The Complete Guide To Setting Up A Company Share Scheme

Everything UK-based SMEs need to know

2018 edition

Introduction

There are so many great reasons to set up a company share scheme. Distributing equity is a fantastic motivator for your team, and helps underpin a strong company culture.

The problem is that it is such a complicated area. It should be simple, but questions around the different options, tax and protecting the business make the whole process cumbersome and costly.

We wanted to do something about this, so we launched Vestd, the UK's first share scheme management platform for SMEs. It is easy to use and very cost effective. We hope you like it.

But let's not get ahead of ourselves... you will have lots of questions about the ins and outs of share schemes. This guide will help you filter out the noise and answer the key questions in plain English.

I hope you find it helpful. Do get in touch if you have any other questions, or want to give Vestd a try.

Thanks,

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Which share scheme should I use?

The vast majority of SMEs distribute shares to employees in one of three ways: **EMI shares**, **unapproved options**, or **growth shares**.

Fundamentally, you can give people **actual shares** now, or choose to issue **options** that can be exercised at some point in the future. We will outline the pros and cons of shares vs options to help you decide which is the best fit for you.

There are a few other schemes to consider but they tend to be adopted by much larger companies.

If your business has less than 100 staff then one of the following is likely to be a great fit...

1. EMI share options

This scheme not only allows you to reward your employees with share options with massive tax advantages, but also allows you to offset both the cost of the scheme, and the tax benefits achieved by your employees against your company's tax liability.

If you're sharing ownership with your employees, an EMI scheme makes a lot of sense because of its tax efficiency.

2. Unapproved options

Unapproved options are flexible and can be given to employees, contractors, advisors, and consultants.

These options don't require any formal valuation or notification to HMRC when the options are set up (unlike EMI), although they do need to be included in an annual report to HMRC if they have been given to employees or directors.

There is however no tax benefit for the recipient, who is liable for Income Tax on the difference between the exercise price and the market value of the shares at the time they are exercised.

An employee may also be liable to pay National Insurance on this sum if the shares are readily convertible to cash at the point of exercise (in a sale scenario, for example).

3. Growth shares

This provides employees with a share in the capital growth of the business from the point at which they are issued.

For example, if they are issued at a 'hurdle' of £1 per share, they will only share in any eventual net sale proceeds that are over and above £1 per share. As such, existing shareholders are only value diluted for growth from that point, rather than the existing worth of the company.

Recipients of growth shares don't have to pay income tax on exercise, only capital gains tax on sale.

Let's now take a look at the **pros and cons** of each of these schemes.

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EMI share options

EMI is a government-backed, tax advantageous, share options scheme for employees that is used by over 10,000 SMEs in the UK.

Pros

- The scheme is relatively flexible, in terms of the conditionality and timeframes that can be set as part of its terms to the employee.
- Income Tax is only payable on the difference between what the employees pay for them (the exercise price) and their value when the options were originally awarded.
- Recipients will have to pay Capital Gains Tax when they sell their shares, but at a lower rate than normal. This is because you can get Entrepreneurs' Relief with EMI shares which means you only pay tax at 10% rather than the usual 20%.
- Likely to be the most tax efficient scheme for employees (people who spend more than 75% of their time at your business).
- You can set conditions for recipients, such as achieving milestones, or staying with the company for an agreed period of time.
- The company can offset the costs of the scheme, as well as the tax benefit achieved by the employee between issuance and exercise against their own profits as a corporation tax relief.

Cons

- There are a number of criteria that must be met for the company and the employees to be applicable, and a number of processes that must be followed to ensure that they remain so.
- You cannot award EMI shares to non-employees.

(Hungry for more details on EMI? Read our help article).

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Unapproved options

Unapproved options can be really useful if you need an extremely flexible scheme that can be issued to employees, contractors, advisors or consultants.

