Scottish Enterprise

Co-operative Development Scotland

Recognition & Reward – Share Schemes within the EOT Business

22 November 2023

Agenda

- **10:02** **Introduction** Glen Dott, CDS
- **10:10** **Recognition & Reward – Share Schemes within the EOT Business** Rodger Cairns & Gavin Charlton, Shepherd and Wedderburn
- **10:45** **Q&A** Carole Leslie, Ownership Associates

Who we are, what we do

Co-operative Development Scotland is a specialist unit within Scottish Enterprise, covering Highlands and Islands and South of Scotland.

Provides expert advice on:

- Co-operatives
- Employee Ownership

What is employee ownership?

Significant ownership by employees

- Trust ownership
- Individual share ownership

Enhanced employee influence

- Employee Council
- Elected employee directors
- Employee Trustees

Employee ownership sector in UK and Scotland

UK

- 1,650 EOBs operating across the UK (as of Oct 2023)
    - 30% growth on previous year
- EOBs are 8% – 12% more productive than non-EOBs (calculated on a Gross Value Added per employee basis).)
- Greater economic contribution
    - EOBs make up just 0.1% of businesses but drive 0.8% of direct GVA and 1.7-2.1% of overall economic activity (reflecting direct, indirect and induced GVA).
- Growth due to success of the EOT
    - 90% of all EOBs became employee-owned after 2014 EOT Legislation

Scotland

- Current estimate is around 230 EOBs operating in Scotland
- Scottish Government aspiration: 500 EOBs by 2030

LISLE DESIGN

Swansons FOOD WHOLESALERS

The TEFL org

guitarguitar®

PAUL Heat Recovery Scotland

QUANTICS BIOSTATISTICS powerful thinking

microtech-group

Examples of Scottish and UK EOBs

CLANSMAN DYNAMICS

WH ENGINEERING SERVICES

accord

GORE Creative Technologies Worldwide

Jerba CAMPERVANS

PERTEMPS

GRIPPLE

Scott & Fyfe

chemco INTERNATIONAL PROTECTIVE COATINGS

Aardman

ARUP

Aquascot

richer sounds Experience Better

John Lewis

GUARD archaeology

Go APE

voice TECHNOLOGIES

Aspire Housing & Personal Development Services

MEDIAscape Integrated Audio-Visual Solutions

Golder Associates

hhc

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Succession Planning and Employee Ownership Support

Up to 3 days funded support:

- Ownership succession review
- Employee ownership feasibility study
  - Report outlining ownership structures, governance systems, engagement mechanisms and funding options.
- Our specialist advisors can also advise around implementation
- **All support is conditional upon Fair Work and environmental criteria being met**

Employee Ownership Resources

- CDS web pages: https://www.scottish-enterprise.com/eo
- Social media videos
  - Intro
  - Support
- CDS Blog: https://cdsblog.co.uk/
- Podcast series: The EO Podcast
- Video guide: Could employee ownership be good for your business?
- Video guide: How to sell your business to an EOT)

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Recognition & Reward – Share Schemes within the EOT Business

Rodger Cairns and Gavin Charlton,
Shepherd & Wedderburn

22 November 2023

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SHEPHERD+ WEDDERBURN

Recognition & Reward – Share Schemes within the EOT Business

1. Introduction to Shepherd and Wedderburn
2. Why do companies introduce share incentives
3. Main types of share incentive schemes operated by private companies
4. Brief introduction to EMI schemes
5. Operating EMI schemes in an EOT owned business
6. Practical tips – pitfalls to avoid with EMI schemes
7. Other share incentive schemes – SIPs, Growth Shares etc.
8. Realising value for shares in an EOT owned business
9. Other practical tips for getting the most out of share plans
10. What does the future hold – consultations

Introduction to Shepherd and Wedderburn

- Full-service law firm founded in 1768
- Headquartered in Edinburgh with offices in Glasgow, Aberdeen, London and Dublin
- Advise organisations active in more than 120 overseas jurisdictions

Employee share incentives group ranked 'Band 1' in Scotland in Chambers and Partners:

"The Shepherd and Wedderburn team are very experienced and provide practical and easy to understand advice."

