Application and Professional Skills

Chartered Institute of Taxation
Excellence in Taxation

Human Capital Taxes

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0	6	1	1	2	0	1	9	Date of Examination

☐ Tick box if you have answered in accordance with Scots Law

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Instructions

Your script will be scanned electronically. Failure to comply with these instructions may lead to your paper not being marked. You must:

(a) Write on the answer pages using BLACK or BLUE ballpoint pen only.

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Please do all of the above before the end of the examination.

Plan

LTI awards for senior staff
→ incentivise & retain key senior employees over 3 years

① cash awards
② share options

Consider:
Income tax / PAYE
NIC
CT
Reporting

Share options: EMI / CSOP or unapproved as key inds only
↳ consider EMI & CSOP conditions
Sch 4 & 5 ITEPA 2003

thoughts on Timothy's suggestions
Recommendations on implementing

Expanding team
- new recruits x 2 March 2020

Total of 19 employees

Share options - only dilute William, not Petra
= options over William's shares & not newly issued

Human Capital Taxes

Report

To: William Edwards - ASU Ltd
From: Anna Smith
Date: 6 November 2019
Subject: Incentive scheme for Senior Staff

Introduction

Please find enclosed my report on a new incentive scheme for senior staff in response to your email dated 1 November 2019.

Please note that this report is provided to you on the basis of information provided by you and is correct based on tax law as at today's date.

Once you have had a chance to digest the report, I'd be pleased to answer any queries you may have.

Executive Summary

- Cash awards are taxable as employment income and subject to PAYE/NIC of up to 47% for the employees
- ASU Ltd is liable to NIC of 13.8% but will also receive a CT deduction.
- Paying out cash awards over the 3 years may not discourage them from leaving the company and there is a risk the company is not sold by the time of the final pay-out
- A 'phantom' share option plan could be used ~~to~~ similar to an actual share option scheme but would not result in your share holding being diluted and may result in retention of staff until a sale
- You could consider making tax-free employer pension contributions instead but be aware of annual allowances and employees would not have immediate

access to the funds.

- ASU Ltd is likely to be a qualifying company for EMI, subject to any IP licence issues
- All full-time employees will be eligible employees though Harry Monk may not meet the working time commitment
- EMI options are not subject to tax on grant and usually not subject to PAYE/NIC on exercise provided no discount is given
- On sale of the shares employees are likely to qualify for ER and therefore CGT at 10% is payable.
- ASU Ltd will receive a CT deduction on exercise of the options
- The grant of EMI options must be notified to HMRC within 92 days and annual returns submitted annually by 6 July.
- Alternative share option schemes include CSOP and non-tax advantaged

1 Cash based scheme

Timothy has suggested a flexible cash award scheme in his letter dated 25 October 2019.

Cash awards or a 'phantom share scheme' are treated like cash bonuses and are therefore subject to PAYE and Class 1 National Insurance Contributions (NICs) at the time of payment.

For higher rate tax payers, such as Harry Monk, this will be at 42% (40% tax plus 2% Class 1 NIC) and for additional rate tax payers this will be at 47% (45% tax plus 2% NIC)

In addition, ASU Ltd will be liable for secondary Class 1 NIC at 13.8%. With cash payments to

19 employees, this could be a large liability for the company.

Of course, the cash awards plus employer's NIC liability will be eligible for a Corporation tax (CT) deduction for the company.

The company would need to report these cash awards on a Full Payment Submission (FPS) via Real Time Information (RTI) on or before payment is made.

Timothy's suggestion of paying out awards annually over the 3 years has the effect of splitting out the tax/NIC and reporting burden. However, it also means the employees could leave the company before a sale and still benefit from the scheme.

there is also a risk that you are unable to sale the company after the 3 year period but all employees have fully benefitted from the scheme.

You may therefore want to design the scheme as a 'phantom' share option scheme which is linked to the sale of the company and/or employee performance.

Alternatively, you could consider making a bonus payment from your sales proceeds upon sale of the company

Pension Contributions

As the cash awards will result in almost half being lost to tax/NIC you could consider making an employer pension contribution

~~with~~ instead of the 'bonus' payment

Employer pension contributions are a tax-free benefit for employees and qualify for a CT deduction for the company.

However, this alternative may not be suitable for all employees, such as Frances Isabel, whose salary of £140,000 may mean her annual allowance of £40,000 is tapered to a minimum of £10,000.

In addition, employees are unlikely to be able to access their pension pots ~~for~~ immediately and may therefore not be incentivised by this arrangement

2 Share based scheme

A share option scheme is a great way to incentivise and retain your existing key senior employees. It is also a good way to recruit and incentivise new senior employees, such as the Head of Sales and Head of marketing you hope to have in place by 1 March 2020.

