



HERBERT  
SMITH  
FREEHILLS

# POST-ESS

9 MAY 2017

**Mark Ife**, Partner, +44 20 7466 2133, [mark.ife@hsf.com](mailto:mark.ife@hsf.com)





HERBERT  
SMITH  
FREEHILLS

POST-ESS, WHAT SHARE INCENTIVE STRATEGIES REMAIN AVAILABLE FOR START-UPS, SMES AND PE BACKED COMPANIES (UNDER THE EMI THRESHOLD)? IS IT NOW ALL A MATTER OF SHARE PLAN DESIGN?



# ESS IS DEAD... LONG LIVE ESS

---

- ESS tax benefits no longer available
- ERA continues to provide the ability to waive employment rights for ESS shares
- HMRC continue to provide ESS valuations in respect of £2,000 minimum requirement
- Continuing benefit for companies
  - HMRC not bound by ESS valuation
  - comfort for companies in respect of restricted securities / growth shares / flowering shares

# WAS ESS BEING USED AS INTENDED?

---

- ESS tax relief scaled back from 16 March 2016 to limit CGT relief to £100,000 of gain
- Maximum benefit to participants: £20,000
- Was it worth it for employees?
- Why did companies continue?
- Valuation key

# WHAT ESS SHARES WERE AVAILABLE?

---

- Companies with low value shares (start-ups)
- Companies creating low value shares
  - growth shares
  - flowering shares
- ESS seen as an overlay – nice to have – rather than driving the underlying arrangement
- Is it, therefore, business as usual?

Post-ESS, what share incentive strategies remain available for start-ups, SMEs and PE backed companies (under the EMI threshold)? Is it now all a matter of share plan design?

## THE MOST OBVIOUS ANSWER... EMI

---

- Even before the abolition of ESS tax benefits, EMI remained the most popular arrangement for start-ups and SMEs
- Possibly not available for PE backed companies depending on ownership structure
- Qualifying conditions also prohibited some companies from taking advantage – gross assets, number of employees, underlying business
- Simpler for employees and company
- Potentially greater tax benefits

## ESS VS EMI EXAMPLE

---

- Paul is employed by Articran Ltd. In July 2016, Articran Ltd created a new class of growth shares which had a market value of £0.10 each. Paul was awarded 20,000 employee shareholder shares, with a total value of £2,000.
- Articran Ltd is sold when the shares are worth £40 per share.
- Paul sells his shares for £800,000.
- Under ESS, Paul was not taxed upfront, but only £100,000 of his gain is tax-free, leaving £686,700 (£698,000 less annual exemption) to be subject to CGT at 20%.
- Paul pays £137,340 tax.

## ESS VS EMI EXAMPLE

- What if, instead of ESS, Paul had been granted an EMI option over 20,000 growth shares in Articran Ltd, with a nil exercise price?
- Paul exercises his EMI option and sells his shares for £800,000.
- Under EMI, Paul pays income tax and NICs (employee and employer) on £2,000. Employer NICs at 13.8% (£276); employee NICs at 2% (£40) and income tax at 45% on £1,724 (£775.80). £1,091.80 in total.
- Paul makes a gain on his EMI options of £798,000. After the annual allowance, this is £786,700. Paul pays CGT at 10% due to Entrepreneurs' Relief (£78,670).
- Paul's total tax bill would have been £79,761.80 compared to £137,340 under ESS.

# IS EMI RIGHT FOR YOU?

---

- EMI is a very flexible tax-efficient arrangement
- Grant as 'free shares' or at market value
  - can get valuation from HMRC for these purposes
- Can use ordinary shares or new class of share created for employees
- Exercise can be subject to performance conditions
- Exercise can be limited to exit events (IPO or sale)
- BUT... significant limitations on types of company that can grant and pitfalls for the unwary

# EMI OPTIONS

---

- Does the company qualify?
  - gross assets of less than £30m
  - less than 250 FTE employees
  - qualifying trade
- Are there option agreements in place? Are they signed and dated? Do they contain details of restrictions?
- Were the options notified within 92 days?
- Did the employee sign a working time declaration?
- Was market value agreed with HMRC? Were the options granted within the agreed period for this market value to hold?

# WHAT ELSE IS THERE? KEY ISSUES TO CONSIDER

---

- Design is key – think about what the company is trying to achieve
- Incentivise key drivers of the business through performance targets?
- Drive income generation or share price/capital growth?
- Deliver shares only on an exit or allow employees to acquire shares upfront/periodically?
- Dilute all shareholders or only some?
- Retention – what happens to leavers?
- How is value delivered to participants? Exit or liquidity arrangements?
- Sharing share price growth can be delivered through CSOP options, ‘unapproved’ options, growth shares or joint ownership

# WHAT ELSE IS THERE? KEY ISSUES TO CONSIDER

---

- Requirement for “skin in the game” through upfront acquisition?
- Is what is proposed understandable for participants?
- Is the arrangement simple or complex to administer?
- When will tax be paid? Tax may not be a key driver; indeed, for some companies tax structuring is frowned upon
- How much will it cost? Accounting treatment? Tax deductions?
- Is a valuation required? Valuations can still be obtained for all tax-advantaged arrangements
- Consider broad-based incentives – increased flexibility in SAYE/SIP
- Alternatives to direct share ownership.

