inbrief

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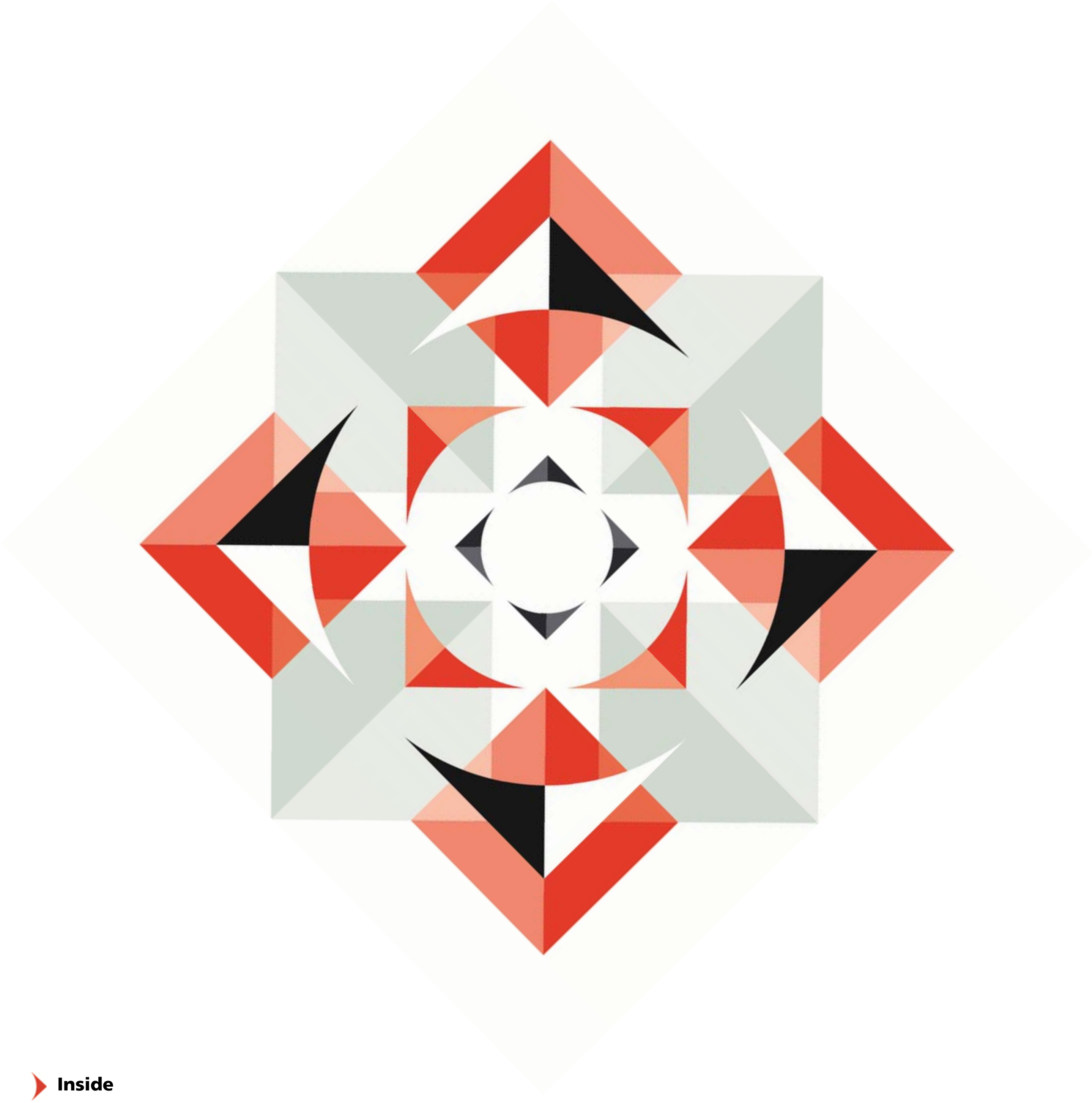
# Employee shareholders



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## Introduction

With effect from 1 September 2013, the Government has introduced a new tax efficient way for employees to share in the growth of their employers – employee shareholder status. This new status involves giving up certain employment rights in return for shares with favourable tax treatment.

