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Summary of incentive arrangements

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Executive summary

There are several types of arrangements that founders might consider when looking to incentivise staff. The purpose of this note is to set out, at a high level, the different alternatives available and the pros and cons of each. It will consider:

- tax-advantaged option arrangements (Enterprise Management Incentives, or "EMI" options and Company Share Option Plan, or "CSOP" options);
- introducing a separate class of share that only entitles the holder to the growth in value of shares above a threshold amount ("Growth Shares"); and
- non-tax advantaged options and cash-based schemes.

This note focuses on "discretionary" arrangements (i.e. where there is a choice as to who benefits from the incentive arrangements) for private companies, so it does not consider the 2 types of "all-employee" tax advantaged schemes, being Share Incentive Plan ("SIPs") and Save As You Earn ("SAYE").

It is important to take professional advice before implementing any form of incentive arrangements, not only to ensure that the right scheme for the company in question has been selected, but also to ensure compliance with the applicable rules and regulations relating to that scheme, which can be complex – particularly for tax-favoured schemes such as EMI options and CSOPs.

EMI

A very common type of incentive as they offer significant tax advantages for both the employee and the company. They are the "go-to" type of incentive for UK employees, provided the company and the option holder are EMI qualifying, and are widely used by early-stage and scale-up companies.

EMIs are tax-advantaged options available to small and medium sized companies (those having no more than 250 employees and no more than £30m gross assets on a group-wide basis, amongst other qualifying criteria). The granting company must also be independent (not controlled by another company) and must carry out a qualifying trade. EMI options have a market value limit of £250,000 per individual and a company-wide limit of £3,000,000 – these limits are measured at the time of grant of the option and it is common to agree this with HMRC as part of the EMI option grant process. The grantor has a lot of discretion as to who it can offer the EMI options (provided they are qualifying employees) and what the commercial terms can be on grant, although these terms are then fixed once the options are granted (without much flexibility to amend the terms following grant, so they need to be fit for purpose at the outset).

There is no income tax liability on exercise provided the exercise price is at least equal to market value of the shares at grant and provided it remains an EMI qualifying option.

Pros	Cons
• Share option scheme, so doesn't create minority shareholders, easier to deal with leavers, etc. • Can agree the market value with HMRC in advance. • Gains subject to lower rate CGT. In addition, Business Asset Disposal Relief may be available so 10% CGT payable (rather than 20% for higher or additional rate taxpayers). • No upfront cost to employees. • High value limit of £250,000 per individual. • Flexibility of setting exercise price – EMI options can be granted with an exercise price set at a discount to market value • Allow flexibility for scheme rules when company is decided who to offer scheme to and when options will lapse. • Will trigger a Corporation Tax deduction for the employing company on exercise of the option.	• Only available to employees working 25 hours or more per week with the company or employees who spend at least 75% of their working time with the company. • Companies in some industries are excluded from the scheme (these are typically industries that involve holding assets such as land or certain financial activities).

CSOPs

May be a good alternative where companies do not qualify for EMI options, but are more restrictive as to when the tax advantages will apply and have a smaller value limit, so not appropriate for senior managers who will expect a high-value option grant.

CSOPs are similar to EMI in that they are a form of tax-advantaged option. Whereas EMI options are intended for small and medium sized companies, CSOP options can be granted by any size of company and are not restricted by the type of trade carried on by the company. However, CSOP options are generally more restrictive in what commercial terms can apply. The value limit is also significantly less for CSOP options £60,000 per individual, measured at the time of grant).

As with EMI options, there is no income tax liability on exercise (assuming the CSOP still retains its tax-advantaged status) if the date of exercise is at least three years (and no more than ten years) after the grant date. If the employee exercises before three years after grant, there will be no income tax liability if the exercise is in connection with the employee's employment endeing and it ended because of disability/injury, redundancy, retirement or a TUPE transfer. There are other, niche circumstances where exercise before the three year date after grant would not give rise to an income tax liability, although these relate to the status of the company or court orders. Certain types of exit event also allow CSOP options to be exercised within the first 3 years after grant without triggering an income tax liability, but not all.

Pros	Cons
• Share option scheme, so doesn't create minority shareholders, easier to deal with leavers, etc. • Can agree the market value with HMRC in advance. • Gains subject to CGT, so tax efficient if exercised in a qualifying manner. • No upfront cost to employees. • Will trigger a Corporation Tax deduction for the employing company on exercise of the option.	• More restrictive commercial terms than with EMI, Growth Shares and non-tax advantaged options. • May not get tax relief if options are exercised in first 3 years following grant (depending on the circumstances of exercise). • Lower value limits compared to EMI. • Only available to employees and executive directors. • Options must generally be granted with an exercise price equal to market value at grant.

Growth shares

A good alternative for companies who do not qualify to grant EMI options, or where the proposed option holder does not qualify (e.g. non-executive directors) and where CSOP options are considered too restrictive. They involve the issue of shares directly (rather than the grant of share options) so are generally more time consuming to implement.

Growth shares usually involve the creation of a new class of shares which do not 'participate' until the value of the company exceeds a given threshold.

