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Trading shares for rights

How will George Osborne's new share scheme work?

"Workers will be asked to surrender employment rights in return for shares in their company under plans to boost enterprise announced by George Osborne. People who accept the shares will have to waive their rights to redundancy or to sue for unfair dismissal and will not be able to request flexible working hours. The Treasury will not levy capital gains tax when workers sell their shares, which can be worth between £2,000 and £50,000." - Daily Telegraph

I don't wish to enter the political debate on whether employees in small businesses should be able to opt for reduced employment rights, or whether they should have full rights at all. But how would this proposal work on the shares side? I strongly suspect that if it ever sees the light of day, this will be one of those schemes that languishes largely unused – unless it becomes a bonanza for tax avoidance.

Of course there are few details available beyond what George Osborne said in his Conference speech. A Government press release adds a couple of points, and promises a consultation, so the promise to "rush through" legislation to be in force by April 2013 looks unlikely to be fulfilled.

So what are the issues that would have to be addressed?

- Under present legislation, the value of the shares (between £2,000 and £50,000 we are told, assuming this means value when they are given) would be immediately charged to income tax, and usually national insurance, when the shares were given. But the new "owner-employee" would have no money to pay the tax, other than his other earnings. Mr Osborne says there will be an exemption from CGT, but doesn't mention income tax. Will there be an exemption?
- If so, HMRC has been tightening up on employers finding was to confer tax-free benefits on employees, including through employee shares, and this could blow a hole in their strategy. What will stop a senior employee waiving his bonus (and his employment rights) and instead receiving £50,000 in tax-free shares, which he then sells back tax free?

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- Further income tax charges can arise if the shares are subject to restrictions or risks of forfeiture. If these rules are waived, further tax planning opportunities open up.
- If the company buys back its own shares within five years of their issue, the gain made by the employee is normally charged to income tax and not CGT, so the promised exemption from CGT looks a bit hollow.
- Most small businesses are very reluctant to part with equity in the company. Minority shareholdings can be a significant brake on the development of the business, especially if they remain after an owner-employee has left and ceases to contribute. But an open-ended commitment to buy shares for cash if an employee leaves would be unaffordable as well as unacceptable. Where is the cash going to come from? Most successful private companies could not easily fund an obligation to buy a significant proportion of their own share value.
- In a start-up micro business the shares are worth very little, so you get an awful lot of shares to make up a minimum market value of £2,000. Entrepreneurs could find they have given away equity that becomes extremely valuable once the business takes off.
- It is an important part of employee share scheme planning to avoid creating incentives for employees to leave. The press release makes it clear that owner-employees must be entitled to full value for their shares and cannot forfeit them as “bad leavers”. This is one of the many attractions of employee management incentive scheme (EMI) options: the employee does not get the shares until their value has been earned.
- Unless a small business is looking for an exit through sale, there will be no visible route for owner-employees to realise their shares except by selling them back to the employer at a valuation. Companies are reluctant to commit to buying shares at someone’s opinion of value. Employee shares can become negative incentives if they fail to grow in value, or if there is no realistic prospect of selling them.

I have been advising companies on employee share incentives for 30 years. If I can help with EMI options or any other kind of share scheme, do get in touch.

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