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Talking Tax and Incentives – An introduction to share incentives

Kathy Granby and Matthew Rowbotham, both Partners in the Tax, Rewards and Incentives team at Lewis Silkin join us for the second in their podcast series to discuss share options and incentives.

Share incentives are commonly used as a recruitment or retention tool by all types of companies. from startups to large multinationals both private and listed. But what's the difference between share incentives, share schemes and share plans? From LTIPs and MIPs to EMIs and CSOPs – Kathy and Matt demystify the world of share incentives and highlight key considerations for private companies thinking about share incentives for the first time.

Matthew Rowbotham: Hello everyone and welcome to the second in the Lewis Silkin Tax and Incentives podcast series.

My name is Matthew Rowbotham. I'm a Partner specialising in tax and incentives here at Lewis Silkin and I am joined by Kathy Granby who's a Partner and specialist in share incentives so she's the real expert here - hello Kathy.

Kathy Granby: Hi there Matt.

Matthew Rowbotham: So, in our previous episode we discussed employee ownership trusts and now we're going to kick off what will become a series of podcasts about share incentives and there's plenty to discuss. It's a whole area of expertise but we're going to start off today by discussing share incentives at a high level and just set the scene for people, so they understand what we're talking about in future episodes.

What are share incentives and who can use them?

Matthew Rowbotham: I'm going to start off with a nice broad question Kathy. Can you explain what share incentives are and who can use them?

Kathy Granby: Yes, of course. Share incentives or share schemes are very commonly used as a recruitment or retention tool by all types of companies from startups to large multinationals both private and listed.

Now essentially a share incentive is a promise to receive a future reward in the form of shares in the company and that reward is normally received by the employee after a period of time that they stay in employment or on the achievement of specific goals. Those goals can be based on individual performance metrics, or they could be company performance metrics like profit or EBITDA growth or they could be based on a specific milestone like the sale of the company or a combination of those things.

They're a really great way of incentivising employees to stay working for the business and to help it to grow in value. Because their reward is in shares it effectively aligns their interests with the company's shareholders encouraging them to think more like an owner and to really care that little bit more about the company they're working for and to stick with it.

They're generally very highly valued by employees. Assuming you're not making your share incentives too complex, many employees really appreciate that to receive shares in the business, they're effectively being given an opportunity to reap the benefits of the company's success, just like a shareholder, like an owner.

Matthew Rowbotham: Exactly. We see them in a variety of sectors but there's quite a culture of them in the tech sector for all sorts of reasons and perhaps even the level of expectation from employees that share incentives should be on the table if they're in the tech sector.

Kathy Granby: Yes, yes, that's absolutely right. But of course, they're not limited to any particular sector and companies of all sorts can use share incentives.

Matthew Rowbotham: Just to pick that out. There's an important word there – companies. I suppose there are other kinds of business that can't grant share incentives because they don't have shares. Sole traders and partnerships of different kinds; they've got other incentive alternatives and perhaps a more limited range but we're going to focus on share incentives today.

Kathy Granby: Exactly Yes, so we're talking about companies with shares that they can use.

Matthew Rowbotham: This is an area which is absolutely packed to the brim with acronyms, and it can all be a little bit confusing for people coming to it cold. So, let's get into a bit of that and try and demystify some of that.

Jargon buster - what's the difference between a share incentive and share schemes? What do the acronyms LTIPs, MIPs, EMIs and CSOPs stand for?

Matthew Rowbotham: Lots of companies ask so what's the difference, is there any difference between share incentives, share schemes, share plans. I'm also going to ask you to unpack some of these awful acronyms like LTIPs, MIPs, EMIs and CSOPs. Take it away Kathy.

Kathy Granby: Yeah, so there are a lot of terms that fly around so bit of a jargon buster then. Share incentive or share scheme mean essentially the same thing and if you just have one employee that you're granting some sort of share award to, then you might refer to it as a share incentive rather than a share scheme. If you're talking about more than one employee being involved or potentially involved, then you can go with either phrase, share plan as well as scheme.

Then these break down into different types of share incentive or scheme and there are a number of very well-established types of share scheme. Listeners might have heard of various schemes like option plans, growth share plans, EMI plans for example. These are all share schemes that are structured differently depending on factors like what type of company it is, are the shares in that company readily tradeable or not, is it small or large for example. Also, when the shares are intended to be delivered to the employee and what type of shares are going to be used and also what tax breaks they're able to benefit from. So, if you can meet the conditions for one of HMRC's tax advantage schemes, then the terms and conditions of the share awards will be structured in a certain way to fall within that framework.

