PETT, FRANKLIN & CO. LLP

HELPING *SHARE* GROWTH

TAX, INCENTIVES AND EMPLOYEE SHARE PLANS

‘Growth shares’

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Employee Incentives and Share Plans

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Pett Franklin

- Who are we?
  - a firm of specialist share schemes, valuation and employment tax advisers that combines tax specialists, lawyers and accountants in a multidisciplinary practice.
  - this is particularly valuable with JSOPs and growth shares where the best results are achieved by dovetailing legal drafting with share valuation.
  - we produce *Employee Share Schemes*, the leading textbook in this area
  - we have extensive experience in the background and history of growth interests – developed the concept of joint ownership

Introduction

- What is the attitude of HMRC towards the use of 'growth shares' as an incentive, and what are the tax implications of the acquisition, and grant/exercise of options to acquire, such shares?
- HMRC's attitude to anti-avoidance
- Tax treatment of growth interests
- 'Growth shares' vs 'joint share ownership'?
- Share valuation issues

HMRC Survey

- Recent HMRC survey of 25 advisers (including us !) and companies on current use and operation of growth shares
- Wanted to know why and how growth shares were used in practice
- Wanted to know why the fees charged for setting up growth shares were high and meant that only a relatively small number of larger companies could afford to use them

Development of Growth Interests

- Development of growth interests linked to private equity transactions 20 years ago (before CT relief for options allowed)
- Objectives for management to have “skin in the game,” be aligned with investors, take some degree of risk and in return pay CGT rather than income tax/NICs
- Typical structure:
  - Low equity value but high enterprise due to highly leveraged structures
  - Potential for substantial equity value growth as debt repaid
  - Growth shares may participate in value above a premium to the initial equity value
  - HMRC at that time generally accepted low values as a result
  - Pre 2003, value also depressed by performance targets and other restrictions.
- Failure of HMRC to take a robust approach and treat ‘shareholder debt’ for valuation purposes as if it were equity, not debt

Different types of 'growth share'

- 'sweet equity' – see MoU of 25 July 2003 as to basis on which HMRC will accept that price paid is not < IUMV
- Shares of a class which will increase in value as other classes convert into deferred shares if targets not achieved
- 'B Shares' entitling holders to either:
  - exit proceeds (or pro rata tranche of proceeds) in excess of a threshold 'hurdle' level
  - Variable tranche of exit proceeds if and insofar as different performance targets are achieved
  - A proportion of exit proceeds fixed according to the value at exit of a given business, division or subsidiary
- Joint share ownership of ordinary shares subject to a JOA providing for differential split of proceeds on sale ("JSOP")

Tax : the statutory background : part 7, ITEPA 2003

- If employment-related shares subject to “restrictions”, the ***proportion*** of UMV attributable to the depreciatory effect of the restrictions will fall to be charged to IT upon a sale or other chargeable event (eg lifting of restrictions)…..
- unless a joint election made under ss425(3), 431(1) (full) or 431(2) (partial) or 430 (balance on a chargeable event) – s426-428
- In practice, a s431(1) election is almost always insisted upon by employer, if only to protect against future company NICs charges
- What then is the IUMV of the shares/interest acquired ?
- Crucial distinction between (a) ‘inherent characteristics’ of a share, and (b) ‘restrictions’ to be ignored in determining the IUMV of the shares/interest

