ESOP centre

Towards a rational common framework

A silver bullet for the coalition government

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The Employee Share Ownership Centre

Spreading the Wages of Capital

EMPLOYEE SHARE OWNERSHIP – TOWARDS A RATIONAL COMMON FRAMEWORK

A SILVER BULLET FOR THE COALITION GOVERNMENT

The Esop Centre is an independent social enterprise which supports the idea of employees owning shares in the companies they work for. Founded in 1985 it has members among companies large and small, law firms, accountants, trustees and specialist consultants.

Over two million employees in the UK have a stake in their companies thanks to a government-approved share scheme and many more benefit from schemes which do not carry tax breaks. Employee share ownership has been shown to exert a positive effect on more than 12,000 companies where the share effect is an aid to productivity and to recruiting and keeping staff.

The four HMRC-approved schemes are: Save as you Earn (SAYE) Sharesave, the Share Incentive Plan (SIP), Enterprise Management Incentive (EMI) and Company Share Incentive Plan (CSOP). Each has a distinct rationale, application and regulation (see Appendix 1). These differences reflect not only variations in purpose but also the state of the legislation at the time.

Many measures in the four schemes are designed in different ways to preserve tax integrity but that has since been overtaken by new legislation. The anomalies between schemes now present more of a barrier to adoption than a safety mechanism for taxation.

The Esop Centre's (the Centre) key proposal is that while the rationale and structure of each plan should remain, together with the applicable tax benefits, anomalies within the regulations should be eradicated to encourage companies of all sizes to adopt and implement employee share schemes.

Bringing all four plans within this **rational common framework** for tax regulation will enable the government to relaunch employee share ownership and ensure it contributes to national regeneration to its full potential. HMRC studies have shown that in general the cost of tax breaks varies with the strength of the economy: to that extent they pay for themselves.

The Employee Share Ownership Centre

Employee share ownership could provide a different model of ownership for the future.[1] Beyond the direct benefit share schemes can provide a way of encouraging millions of employed people to save more, a key aim in the wake of a devastating bout of borrowing. It can also offer an answer to increasing pensions deficits, by providing an alternative form of saving for retirement.

Given the debt situation in many countries governments are looking for new ways to solve savings and pensions problems. Delegates at our World Centre for Employee Ownership conference in Cannes heard Mick McAteer of the FSA and CESR[2] suggest that employee ownership schemes could provide a means for governments to encourage savings and through this develop an alternative pension scheme of sorts.[3]

On a practical level, the government might endorse a ten-point financial education agenda for employee share ownership which the Centre would undertake to produce in conjunction with the Consumer Finance Education Body.

1. Rational common framework

At the centre of our proposal is the plan for a common and simplified framework to embrace all current approved share schemes. Unnecessary anomalies would be culled. The difference between shares and options would be maintained, but where there are now differences in material interests tests and eligibility there could be one single set of rules.

The creation of the **rational common framework** will enable the government and partners such as the Centre to breathe new life into employee share schemes. An opportunity for re-branding and a fresh launch will be created within the framework of this new simplified tax regime, while preserving the overall tax reliefs currently enjoyed. Companies considering an employee share scheme will find it easier to compare and contrast choices.

[1] Davies W, *Reinventing the Firm* Demos, 2009
[2] Presentation by Mick McAteer "The Regulatory Environment for Employee Share Ownership" World Centre for Employee Share Ownership Conference, Cannes July 8 2010
[3] One issue could be the relative lack of diversification for a pension fund, but companies could ensure this does not become an issue by increasing diversification as employees move towards retirement age.

2. Other key steps:

2.1 *Increase prominence of EMI*

Since its introduction in 2003 the Enterprise Management Incentive has been a runaway success. The number of companies operating the approved discretionary EMI share option awards – usually to key employees alone - rose from 9,110 to 10,050 last year.[4] The scheme gives SMEs a chance to attract and keep talent, while linking reward to company performance and avoiding large cash salaries. However, considering the onus the government has placed upon enterprise providing the economic growth to lead the United Kingdom out of the recession, virtually nothing is done to promote EMI.

This is mainly attributable to EMI's having sprung from the Treasury and not having been fully adopted by DBIS whose promotional material on what government is doing for SME rarely even mentions EMI. A more prominent position for the scheme on the DBIS, HMRC and other government websites, coupled with ministerial championing of the scheme, would improve publicity. Currently the remarkable annual statistics of EMI take-up creep out unannounced.