This means the value of the growth shares is kept low at the date of issue and is more affordable than employees buying ordinary shares in the existing share classes in the company. Additionally, growth shares typically have no rights to dividends or voting (but can do if that is commercially intended).

A third-party valuation is often obtained in respect of the value of growth shares to help determine where the threshold should be set and to give some protection in the event HMRC challenges the valuation at some point in the future. Growth shares will often have "hope value" on acquisition, being a small but meaningful value (i.e. not just nominal) attributed to reflect the fact the holder will hope there is a pay-out on the shares in the future. Provided the employee pays an amount equal to this hope value on acquisition, and provided the correct statutory elections are made, the growth shares can usually be acquired free of income tax for the employee. The employee would then be liable to CGT upon disposal.

Pros	Cons
• Gains subject to CGT, so tax efficient. • Very flexible – commercial terms don't need to comply with any statutory requirements. • No value limits or caps. • Available to anyone (employee, director, consultant, advisor, etc).	• Share scheme, so it will create minority shareholders – need a mechanism to get shares back in certain circumstances (e.g. leavers) and consider nominee arrangements to keep details of the holdings confidential. • Cannot agree the market value with HMRC in advance – recommended to have a third-party valuation. • Need to create a new class of share, so requires amendment of articles, circulating resolutions to shareholders, etc. • Small upfront cost to employees (but could be funded by bonuses). • Typically there will be no Corporation Tax deduction available for the employing company.

Non-tax advantaged options

Also known as “unapproved options”, these are not tax efficient so generally not as popular as some of the other arrangements in this note, but are still common as they are generally quick and cost-effective to implement.

Non-tax advantaged options are not afforded any special tax advantages and are usually only used where EMI options, CSOPs and Growth Shares are not, for whatever reason, utilised by the company. They are quick and easy to implement though, in light of the fact they do not need to meet any statutory requirements and do not generally involve the need to amend the company’s articles of association or any other shareholder documents.

Pros	Cons
• Share option scheme, so don’t create minority shareholders, easier to deal with leavers, etc. • Very flexible – commercial terms don’t need to comply with any statutory requirements. • No value limits or caps. • Available to anyone (employee, director, consultant, advisor, etc). • No upfront cost to option holders. • Relatively quick and easy to implement. • Will trigger a Corporation Tax deduction for the employing company on exercise of the option.	• Not tax efficient – gains subject to income tax (and possibly both employee’s and employer’s NICs, depending on timing of exercise), so effective tax rates of more than 50% in many cases.

Cash-based schemes (e.g. phantom shares)

Similar to non-tax advantaged options, cash-based arrangements are generally quick and easy to implement, but do not carry any tax advantages.

Included for completeness, but effectively the same treatment and pros/cons as non-tax advantaged options as set out above. The key difference is that employees do not have a right to acquire any shares at any point, but instead just a cash payment equal to the amount they would have received had they had an option to acquire shares. However, this means that a cash bonus payable on an exit event may not benefit from a Corporation Tax deduction.

	Enterprise Management Incentives (EMIs)	Company Share Option Plans (CSOPs)	Growth Shares	Unapproved options	Cash-based schemes (e.g. phantom shares)
Who can participate?	Employees (working 25 hours or more per week with the Company or employees who spend at least 75% of their working time with the company) without a material interest in the company only.	Limited to employees and full-time directors without a material interest in Company.	Anyone	Anyone	Anyone
Conditions	Flexible. Must be capable of being exercised within ten years of grant.	Prescriptive rules which must be adhered to. Little flexibility.	None – very flexible. Can set a threshold before shares 'participate'.	None – very flexible. Exercise price set at any figure from nominal value and above.	None – very flexible.
Time and cost to implement	If doing valuation (recommended), within 90 days of HMRC approval and once corporate authorisations in place. Implementation costs include fees involved with valuations, corporate authorisations and professional fees for drafting scheme rules and to ensure setup requirements are adhered to. Mid-range implementation costs.	Limited to employees and full-time directors without a material interest in Company.	Anyone	Anyone	Anyone
Tax efficient	Yes	Yes (subject to options being exercised in qualifying manner).	Yes	No – but can be for non-employees.	No
Taxable at grant / issue?	No	No	Yes, but generally designed so upfront cost is minimal and could be funded by bonuses.	No	No
Taxable on exercise?	Yes (income tax if EMI options granted at discount to market value).	No, if exercise is at least three years but not more than 10 years from grant.	n/a	Yes (income tax and NICs on value at exercise). Employer's NICs can be transferred to employee.	Yes (income tax and NICs on amount of cash payment).
Taxable at disposal?	Yes (lower rate CGT and possibility of qualifying for business asset disposal relief).	Yes (CGT).	Yes (CGT)	Yes (CGT) if any additional gain following exercise – not normally the case.	n/a – cannot be disposed of as no shares issued or rights to shares granted.
Immediate share issue or option?	Option	Option	Immediate Issue (although may not 'participate' straight away). Can use nominee arrangements to protect confidentiality.	Option	n/a – no shares issued.
Corporation Tax deduction?	Yes	Yes	No	Yes	Typically no

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