Simplified illustration of the tax treatment of employee shares

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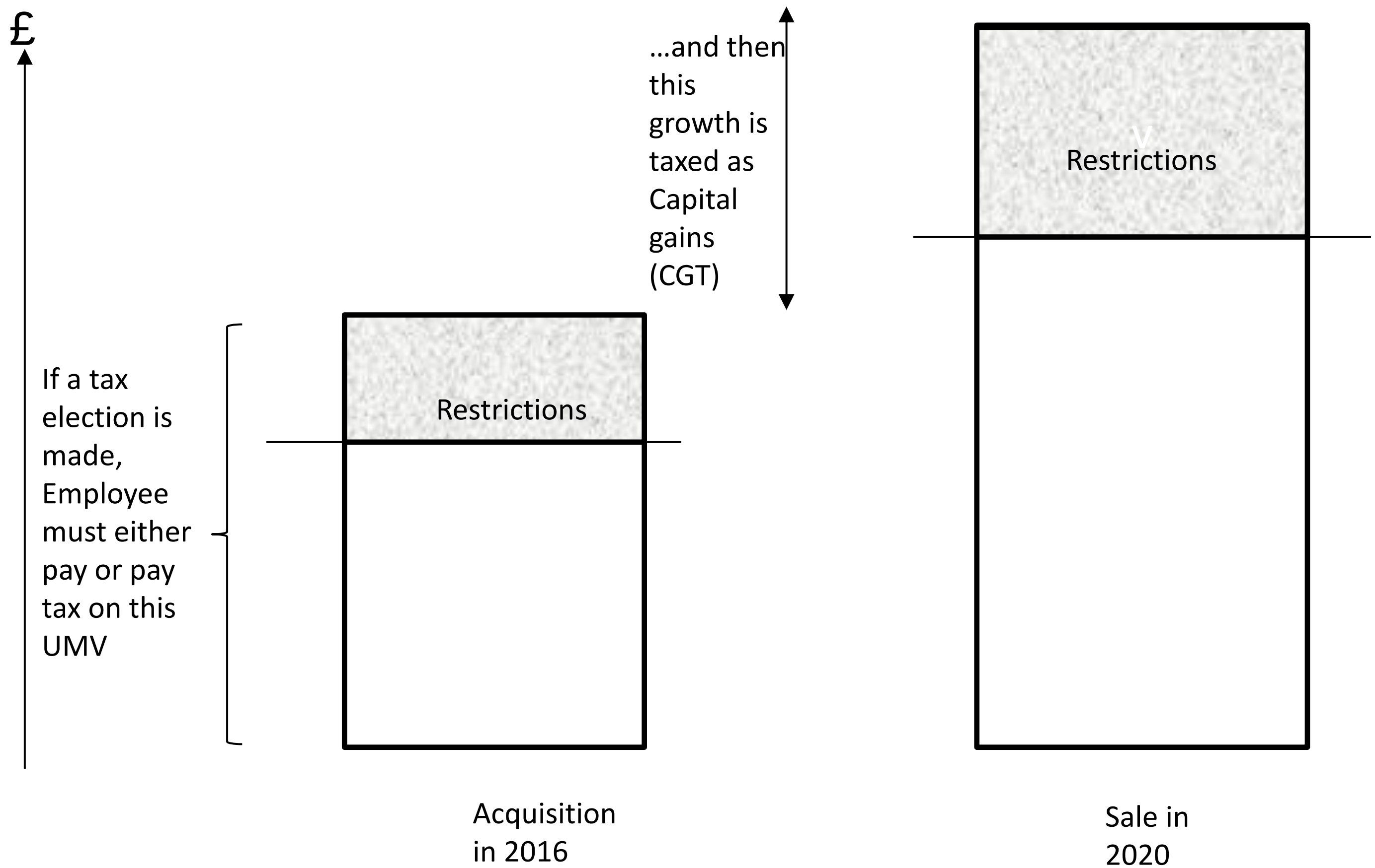

Tax treatment of growth in value 'employee shares' (assuming a tax election is made)

‘restrictions’ vs ‘inherent characteristics’

- “restrictions” are defined in s 423(1)-(4), but shares are not restricted only by reason of being partly-paid or there being an obligation to sell on leaving for misconduct.

- The distinction between (a) ‘inherent characteristics’ of a ‘growth share’, and (b) ‘restrictions’ to be ignored in determining the initial taxable value of the growth shares, is crucial in determining the IUMV of the shares

‘restrictions’ vs ‘inherent characteristics’

- Example 1 :
  ‘B Shares’ are
  (a) non-voting;
  (b) not entitled to dividends;
  (c) not transferable;
  (d) required to be sold on leaving at ‘good/bad’ leaver prices;
  (e) are entitled upon a sale of the company, or (if business is sold) a return of capital, to say 1% of exit proceeds if they are at least, say, £10m; or 4% if above £12m; 5% if above £20; but only a return of nominal value if below £10m (when co value at issue is, say, £2m)

