ENTREPRENEURS' RELIEF - GIVING EQUITY TO EMPLOYEES

A HANDY GUIDE

BRODIES LLP

Entrepreneurs' Relief: are you sure you qualify?

Entrepreneurs' Relief ('ER') is so well known it is often taken for granted by those disposing of their business. This valuable relief reduces the rate of tax to 10% on gains of up to a lifetime limit of £10 million and is designed to benefit those who create and develop economic growth. However all too often issues jeopardising the availability of ER are only identified when advising on an imminent disposal. This is frequently too late to remedy the problem and can be a costly mistake.

Even where a sale may not be contemplated, it is good housekeeping to review your ER position to ensure it remains available. Many of the conditions relevant to ER have to be satisfied for a 12-month period leading up to (and ending with) the disposal.

Who knows where the next 12 months may take you and your business, but ensuring you qualify for ER is simple.

In our ER health check series we will:

- explain how ER works;
- look at some planning ideas; and
- examine the pitfalls.

> Even where a sale may not be contemplated, it is good housekeeping to **review your ER position** to ensure it remains available.

Piece of cake

Regardless of size, almost all enlightened companies look for ways to give equity to their key managers and employees.

Owners and shareholders usually overcome their reluctance to concede part of their equity share capital to managers and employees because they recognise the importance of incentivising and motivating their staff - what is important is not the size of the cake itself, but the value of each slice.

If managers and employees have valuable shares or share option rights these can be a very powerful incentive and motivator to stay with the organisation, be more productive and to think and behave as an 'owner' of the business.

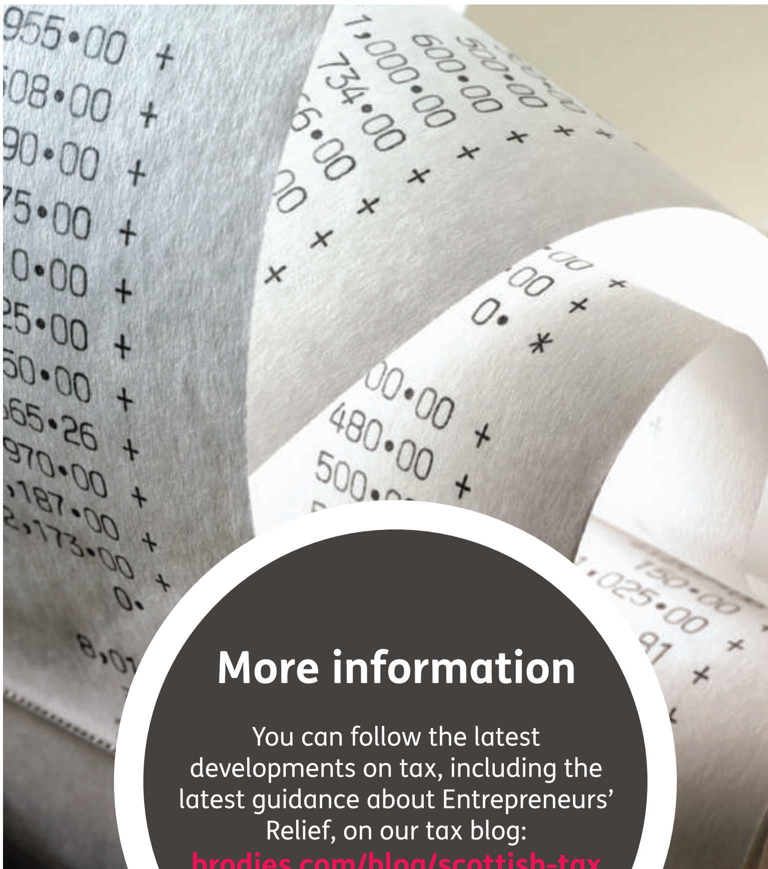
Quite simply the interests of the manager and the employee are more closely aligned with those of shareholders.

Maxi-min

Maximising what you own is therefore a very normal and rational by-product of owning something. By the same token it is normal and rational to minimise anything that could reduce or impact what you own.

Tax is like that too

If you can maximise the amount of profit by minimising the amount you have to pay over to HMRC, then it is perfectly normal and rational to structure your economic and financial affairs to achieve this.



More information

You can follow the latest developments on tax, including the latest guidance about Entrepreneurs' Relief, on our tax blog:
brodies.com/blog/scottish-tax

Indeed, HMRC practically encourages this through a system of tax reliefs and allowances.

One such HMRC mechanism for encouraging and rewarding behaviour is ER. The theory behind this relief is that if wealth creators are encouraged to be productive and invest in trade and industry, this in turn will create jobs and help to redistribute wealth and capital.