Matthew Rowbotham: There's no such thing as a free lunch from HMRC!

Kathy Granby: That's right, there is a little bit of a trade-off there, but the degree of flexibility you get with each scheme, it varies.

So those four tax advantage schemes that HMRC formally supports are the EMI option scheme, the CSOP scheme, the SAYE scheme and the SIP scheme. The first two of those which is EMI and CSOP; those are discretionary share option schemes and those are really popular with private companies. The second two of those, so that's the SAYE and the SIP schemes; those are all employee share schemes and so they're much more popular with listed companies.

Broadly all of those provide different mechanisms to enable employees to have increases in the value of their shares treated for tax purposes like capital gain instead of employment income. So, they're taxed at much more favourable rates. So that's 20% or sometimes even 10% instead of 40% plus in tax. Those schemes won't always be available or necessarily suitable and will explain more about that and the choices available if you can't use any of those schemes later on in our podcast series.

Another question that's often raised is what's the difference between an LTIP and a MIP. An LTIP really means Long Term Incentive Plan and it can mean any type of non-tax advantage incentive scheme that's expected to have a timeframe that's essentially longer than that for an annual bonus. It's used very loosely in the private company context to cover all sorts of structures for all different levels of employee, and it can even mean a share-based scheme or a cash-based scheme.

In the listed company context, the word LTIP is actually used to describe a more specific type of share scheme which is a plan where shares are delivered at the end of a period which is typically three years following an assessment of performance over that period and usually with a minimum two year holding period for the shares on top. Now a MIP means Management Incentive Plan and it's a very similar concept to LTIP. It tends to be used by private companies to describe a broad range of long-term incentives, but it's limited to senior management and the term tends to be used more by companies that have private equity investment in them.

More acronyms, what do EMI, CSOP, SAYE and SIP stand for?

Matthew Rowbotham: We've got to unpack these acronyms, there's a few more and we're going to unpack them all. Quick fire round Kathy so EMI and CSOP, what do those stand for?

Kathy Granby: So, EMI so that means Enterprise Management Incentive; that's a type of tax advantaged option plan that's really only available to smaller companies. Companies that have fewer than 250 employees broadly and there's a threshold on the gross assets that the company can have so the threshold is £30 million in gross assets and that's group wide. So that's a bit of a snapshot as to who can use EMI schemes.

Matthew Rowbotham: And CSOPs for the larger companies. It's a little bit less generous I think but broadly available to larger companies.

Kathy Granby: That's right agree, so CSOP means Company Share Option Plan. It's not a very imaginative name.

Matthew Rowbotham: The most generic name and there are more of them to come unfortunately. But that's why we call them CSOPs.

Kathy Graby: That's right. When we refer to CSOPs, we tend to be referring to the second type of HMRC backed plan, which is the plan you would probably turn to if you were looking at share options, but you couldn't qualify for EMI. You would look to see whether you might qualify for CSOP instead and whether implementing that kind of plan meets your needs. There are a few more constraints around that type of plan. One of them is there is a smaller limit on how many you can grant.

Matthew Rowbotham: Yeah, the actual value you can give to people.

Kathy Granby: Exactly. That's much lower than the limit on EMI options and you also have to make sure that the price that employees pay for their shares when they exercise isn't lower their market value at grant. So, there are a few requirements around the CSOP that make it a little bit less favourable than the EMI.

But in some cases, it still can be really useful because it can give access to real tax savings if the conditions are met. Usually, the employee would have to wait three years before they can get the shares to benefit from those tax savings which you don't have for EMI.

Matthew Rowbotham: Then you also briefly mention, and maybe we'll leave the detail on this one for a future podcast, but there are also plans that are intended to be operated on a whole company basis - SAYE and SIP. Tell us what those imaginative acronyms stand for.

