THE ICSA EMPLOYEE SHARE SCHEMES HANDBOOK

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David Craddock is a renowned lecturer on employee share schemes and lectures regularly for the ICSA in London. He is a regular speaker at conferences and seminars all over the world and is a recognised authority on the subject. ***David Craddock*** is a major contributor to the debate on employee share ownership and is the author of a series of papers on employee share ownership.

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ICSA PUBLISHING

Published by ICSA Publishing Ltd
16 Park Crescent
London W1B 1H
www.icsapublishing.co.uk

First published 2002

Designed and typeset in Sabon by Paul Barrett Book Production, Cambridge

Printed and bound in Great Britain by TJ International Ltd., Padstow, Cornwall

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library.

ISBN 1 86072 097 8

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Acknowledgements

I wish to acknowledge the support given to me in the writing of this book by my assistant, Josie Abbey. Her commitment and dedication, expressed through long hours work during evenings and weekends, assisted me greatly in the preparation of the work. Additionally, I wish to thank Isabel Gillies for her patience and direction throughout the project.

Introduction

Development of Employee Share Schemes

The development of employee share ownership in the UK has a history spanning more than three centuries. It had acquired, therefore, by virtue of the sheer time span involved, the title of 'The Quiet Revolution'. However slow the historical development had been, events took a change of pace from 1978 when under the influence of the 'Lib-Lab Pact' the first tax-approved employee share scheme found its way on to the statute book in the form of the tax-approved all-employee profit-sharing employee share scheme.

Rather than being an isolated albeit spirited initiative, this development began the acceleration of a process that was to result in a much fuller acceptance of the concept of employee share ownership by the Conservative administrations of Margaret Thatcher and John Major. The savings-related share option legislation of 1980, followed by the 1984 share option legislation, established the power of the option as a means of concentrating the minds of executives/employees over a finite period of time.

With the institutional investors restricting the use of newly-issued shares for use in employee share scheme initiatives, attention turned in the mid-1980s to the development of trust law as a means of servicing the development of employee share schemes.

The establishment of a discretionary trust arrangement enabled the recycling of shares that were already issued and either being traded through a recognised stock exchange in the case of the quoted company, or held in the hands of a restricted number of private investors in the case of the private company. The operation of employee share schemes was not restricted, therefore, to the number of new issue shares allowed under the institutional limits that were set by the Association of British Insurers and the National Association of Pension Funds.

The increasing use of the employee share trust, coupled with the very successful Roadchef experience and the lobbying activities that followed, particularly from The ESOP Centre in London, resulted in the Qualifying Employee Share Ownership Trust legislation, the so-called 'QUEST' arrangement, in 1989. This gave a statutory status to the corporation tax deduction for contributions made by the sponsoring company to the employee share trust, provided certain specified conditions were met. Subsequent Finance Acts have made the QUEST slightly more attractive. In particular, the main employee share scheme legislation introduced by the Major government allowing the QUEST to be linked to the tax-approved savings-related share option scheme, again responding to the lobbying activities of The ESOP Centre, has opened up a further opportunity for the use of the QUEST legislation.

The QUEST legislation has, though, continued to have a restrictive use. It must be linked to a tax-approved all-employee share scheme and there is a requirement for employee representation in the trusteeship. The case law employee share trust, so-called from its use of case law to defend the corporation tax deduction, has continued to be the more palatable alternative for companies seeking to use existing shares purchased off the market, either as a commercial alternative to new shares or, indeed, because their new allocation allowed under the institutional limits has been exhausted.

The election of a New Labour government in May 1997 resulted in considerable attention being given to the future of employee share schemes with the Chancellor of the Exchequer recognising that they have a pivotal role to play in increasing the productivity of British industry. The Chancellor of the Exchequer began with the declared intention of doubling the number of UK companies that have employee share schemes. This resolve will only be realised by increasing significantly the attractions of employee share schemes to the private company arena. It is with this awareness, therefore, that the Government has sought to devise two employee share schemes that are appropriate for use in the private company.

The plans of New Labour during their first term of office have borne fruit, through the Finance Act 2000, in the establishment of a new all-employee share scheme that comprises three modules for gifting shares, purchasing shares and matching shares respectively. The Government has said that it wants this scheme to be known as 'the Share Incentive Plan', or 'SIP' for short.