Pros

- There are no limits to the number of options that can be given in total or to an individual.
- Options do not require any formal valuation or notification to HMRC when they're issued (unlike EMI), although they do need to be included in an annual report to HMRC via ERS if they have been given to employees or directors.
- You can set conditions for recipients, such as achieving milestones, or staying with the company for an agreed period of time.

Cons

- There is no Entrepreneurs' Relief, so the normal rate of Capital Gains Tax will need to be paid once sold.
- Employees have to pay Income Tax based on the value of the shares (less what they pay for them) when they exercise them.

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Growth shares

Growth shares are a particularly good for non-employees, though this scheme can be complex to create (if done manually).

Pros

- By using growth shares you can limit the risk of the recipient having to pay Income Tax on receipt of the shares.
- Growth shares are designed so that recipients only share in the capital growth of the business from the point that the shares were issued.
- Minimises dilution on existing shareholders.
- You can set conditions for recipients, such as achieving milestones, or staying with the company for an agreed period of time, so long as your Articles of Association have been drafted to enable this.
- Shares are issued immediately.
- A great alternative to EMI options for businesses that are not likely to sell in the short term.

Cons

- Unless the shareholding exceeds 5% at the point of exit, there is no Entrepreneurs' Relief, so the normal rate of Capital Gains Tax will apply once they have been cashed in.

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Share scheme comparison chart

We've mapped out all of the different share schemes so you can see how they compare...

Details	Type of share scheme		
	EMI options	Unapproved options	Growth shares
Tax efficient for employees	✔	✗ (not typically)	✔ (following EMI)
Tax efficient for non-employees	✗ (not available)	✗ (not typically)	✔
Incurs tax on award	✗	✗	✗
Incurs tax on exercise	✔ (Income Tax, based on award value)	✔ (Income Tax, based on exercise value)	n/a
Incurs tax on sale	✔ (CGT, but at a lower rate)	✔ (CGT)	✔ (CGT)
Benefits from Entrepreneurs' Relief	✔	✗	✗
Shares issued immediately	✗	✗	✔

Options (shares issued at a later date at a pre-agreed price)	✔	✔	✗
Conditional shares (ability to set specific requirements that must be met to complete share ownership)	✔	✔	✔
Typically used when exchanging equity for cash	✗	✗	✗

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Tax

Different share schemes have different tax implications, as shown in the comparison chart above.

In the UK there are three points at which tax can be due:

- On award (only affects ordinary shares)
- On exercise (only affects options)
- On sale (always due on all shares)

Then there are two different types of tax that generally apply, with an extra bonus for qualifying entrepreneurs:

- **Capital Gains Tax (CGT)**
  Normally between 10–20% and is due on sale of the shares and applied to the gain in value of your shares from the point they were given. Or in the case of options, on any gain in value over the price paid on exercise.
- **Income Tax**
  Typically between 20–45% (based on the recipient's current tax rate) and is due at the point that the option is exercised, or in some cases, on sale.
- **Entrepreneurs' Relief**
  A maximum of 10% paid on all gains.

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Shares vs options

As mentioned above, you can give people **actual shares** now, or choose to issue **options** that can be exercised at some point in the future.

Let's quickly summarise shares vs options to help you figure out which is best for you.

Real shares

Ordinary shares are real share in the business (rather than an option to buy at a later date) and can be given to anyone. They are typically the shares business owners and investors will hold.

Growth shares are just like ordinary shares but are issued at a 'hurdle price' that represents the value of the company at that time. As such, the recipient only shares in the businesses growth in value from that point on.

Key takeaways

- Shares only incur Capital Gains Tax.
- There is no tax to be paid upon issue (for growth shares).
- Gives people real ownership, immediately.
- Shares are issued in the recipient's name.
- Recipients can benefit from dividends.

- Recipients can receive voting rights.

Options

Options allow recipients to buy shares at a later date, at a pre-approved price. If you want to set up a tax efficient share scheme for employees (as opposed to non-employees), then in almost all cases an EMI option scheme is the best way to go.

