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Incentivising your employees:
Considered an employee share scheme?

An effective way to attract, retain and incentivise your key people is by creating an employee share scheme.

Under these schemes, the company will issue shares (or an interest in shares) or options to key employees, directors or independent contractors who accept an offer to participate in the scheme (Participants).

With the introduction of the Financial Markets Conduct Act 2013, it has now become possible to offer these schemes without the requirement for full and detailed disclosure documentation by complying with the exemption for employee share schemes.

Set out below are three possible employee share scheme structures that you may consider as a means of rewarding, retaining and incentivising the key people in your business.

Employee share trust

Under an employee share trust, the company would enter into a trust deed with a wholly owned subsidiary (Subsidiary). The Subsidiary will hold the shares on trust for the Participants, who would acquire a beneficial interest in the shares (Interest) rather than the legal title.

The Subsidiary would exercise all voting rights in respect of the shares it holds, which makes this structure relatively easy to administer. Any dividends received by the Subsidiary will be passed down to Participants, including any proceeds of sale following an exit or liquidity event.

Depending on the terms of the trust deed, if Participants leave the business, they can be paid out for their Interest at fair value or at some other pre-agreed formula. This formula can be structured to incentivise participants to stay in the business (for example, their Interests can vest over time). To the extent a Participant leaves the business and is paid out, the capital gain should be non-taxable to the Participant.

Loan to purchase scheme

Under a loan to purchase scheme, shares in the company would be issued up front to Participants, who would then pay for those shares using money loaned to them (usually on an interest free basis) by the company. Participants would then be contractually required to repay this loan through their salary and any dividends.

A loan can also be structured so that a Participant would be eligible for a cash bonus under their employment or service contract subject to achieving specific milestones or KPIs, with such bonuses (if achieved) being applied towards repayment of the loan.

The company should not have to account for fringe benefit tax on interest free loans to Participants so long as the loan is structured appropriately and the borrower is an employee. The tax cost base for the employee's shares should be set at the value that the shares were purchased for. To the extent the loan is not repaid, this should generate taxable income to the employee.

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Phantom scheme

Under a phantom scheme, a Participant will be granted what is known as a "phantom share option". When the employee exercises the option, they simply get a cash bonus which, subject to the rules of the scheme, is equivalent to the difference between the market value of the shares at the time of exercise and the relevant option price paid by the Participant.

Usually, no shares are actually issued or transferred to the Participant on the exercise of the phantom share option, as it is effectively a cash bonus scheme.

From an income tax perspective, the cash bonus should be treated in the same way as salary and will be taxed at source under PAYE rules.

A phantom scheme can also provide Participants with a contractual right to receive a pre-determined percentage of the proceeds of an exit or other liquidity event. The payment should also be treated as a taxable payment for income tax purposes, and be taxed at source under PAYE rules.

Other points to note

Under most employee equity scheme structures, a company can provide an interest free loan to the Participant to acquire their interest. The advantage of these loans is that, if they meet certain conditions, they will not attract a fringe benefit tax liability for the employer.

If you would like to discuss creating an employee share scheme, please do not hesitate to contact either Graham Lawrence at Bellingham Wallace or Hayley Buckley at Wynn Williams.

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