The second New Labour initiative, also through the Finance Act 2000, is 'Enterprise Management Incentives' or 'EMI' for short, a share option arrangement targeted at the smaller independent company. The Chancellor of the Exchequer had indicated during the early part of his term in office that he was not particularly enamoured with employee share schemes that are based on option arrangements, whether they are discretionary or all-employee. The subsequent announcement of EMI indicates, therefore, that he has developed some understanding of the power of the option to motivate over a set period of time. In many respects, for the purpose of motivating employees, the holding of an option is more powerful than the holding of shares.

The Chancellor of the Exchequer does, indeed, have a laudable objective in promoting long-term employee share ownership. In reality, though, this only becomes a feasible policy objective if detailed and constructive policies are introduced to encourage long-term employment. Indeed, long-term employee share ownership is dependent on a resolve from company leaders to pursue actively policies that strengthen the long-term employment prospects of their workforces. Where an economy is plagued with constant restructuring and successive bouts of redundancies following takeovers or amalgamations the business environment is not necessarily conducive to promoting employee share ownership of a long-term nature. It should also be recognised that most employees are, generally speaking, not psychologically attuned to exposing themselves to significant risk. It is the case that both the economic climate and the views of employees reinforce the appropriateness of option arrangements.

The success of EMI in its attractiveness to its target market testifies to the perceived strength by company leaders of the option arrangement. It encourages an intense short-term focus on company productivity. It rewards at the end of its set term, as, indeed, would be expected from an investment. Additionally, it appreciates the risk- averse nature of employees by not having a downside that is represented in the physical loss of an investment of cash.

The other government-sponsored share option arrangements, the tax-approved all-employee savings-related share option scheme and the tax-approved discretionary share option scheme, continue to have significant roles to play in the structuring of a company's employee share scheme matrix.

The tax-approved all-employee savings-related share option scheme caters for employee aversion to risk through the safety parachute of the accumulated savings together with the bonus/accrued interest. However, the fact that this scheme minimises risk does not mitigate against the very powerful sense of identification and motivation that this scheme, properly communicated, can encourage within the workforce.

The tax-approved discretionary share option scheme has, interestingly, survived the change of government to New Labour. Certainly, the original Finance Act 1984 legislation, that, before its reform through the Finance Act 1996, enabled tax-free share options based on up to four times remuneration, encouraged excesses that did not have any real commercial justification. However, the 1996 reform established the lower maximum limit of £30,000 for the tax allowable option value. Indeed, although this scheme has remained statutorily a discretionary scheme it has been used most effectively as an all-employee scheme by a number of leading companies following the example of Asda, which came to the attention of the media through its introduction of a discretionary scheme.

Key considerations when choosing a scheme

For the company seeking to introduce an employee share scheme of some kind, there are certain key decisions in the design of the arrangement of the scheme which should be considered. These are summarised below.

1 Tax-approved or unapproved?

The tax-approved legislation offers significant opportunities for tax relief, both for the employees and for the company. The tax-approved infrastructure offers guaranteed protection, within the limits set by the legislation, provided certain conditions are met. The company may, therefore, and often does, find the tax-approved route to be very attractive. Additionally, EMI, although not a tax-approved scheme, offers significant government-sponsored tax advantages that are enshrined within the legislation.

Nevertheless, the company may purposely choose to introduce an employee share scheme arrangement that does not attract tax-approved advantages. This is for the reason that it may be more tax advantageous and commercially advantageous to construct a scheme arrangement that is based upon the general legislation, in particular, utilising reliefs that are available through the reorganisation of the share capital of a company and the use of capital gains tax reliefs and exemptions. Typically, these will be harnessed to an inventive use of the valuation of the company's shares.

It should also be recognised that, although tax approval from the Employee Share Schemes Unit of the Inland Revenue effectively provides a clearance, that the scheme rules comply with the tax-approved legislation, the status of tax approval does not ensure consistency with other areas of legislation. In particular, the company should take responsibility for ensuring full compliance with securities laws and regulations, financial services laws and regulations, employment laws and data protection laws. The complexity of any employee share scheme requires that the company obtains detailed advice and clearance in each of these areas.

2 Shares or options?

An employee share scheme that offers immediate share ownership from the outset of introducing the arrangement will often offer attractions to the company, particularly where the company wishes to pay ongoing dividends as part of the incentive. Immediate ownership may be on the basis of full legal title. Alternatively, if the shares are held in a trust for a prescribed period of time then for the duration of that period the employees may have beneficial ownership only, falling short of full legal title with restrictions on the sale and the transfer of the shares that have been allocated to them.