SHEPHERD+ WEDDERBURN

Introduction to the Employee Share Incentives Group

Rodger Cairns

Partner

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Rodger (qualified in 1997) heads up the practice and provides advice on all aspects of employee share participation to a broad range of listed and private organisations. Having previously been head of Ernst & Young's Performance and Reward Practice in Scotland and Northern Ireland, he continues to have a particular interest in wider executive compensation issues and regularly assists clients on corporate governance matters.

The team has been top-ranked by Chambers for many years and Rodger individually also received a "Star Individual" ranking from Chambers.

According to Chambers, Rodger is "thorough, clear and provides an excellent service. He makes every effort to understand a client's business and what client needs are as they grow". Chambers 2023

Introduction to the Employee Share Incentives Group

Gavin Charlton

Director

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Gavin qualified into the team in 2009 and over the past 14 years has worked exclusively on employee share schemes for all sizes of clients, from small private start-up companies to FTSE100 companies. He has extensive experience of share plan design, implementation and operation including providing ongoing, practical assistance in such areas as grant process management, performance condition monitoring, participant communications and treatment of leavers. Gavin also provides support on share plans and executive compensation to listed company Remuneration Committees and to private companies transitioning to employee ownership.

Gavin Charlton is described as "responsive, accurate and easy to work with." Chambers 2023

Why do companies introduce share incentives?

- **Recruitment**
  - Either:
    - ability to offer share incentives package may attract new talent; or
    - lack of share incentives package may make recruitment harder.
  - Allows smaller companies to “punch above their weight”.
- **Retention**
  - An effective(?) set of “golden handcuffs”.
- **Incentivisation / Motivation**
  - Allows the employer to incentivise on a collective level (i.e. share price growth) and at an individual level (i.e. performance conditions).

Why do companies introduce share incentives?

- **Alignment**
  - Aligns employees' interests (i.e. reward!) with those of shareholders.
  - Encourages staff to take a long-term strategic view (e.g. benefit from future growth rather than resistance to changing working practices).
  - Facilitates achievement of a common goal (e.g. IPO, 3rd party sale etc).

- **Reward**
  - Potential for significant earnings.
  - Cheaper than cash (normally!).
  - Tax breaks available (both employer and employee).

Main types of share incentive schemes operated by private companies

- Share options – Enterprise Management Incentive (EMI), Company Share Option Plan (CSOP), SAYE or Sharesave Schemes, Unapproved share options
- Nil cost options / Long Term Incentive Plans (LTIPs) / Performance Share Plans (PSPs)
- Share Incentive Plans (SIPs)
- Growth Share Plans
- Deferred bonus schemes / Co-investment or Matching Plans

Brief introduction to EMI schemes

- Granted by existing shareholder or company.
- No charge to Income Tax (“IT”) on grant.
- No charge to IT on exercise (unless “discounted”) – capital gains tax on disposal.
- “Qualifying company” and “eligible employee” requirements.
- Statutory limits:
  - £30 million of assets.
  - Fewer than 250 employees.
  - Limit of £250,000 initial market value (IMV) of shares per employee.
  - Limit of £3 million aggregate IMV under all outstanding EMI options.
- Link with Business Asset Disposal Relief (i.e. 10% CGT tax rate) – 5% holding requirement disapplied, 2 year holding requirement operates from date of grant of option.

Brief introduction to EMI schemes

- Most generous limits of all the statutory tax-advantaged schemes.
- Designed to facilitate the growth of smaller companies by assisting recruitment and retention of key employees.
- Needs to be granted for commercial reasons rather than simply tax advantage.
- Exercise timing – 10-year limit for tax advantage.
- Doesn't need scheme rules – can be stand-alone agreement. Wouldn't use option certificates as the legislation requires option agreements.
- Need HMRC valuation on grant, disqualifying event, roll-over and exercise (if subject to income tax).

Brief introduction to EMI schemes – EMI tax example

- Employee granted option over 100,000 shares in XYZ Limited, a private company, on 23/09/2018
- MV of a share at grant is £0.10
- Exercise price per share under option is £0.10
- 5 years later XYZ Limited is taken over by ABC PLC for £7.50 per share
- Option exercised in full and shares sold immediately to ABC PLC as part of the deal
- Employee is Scottish resident, top rate (46%) tax payer

Brief introduction to EMI schemes – EMI tax example

	Discretionary Cash Bonus	Unapproved option	EMI
Gross gain on exercise	£740,000	£740,000	£740,000
IT and NICs on exercise	(£355,200)	(£355,200)	0
CGT payable on disposal	0	0	(£73,400)(1)
Net proceeds for employee	**£384,800**	**£384,800**	**£666,600**
Cash cost to employer of providing benefit	£740,000	(£10,000)	(£10,000)
Employer's NIC charge	£102,120	£102,120	£0
Overall cash cost to employer(2)	£842,120	£92,120	(£10,000)

(1) CGT charge calculated after application of annual CGT allowance of £6,000.
(2) Ignores impact of CT deductions that may be available.
(3) Position is even worse for unapproved option where individual bears the employer's NIC liability.