Kathy Granby: Yes, so SAYE, that's Save As You Earn plan. Sometimes that's called a share save plan. So that will tend to be used by listed companies because as I mentioned before, if you offer a SAYE plan, you do have to offer it to pretty much your entire workforce. Essentially that's an option where the employee will put aside some savings so, an amount will be deducted from their pay over a period of time and effectively they'll save up to be able to exercise their option using those savings at the end and usually there's a discounted exercise price as well, and the gain they make

benefits from tax advantages. So, a really great plan for listed companies if they're looking to roll out a plan for their workforce.

The other one you mentioned is the SIP. So that means Share Incentive Plan but when you see it with capital letters SIP, that means the fourth type of HMRC backed plan. Under that type of plan actually employees purchase shares as they go so, they will have contributions deducted from their pre-tax salary over a period of time or on an ongoing basis and those deductions are used to purchase shares and those shares are held for them in a sort of special trust vehicle. The longer they hold those shares, the more chance they have of being able to come into tax benefits.

If they sell them straight away, they won't be able to get them, but if they hold those shares for either three or five years at the moment then those shares will benefit from tax advantages. Actually that area is under review by the government at the moment, they might be lowering those time limits and making it more favourable to employees but we're watching that space.

How does a company choose the right share scheme for their business?

Matthew Rowbotham: Fantastic. Okay, we've overwhelmed our poor listeners with acronyms, so it probably is sounding quite complicated at the moment. How does a company go about choosing the right scheme for them?

Kathy Granby: Really, it'll be a case of deciding what type of scheme is best for achieving the goals that they want to achieve, bearing in mind who they're looking to incentivise. Is it just senior management? Is it the entire workforce for example? And weighing up the pros and cons of the choices available. It sounds complicated and that's because it is a specialist area and it's unfamiliar to most people.

But in our experience, it's usually possible to narrow the options down to the right scheme pretty quickly; a short discussion is normally all it takes, and most share schemes are actually pretty straightforward to set up. My advice would be to avoid unnecessary complexity, make sure you get proper advice that's tailored to your company and make sure that everybody understands exactly what they're signing up for, so that business owners can be comfortable that they're putting in place the right scheme for them. And also, to really maximise that incentive benefit that you want the scheme to deliver.

Matthew Rowbotham: Absolutely I'm a big fan of keeping things simple. The worst possible combination for a company is that it does something very expensive, gives away a lot of value and the employees don't even realise or appreciate it. Simplicity can definitely help with that.

Kathy Granby: That's right.

What are the benefits of using share incentives?

Matthew Rowbotham: I think we understand that it's good for motivating employees. Are there any other benefits that come from using share incentives?

Kathy Granby: Yes, absolutely. So, obviously cash savings so you're using shares, or you're using rights to acquire shares in the future and that saves the company's cash reserves. A lot of startups that are short on cash use share options to boost their pay offerings and share schemes that benefit from tax savings save the employer money in employer National Insurance contributions and of course they get more value into the hands of the employees which you can't do with cash bonuses. Some types of scheme also benefit from a corporation tax deduction as well.

Locking in management for the longer term is another key benefit. So, lots of business owners are really keenly aware that their business relies on some very key employees and if they're aiming to sell the company one day, they'll know that any buyer will need assurance that the company's key employees are sufficiently invested in the business beyond that sale.

A really great way to make sure of that is to give key management shares at some point before the sale so that they receive something in return for the sale of those shares to the buyer that's going to make them want to stick around afterwards; that could be shares in the buyer. So, we call that a rollover of shares so that's where the employee sells

their shares to the buyer partly for cash and partly for shares in the buyer. Or it could be value that's only delivered to them in the years after the sale that's linked to the post-sale performance of the company and we call that an earnout.

Matthew Rowbotham: That's a point that we come across quite a lot on transactions isn't it. It can be a real sticking point on an M&A transaction if management don't hold enough equity because actually it just makes the whole deal harder to make work. Whereas the buyer will find it a lot more attractive if the key senior individuals within the business actually have equity because that gives you much more scope to structure the transaction in a way that suits the buyer and the sellers.

Kathy Granby: That's right, it's unfortunate if a company gets to that point when actually they're approaching a sale and they are gearing up to sell the company, maybe they've even reached the point where they're starting to have discussions and they only start thinking about their share schemes at that point and who are the right people with the right amount of shares. At that point, it's very late in the day to set these things up. If you try to put say an EMI options scheme in place right at the last minute, then it's actually unlikely to benefit from any tax advantages because the value of those shares at that point, when you're actually thinking about a sale, is likely going to be much higher than it would have been a year or two ago.

