EMPLOYEE SHAREHOLDER STATUS

Employee shareholder status for private equity and high growth companies

From 1 September 2013 an employee may be issued shares in the employer company or its parent undertaking as an "employee shareholder" and the shares will be exempt from capital gains tax (**"CGT"**) on disposal. The principal conditions are that the shares must be worth a minimum of £2,000 on issue and the only consideration from the employee must be reduced UK employment law rights.

Employee shareholder status has been politically controversial ever since it was first announced in October 2012. However, whatever the take-up by employers generally, the new status could be very attractive to private equity-backed and high growth companies.

An alternative to entrepreneurs' relief for private equity-backed and high growth companies?

Under entrepreneurs' relief, a 10% rate of CGT applies to the gain on disposal of the shares if the individual satisfies certain conditions. The individual must be an employee or director. The shares must carry at least 5% of the voting rights and represent at least 5% of the issued share capital. These conditions and others must have been satisfied for at least 12 months prior to the disposal. This means that special share structures are often needed to access entrepreneurs' relief which add complexity and can be particularly problematic in a private-equity context.

Employee shareholder status will remove these difficulties, as well as giving a nil rate of CGT on disposal, rather than 10%. The price of the CGT exemption - loss of certain employment rights - is unlikely to worry key managers.

Outline of employee-shareholder status

- In consideration of entering into an agreement to waive certain employment rights, including the rights to a statutory redundancy payment and to claim unfair dismissal, the manager will be issued a minimum of £2,000 of shares in the employing company or its parent. There must be no consideration given by the manager for the shares, other than entering into the agreement.
- There will be no income tax charge on the first £2,000 of shares issued, and any capital gains arising on disposal will be exempt to the extent that the value of the shares does not exceed £50,000 on issue.
- There will be **no restriction on the types of share** which can be used, nor the rights and restrictions attaching to them. In particular, shares **need not have voting or dividend rights**, and **employees can be required to forfeit shares** when they leave the company. The manager is likely to elect for up-front income taxation so that there is no income taxation when the restrictions are lifted or the shares disposed of.

However, the shares must be fully paid up and must be in the employing company or its "parent undertaking" (using the UK company law definition).

- The manager must be given a written statement giving details of the employee shareholder status and the rights attaching to the shares, and must receive independent advice on the terms and effect of the agreement, and be given a seven day "cooling off" period after receiving that advice.

The importance of valuation

- A third party valuation of the shares will be key. If the manager does not receive at least £2,000 worth of shares employee shareholder status will not be achieved and the value of the shares given will be taxable at the outset. More importantly, the CGT exemption will not be available. It will not be possible to "top up" the number of shares awarded later if the initial award turns out to be worth less than £2,000. The £2,000 of shares must all be issued at the same time.

  HMRC are expected to publish guidance on valuation. This might be a methodology similar to that recently produced for EMI option purposes, but there will remain a significant risk of getting the valuation wrong. In practice, companies will wish to err on the side of caution and award more rather than fewer shares. Indeed, to the extent that the value of the shares awarded is greater than £2,000, an income tax charge will arise at the outset. It is not possible for the manager to pay anything for the shares to avoid this charge because this will defeat employee shareholder status. However, a manager who expects substantial growth in value is likely to be more interested in using the £50,000 limit than in the initial income tax charge.

- For maximum tax efficiency, a section 431 election should be entered into when the shares are acquired. Assuming that there are some restrictions attaching to the shares (such as restrictions on transfer and "good leaver/bad leaver" restrictions), the election will give rise to, or increase the initial income tax charge. However, this will be a small price to pay for no income taxation on disposal if the shares perform as hoped.

- In practice, employers may choose to pay managers a sufficient after-tax bonus to enable the employee to meet the initial income tax charge.

- In a private equity context, the shareholding structure will often be such that the income tax charges will have to be accounted for by the employer under PAYE and in addition NICs (employer and employee) will also arise. Employers should obtain indemnities for PAYE and employee NICs from the managers (as is normally the case now), but employer NICs will remain the employer's cost.

Practical employment law points

- The manager must receive independent advice in writing on the agreement and share rights. It is likely that this will result in some form of endorsement or certificate on the agreement from the independent adviser. It is a requirement that the employer must meet the costs of the independent adviser so far as they are reasonable.

- It has been mooted that some of the statutory employment rights which have been given up could be given back under contract (the original Treasury paper suggested that this would be possible). This is likely to be inadvisable. It would introduce common law remedies of breach of contract/damages rather than statutory rights such as re-engagement. It would also create more generous time limits for when a claim could be brought.

- Consultants who act as independent contractors but who are due to receive equity incentives might also consider employee shareholder for the tax advantages. Employers should be wary of this - whilst certain employment rights are waived, employee shareholders still have the right to bring a claim in respect of an automatically unfair dismissal, such as health and safety, whistleblowing and discrimination. Also, the individual would gain other employment rights that he would not otherwise have had, for example, rights to holidays and statutory sick pay. Against that, for the individual, earnings of the employment as consultant would become subject to PAYE.

Other practical matters

- If the shares are issued by a non-UK parent undertaking of the UK employing company, UK company law which allows the shares to be issued fully paid in exchange for the surrender of the employment rights will be irrelevant. Although the manager may not give any consideration for the shares, employee shareholder status will not be lost if the employing company pays for the issue of the shares by its parent undertaking. UK and foreign law requirements on a subsidiary financing shares in its parent will need to be followed.

- It must be clear that the shares are given in consideration of the employment agreement. Where the shares are being issued by the parent undertaking rather than the employer, this is likely to require a tri-partite agreement, or at least a separate agreement between the employer and the issuing company relating to the provision of the shares.

- Private equity shareholding structures often involve double or triple "newco" arrangements. It is often the case that the managers will already hold shares in the existing target company and through a series of share and/or loan note exchanges, as part of the private equity structuring, they will end up with shares in the "topco". These types of exchange mechanisms will not be possible if the managers are to be employee shareholders in topco, and consideration will therefore need to be given to how the managers' equity in target will be dealt with whilst enabling them to acquire new shares in topco.
- The timing of the giving of the independent advice, cooling-off period and subsequent issue of the shares and entry into the employee shareholder agreement will be critical, as will the implementation documentation. The documentation will need to make a clear link between the issue of the shares and entry into the agreement, cover all statutory requirements and demonstrate that those requirements have been satisfied.`

How we can help

DLA Piper has significant expertise in advising companies on all types of share-based incentives and associated documentation for key management and employees. We will assist you in achieving employee shareholder status for your managers, ensuring that statutory conditions are satisfied and technical pitfalls avoided, that the arrangements are compliant with local company law requirements and are properly documented and implemented.

If you would like to discuss employee-shareholder status further, please contact one of the following or your usual DLA Piper contact on 08700 111111:

Stephen Hoyle
Partner, Tax
T +44 (0)207 153 7439
stephen.hoyle@dlapiper.com

Lynda Finan
Legal Director, Tax
T +44 (0)113 369 2439
lynda.finan@dlapiper.com

Jonathan Exten-Wright
Partner, Tax
T +44 (0)207 796 6619
jonathan.exten-wright@dlapiper.com

Luca-Gori
Legal Director, Corporate
T +44 (0)207 796 6469
luca.gori@dlapiper.com

www.dlapiper.com

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UK switchboard**:** +44 (0) 8700 111 111