This Inbrief considers the various issues and steps involved in adopting this new type of employment status, and how it might affect the range of incentives employers have to choose from.

### The basics

The new status of 'employee shareholder' was introduced by the Growth and Infrastructure Act 2013. It allows employers to offer new recruits or existing employees the opportunity to acquire shares worth at least £2,000 in itself or its parent company in exchange for them giving up some of their employment rights such as unfair dismissal and statutory redundancy pay. A very significant advantage of shares acquired under this new regime is that any gains made on the first £50,000 worth of shares (valued at the time of acquisition) will be completely exempt from capital gains tax (CGT). The Government hopes this will encourage the creation of new jobs by having a more flexible workforce which can adapt to tougher economic times and incentivise staff by giving them the opportunity to share in their employer's growth.

### Who can become an employee shareholder?

Any employee can become an employee shareholder so long as their employer is able to issue them with the necessary shares (for example, an LLP or charity cannot have employee shareholders as they are not able to issue shares). However, anyone who has a 'material interest' in the employer or its parent will not enjoy the favourable tax treatment accorded to other employee shareholders. In broad terms, someone who has 25% of the voting rights in the employer or its parent is considered to have a 'material interest'.

### How do the tax advantages work?

To be a valid employee shareholder arrangement, the shares received by the employee shareholder must be worth at least £2,000 at the time they are issued to the employee. An employer can give an employee shareholder more than £2,000 worth of shares if they want. The first £50,000 of shares given under this arrangement will be exempt from CGT (by reference to market value at the time of acquisition). If more than £50,000 of shares is granted, the surplus will be subject to usual tax rules, with no special advantages.

Ordinarily, a grant of free shares to an employee would attract an income tax charge. However, employee shareholders will be deemed to have paid £2,000 for the shares they receive as part of accepting employee shareholder status. This means that the first £2,000 worth of shares will not incur an income tax charge, but any shares worth more than this amount will. This tax may be payable via self-assessment, or alternatively PAYE and employees' and employers' national insurance contributions may apply (where the shares are tradeable or shares in a subsidiary of another company).

While this income tax benefit is helpful, it is the CGT exemption which could be extremely valuable. Aside from the £50,000 cap on the up-front value of the shares which get special treatment, there is no cap on the amount of capital gain which someone might get tax-free. So if £50,000-worth of shares is later sold for £1m, then the entire gain could be free of income tax and capital gains tax. This makes employee shareholder shares even more advantageous than enterprise management incentive (EMI) options in some circumstances.

EMI options should still be considered by those businesses for which employee shareholder shares are not appropriate, or which exceed the £50,000 limit. Following changes made in the Finance Act 2013, shares which are acquired on exercise of an EMI option will more easily benefit from 'entrepreneurs' relief' on sale, meaning that the shareholder could pay as little as 10% tax on any gain in value from the date the option is granted to the date the shares are sold.

### Employment rights

What employment rights do employee shareholders have to give up?

Employee shareholders will not have the right to:

- claim ordinary unfair dismissal
- receive a statutory redundancy payment
- make a flexible working request under the statutory procedure (unless returning from parental leave)
- request to take time off to study or train.

In addition, employee shareholders have increased notice requirements when informing their employer of their intention to return to work from maternity leave or adoption leave (16 weeks rather than 8 weeks) and additional paternity leave (16 weeks rather than 6 weeks).

What employment rights do employee shareholders retain?

Other than the above list, employee shareholders will have the same rights as ordinary employees. For example, they will have the right to:

> not be automatically unfairly dismissed (e.g. because they have made a protected disclosure)

> not be discriminated against under the Equality Act 2010

> maternity, adoption, paternity and parental leave

> protection under TUPE

**Making and ending the agreement**

What has to be done to make someone an employee shareholder?

Specific steps must be followed in order for an agreement about employer shareholder status to be entered into correctly. Prospective employee shareholders must:

> be given an employee shareholder agreement setting out the terms on which they are employed as an employee shareholder

> be given a written statement of the particulars of the employee shareholder status containing specific information, including information about the employment rights they are giving up and of the rights attaching to the shares on offer

> be advised by an independent adviser (which can be a lawyer, trade union official or someone otherwise certified as competent) on the proposed employee shareholder agreement's terms and effect (the reasonable costs of which are to be paid by the company), and then wait until seven days have passed since receiving the independent advice before they can enter into the agreement. If these two steps are not followed correctly, the employee shareholder agreement will have no effect.