- If the articles are properly drafted, (a), (b) (e) are inherent characteristics, and therefore taken into account in determining IUMV, but the depreciatory effect of (c) and (d) is ignored as these are ‘restrictions’

- So, what is the IUMV of such B shares ? It must have regard to the likelihood of not meeting the target(s) and of the expectation of future growth

- Conversely, if the articles were drafted so that, on a sale of the company, the holders of B shares are entitled to a pro rata share of the ‘exit value’ as divided equally between the holders of A and B shares, but to a smaller tranche of proceeds if threshold levels of exit value are not met, the IUMV of a B share will be no different from that of an A share – see s423(4) ITEPA 2003.

Growth shares vs JSOPs

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- Example 2:
  - 'B shares' entitle the holders to share pro rata with the holders of A shares, in any growth in value of the company above the market value of the company as at the date of issue of B shares ("the threshold amount")
- Compare this with a JSOP award of A shares
  - IUMV of B shares will be the present value of the 'hope of growth'
  - If the threshold amount is set at a premium to the initial market value of the company, this will reduce the IUMV of B shares
  - In a JSOP award, the premium threshold is normally reflected by a 'carrying cost' (typically simple interest over 3 years on the IUMV) which reduces the growth accruing to the employee

‘growth shares’ vs JSOPs

- Very broadly:
  - JSOPs suit quoted companies (as they use ordinary shares and a quoted price), but have also been widely established by unquoted companies using either shares in the holding co., or shares in a trading subsidiary
  - ‘growth shares’ may be better suited to unquoted companies, although there are examples of growth shares in listed companies (e.g. Melrose)

Tax traps

- Essential that a s431(1) or (2) election be made on acquisition so as to ensure that future growth in value is not charged to IT under Chapter 2, Part 7
- Why does not Chapter 3A, part 7 apply ?
- Avoid ‘convertible securities’ per Chapter 3, Part 7
- Importance, and now the difficulties, of securing certainty of valuation on award for tax purposes
- Effect of a ‘sale price’ specified by reference to an agreed formula

Tax traps, cont.

- Chapter 3D, Part 7
  - employment-related securities disposed of for more than market value – proceeds in excess of market value are charged to income tax
  - HMRC manual ERSM80010 gives examples including “arrangements that enable employees to sell their shares at an inflated price over that achieved by other shareholders (perhaps during a take-over of their employer)”
  - *Grays Timber Products Ltd v HMRC (Scotland) [2010] UKSC 4*
    - Rights essentially personal to participant and not of value of the hypothetical purchaser
    - “These rights would have been personal to Mr Gibson even if they had been set out expressly in the new articles adopted by Group when the subscription agreement was entered into. A right can be personal even though it is intrinsic in the sense previously discussed, since class rights can be enjoyed by a class with only one member.” (para 39)

Share Options v Growth Interests

- Share options
  - outside statutory tax advantaged schemes, tax treatment is simple, but unattractive
  - no tax on award but full tax and NICs on exercise on intrinsic value
  - may be CT relief for intrinsic value but:
    - may not apply to many private companies; and
    - may be of limited value if exercise is linked to exit

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Design of Growth Interests

- Growth shares can be highly complex, reflecting the complexity of the underlying transaction
- Unnecessary complexity is counterproductive in terms of:
  - increased risk of share rights failing to achieve their commercial objectives
  - increased risk of scrutiny and HMRC challenge
  - greater risk of being viewed as ‘avoidance’
  - difficulties of identifying their IUMV

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Design of Growth Interests

- Stay true to underlying objectives of reducing initial market value with subsequent genuine capital growth being taxed as capital
- Dovetail commercial, tax and accounting impacts in that order
- The tax and accounting should follow the basic commercial treatment if the share rights are well designed
- Share rights should be transparent to participants, investors and HMRC