2.2 *SIP – scrap negative clawback if company is sold in first 3 years*

There is current enthusiasm among SMEs for SIP, but many are put off by the three year claw-back period. For private unquoted companies this can be a big barrier as the total amount clawed back can be many times the amount of relief given owing to the potentially significant increase in value of the shares upon a sale of the company.

As explained by Esop Centre expert David Pett "Although a participant is not charged to income tax (or NICs) on that part of his salary used to acquire partnership shares, if those shares are withdrawn from the SIP, or cease to be subject to the SIP because the participant ceases to be employed by the plan company, or any associated company within three years of the acquisition date of the shares he will then be charged to income tax and, if the shares are "readily convertible assets" (RCAs), NICs on the market value of the shares at that time. The amount of the NICs could then be considerably greater than the amount of NICs which would have been paid on the salary deducted and used to acquire partnership shares!"[5]

The problem for employers is that it is calculated not on what would have been paid originally, but on the current share value, when it is higher. The resulting NICs bill can therefore be sometimes unexpectedly high. The Centre would like to

[4] http://www.hmrc.gov.uk/stats/emp_share_schemes/menu.htm
[5] Pett, D *Employee Share Schemes,* Thomson Sweet & Maxwell, 2006, 7A.33

investigate ways of limiting companies' exposure to NICs in this instance, possibly through limiting the amount payable to the amount saved when the partnership shares were initially purchased by employees.

2.3. *Pensions: SAYE & SIP to SIPP*

The government should unify the CGT treatment of SAYE-SIPP and SIP-SIPP transfers in order to allow both and clearly increase tax efficiency of moving money from employee share scheme savings to pensions.

2.4 *SAYE increase period of non-contribution:*

The coalition government should raise the period of non-contribution on SAYE contract before the option lapses from 6 months to 12 months (or staggered depending on the length of the savings contract). This would demonstrate the government's understanding of savers' current hard times

2.5 *Increase SAYE contribution limit:*

To send a clear signal that savings are to be encouraged it will make sense to review the current limit on contributions to an SAYE contract, which has not moved from £250 since 1991.

Nearly a quarter of savers under SAYE contracts are now at the limit.[6] In Ireland the previous limit of €320 was increased to €500 in February 2008.

2.6 *Entrepreneurs' relief:*

The increase of the amount on which ten percent CGT rate is available from £2m to £5m was welcome and generous.

However the 5 percent holding rule is too restrictive. This should be changed to five percent or any "employment-related security".

[6] IFS ProShare annual survey 2010

2.7 ***Allow private equity and venture capital backed companies to implement EMI.***

In line with our recommendation on the rational common framework simplified EMI rules will allow use by private equity and venture capital. The proposed change in status for Royal Mail may precipitate this in any event.

Conclusion

Employee share schemes have a larger part to play in national economic and social recovery. The Esop Centre has put forward a powerful range of expert and inexpensive measures which will support the Coalition government in its aims.

Contributing ESOP Centre members:

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Appendix 1
Source : http://www.hmrc.gov.uk/stats/emp_share_schemes/intro-note.pdf

EMPLOYEE SHARE SCHEMES

1. This note gives brief introductory information on each scheme.

Save As You Earn Share Option Schemes

2. Tax relief for approved SAYE Share Option schemes was introduced in 1980. The scheme allows a company to give employees the right ('option') to buy shares in the company at an exercise price that is fixed when the option is granted. The exercise price must not be less than 80 per cent of the value of the underlying shares at that time. Participating employees can save between £5 and £250 per month under a SAYE savings contract with either a bank, building society or Relevant European institution. These contracts last for three or five years. Employees with five-year SAYE contracts may decide at the outset whether to take the proceeds after the fifth anniversary or leave the savings for another two years to earn an additional bonus. The bonus or interest earned on these savings is tax-free.

3. The lump sum resulting from the SAYE contract can be used to buy the shares if the employee chooses to exercise their options after 3, 5 or 7 years, depending on the terms of the contract. Employees are not obliged to exercise their options and they may not want to do so if the current share price is less than the exercise price set when the option was granted. If the option is not exercised, the employee receives the proceeds of the SAYE contract in the normal way.

