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A Stake in the Business — Simplifying Employee Share Ownership

A new, simpler tax and administrative regime will help employers to — quite literally — get staff buy-in to their company's future.

Recent amendments to UK company law and proposed tax reforms have been designed to simplify and promote employee share ownership in the UK. If implemented, these reforms will significantly change the administrative and tax framework for those granting shares or options to employees, but they will be welcome news for many employers. Particularly for private companies looking to use employee share ownership to align their employees' remuneration with their shareholders' interests, or those seeking to comply with Financial Conduct Authority regulations on remuneration which require an element of share ownership, these changes will be key.

Background

The current UK Government has promoted employee share ownership through a number of initiatives. In April 2013, Parliament approved the new "employee shareholder" status under which employees can trade-in certain statutory employment protections in return for a tax efficient grant of shares.[1] In 2012 the UK Government commissioned Graeme Nuttall to lead an independent review to identify what barriers exist to employees owning shares and how those barriers could be dismantled. In July 2012, the Nuttall Review was published, setting out a number of recommendations. The government has set up a special task force — the Employee Ownership Implementation Group — to consider and implement these proposals. Together with another initiative led by the Office of Tax Simplification (OTS), the effects of these policies look set to change the UK landscape for employee ownership considerably over the next few years.

Changes to the buy-back rules

On 30 April 2013, the UK Government introduced a number of changes to the UK Companies Act designed to simplify the rules which govern how shares can be bought back by companies. This was identified as a stumbling block for many private companies considering employee share ownership arrangements. Employee share ownership is widely recognised as an effective way to align employer/employee interests and promote long-term employee retention. In reality, however, employees will leave and employers do need to have simple mechanisms in place for buying back shares from leavers.

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Under the new rules:

- Shareholders are now able to approve off-market share buy-backs (*i.e.* purchases of shares other than through a recognised investment exchange) by an ordinary resolution (requiring 50 per cent not 75 per cent approval).

- Share buy-backs which are connected to an employee share scheme will be eligible for approval in advance — companies will not be required to seek approval for individual share buy-backs but rather can obtain approval for all buy-backs relating to employee share schemes in advance.

- New solutions will be available for financing share buy-backs including: payments by instalments; a simplified regime for buy-backs out of capital (requiring a solvency statement and special shareholder resolution); and allowing a shareholder resolution to approve payments of cash up to £15,000 or five per cent of the company's total share capital without having to identify distributable reserves.

- More companies will be able to hold shares which have been bought back "in treasury" so that these shares can be re-issued to new employees more easily. This creation of a warehousing arrangement will be particularly welcome to private companies wishing to facilitate employee ownership without having to establish an employee benefit trust.

These amendments to the Companies Act should help minimise some of the administrative headaches that employee ownership can cause private companies.

Proposed tax simplifications

The OTS — the task force established to reduce the burden on businesses of tax compliance — has this year announced further-reaching recommendations for simplifying tax rules surrounding unapproved share ownership arrangements. The UK Government has now given an initial response to these recommendations. Some will be taken forward for consultation including the following key recommendations:

Marketable securities — The OTS's most striking recommendation was for sweeping changes to the existing tax rules to create the concept of a "marketable security". This proposal is intended to clarify the existing complex rules which can lead to "dry-tax" events. In these circumstances, employees become liable to income tax before they have the means of liquidating their shares to fund the tax payment.

The proposed reform would mean that income tax charges would only arise once either (i) an employee acquires "marketable" securities, (ii) non-marketable securities become marketable or (iii) an employee elects to be taxed on non-marketable securities as if they were marketable.

"Marketable" would have a simple definition: shares will only be "marketable" once they can be sold to a third party for an amount of money equal to the unrestricted market value of the shares. Listed company shares will automatically be "marketable" unless subject to forfeiture restrictions. The government has indicated that it will consider implementing this reform in 2015.