A share option is a right to acquire a certain number of shares at a set price at some point in the future.

Therefore, your shareholding in ASU Ltd would not be diluted on the grant of share options.

As you are looking to incentivise 19 employees, you should consider how much of your shareholding you are willing to give away.

As you have agreed with Petra that her shareholding would not be diluted, any share options will need to be granted over your existing share holding, rather than over newly issued shares.

Timothy has suggested that individuals be only allowed to exercise their options if they are still employed by the company at the date of exercise. This could be achieved by including within the plan rules or as a vesting condition attached to the option.

However, you may want to consider whether you allow 'good leavers' to exercise their options ie on injury, ill-health, disability or death.

Although the employees will be required to pay for the options when they exercise, the exercise price of the options, if the plan is an exit only scheme it is likely that the scheme can allow for a 'cashless' exercise process.

This means the total exercise price will be deducted from the employee's sale proceeds and the net amount will be paid to them.

2A Enterprise Management Incentive ~~Sch~~ (EMI) Scheme

Timothy has recommended you implement an EMI scheme in his letter dated 25 October 2019.

As he mentioned, this is a HMRC tax-advantaged scheme which benefits from certain tax advantages, detailed below. It is also a flexible scheme which is often used by companies to incentivise and retain key employees.

Timothy made a suggestion of setting up the plan as an "exit only" scheme. This is a good idea as it avoids any issues of having employee shareholders before an exit event and it also means the employees are locked into the company until an exit event if they wish to benefit from the scheme.

i) Qualifying conditions

The legislation contains many conditions in order for options to qualify as EMI options.

a) Qualifying company

We firstly need to check that ASU Ltd is a qualifying company

As ASU Ltd is a standalone UK entity, it meets the independence and qualifying subsidiaries requirements.

As ASU Ltd does not have a balance sheet total of more than £30 million or more than 250 full-time equivalent employees, it meets the gross assets and the number of employees requirements.

Finally, ASU Ltd needs to meet the trading activities requirement.

I note that the company is letting out its excess office space. However, as the rental income received of £100,000 does not exceed 20% of sales (3,500,000 x 20% = £700,000), its investment income is not a 'substantial' amount of its business and it is ~~theefo~~ therefore a UK trading company.

As ASU Ltd is a software development company, we must ensure that it does not carry out exclud~~ing~~ed activities such as receiving licence fees for any intellectual property.

However, if at least 80% of the IP was created in-house then no issues will arise.

It would be useful to obtain more information regarding the IP and if necessary we can write to HMRC for advance assurance that the company is a qualifying company for EMI purposes.

For the basis of this report I will assume ASU Ltd is a ~~trad~~ qualifying company

Qualifying options

To be a qualifying option, a share option must be granted for commercial reasons in order to recruit or retain an employee and not as part of a scheme or arrangement where the main purpose is the avoidance of tax.

As you have already expressed that the main aim of the incentive scheme is to recruit and retain key employees, this condition is met.

Please note that you cannot grant options over shares with a total value of more than £250,000 to an employee and overall the total value of options granted to all employees cannot exceed £3 million.

The above limits will be based on the unrestricted market value (UMV) which will be agreed with HMRC at the time of grant. These limits are unlikely to cause an issue as we would ~~expect~~ carry out a tax valuation of the shares which would be heavily discounted for a minority holding.

<u>Eligible employees</u>

To be an eligible employee an ~~a~~ individual must be an employee of ASU Ltd. For new recruits, EMI options would only be granted once they ~~are em~~ have commenced their employment with ASU Ltd in March 2020.

The individual must not hold a material interest in the company which means more than 30% of the ordinary share capital. Therefore you would not be able to have EMI options, but Petra would, although you have not expressed interest in granting any options to yourself or Petra.

To be an eligible employee an individual must meet the working time commitment of 25 hours a week or 75% of their working time.

I note that Harry Monk works 3 days a week for ASU Ltd and may therefore not be an eligible employee under the working time commitment.

I have therefore outlined in Appendix 1 a couple of alternative share option schemes that could be suitable for Harry and any other senior employees who may not be eligible employees for EMI.

ii) Tax consequences

On grant

There are no tax or NIC consequences at the time of grant.

On exercise

A tax liability would only arise at the time of exercise if the exercise price of the options is less than Actual Market Value (AMV) agreed with HMRC ie a discount was given at date of grant.

The taxable amount would be the amount of discount given. As a private limited company, the tax would ordinarily be due via the ~~s~~ individual's self-assessment tax return.