Matthew Rowbotham: You and I are used to working in the very odd share incentives world where a low value is a good value because a lot of the tax benefits increase if you can secure a low tax value. Whereas most companies are obviously looking for the highest possible valuation of their company further down the line.

Kathy Granby: Exactly. So yes, you get a conflict there, that's right. So really the takeaway on that is if you do have plans to sell the company one day or you might do, it's better to think about putting in place these things early in the day so now rather than later.

What do private companies need to consider if they're thinking about offering share incentives and are there any drawbacks that they need to be wary of?

Matthew Rowbotham: Let's say that someone has heard us speaking and is interested in putting something in place. What do private companies need to consider if they're thinking about offering share incentives and are there any drawbacks that they need to be wary of?

Kathy Granby: Really, it's a good idea to start with whether you're comfortable with using shares as a method of incentivising your employees in the first place as opposed to using cash awards that perhaps mimic the value of shares. So that would be what we would call a phantom share scheme. Most private companies get comfortable with this on the basis that they're looking to use an exit only scheme.

Essentially what that means is a share scheme or an option scheme where employees only get their hands on the shares right at the last minute just when a sale is about to happen. They get the shares basically a moment in time before the company is sold and then they sell those shares immediately. So, they're not getting their hands on the shares in the ordinary course of business.

Matthew Rowbotham: They're not turning up to shareholders meetings and disrupting decision making and that sort of thing.

Kathy Granby: Exactly. They share in that benefit that they receive a portion of the sale proceeds right at the end, just like the other shareholders but exactly up until that moment, they are not a shareholder. And of course, when you're thinking about this, if the company has investors, they will need to get them on board with implementing a share scheme.

Matthew Rowbotham: But that's not usually a problem in our experience. Generally, investors recognise the benefits of using share incentives to motivate employees. In fact, you sometimes see investors making it a condition of their investment that the company puts in place a proper share incentive plan, far from being worried about the dilution, they actively want the key management to be properly incentivised.

Kathy Granby: Yes, absolutely agree. Also, when owners are considering whether to use shares versus cash, it's also worth bearing in mind that it's really only share incentives that can potentially be structured to deliver tax benefits. Cash will be subject to income tax and National Insurance just like salary. They'll also need to think about how much they would like to give away, what's the maximum they would like to dilute. So how many shares they'll authorise to be given out under the scheme, that's known as deciding on the scheme pool. Also, who will get diluted from that will it be all of the shareholders? Or is there a reason to ensure that only the founders are diluted?

Another really key decision to make early on will be whether you'll let employees get their hands on the shares in the ordinary course of business. So as and when time-based or performance-based conditions are met or whether you just want to go for the exit only scheme. Exit only schemes also have the advantage of being slightly more straightforward to put in place because you don't have to set the scheme up to deal with leavers. You don't have to get the shares back from anyone who leaves the business. You might not even need to set up a new class of shares because you won't be expecting to worry about employees receiving dividend rights or voting rights and because obviously the employees don't get their shares until right before the exit.

Matthew Rowbotham: That could be an important factor for smaller companies who are looking to put in place something cost effective and simple. The less engineering they have to do around the edges of the scheme to make it work, often the better from their perspective. Also, the ease of tradability, so whether the company is listed or not, presumably that will also influence that decision around exit only, versus non exit only options.

Kathy Granby: Absolutely, that's a good point. So, most private companies won't have any liquidity in their shares, so it means that shareholders aren't readily able to sell them in the absence of an exit. It means that employees, if they were to get shares, they generally won't be able to realise the value of those shares outside of an exit. Essentially, they're locked into those shares just like an investor.

Plus acquiring the shares will normally come at some cost to the employee. Whether it be in the form of an exercise price or purchase price or some tax and without the means to sell some of their shares to fund that tax, then employees can be left with having to reach into their pocket which usually isn't an attractive proposition. That's another reason why exit only option schemes are really popular amongst private companies whether they can benefit from tax advantages or not, they avoid those problems.

Matthew Rowbotham: Well, thank you Kathy for that. I'm sure people will have found that very interesting and if you want to find out more. We'll be doing further podcasts on these themes and discussing in more detail some of the topics within the world of share incentives. You can always email us at info@lewissilkin.com or you can head to our website. Thank you.

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