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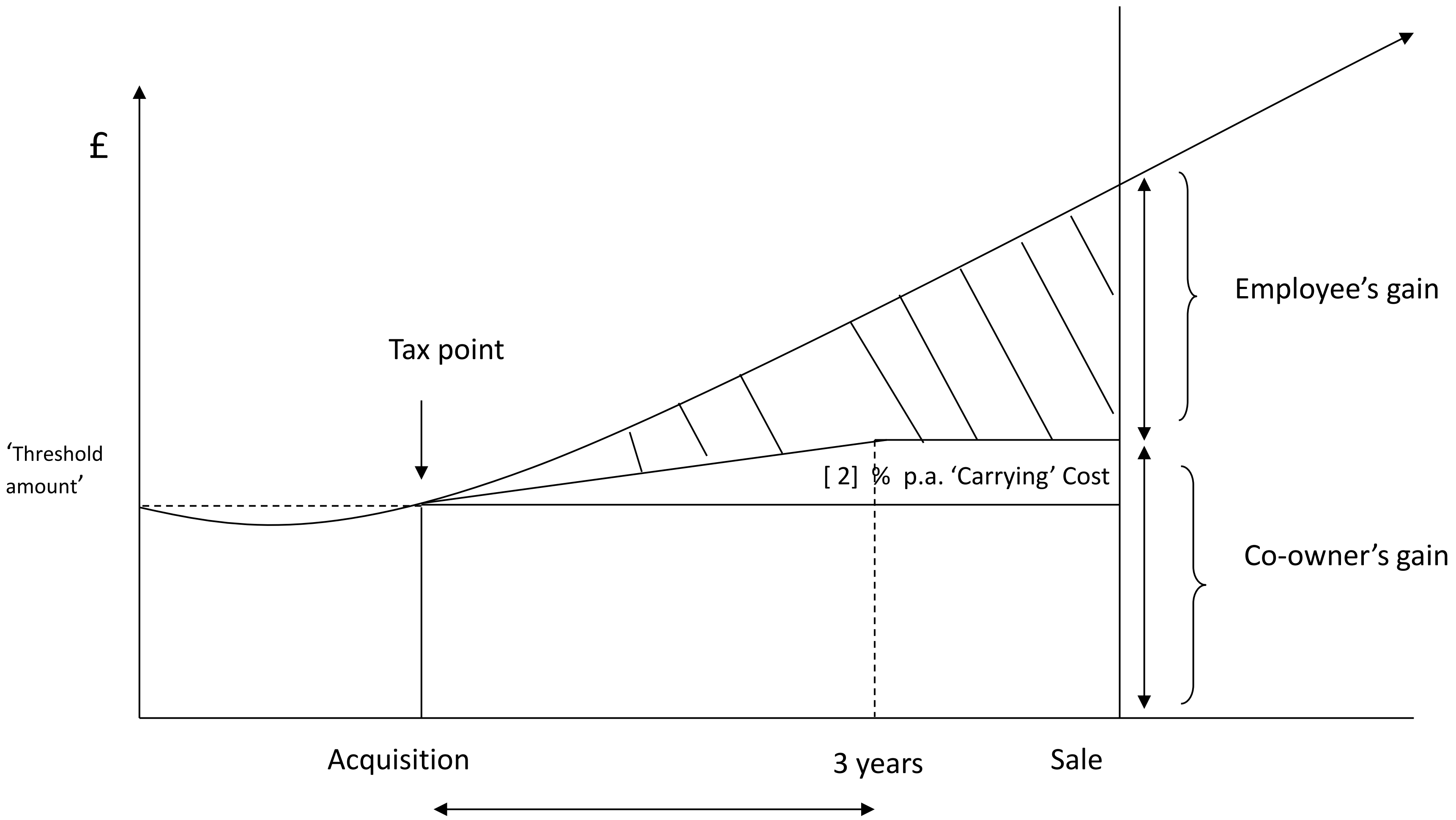
Joint Share Ownership Plans

- Shares are held jointly by the employee and a co-owner, which is usually an ESOT for convenience, but may be another person (such as the parent company where a JSOP is set up using shares in a subsidiary)
- The terms of the agreement between the employee and the co-owner normally give the growth in value to the employee (less an an annual funding charge or hurdle)
- This growth in value is taxed as a capital gain but the JSOP was originally invented by David Pett and William Franklin in 2001 to simplify the treatment of options in take-over situations
- Instead of needing special arrangements for exercise or rollover of share options the jointly owned shares can be treated like any other shares in the company


