Equity Incentivisation / ownership schemes

The terms of a venture capital investment generally include a provision that the investee company will establish a share option pool. This is a pool of shares notionally set aside for future allocation to employees, consultants, and/or advisers: the intention is to give those people who are regarded as key to the growth prospects of a business ("stakeholders") an ownership stake in the company. Whilst the option pool will normally not be more than 10–15% of the fully diluted ordinary share capital and so is not a large enough portion to give any form of stakeholder control, it nonetheless creates a commonality of interest with the venture capital investor and any other external investors. Giving the opportunity to participate in the equity of the company and hence any profits realised on a future sale provides a financial incentive for the management team/stakeholders to grow the business to that end.

There are a number of ways to structure an equity incentive. Those most commonly utilised by venture capital backed companies are: Enterprise Management Incentive Scheme, growth share schemes, phantom/ shadow share schemes, and unapproved share options. The choice of which structure to use in any particular case will be based on both commercial and tax factors, and a combination of different schemes may well be appropriate to ensure all relevant stakeholders can be effectively brought on board.

This article sets out a summary comparison of these various structures.

Enterprise Management Incentive ("EMI") Scheme		
Key Characteristics	***Key commercial points***	***Key Tax/Procedural Points***
A right (option) to acquire shares at a future date. No voting rights, rights to dividends or rights to participate in a sale until EMI option is exercised and shares are acquired. Ordinary shares must be used but different classes of ordinary shares can be used with differing rights e.g. as to voting or dividends.	Straightforward to operate and flexible. Exercise can be subject to length of service, performance conditions and/or tied to specific capital events e.g. a trade sale. If exercise is permitted at any time, leaver provisions requiring compulsory transfer of any shares thereby acquired likely to be required in the event of a cessation of employment. Differentiate between good, intermediate, and bad leavers in terms of price. The Articles of Association can contain provisions	The most tax efficient way of distributing equity to employees: • No income tax on exercise provided option price is market value at date of grant. • Capital gains tax (CGT) on sale on the difference between exercise price and sales proceeds, attracting the reduced CGT rate of 10% provided sale of shares is at least 2 years from date of option grant. • Corporation tax deduction for the company equal to gain made by employee on exercise of option. Generally, before each grant of EMI options, an application will be made to HMRC to obtain their agreement

	ensuring the share class used is self-diluting.	to the valuation of the class of shares to be used. This ensures certainty as to the tax consequences on the exercise of the option. Any agreement to a share valuation given by HMRC (in the form of a confirmation letter) for the purpose of EMI option grants is valid for 90 days from the date of confirmation. Once established, an EMI Scheme will need to be registered with HMRC. Each new grant of options under the scheme will also need notifying to HMRC. For options granted on or after 6 April 2024 notification must be given on or before 6 July following the end of the tax year in which the grant is made. As with all employee share and share option schemes, once an EMI Scheme is established, an annual return ("ERS return") must be made by 6 July.

Growth Share Scheme		
Key Characteristics	***Key commercial points***	***Key Tax/Procedural Points***
Actual share ownership. No right to participate in the proceeds of a trade sale or other "exit" unless a hurdle return is achieved on all shares in issue at the relevant time. Growth shares can have voting rights and/or dividend rights but do not need to do so.	Suitable for businesses where an EMI scheme is not available or to incentivise non-qualifying stakeholders e.g. non-executives and service providers. Growth shareholders only share in the capital growth of the business from the point that the shares were issued. Can set additional conditions for recipients, such as achieving milestones, or staying with the company for an	Growth shares should, when issued, have a very low initial value and as such the amount the recipient would be required to pay for them to ensure no or minimal income tax liabilities on acquisition should be correspondingly low. It is not possible to agree a value for the growth shares in advance of their issue and it should be borne in mind that HMRC is no longer prepared to accept that the value of such shares is minimal – and a hope value will need to be built in when determining issue price and/or any income tax consequences. A valuation of the business should be

	agreed period of time. As actual share ownership is involved, leaver provisions will be required in the event of a cessation of employment (see above). If used, this class of shares would also be self-diluting.	prepared or obtained each time there is an issue of growth shares. On a future sale of the company, capital gains tax is payable at the standard rate on the excess of sales proceeds over the price paid for the shares. Corporation tax deduction or the company for the amount on which employee is liable to income tax on receipt of growth shares (likely insignificant). Where the growth share scheme includes employees and/or officers, it should be registered with HMRC and thereafter an annual ERS return made.

Phantom/Shadow Share Scheme		
Key Characteristics	***Key commercial points***	***Key Tax/Procedural Points***
No shares are acquired by employees so no entitlement to voting rights, dividends or capital. Employees are instead allocated hypothetical/notional shares and in the event that the Company pays a dividend, employees receive a bonus payment computed as if they had held actual shares. The number of notional shares “given” to each employee can depend on a number of factors e.g. length of service, seniority. The phantom share “rights” can extend to capital so that, on a sale, relevant employees receive a bonus based on the proportion of sales proceeds they would have received had they held actual shares.	Simple to operate and flexible and as such can be set up with conditions which suit the requirements of the company – they don’t need to meet specific legislative requirements since they are not tax-advantaged. Rationale is that employees are incentivised to help the company achieve share price growth in return for a cash bonus (instead of becoming shareholders).	At the time of award, the employee does not receive money, or any form of ‘money’s worth’ and so no charge to tax on employment income at the time of the initial award. Otherwise, tax consequences of future payments under the scheme are as for any other bonus payment i.e. made through payroll and subject to PAYE including employer NICs. Payments made under the scheme should be corporation tax deductible for the employer. As a phantom share scheme does not involve actual securities, the registration, notification and reporting requirements applicable to those schemes such as EMI and growth share schemes should not apply.

Unapproved Option Scheme		
Name of Equity Incentive Key Characteristics	***Key commercial points***	***Key Tax/Procedural Points***
A right (option) to acquire shares. No voting rights, rights to dividends or rights to	Despite the lack of tax advantage “unapproved” or non-tax advantaged options are used for their flexibility.	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 the option is

participate in a sale until unapproved option is exercised and shares are acquired. Different classes of shares can be used with differing rights e.g. as to voting or dividends.	No limits on the number of options that can be granted in total and/or to individuals. Can be awarded to consultants, non-executive directors and other employees who are not eligible for HMRC approved options, with performance conditions attached as required. HMRC requirements: • registration of scheme with HMRC. • annual reporting of the scheme.	exercised. There may also be National Insurance (employer and employee) to account for in respect of this sum if the shares are readily convertible to cash at the point of exercise (in a sale scenario, for example). On the basis that the option is exit only, capital gains tax will not be relevant since income tax will have been paid on the entirety of the effective gain. If the option is exercisable otherwise than on an exit, the taxable gain on a subsequent sale of option shares will be the excess of the sales proceeds over the market value of the shares at date of exercise. It is unlikely that the conditions for business asset disposal relief would be satisfied so the normal rate of capital gains tax will be payable. A corporation tax deduction may be available to the company for all or some of the costs of implementing and operating the scheme, under general principles. A statutory deduction is available for an amount equal to the value or benefit received by the employee on the exercise of the option.

Christine Ward & Monty Halliday
30 April 2024