UNITED KINGDOM

Nicola Parkinson
Director
Walker Morris
33 Wellington Street, Leeds, LS1 4DL
0113 283 2500
nicola.parkinson@walkermorris.co.uk

Q&A

Please provide a brief overview on how an ESOP in a start-up is usually structured in your jurisdiction (of particular interest: virtual or real participation programs, market practice with regard to vesting, participation (exits, proceeds and dividends) and voting rights).

Broad-based employee share ownership in a company is unusual in the UK, and is usually only used where the business is set up as a cooperative with limited external investment or a family owned business exiting by a sale to the management and employees.

Start- ups and VC backed companies almost always offer share participation to selected employees, rather than to most or all of the workforce.

The most usual form of employee share participation in a start-up is for share options to be granted to selected employees. If possible, options are granted under an Enterprise Management Incentive Scheme (EMI scheme) because of the beneficial tax treatment for EMI option holders (see question 2). (There is another tax–advantaged share option scheme called a Company Share Ownership Plan (CSOP) which allows income tax benefits on exercise of options but the conditions are more restrictive than EMI, including an individual limit on share value that an individual can hold of £30,000, so it will not be used in a start-up where the more flexible EMI scheme can be).

EMI schemes are available to SMEs (gross assets of less than £30 million, and fewer than 250 employees) which carry on a qualifying trade. Activities which are real estate or financial services related will generally not qualify. An EMI scheme option can only be granted to an employee working at least 25 hours per week for the company or who spends at least 75% of their total working time on the company's business. Options may be granted to selected employees only. Options must be capable of exercise within 10 years of grant and exercise can be subject to conditions, including performance of the company,

EMI options cannot be granted over shares in a company which is controlled by another company- this can prevent EMI options being used where VC or other corporate investors have a significant shareholding. EMI options can be granted over a special class of employee shares as long as the shares are not redeemable.

There is an individual limit on EMI options of £250,000 and an overall limit of £3 million on the total exercise value of EMI options granted by a company.

Share options, whether falling within EMI or not, are in practice usually exercisable only on an exit or, at the company's discretion, on leaving employment before exit.

Employees are not generally invited to acquire shares directly in a start-up. This is for commercial reasons as the company may not want minority employee shareholders, and because an immediate income tax charge arises where shares are acquired by an employee for less than their market value (see question 2).

Generally, a maximum of 10% of the company's equity will be available for equity participation. The maximum is a commercial issue, rather than a tax or regulatory issue.

Virtual share participation – where employees are given a bonus linked to an exit or the financial performance of the company – is unusual. This is because such bonus is subject to income tax and social security contributions (NICs) and it is usually possible to achieve the incentive effect in a more tax efficient way.

Please provide an overview of the respective tax situation an employee finds him-/herself in when he/she participates in a real/virtual equity investment program (applicable taxes and approximate tax burden (a) at the time of the investment and (b) at the time when revenues therefrom are received).

Share acquisition: an employee is subject to income tax when employee shares are acquired on any under value- that is the difference between the price paid and the market value of the shares acquired. The income is treated in the same way as employment earnings and subject to income tax (at a rate of 40% on annual income up to £150,000). Employee and employer NICs are payable on the amount, at a maximum employer rate of 13.8%.

On sale of the shares, any gain in excess of the acquisition price is usually treated as a capital gain, rather than earnings subject to income taxes. In some circumstances -for example, where the initial value of the shares is reduced by restrictions-, the gain can be subject to income tax but these are unusual and can be mitigated by ensuring that the holder elects to pay any income tax on such reductions in value when the shares are acquired.

There is an annual exempt amount of capital gains (currently £12,300) and capital gains are taxable at the rate of 20% (or 10% for individuals with income and chargeable gains below the higher rate income tax threshold of, currently £50,270). Further capital gains reliefs may be available to shareholders holding 5% or more and meeting the conditions for Business Asset Disposal Relief which will reduce the rate to 10% on lifetime gains up to £1 million. No NICs are due from employee or employer on capital gains.

Share options: no tax arises on the grant of a share option.

On exercise of a share option, income tax and NICs are payable on the difference between the exercise price and the value of the shares acquired unless the option has been granted under an EMI scheme or a CSOP.

On exercise of an EMI (or CSOP) option, there is no income tax or NICs on exercise as long as the option was not granted at a discount to the share value at the time of grant and all other EMI (or CSOP) conditions have been met. Under an EMI scheme only, any difference between the exercise price and market value at grant can be taxed as income without affecting the capital gains treatment of the sale proceeds.

Any gain on sale of the option shares is subject to capital gains tax as outlined above. Gains on an EMI option may qualify for the 10% rate for Business Asset Disposal Relief where the shareholder was employed in the 2 year period before disposal. No NICs are payable on the gain.

Virtual participation: cash rewards linked to equity performance and/or exit will be taxed as earnings and subject to income tax and NICs.

No income tax and NICs will arise when the right to reward is granted, but there will be tax and NICs on the earlier of a payment being made or the right to payment vesting, even if payment is deferred.

Are there any tax advantages for an employee if the revenues based on the equity investment are reinvested in start-ups or other companies?

There are no tax deferrals or advantages specifically for employee shareholders who reinvest gains in their employing company or in other companies.

However, gains which are invested as shares subscribed in certain unquoted trading companies may qualify for income tax relief and/or capital gains deferral where the investment meets the conditions under the Enterprise Investment Scheme (EIS) or Seed Enterprise Investment Scheme (SEIS). These reliefs are available to all individual taxpayers. However, the individual must not be an employee of the investee company and therefore employees cannot make qualifying investments in their own employer.

Are there any tax advantages for the company if an ESOP is established in the company?

There are no tax advantages specifically for a start- up or SME company relating to employee share participation.

However, the amount of the gain made by the employee on exercise of a share option will generally be deductible in computing the company's profits subject to corporation tax.

Where the employee's gain is treated as a capital gain (for example, under a qualifying EMI option), no NICs are payable by the employer on that gain. Capital gains treatment is therefore preferable from an employer's as well as employee's point of view.

Please highlight one pro and one con of the legal set up with regard to ESOPs in your jurisdiction.

UK pro: the EMI option scheme for SME businesses is a flexible route to allow employees to participate in the company's equity as long as the company is not controlled by another company. The capital gains treatment for employees, and corporation tax deduction for employers make it a popular and familiar route which is well understood by businesses and advisers.

UK con: there is no relief or exemption from income tax for shares given to employees. A relief applying to small values of shares acquired at an under-value by employees was withdrawn in 2016. As employees will not necessarily be able to fund the purchase of shares, this has focussed participation through share options, particularly under the EMI scheme.