New employee shareholding vehicle — The OTS recommended creating a new, simplified vehicle for warehousing company shares in connection with employee share ownership arrangements. This new vehicle can be set up as a UK resident entity without triggering capital gains or corporation tax liabilities — on the condition that it is properly used to hold employer or parent company shares and cash and is used for facilitating employee shareholding.

This proposal is clearly intended to address the growing complexity of employee benefit trusts which are usually off-shore and which can be fraught with tax risks under inheritance tax, disguised remuneration and corporation tax rules. The government has confirmed it will consider this proposal further, although it has not committed to a timeframe for doing so.

Corporation tax deductions — Another OTS suggestion was that where a company is taken over by an unlisted acquirer, there should be a grace period (*e.g.* 90 days) during which a corporation tax deduction is available in respect of share acquisitions by employees. The government is consulting on this proposal and may potentially legislate for it in 2014. This will be a welcome amendment to the existing rules as it will enable more companies to benefit from potentially valuable corporation tax deductions when private companies with outstanding employee share options are acquired by other non-listed companies (in particular private equity buyers).

Extension of rollover rules to restricted shares — The government is considering an OTS proposal that the existing rules — which allow employee share options in a target company to be exchanged for share options in an acquiring company without triggering a tax charge — should be extended to apply to restricted shares and nil or partly paid shares as well. The government have indicated that this could be legislated for in 2014.

Simplifying the operation of unapproved share schemes — The government has committed to consider a number of other OTS recommendations designed to simplify the practical operation of "unapproved" share schemes (*i.e.* employee share option plans, restricted stock units and restricted share plans that don't qualify for beneficial tax treatment). These proposals include:

- Simplifying the annual filing process so that it can take place online and be integrated with existing PAYE reporting.

- Allowing employees more than 90 days to make good any tax paid by an employer on their behalf before an additional tax charge is triggered.

Internationally mobile employees — The government has said it will consider certain proposals to simplify how internationally mobile employees are taxed in relation to their ownership of shares, from grant through to disposal. The OTS's proposals were intended to align their tax treatment more closely with that of UK resident employees.

What about valuation issues?

Perhaps the biggest disappointment is that the UK Government has shied away from introducing certainty for private companies on the valuation of their shares. OTS had recommended that during the tax year 2013–14 the HMRC's Shares and Assets Valuation Unit should be empowered to provide pre-transaction valuations for unapproved share schemes, at least in some common and straightforward scenarios. The government has said it will consider this once it can assess the impact on HMRC's valuation resources following the introduction of the new employee-owner status. The government also rejected the suggestion that HMRC should automatically accept the valuation of shares listed on a non-recognised stock exchange (such as AIM). These decisions are disappointing as for many unlisted companies the cost of getting their shares valued in order to accurately tax employee share grants, and the risk that any such valuation could still be challenged by HMRC, is enough to put them off granting employees share options altogether.

That said, the government has indicated it will consider improving the HMRC guidance on the valuation of shares. Hopefully these improvements will provide some greater clarity to private companies looking to offer shares to its employees.

What about approved share option plans?

The government has also taken steps to simplify the administration of tax approved employee share option plans — Share Incentive Plans (SIPs), Company Share Option Plans, (CSOPs) and Save-As-You-Earn (SAYE) plans — and Enterprise Management Incentives (EMIs). Many of these proposals were introduced in the Finance Bill in April 2013 and are expected to come into force later this year. Perhaps the most interesting of these reforms was the widening of the circumstances in which SAYE and CSOP options can be exercised without triggering income tax charges in the context of a takeover. Plan rules should be reviewed and amended to take advantage of these changes.

However, the best may be yet to come in that the government is considering introducing in 2014 a new "self-certification" approach so that SAYE, SIP and CSOP schemes can be introduced without prior approval of HMRC. This will be welcome news to any employer who has undergone the time-consuming HMRC approval process.

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Endnote

[1] For more information, see "UK Government Enacts New 'Employee Shareholder' Rules," in *The Working World*, Issue 18 (July 2013), published by Latham & Watkins.