Encouraging investment has always been problematic as capital gains tax ('CGT') is, fundamentally, a tax on investment. But rather than abolish CGT, successive governments have tried to encourage enterprise and entrepreneurship by 'modifying' the CGT regime.

ER is one such modification and it operates to reduce the rate of CGT to 10% on a disposal of shares or securities in a company.

Employee equity

If employees are to receive equity in their employer then it is perfectly normal and rational to try and structure the delivery of that equity so that they too can benefit from ER.

There are two ways for employees to qualify for ER:

- Exercise an EMI option.
- Hold and dispose of a 5% shareholding.

EMI options

For an employee to be eligible for ER in relation to EMI options, there are at least five conditions that need to be met. One of the most important is that a disposal of the option shares must take place more than 12 months after the EMI option was originally granted. In other words the option period counts towards the 12-month ER qualifying period.

Of course, obtaining ER in relation to EMI options presupposes that all the other EMI criteria have been satisfied to make the option a qualifying EMI option in the first place.

ER automatically applies to disposals of EMI option shares – the two 5% shareholding tests (see below) do not apply.

5% shareholding

For an individual to be a qualifying employee shareholder for ER purposes, the following conditions must be satisfied:

- The shares (or loan stock, securities, etc.) must be shares in the individuals' 'personal company', meaning that the employee must hold at least 5% of the 'ordinary share capital' and 5% of the voting rights.
- The personal company must be a trading company or the holding company of a trading group and the shareholder must be an employee or officer of a company within the group (there is no requirement that the employment is full-time).
- The individual must be an officer or employee of the company or a company within the group.

All of the above conditions must have been met at the date of disposal and for the 12 months leading up to the disposal, meaning that there is plenty of time for things to go wrong.

Self-sabotage?

There is absolutely no point of going to all the trouble of giving employees tax efficient equity if the tax planning is then inadvertently sabotaged through poor execution.

The following are examples of inadvertent ER sabotage:

Pre-sale dilution

The exercise of employee share options on or shortly before a sale will necessarily dilute existing shareholders and so for existing shareholders who are at risk of falling below the 5% threshold, the timing of the exercise of the employee share options is key for ensuring that the 5% holding has been held throughout the 12 months before disposal.

If the option holder exercises too soon, this could cause existing shareholders to inadvertently lose their ER.

> There is absolutely no point of going to all the trouble of giving employees **tax efficient equity** if the tax planning is then inadvertently sabotaged through **poor execution**.

Ordinary share capital

Ordinary share capital refers to shares that do not carry a right to receive a dividend at a fixed rate. Furthermore, HMRC's view is that the share capital test is measured in terms of the nominal value of the shares (as opposed to number or economic value).

Where companies have private equity investment or other classes of shares this is likely to substantially increase the ordinary share capital and may dilute other holdings below the required 5%.

In the recent case of HMRC v McQuillan and another [2017], the Upper Tribunal found that shares with no right to participate in dividends qualified as 'ordinary share capital' for the purposes of ER.

The effect of this decision meant that certain redeemable shares were counted as ordinary share capital. As a consequence, two individuals who each held 33% of the ordinary shares ended up holding only 0.1% each and so no longer satisfied the 5% shareholding requirement (basically because they were swamped by the redeemable shares counting as ordinary share capital).

Share reorganisations and transactions

Where there is a share reorganisation or transaction and a new company acquires the shares of the target company by way of a share-for-share exchange, normally the new shares issued in exchange for the old shares are treated as the same asset, i.e. the new shares 'stand in the shoes' of the old shares.

Sometimes the old shares may qualify for ER but the new shares do not, perhaps because the new company is no longer the employee's personal trading company. If no action is taken ER might be lost for good.

Fortunately the legislation provides an escape route that allows an individual to elect to disapply the share-for-share exchange provisions. This means that at the time of the exchange, a disposal is deemed to have taken place based on the market value of the new shares. This then allows the individual to claim ER on the old shares.

And finally

Remember that ER has to be claimed through self-assessment. It doesn't just happen automatically. So an ER claim on a qualifying gain in the 2017/2018 tax year must be made by 31 January 2020.

Key contacts

Isobel d'Inverno
DIRECTOR OF CORPORATE TAX
+44 (0)131 656 0122
isobel.dinverno@brodies.com

Nigel Watson
PARTNER
+44 (0)131 656 3720
nigel.watson@brodies.com

Heather Gibson
ASSOCIATE
+44 (0)141 245 6223
heather.gibson@brodies.com

More information

You can follow the latest developments on tax, including the latest guidance about Entrepreneurs' Relief, on our tax blog:

brodies.com/blog/scottish-tax

BRODIES LLP

brodies.com