Your company will need to meet some qualifying criteria to be able to benefit.

Key takeaways

- Options can be granted to anyone.
- EMI options can only be granted to employees working more than 75% of their time at the business.
- Companies need to qualify to be able to issue EMI options.
- Options are not real shares until exercised
- Recipients do not get any benefits of being a shareholder (e.g. dividends, or voting rights).
- Options incur a tax liability once exercised.
- In some cases there is also a cost to exercise, which some employees may struggle to afford. EMI options also have a limited exercise window (which may not give recipients enough time to find the cash to purchase them as shares).
- If the business isn't gearing up for exit they may incentivise the wrong behaviour and attitude.
- Designed for high growth businesses with an exit on the horizon.

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Setting conditions

What if somebody leaves the business, or doesn't perform as expected?

This is a big worry for business owners, who don't want to give out equity to people who don't deliver. Thankfully it is very easy to protect yourself: you just have to **put some conditions in place**.

By attaching conditions to shares and options you can be sure that you only distribute equity to those who deserve it.

For example, if you hire someone you might specify that in return for the shares they will **work for a specific minimum period** and / or help **reach certain milestones**. These conditions form the contract. Therefore, if the recipient doesn't deliver on what they promised they simply don't get the shares.

With options, this is known as a 'vesting period' and with shares, you can have a 'conditional period' (so long as your Articles of Association have been drafted to enable this), during which the shares can be deferred to worthless shares if conditions are not met.

As a business owner you have plenty of protection in the event that an individual leaves or doesn't deliver. However, it's important for the equity to create the desired impact and incentive. That means **the recipient also needs to feel that the criteria is fair**.

You can think of setting conditions as protecting yourself in the worst case rather than outlining the dream situation. Businesses change and you don't want criteria so rigid that they don't allow for that.

Conditions / criteria to consider includes...

- Number of shares — how many will they receive?
- Time horizon (or vesting/conditional period) — when will they receive the shares?
- Performance conditions — what they must do before the shares are fully theirs? This might include things like staying with the business for a minimum period, and/or the deliverables you'd expect from the person in that role.

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Valuations for share schemes

Share schemes sometimes require a valuation to be placed on the business prior to issuing shares.

Here's a quick overview...

Action	Type of share scheme		
	EMI options	Unapproved options	Growth shares
Valuation needed to start distributing shares	✔	✗	✔
Valuation needs to be approved by HMRC	✔	✗	✗
Premium recommended on share movements	✗	✗	✔ (Typically add 10-20%)

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HMRC timetable for EMI options

It's really important to understand the timelines involved, especially when it comes to executing and filing documents with HRMC.

Many professionals believe that 50% of the EMI's set up won't qualify when it comes to exit because they didn't meet the criteria.

We've unfortunately seen too much misinformation from those that should really know when it comes to timelines and submission dates for EMI. **You need to be fully prepared** if you want to qualify.

Here's how to stay compliant...

Details	Period	Note
Valuation	1-4 weeks (responsiveness of accountants can vary - make sure you allow enough time)	Ask your friendly accountant to provide a valuation for submitting to HMRC for EMI purposes. They will know all about Unrestricted Market Value (UMV) and Actual Market Value (AMV) and the format in which to provide this.
HMRC Approved valuation	Valid for 60 days	Getting a valuation agreed by HMRC will typically take 4 weeks from date of submission and will be valid for 60 days from the date of agreement. This can be extended further by writing to the SAV and seeking an extension.
Preparing EMI option documentation for	Minutes - months	If you are digitally generating your documents using Vestd this is **as**

shareholders		**simple as a click of a button**. If you are going a more traditional route of manually preparing your documents with a lawyer we typically see these taking between 3 weeks and 3 months to prepare.
Executing share scheme	Hours - weeks	If you are digitally executing your documents using Vestd **everything is automated and digitally signed** including the option pool creation and board resolutions and can be completed in under an hour if everyone is available. If you are going a more traditional route of printing, posting, chasing, signing, processing we'd advise you leave a minimum of 2-3 weeks to complete this process.
Once options have been granted notify HMRC	Within 92 days	It is important not to leave this until the end of the 92 period, as the process involves registering, asking for a password (that takes 5 working days to arrive), and only then entering the details. Always start this process at least two weeks before the deadline.
Annual return	6th July each year	An EMI annual return must be submitted by the company by July 6th each year for the prior tax year.