£
Tax point
'Threshold amount'
[2] % p.a. 'Carrying' Cost
Employee's gain
Co-owner's gain
Acquisition
3 years
Sale

Joint ownership – not a panacea

- JSOPs are useful in the right circumstances but they are not a panacea
- A co-owner is required which ordinarily has to be funded to acquire its interest
- All the potentially necessary ordinary shares need to be put into the arrangement from the beginning
- No corporation tax relief on growth in value
- Will not normally qualify for entrepreneurs' relief from CGT
- Because JSOPs involve splitting a share, rather than creating a new independent instrument such as an option or a growth share, the underlying economic and mathematical concepts of a JSOP are fundamentally different. This raises challenging mathematical and valuation issues

At its simplest….

- X plc and Y PLC agree to form a joint venture to exploit a new technology discovered by Y, but not core to their business
- JV Co. established and owned X plc 80 : 20 Y PLC
- X plc puts 10 JV Co. shares into the joint beneficial ownership of X plc and employees of the JV Co. (subject to s 431 election)
- IUMV of JV Co. shares is low (high risk of failure to meet targets)
- On sale of JV Co., employees receive growth in JV Co. shares above the IUMV + a 'carrying cost'
- Employees who leave, or wish to 'cash-out' after 5 years, can sell back to X plc at (low) MV

Advantages of Joint Ownership

- JSOPs can be simpler to set up and operate than ‘growth shares’
- All the terms are in contract so you do not need to create a separate class of shares
- Don’t need to disclose performance conditions publicly in the Articles
- Don’t need to revise the Articles for joiners who need a new class of shares
- Don’t have to make the Articles complicated and difficult to follow for everyone except specialist lawyers
- On an exit JSOP shares can be treated like other shares and one does not have to interpret imperfectly drafted Articles as can be the case with growth shares.

Advantages of Growth Shares

- Can allow further tax reliefs – e.g. Entrepreneur's Relief and Employee Shareholder Status – which are not available for JSOPs
- Simplified structure (as no ESOT or other third party is needed)
- On exit, participants are treated in the same way as other shareholders
- Clearer alignment of participants and other shareholders

Valuation

- Contrast methodologies used for options (Black-Scholes, etc.), and identifying the value today of the hope of future growth
- Special considerations for JSOP awards
- HMRC attitude and approach
- Change in the balance of risk as between advisers and clients now that ‘healthcheck’ and PTVC agreement facilities withdrawn

Withdrawal of PAYE Health Checks and ITEPA Post Transaction Valuation Checks

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- SAV announcement on 31 January 2016

- Both these categories of check often involve complex valuation scenarios, which absorb considerable valuer resource but result in no change to the valuation proposed. Currently, almost 90% of ITEPA Post Transaction Valuation Checks and PAYE Health Checks are accepted as submitted.

- Accordingly, and in line with HMRC's Promote, Prevent, Respond Compliance Strategy, SAV will be:

  Providing further help to customers, to sustain and improve levels of compliance, by updating guidance in its Manual.

  Considering the possibility of running a small number of Valuation Workshops for agents in 2016/17.

  Working with colleagues in Special Employer Compliance, Large Business and the Risk & Intelligence Service, to identify the minority of cases from submitted returns where valuation tax risk exists and where a review of the valuation is appropriate.

- PTVCs and PAYE Healthchecks will be withdrawn with effect from 31st March 2016.

Overview

- Growth interests offer an alternative to conventional options which can deliver a more favourable tax treatment in the right circumstances
- Key points are to create rights appropriate for the particular commercial deal, accepting that CGT will apply to capital growth only
- Avoid standardised documentation – important to reflect specifics of the commercial objectives.
- Avoid artificial participation which could lead to HMRC challenges and valuation problems.
- Consider all aspects – commercial, tax, accounting and valuation

What is ‘acceptable’ structuring?

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- Issuing employee-shareholder shares which are ‘growth shares’ ?
- EMI share options over ‘growth shares’ ?
- Joint ownership of ‘growth shares’ ?

….what do you think….?

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