Once an individual has been independently advised and agreed to the employee shareholder agreement on offer, the employer will issue them with fully paid up shares in it or its parent with a market value of at least £2,000. The individual is not permitted to pay for these shares.

Can an existing employee be compelled to accept employee shareholder status?

No. During the Government consultation on the introduction of employee shareholder status concerns were raised that employees would be pressured into accepting this new status. In response, the Government has amended the Employment Rights Act 1996 to specifically prohibit employees being subject to a detriment because they refuse to accept an offer to become an employee shareholder, and to classify any dismissal due to a refusal to accept an offer of employee shareholder status as automatically unfair.

For new recruits the position is different, as an employer is free to make any job offer dependent on the acceptance of employee shareholder status. However, unemployed job applicants will not lose their benefits if they refuse an offer of employee shareholder status in the same way as they would if they refused an offer of employment.

What happens on termination of the employment relationship?

Employers will be able to terminate an employee shareholder's employment in the normal manner (with or without notice as appropriate). However, the employee may still retain the shares in the company. What happens to the employee shareholder's shares on termination of employment will depend on what specific terms have been agreed between the company, the employee shareholder and the other shareholders.

**Are there any share valuation issues to be aware of?**

Yes. For private companies it will be necessary for the value of their shares to be agreed with HMRC. Normal valuation principles apply a substantial (80-90%) minority discount where small stakes are to be acquired and in practice this means that in order to get to the £2,000 minimum threshold employees might need to acquire a sizeable stake in the company. Failing to give an employee at least £2,000-worth of shares would mean that the whole arrangement is invalid, and the shares received have no special tax treatment. Valuation will therefore be absolutely key to ensuring that both employer and employee have a clear understanding of the implications of the plan.

**Are there any company law issues to be aware of?**

Yes. There are a number of company law issues to consider before making any offers of employee shareholder status. This will involve reviewing the company's existing articles of association as they may need to be changed to accommodate the introduction of employee shareholders.

Fortunately for employers, the legislation gives them a lot of flexibility about the type of shares they want to offer (provided the shares have a market value of at least £2,000 at the time of issue). Particular issues employers will want to consider are:

> **Buy-back.** It is likely that many employers will want to ensure that they can get back an employee shareholder's shares if they leave – particularly if they have left to join a competitor or been dismissed for misconduct. Employers will want to consider whether to impose buy-back and/or forfeiture provisions on employee shareholders' shares and whether to include 'good' and 'bad' leaver provisions, which vary the price employee shareholders will receive for their shares depending on the circumstances of their departure. Employers will need to check to see if their existing articles of association would allow this and, if not, make the necessary changes.

> **Transfer.** Employers may want to impose restrictions on employee shareholders' rights to sell their shares. For example, many employers are likely to want to ensure that employee shareholders wishing to sell their shares offer them first to existing shareholders. Employers may also want

to have a 'lock-in period' where employee shareholders are prevented from selling their shares for a period of time. Again, employers will need to make sure any transfer restrictions are inserted into their articles of association.

> **Drag and tag rights.** Employers will need to decide whether the shares given to employee shareholders will be subject to drag-along rights, or have the benefit of tag -along rights. Drag-along rights are rights enabling a majority of an employer's shareholders that accept an offer from a third party for their shares to force the holders of the remaining, minority shares to accept the same offer for their shares – so allowing a majority of shareholders to force the sale of the entire business. Tag-along rights, also known as piggy-back rights, are rights given to minority shareholders to force the majority shareholder to include them in any proposed sale to a third party.

> **Voting rights.** Employers may want to limit (or exclude altogether) the voting rights of shares given to employee shareholders to ensure that the founding/ existing shareholders and/or the board can continue to manage the company without the risk of employee shareholders overriding management decisions.

## The future

As a brand new type of incentive, with unusual consequences for employee rights, it remains to be seen how employee shareholder status will be used in practice and how the law around it will develop. Employers and entrepreneurs will be particularly keen to see how successfully the potentially significant tax savings offered by employee shareholder status can be exploited.

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