The virtues of a share option arrangement as an alternative have already been expressed. The involvement in a share option arrangement still gives the employee a legal interest in the shares and has advantages in not requiring an initial outlay of cash if that is considered appropriate. The share option arrangement has the distinct psychological advantage in focusing employee business behaviour on particular targets throughout the finite life of the scheme.

3 All-Employee or Discretionary?

The decision between all-employee and discretionary status for the employee share scheme has become increasingly blurred through the use of discretionary arrangements on an all-employee basis even though it may not be a statutory requirement.

The company could introduce a discretionary arrangement for the upper levels of management with a supportive all-employee arrangement for all employees. Alternatively, the company might operate a statutory discretionary arrangement throughout all levels of the company's workforce but at the same time ensure that there are meaningful differences in the number of shares that are allocated to the different levels. There may even be different allocations of shares to different employees within the same level.

The company should give particular regard to the objectives of introducing an employee share scheme in the first place. Always, the company should not lose sight of the fact that the employee share scheme is at the same time an employee incentive and an employee benefit. As such, careful structuring is required, as with any human resources policy, to ensure that the design of the employee share scheme feeds and supports the achievement of the company's corporate objectives. Especially crucial in this regard is the need to define properly the employee base that is to be offered the employee share scheme and to construct the employee incentive/benefit appropriately.

4 New or existing shares?

The institutional investors place limits on the percentage of new shares that can be used for employee share schemes. However, the company may take the view that it is going to use existing shares anyway on the basis that the decision has been made that, in financial terms, this is more advantageous.

The company should perform detailed calculations before making this decision, particularly with regard to the effect on the earnings per share calculation if, indeed, this is a parameter that is given noticeable profile by analysts of the company.

With the evolving use of the employee share trust, companies have increasingly taken the view that warehousing existing shares within a trust offers advantages for legitimate tax avoidance and cash flow management. Although they may use new shares for their initial employee share schemes, a meaningful education in the use of employee share trusts will often lead to an earlier use of existing shares even before the institutional limits have been exhausted.

Warehousing offers key advantages in hedging, budgeting and capping liabilities on phantom arrangements. Additionally, careful structuring can offer meaningful tax advantages to the company and to the employees.

5 Statutory or case law trust?

The company will often take a view on whether or not the use of an employee share trust offers the opportunity for the company to achieve a corporation tax deduction, either on the initial trust funding or on the subsequent option gain. This decision carries with it a secondary decision on the residence of the trust, either onshore or offshore.

Where the employee share scheme requires the trust to be sited onshore there is, of course, no alternative. This is the case in relation to the tax-approved profit-sharing employee share scheme trust, the QUEST arrangement and the SIP arrangement where onshore residence is a requirement, and with it comes a statutory basis for the corporation tax deduction. However, the onshore positioning is not conducive to capital gains tax efficiencies. In the absence, therefore, of an onshore requirement the company will almost always choose an offshore trust arrangement where the absence of either UK residence or UK ordinary residence ensures that there is no exposure to capital gains tax on sales or transfers, with a reliance upon case law to support the corporation tax deduction.

In summary, therefore, the company that is seeking to introduce an employee share scheme should be aware of the following:

- The developments of the last twenty years have complicated the decision-making process by offering significantly more choices in the permutations and combinations that can support a meaningful employee share incentive/benefit.
- The company must always structure its employee share scheme arrangements in such a way as to support the company's corporate objectives. The opportunity for more detailed fine-tuning of the arrangements brings with it a further opportunity for more careful alignment to the company's corporate objectives.
- The company's commercial position and financial status will be key elements in deciding on the structuring of the employee share scheme and, in particular, whether or not to link the employee share scheme to an employee share trust for purposes of treasury and tax advantages.
- The company should guard against simply following corporate trends that are published in the financial press and ensure that it is introducing an employee share scheme that is specifically appropriate to its own needs.

- The opportunities for treasury and tax management require detailed calculations and projections before final decisions are made on the infrastructure which is to support the employee share scheme arrangement. The subsequent decisions will be based as much on the wider financial objectives of the company as on the particular employee share scheme arrangement that is considered to be appropriate for introduction.