January 2013

HMRC - approved 'Share Incentive Plans' (or SIPs) for all employees:

Why you should now look again at establishing a SIP

Share Incentive Plans (or '*SIPs*') were first legislated for in 2000, along with provision for tax-favoured EMI share options. They provide for independent companies to:

a) invite all eligible employees to apply up to £1,500 per tax year, out of gross (pre-tax) salary or bonus and subject to a maximum of 10% of annual salary, in the acquisition (at their market value) of shares in the company ('Partnership Shares') to be held in the Plan;

b) allow the company to procure that those who take up the opportunity may be awarded additional 'Matching Shares' at no cost, on a basis of up to 2 Matching Shares for every 1 Partnership Share acquired, such additional shares being held in the Plan; and/or

c) procure gifts to all eligible employees, on a 'similar terms' or performance-linked basis, of 'Free Shares' with a market value of up to £3,000 per tax year; and

d) allow cash dividends on shares held in the Plan to be reinvested in further Plan shares.

Such a plan requires the establishment of a special form of trust and must be approved in advance by HMRC – a process which can take many weeks, given the small number of HMRC officers now assigned to reviewing such plans.

The tax reliefs afforded to participants and to the plan company are generous. There is no charge to income tax on the acquisition of plan shares, and for so long as the shares remain in the plan, growth in their value is free of capital gains tax. Even more generous reliefs are available if the shares used amount to at least 10% of the issued ordinary share capital and the shares are purchased by the plan trustee from an individual shareholder (see our website for more detail).

Until now, SIPs have been established for the most part by listed companies with large numbers of employees, and those unlisted companies with a corporate ethos of encouraging 'employee ownership'. Private companies have been deterred from establishing such plans by certain 'traps' and restrictions embodied in the existing legislation. In particular :

i) HMRC have interpreted the legislation in a manner which means that restrictions on the shares (e.g. an obligation to offer up plan shares for sale on ceasing employment) must extend to the holders of all shares, including founders' shares - not commercially attractive to existing shareholders;

ii) a sale of the company within 3 years after awards have been made can lead to clawbacks of relief on a penal basis;

iii) employee-shareholders who, together with their associates have a 'material interest' (broadly, 25%) in the issued share capital, are presently excluded from participating.

In response to submissions from ourselves and others, the Office of Tax Simplification recommended to the Coalition Government and to HMRC that a number of changes be made to the SIP legislation to remove these barriers to adoption, and to simplify the operation of a SIP. *We are pleased to report that the Government has accepted nearly all of the recommendations made* and draft legislation to give effect to these with effect from Royal Assent of the 2013 Finance Act has been published.

In consequence, we strongly recommend that all independent private companies wanting to explore tax-efficient ways of rewarding employees, and which are willing to do so using shares in the company, should look again at establishing an HMRC-approved Share Incentive Plan.

What will change from Royal Assent ?

The principal changes expected to be made are:

- plan shares may be subject to 'restrictions', although for the purposes of applying the limits on awards of shares, it will be the 'unrestricted' value which counts. This will be of particular benefit to proprietors of private companies who will now be able to operate a SIP using shares with restricted and differentiated rights of transfer as well as (as now) restricted voting rights. For example, a participant may be obliged to offer for sale all of his or her shares on leaving the company without an existing shareholder being likewise obliged to offer for sale other shares on leaving;

- the 'material interest' test will cease to apply. It follows that existing holders of 25% + may participate on 'similar terms', and those companies with only a very small number of employees may take advantage of the exemptions from income tax and NICs for shares acquired under a SIP;

- there will no longer be a penal, or indeed (as it is presently drafted !) *any*, clawback or loss of reliefs if the company is sold for cash within 3 years. This is of particular benefit to private companies for whom the prospect of a penal clawback (under existing rules) has been a natural deterrent to establishing a SIP.

- if (as permitted) employees accumulate deductions from monthly salary over a period of up to 12 months, the price at which savings are used to buy plan shares at the end of what period may be fixed at (a) the market value at the start of that period or (b) the market value at the end of that period or (c) (as now) the lesser of these amounts. Choosing (a) enables participating employees to benefit from growth in value of the savings period and avoids any risk of the company having to indemnify the participant against share price movements over that period.

Taken together, these changes mean that awarding shares to qualifying employees under a SIP will open up access to the most generous of all of the various reliefs and exemptions afforded under HMRC-approved (or 'unapproved') plans, and allow independent companies anticipating substantial growth in share value to afford participation in that growth to employees entirely free of all tax!

We anticipate that demand for 'new-style' SIPs will be high. In advance of the proposed introduction in 2014 of a 'self-certification' system of qualifying as an 'approved' plan, those companies wanting the certainty of review by HMRC officials will need to apply early as HMRC resources for scrutinising documentation, and granting formal approval, are very limited.

We have submitted for approval a 'standard form' of plan documentation in the expectation that applications for approval of a SIP based on this documentation will be 'fast-tracked', but we strongly recommend that companies now looking to establish a SIP under the new regime seek advice from us 'sooner rather than later'.

Yet more generous reliefs for companies with 10% + held through a SIP

Existing, but little known, rules allow for yet more generous reliefs from tax if the shares acquired by the SIP trust amount to 10% or more of the issued ordinary share capital. In this event, an individual vendor of shares to the SIP can roll-over any capital gain into almost any other chargeable asset. Further, provided the 10%+ shareholding requirement is met within 12 months thereafter, the sponsoring company may claim a 100% 'up-front' deduction from corporation tax for a contribution made to the SIP to fund the acquisition of such shares. (CT relief is otherwise normally available only when 'free' or 'matching' shares are awarded.) Such 'up-front' relief is 'clawed-back' if at least 30% of the shares so acquired out of the contribution are not awarded to participants within 5 years, or 100% within 10 years, but even if those requirements are not then met, there is no penalty or interest payable so the company will still have enjoyed a cash-flow advantage.

The combination of (a) a CT deduction for a contribution used to acquire shares into the SIP; (b) CGT rollover on a sale of shares by an individual to the SIP; (c) the exemptions from income tax on the award of, and reinvestment of cash dividends in, shares under a SIP, and (d) the exemption from CGT when shares are eventually sold by an employee after 5 years or, if earlier, on a sale of the company, all add up to the most generous package of reliefs available to employers and employees under current legislation.

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