Employee Incentives briefing

TRAVERS SMITH

Pre-Budget Report

Don't "Taper Away" your Share Incentives!

One of the most publicised measures announced in the Chancellor's 2007 Pre-Budget Report ("PBR") was the abolition of taper relief. From 6 April 2008 a "flat" rate of 18% will apply to all chargeable capital gains. The media has been quick to report the negative impact that this change will have on participants in employee share schemes but is it really all that bad? True, a CGT rate of 18% is not as good as 10%, however, it is still a great deal better than paying income tax or capital gains tax at 40%! Also, will participants in share schemes be as affected by the change as some commentators would have us believe?

The background

Taper relief was introduced in 1998 and has the effect of reducing a taxpayer's effective capital gains tax rate once they have held an asset for a given period of time. Shareholders in private companies (which, for this purpose, includes those listed on AIM) and shareholders who are office holders or employees of listed companies are currently able to claim the more favourable rate of taper relief that applies to "business assets". In short, such an individual can reduce his or her effective rate of capital gains tax to 20% after holding the shares for one year and to 10% after two years. Once the new rate comes into force, an individual will pay capital gains tax at 18% regardless of how long he has held the shares. Depending upon individual circumstances this could be good or bad news.

Employee share offers

Employees who acquired shares through employee offers and who have not held their shares for at least two years will be disappointed by the fact that they are unable to achieve a 10% tax rate. On the plus side where participants have to sell their shares within two years of acquiring them (for example as part of the sale of their company) they will now pay capital gains tax at 18% rather than at 40% or 20%.

Company Share Option Plans ("CSOPs") and Savings Related Share Option Schemes ("SAYE Schemes")

The change in CGT regime will affect participants in CSOPs and SAYE Schemes in different ways. Whether they will be better or worse off depends upon what they planned to do with their option shares. Option holders who would have held onto shares to achieve a maximum rate of taper will have higher tax bills as a result of the loss of relief. On the other hand option holders who choose to exercise and sell straight away will benefit from the reduced headline rate of CGT. In many cases participants in CSOPs find that they have to sell at least some of their option shares immediately in order to fund the exercise price payable.

Although the benefits of taper relief will disappear HMRC approved arrangements continue to hold a number of advantages for employees and employers alike. There are still many attractions in having an option that is potentially within the CGT regime rather than subject to income tax. For example, a CSOP option that is exercised in approved circumstances (broadly between 3 and 10 years from the date of grant) will escape National Insurance contributions ("NICs"). This gives rise to a considerable saving for an employer who currently has to pay NICs at the rate of 12.8%.

The CGT regime is more flexible than that applicable to income tax. For example, individuals have an annual exemption from capital gains (currently £9,200). Rather than sell his or her shares in one go, an option holder can choose to dispose of them over a period of time and make use of the annual exempt amount year on year. If he or she has a spouse or civil partner then a CGT exempt transfer can be made to use the spouse or civil partner's own annual allowance. In this way a couple can make annual gains of up to £18,400 without having to pay capital gains tax.

Other ways in which individuals can consider mitigating their capital gains tax exposure include transferring shares into an ISA or to a pension scheme (subject to scheme rules and limits).

The simplification of CGT means that individuals no longer need to be concerned as to whether or not they are eligible for business asset rate taper relief. This can become complicated, for example, where an employee of a listed company ceases to be an employee but continues to hold his shares. Part of his period of ownership attracts business asset rate taper relief while part is subject to the less favourable rate applicable to non-business assets.

Enterprise Management Incentives ("EMI")

Of all the option arrangements currently available to employers EMI is probably the worst hit by the loss of taper relief. One of the main attractions of EMI is that taper relief runs from the date on which the option is granted (rather than when shares are acquired following exercise of the option). Bear in mind however that this is only one of the many advantages of EMI. Even when taper relief is abolished EMI will remain a flexible and tax efficient means of incentivising employees. Companies can grant EMI options over shares worth up to £3 million with individuals able to hold options over shares worth up to £100,000 (compared with the £30,000 limit applicable to CSOPs). The conditions that a company needs to meet in order to grant EMI are much less onerous than those applicable to CSOPs. Unlike CSOP options, an EMI option does not have to be held for three years in order to receive capital gains tax treatment on exercise. Finally, EMI options can be granted with an exercise price lower than market value (although this will give rise to an income tax charge on the discount when the option is exercised).

Share Incentive Plans ("SIPs")

SIPs are HMRC approved share ownership plans under which participants can be given free shares and/or purchase partnership shares (with or without a matching element of free shares). The participant's shares are held within a trust that is specially set up to operate the plan. One advantage of a SIP is that provided the shares remain within the plan (which they may do while the participant remains an employee) any growth in their value escapes CGT. Therefore the abolition of taper relief will only have an impact on SIP shares once they are removed from the plan.

Will the Chancellor change his mind?

As you may be aware a number of business groups wrote to the Chancellor urging him to reconsider his proposals on taper relief. Representatives from four of the UK's main business groups were subsequently invited to Downing Street to put forward their concerns. The most recent reports indicate that the Government is considering a form of relief for retiring business men and women (and possibly others who are selling businesses). It appears that the Chancellor's current intention is to see the majority of the changes through although we will not know for certain until the draft legislation is published. It is rumoured that this will happen at the end of the year but it is likely that we will not see anything substantial until the next Budget.

As you know, there are many reasons why a company chooses to offer its employees share incentives and not all of them are tax related. We hope that this short note has demonstrated that share schemes can still be an effective way of incentivising employees. If you would like to discuss any aspect of your incentive arrangements further or the impact that the withdrawal of taper relief will have on them then please do not hesitate to contact Mahesh Varia or Laura Wise of the Travers Employee Incentives Group.

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