NIC @ 2%	(2,000)		Less employee NIC @ 0%	-
Less CGT @ 0%	-		Less CGT @ 10%	(10,000)
After Tax Income	**53,000**		**After Tax Income**	**90,000**

*Income tax is levied at the employee's marginal income tax rate. It has been assumed that the employee is an additional rate taxpayer for the purposes of this model. If this is not the case, the after tax income may increase.

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	10%	Assessment of the applicability of each of the two remuneration schemes to William Edward's stated objectives for the scheme.
2	10%	Discussion of potential solutions to ensure that dilution of share value under the EMI scheme is restricted to William Edwards shareholding.
3	20%	Identification of practical aspects involved in the implementation of an EMI option scheme including; setting the option price, share valuations for non-listed companies, additional administration requirements, decisions to be made on scheme operation, facilitation of cashless exercise.
4	25%	Assessment of the eligibility of ASU Ltd and key staff members to EMI option scheme tax benefits both now and in the future.
5	25%	Discussion of tax treatment of each suggested remuneration scheme for employees and ASU Ltd.
6	10%	Identification of points relevant to the interaction of each suggested remuneration scheme with the plan to sell ASU Ltd including - recommended amendments to articles of association re minority shareholders, ensuring current shareholder receive benefit of corporate tax deduction on options exercise, and need to keep cash within the business for growth investment.

A grade of 0,1,2,3, or 4 is awarded to each topic. The weighting is applied to that grade to produce a weighted average grade. Thus, supposing a candidate scores 3, 3, 4, 2, 2, and 2 respectively on the above topics, this will equate to weighted scores of 0.3, 0.3, 0.8, 0.5, 0.5, and 0.2. The total of these scores is 2.6. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

70%	Advice and recommendation, with reasons, on which remuneration scheme should be adopted by ASU Ltd.
30%	Advice and recommendation, on practicalities around how the chosen scheme(s) should be implemented, for example, option price, timing of grants/awards, inclusion of different staff members, sourcing of shares etc.

The final grade will be determined for this skill in the same way as for Identification and Application.