# SOME EXAMPLES

---

## Example 1

- Challenger bank
- Low share price
- Multiple investors on same terms – dilution accepted
- Previously awarded ESS shares
  
- CSOP (market value) options
- Exercise hurdles
- Exit only

# SOME EXAMPLES

---

## Example 2

- Challenger bank
- Low share price
- Individual and institutional investors – dilution accepted only in respect of institutional investors
- ESS tax benefits unavailable
  
- Flowering shares with hurdles
- Split ordinary share capital and reclassify into A and B Shares and create new C share class – B shares represent dilution proportion
- On trigger, B Share rights reduce and C Share rights increase

# SOME EXAMPLES

---

## Example 3

- PE backed insurer
- In growth stage following PE investment
- Some limited dilution acceptable
  
- Performance Share Plan – nil priced options with performance conditions
- All-employee SAYE (tax-advantaged and ‘unapproved’)
- Shares could be acquired at any point following vesting, but subject to lock-in
- Company proposes liquidity arrangements using EBT as market

# SOME EXAMPLES

---

## Example 4

- Small TMT business with significant shareholder
- Long-term share dilution unacceptable
- Benefits only proposed if performance hurdles met
  
- Growth shares with performance hurdles
- Put and call option side arrangement
- Structured as ESS to give comfort on valuation (no tax benefits)
- Supplemented with additional cash bonuses

# SOME EXAMPLES

---

## Example 5

- Small loans business
- Employees in multiple jurisdictions
- Proposes IPO in long term but with no specified timetable
  
- Cash bonus arrangements with deferral
- Performance conditions based on business divisions in relevant jurisdiction
- Ability to deliver shares (with lock-in) in the event of IPO during deferral period

# SOME EXAMPLES

---

## Example 6

- PE backed manufacturer
- Structured through multiple offshore partnerships
- Partnership interests and loan notes held in employee trust
  
- Phantom options backed by partnership interests
- Phantom options exercisable only on exit
- Cash bonus arrangements backed by loan notes
- Performance conditions based on performance in business divisions

# SOME EXAMPLES

---

## Example 7

- ‘Social purpose’ company with private and government investment
- Long term holdings by investors – no proposed exit
- Employee ownership model with 25% of shares held in EBT
- Cash bonus arrangements funded through EBT dividend waiver
- Employee representative council to make recommendations to EBT trustee on management (voting) decisions

**BANGKOK**

Herbert Smith Freehills (Thailand) Ltd  
T +66 2657 3888  
F +66 2636 0657

**BEIJING**

Herbert Smith Freehills LLP Beijing  
Representative Office (UK)  
T +86 10 6535 5000  
F +86 10 6535 5055

**BELFAST**

Herbert Smith Freehills LLP  
T +44 28 9025 8200  
F +44 28 9025 8201

**BERLIN**

Herbert Smith Freehills Germany LLP  
T +49 30 2215 10400  
F +49 30 2215 10499

**BRISBANE**

Herbert Smith Freehills  
T +61 7 3258 6666  
F +61 7 3258 6444

**BRUSSELS**

Herbert Smith Freehills LLP  
T +32 2 511 7450  
F +32 2 511 7772

**DOHA**

Herbert Smith Freehills Middle East LLP  
T +974 4429 4000  
F +974 4429 4001

**DUBAI**

Herbert Smith Freehills LLP  
T +971 4 428 6300  
F +971 4 365 3171

**DÜSSELDORF**

Herbert Smith Freehills Germany LLP  
T +49 211 975 59000  
F +49 211 975 59099

**FRANKFURT**

Herbert Smith Freehills Germany LLP  
T +49 69 2222 82400  
F +49 69 2222 82499

**HONG KONG**

Herbert Smith Freehills  
T +852 2845 6639  
F +852 2845 9099

**JAKARTA**

Hiswara Bunjamin and Tandjung  
Herbert Smith Freehills LLP associated firm  
T +62 21 574 4010  
F +62 21 574 4670

**JOHANNESBURG**

Herbert Smith Freehills South Africa LLP  
T +27 10 500 2600  
F +27 11 327 6230

**LONDON**

Herbert Smith Freehills LLP  
T +44 20 7374 8000  
F +44 20 7374 0888

**MADRID**

Herbert Smith Freehills Spain LLP  
T +34 91 423 4000  
F +34 91 423 4001

**MELBOURNE**

Herbert Smith Freehills  
T +61 3 9288 1234  
F +61 3 9288 1567

**MOSCOW**

Herbert Smith Freehills CIS LLP  
T +7 495 363 6500  
F +7 495 363 6501

**NEW YORK**

Herbert Smith Freehills New York LLP  
T +1 917 542 7600  
F +1 917 542 7601

**PARIS**

Herbert Smith Freehills Paris LLP  
T +33 1 53 57 70 70  
F +33 1 53 57 70 80

**PERTH**

Herbert Smith Freehills  
T +61 8 9211 7777  
F +61 8 9211 7878

**RIYADH**

The Law Office of Nasser Al-Hamdan  
Herbert Smith Freehills LLP associated firm  
T +966 11 211 8120  
F +966 11 211 8173

**SEOUL**

Herbert Smith Freehills LLP  
Foreign Legal Consultant Office  
T +82 2 6321 5600  
F +82 2 6321 5601

**SHANGHAI**

Herbert Smith Freehills LLP Shanghai  
Representative Office (UK)  
T +86 21 2322 2000  
F +86 21 2322 2322

**SINGAPORE**

Herbert Smith Freehills LLP  
T +65 6868 8000  
F +65 6868 8001

**SYDNEY**

Herbert Smith Freehills  
T +61 2 9225 5000  
F +61 2 9322 4000

**TOKYO**

Herbert Smith Freehills  
T +81 3 5412 5412  
F +81 3 5412 5413