4. Under an approved SAYE Share Option scheme, the employee does not pay income tax or National Insurance on the grant of options, the bonus or interest received under the SAYE contract, the benefit from being able to buy shares at a discounted price, or any increase in the market value of underlying shares between the dates on which the option was granted and exercised. Capital gains tax may be payable if shares acquired through a SAYE scheme are later sold.

Company Share Option Plans (CSOPs)

5. A new type of discretionary scheme called CSOP replaced the Discretionary Share Option schemes in 1996. Under CSOP there is a limit of £30,000 on the value of the shares under option that may be held by an employee at any one time (taking into account the value of shares in options held under any other approved CSOP scheme). Also, options may not be offered at a discount (i.e. the exercise price must not be manifestly less than the market value of the underlying shares on the option grant date).

Share Incentive Plan

6. Initially known as the all-employee share ownership plan, SIP was introduced in Finance Act 2000 largely as a replacement for Approved Profit Sharing schemes.
The plan has three key elements:
- Free shares – employers can give employees up to £3,000 worth of shares each year;
- Partnership shares – employees can buy up to £1,500 of shares out of pre-tax and National Insurance earnings;
- Matching shares – employers can give up to 2 free shares for each partnership share bought by the employee.

7. All shares are held in trust on behalf of employees. When an employee leaves, all their shares come out of the plan.

8. Employees do not pay income tax or National Insurance on the value of the free or matching shares given to them provided they keep them in the plan for at least 5 years. If they leave, or take them out of the plan for another reason, between 3 to 5 years, there is no tax and National

Insurance charge on growth in value. If they take them out of the plan within 3 years, income tax and National Insurance is payable on the market value of the shares at the time the employee takes them out. No income tax is paid on the value of the dividends reinvested in more plan shares provided those shares stay in the plan for three or more years. No capital gains tax is payable on any increase in value while the shares are in the plan. When the shares are sold, the cost for calculating capital gains tax liability (if any) is the market value of the shares on exit from the plan and not the market value at acquisition.

9. The number of live plans at the end of the 2008-09 tax year increased marginally from 870 to 890, while the number of plans that appropriated shares also rose from 500 to 530. The initial value of shares appropriated rose by 16 per cent to £980m, and the estimated cost of income tax and NICs reliefs rose to £190m and £130m, respectively.
1 Statistics for DSOP and CSOP are available in the CSOP statistical tables
2 A final version of the APS table produced in July 2005 is available on the website

Enterprise Management Incentives (EMI)

10. Also introduced in Finance Act 2000, EMI offers more generous tax-advantaged share options to help small, higher risk independent trading companies recruit and retain the high calibre people they need to grow and succeed. EMI is open to qualifying companies or groups with gross assets not exceeding £30million (increased from £15million on 1 January 2002).

11. The main features of EMI are that:
- Each employee can be granted options over shares worth up to £120,000 at date of grant;
- Companies can have up to £3million of shares under EMI option at any one time;
- Nil cost and discounted options can be used (though there may be tax and National Insurance implications).
- The maximum size of qualifying companies is 250 full-time equivalent employees.

12. EMI options are discretionary. Qualifying companies can choose to grant EMI options to any number of employees (working for them, a parent, or a qualifying subsidiary) whom they employ for at least 25 hours per week or 75 per cent of their working time and who have no material interest in the company.

13. No income tax or National Insurance is chargeable on either the grant or exercise of EMI options if: the options are exercised within 10 years of grant; the exercise price is the market value of the shares at the date the option is granted; and the company and employee qualifies for EMI throughout the period from the grant to exercise. If the option is granted at a discount, the amount of the discount but not any growth in value is normally taxed on exercise and National Insurance may be payable.

TRANSFERS INTO AN INDIVIDUAL SAVINGS ACCOUNT

14. Employees who acquire shares from an approved all-employee share scheme (SAYE Share Option Scheme, or Share Incentive Plan) may transfer them directly into a stocks and shares component of an Individual Savings Account (ISA). ISA managers cannot accept shares acquired via tax-advantaged discretionary share option schemes (i.e. Company Share Options and Enterprise Management Incentives).

15. Employees' shares must be transferred into an ISA within 90 days of emerging from the scheme. The aggregate market value of the shares when transferred must be within the normal annual ISA subscription limits. There is no charge to capital gains tax on shares transferred. Prior to the introduction of ISAs, from 1992, shares acquired via approved all-employee schemes could similarly be transferred into a single company Personal Equity Plan.