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Common pitfalls

There are five issues that we regularly see when setting up share schemes for SMEs.

These are all easy to resolve... just contact us if you need help.

1. I've set up my company with too few shares

A company can have any number of shares , but most companies are incorporated with either 1, 10, 100 or 1,000 shares.

It doesn't really matter how many shares a company is incorporated with, as they can be relatively easily subdivided at a later date. You do this by passing a board and members resolution and then submitting a form (SH02) to Companies House.

Having said that, it's much easier just to set up your company with enough shares so that it's flexible moving forward.

The main reasons you're likely to issue more shares is if investors are putting money into your company in return for shares, or to give shares to team members who are part of developing the business.

2. The only use for my equity is to sell it to investors in return for cash

At the beginning of a company's journey this is probably the road you're going to want to go down. You need cash for things like overheads, to feed and clothe yourself and your general survival.

But there are other options for your equity, such as **employee retention**. Share schemes reward team members for their loyalty and are a great motivator to encourage people to perform.

3. I haven't kept track of my different share types and classes

Ordinary shares are what most people have. At their simplest, they give the holder of each share the same rights to dividends, capital and voting in the company. Most companies are founded with (and issue only) ordinary shares.

Preferred shares ('prefs') typically give their holders rights to specific dividends ahead of all ordinary shareholders, and may also give them rights to a specific amount of the capital at a winding up of the company ahead of any ordinary shareholders.

Then there are **growth shares**, which are issued at a 'hurdle price' that represents the value of the company at that time, and only share in the capital appreciation in the business from that point on.

The standard approach is that all shares have equal **voting rights**, it's very common that certain classes of shares don't. This may be to ensure that voting control sits with a certain section of the shareholders or maybe to limit the administrative burden of dealing with numerous shareholders in a particular class.

Similarly, all shares usually have equal **dividend rights**, but sometimes certain classes will be excluded from them for a particular reason.

Although the rights of the shares are usually set out in the Articles of Association, they can be changed by a Shareholder Resolution.

4. I've got my share dilution wrong

As part of the incorporation process the company has to decide how the shares are split between the founders of the company.

Each time more ordinary shares are issued, the same dilution process happens and the stakes of existing shareholders in the company reduce accordingly.

5. I keep putting the management of my equity at the bottom of my priority list

Many business owners are understandably put off by the sheer hassle of setting up a share scheme. Traditionally, it would take weeks of time spent with your accountant or lawyer to figure out what to do (and their time is money).

It would then take more weeks for you to talk to your board members and existing shareholders, followed by the agony of printing documents, signing them, posting them and waiting for them to be signed and posted back.

Sorting all this out is sometimes just another piece of admin that gets lost by the wayside. By the time you get around to it a valued team member has left. The advisor you really wanted to collaborate with for equity has had other offers.

Vestd solves this problem for business owners: our platform was specifically built to remove the pain of setting up share schemes.

Give Vestd a try!

Vestd is the UK's first share scheme management platform for SMEs.

It is the **easiest**, **simplest** and **most cost effective** way to create a share scheme for your business.

"It was a combination of extremely knowledgeable support and really simple and intuitive technology. You've massively simplified the whole share scheme process for everyone involved."

Jim Jensen, Propellernet Ltd

Read more customer reviews

Have questions? Want a demo?

Email us at demo@vestd.com