Operating EMI schemes in an EOT owned business

- Can be used for direct share participation in addition to indirect participation through EOT
- Particularly used to incentivise, recruit, and retain key management
- Exercise triggers can be linked to payment of deferred consideration or could be linked to future performance of the business or simply the passage of time
- Key question for participants is how they might realise value from the shares they acquire when the EMI options are eventually exercised (discussed later)
- Qualifying company criteria slightly relaxed for EOT owned businesses (independence test), but qualifying subsidiaries test can be an issue where EOT trustee is a company limited by guarantee within the group

Practical tips – pitfalls to avoid with EMI schemes

Qualifying company criteria

Valuation

Notification of grant

Qualifying individuals including working time

Documentation errors

Exercise of discretions / Amendments to options

Other share incentive schemes – SIPs, Growth Shares etc.

- **SIPs**
  - Must be open to all employees with a minimum period of service, and on broadly equal terms.
  - Very significant tax breaks, but at the cost of fairly complex administration and communication costs.
  - Four different elements, which can be used in almost any combination:

Free shares £3,600 maximum p.a. per individual.

Partnership shares Deductions of up to £1,800 p.a. made from pre-tax salary and used to acquire shares.

Matching shares Company can award up to 2 free matching shares for each partnership share purchased.

Dividend shares Dividends can be re-invested in additional shares.

Other share incentive schemes – SIPs, Growth Shares etc.

- **SIPs (continued)**
  - Shares owned by participants from day 1 but held by trustees of an EBT.
  - Limited performance conditions can be applied to free shares.
- **Growth share schemes**
  - New class of shares created.
  - Participants subscribe for shares (or are granted options to acquire those shares) for full market value at the outset.
  - On an exit those shares only entitle holders to receive a proportion of the excess in value above the market value of the Company at the outset of the scheme – often only the excess above a “hurdle.”

Other share incentive schemes – SIPs, Growth Shares etc.

- **Growth share schemes (continued)**
  - Consequently the market value of the growth shares at the outset is low – if the Company were taken over at full market value the day after the shares were acquired, growth shareholders would likely receive nothing.
  - Therefore the cost to participants is low and as full market value is paid, no income tax is due on acquisition.
  - The gains made on the disposal of the shares are intended to be subject to capital gains tax.
  - Capital gains tax rates (as low as 10%) are lower than income tax rates.
  - Valuation of the growth shares on acquisition is critical – specialist advice required.
- **Others**

Realising value for shares in an EOT owned business

- Dividends
- Sale of company by the EOT trustees
- Repurchase of shares for cancellation by the company
- Purchase of shares by the EOT trustees
- Purchase of shares by the trustees of an EBT including internal market, although note that this requires careful consideration around:
  - funding the trust (particularly for “close” companies);
  - valuation aspects;
  - tax issues (such as disguised remuneration charges and “readily convertible assets” analysis); and
  - practicalities / administration

Other practical tips for getting the most out of share plans

- Invest in getting it right from the beginning e.g. avoiding the pitfalls
- At the start, think about the end
- Keep it simple
- Communicate clearly with employees at the outset
- Keep them alive – continued communication
- Be consistent with treatment of leavers

What does the future hold – consultations

- Extension of time period to notify HMRC of the grant of EMI options – options granted after 6 April 2024 – following EMI consultation in 2021/2022
- EOT consultation closed on 25 September 2023 – potential changes:
  - Majority of trustees / trustee board not to be former owners / connected persons?
  - Trustees to be UK resident?
  - Contributions to EOT not treated as distributions?
  - Changes to employee bonus provisions or other tax rules?
- This afternoon's HM Treasury Autumn Statement (content accurate at time of presentation!)

Questions

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