However, if the EMI scheme is an exit only scheme then the options would be exercised on the sale of the company, at which point they would be 'readily convertible assets'. This means the company would need to deduct via PAYE and class 1 NIC would also be payable by both the employee and ASO Ltd.

On Sale

As little or no tax would be payable on exercise of the options this means the whole or majority of the growth in value of the shares is subject to capital gains tax (CGT) on sale of the shares.

Assuming all your senior employees are higher or additional rate taxpayers, CGT will be due at 20%.

However, provided there is a 2 year period from the date of grant to the date of sale, the gain may qualify for Entrepreneurs' Relief (ER) and therefore be taxed at 10% rather than 20%.

Corporation Tax

ASW Ltd will obtain a CT deduction on the exercise of the share options.

[redacted]

[redacted]

iii) Reporting

The grant of EMI options must be notified to HMRC online within 92 days of the date of grant to be qualifying.

ASU Ltd will also be required to complete online returns annually by 6 July following the end of the tax year.

The returns will be used to notify HMRC of any reportable events ie options cancelled, lapsed or exercised.

If returns are submitted late, an automatic penalty of £100 per return is charged. A further penalty of £300 is charged if the return is 3 months and 6 months late. A daily penalty of £10 may be charged if more than 9 months late.

Appendix 1
Alternative share option schemes

1) Company Share option Plan (CSOP)

A CSOP is similar to an EMI scheme but as it does not contain a working time commitment, it may be more suitable for any part-time employees such as Harry.

The other key differences to an EMI are as follows:
- The total value of options granted to an employee cannot exceed £30,000
- No discount can be given on ~~the~~ grant ie the exercise price must be at least the market value of the shares at the date of grant

In addition, the option may only be exercised after a 3-year holding period. However, where there is a change of control under a general offer the 3-year holding period does not apply.

Therefore, if there is a sale of the company within 3 years, I do not expect this to cause any issue.

Tax implications
As with EMI, there are no tax implications on the date of grant. As no discount may be given, there are also no tax implications on the date of exercise.

The full growth in value of the shares will therefore be subject to CGT on sale of the shares. Unless 5% of the share capital is awarded to the employee.

ER will not be due like on EMI options where the 5% test does not apply

Reporting

Like EMI, there is an annual reporting requirement. However, grants of CSOP options are reported on the annual returns rather than within 92 days of date of grant

2 Non-tax advantaged share options

Also known as an "unapproved option", these share options do not carry any qualifying conditions like EMI or CSOP.

However, as the name suggests, they do not carry any of the tax advantages either.

There are still no tax implications at the date of grant. However, a PAYE/NIC liability will arise at the date of exercise ~~based o~~ calculated as follows:

market value at exercise	X
less exercise price paid	(X)
Employment income	X

As the market value at exercise will be about the same as the

~~mor~~ sale proceeds, the growth in value of the shares will be subject to PAYE & Class 1 NICs rather than CGT.

There is still an annual reporting process which are completed under an 'other' scheme.

Conclusion

My recommendation would be to implement an EMI scheme for the key senior employees.

For any part-time employees, such as Harry, I would recommend that you implement a CSOP scheme and only grant unapproved share options where the value of options would exceed £30,000.

This is my recommendation due to tax advantages to both the company and the employees by using these tax-advantaged share option schemes.

Employees will pay CGT at 10% or 20% rather than PAYE/NIC at 42% or 47%. ASU Ltd will not pay employer's NIC and will receive a CT deduction on exercise.

Human Capital Taxes

The EMI Plan will have a useful life of 10 years once ~~ina~~ adopted by the company and options can be granted to existing employees as soon as possible.

~~We~~ I would recommend writing to HMRC as soon as possible for the following:

i) Advance assurance - if it is unclear whether the Company's trade activities qualify for EMI we can write to HMRC to request their confirmation that the company qualifies. At the same time, we can consider whether Harry Monk will be an eligible employee for EMI

ii) EMI share valuation - we would prepare a valuation report for tax purposes based on the ~~B~~ financial results of ASU Ltd

We would look to discount the value heavily as the employees will be minority shareholders. We would also need to review the company's Articles of Association to check for any relevant restrictions on the shares

If the shares are restricted, we would come up with two value, unrestricted market value (UMV) which ignores any restrictions and actual market value (AMV) which would discount for any restrictions.

Once HMRC agree our AMV and UMV, you would have a period of 90 days to grant ~~ey~~ the options, provided there are no changes in the company's circumstances.

The new senior managers starting in March 2020 may fall outside this 90 day window. However, we would be able to write to HMRC to request an extension or agree a new value at the relevant time and depending on any changes to the company's circumstances.

Please note that EMI and CSOP schemes are very flexible and options can be granted under different terms to each employee