

VALUE CREATION THROUGH SUCCESSION - INCENTIVISING KEY EMPLOYEES THROUGH SHARE OWNERSHIP

The JDC Practical Solutions series



JDC Corporate Finance



HELLO



ISSUE OPPORTUNITY SOLUTION

JON DODGE FCA CF - FOUNDER

TONY LONGMAN CTA - DIRECTOR OF TAX

About JDC Corporate Finance

JDC is a leading independent corporate finance and advisory firm, with an impressive reputation as experts in our field, providing transaction and related corporate advisory and tax planning services to owner managed businesses.

Our team combines a wealth of corporate finance, corporate advisory and taxation experience, offering our clients a range of services to suit their needs and the needs of their company at all stages of its evolution and development.

We are instructed as advisers for both sell-side and buy-side clients in corporate transactions, including outright and partial disposals to trade and private equity purchasers; acquisition mandates to achieve growth objectives; MBOs/MBIs and minority shareholder exits.

We are also specialist advisers in succession solutions and related planning matters and by offering a tailored approach and working with clients for the long term, we remain the retained advisers of choice to many growing and enterprising businesses.

Our specialist skills, experience and ability to deliver integrated advice in a clear, concise, hands-on and cost-effective manner are the primary differentiators that set us apart from the competition.

About the Practical Solutions series

In this series of guides, Jon Dodge and Tony Longman have reflected on the tax aspects of certain key issues that they have, in their combined professional experience of over 50 years, encountered again and again and know to be of particular concern to owner managers.

This series (by reference to tax legislation current at May 2016) focuses on capital value extraction (with or without a 'third party' sale) from a privately owned business; key planning considerations in securing Entrepreneurs' Relief; issues that might arise on the departure from a business of a retiring or dissenting shareholder; the attraction, retention and reward of key people in a tax effective way and inheritance tax planning in relation to the value of a privately owned company.

We hope that the series will be of value to you and would be delighted to discuss any of the issues raised with you in more detail, on an entirely confidential and no obligation basis.

Most employees value an equity shareholding interest in their employing company beyond its monetary value, offering an employer a very cost-effective means of retention.

Employers typically choose tax approved share option schemes as the first choice, but in some cases this option isn't available either because the company doesn't meet the qualifying conditions or the value of the shares exceeds the qualifying limits.

In this scenario, whilst it is possible to grant unapproved share options or make an immediate award of shares, the tax consequences are very unattractive where the shares are already of value. In such situations an alternative solution is required.

There are a number of tax efficient alternatives whereby shares might be transferred to an employee instead of granting share options. With care, the alternatives deliver a low cost, tax efficient 'lock in' with no downsides for the existing shareholders. The solutions include the creation of:

- Flowering shares
- Freezer shares
- Shares with an unpaid call

This guide considers some of the key characteristics of each mechanism.

JDC Corporate Finance is a specialist East Anglian based corporate advisory and transaction practice with particular expertise in designing and implementing tax effective strategic plans for businesses and balancing these plans with the personal objectives of the shareholders.

In this guide we have summarised some of the typical characteristics of tax efficient arrangements through which shares can be transferred to employees and would be delighted to discuss these with you in more detail if the circumstances we have described apply to your situation.

INCENTIVISING KEY EMPLOYEES THROUGH SHARE OWNERSHIP: THE TECHNICAL ANALYSIS

Flowering Shares

The company is valued and a new class of shares is created, whereby the shares of the new class have no value until the company value increases. In effect, the flowering shares give the holder the right to a proportion of future value growth only. Because the shares have little or no value when issued, there are no tax consequences for the shareholder/employee, who would otherwise be chargeable to tax on any value at the time the shares are acquired.

The flowering shares can have a dividend entitlement or not, although if dividends are to be paid it is important that any entitlements do not result in the flowering shares having value at the time of issue.

Because the flowering shares have no value at the time of issue, with a requirement for the company value to increase beyond a 'hurdle' before the flowering shares increase in value, it is possible to issue shares with the right to benefit from a substantial percentage of future growth if this is considered desirable. It is also possible to include a 'ratchet' arrangement whereby the flowering shares have an escalating percentage entitlement as performance hurdles are successively met, thereby really driving forward the growth of the business.

Freezer Shares

In this scenario, the existing shareholders agree to a reorganisation of the issued share capital. This enables the current value of the company to be held by the existing shareholders in a separate class of preference shares, thus devaluing the ordinary shares. Providing the class rights of the preference shares entitle them to a value which is at least equal to the current value of the company the ordinary shares will then have little or no value at that point. The class rights can be arranged to ensure that all future growth in the value of the company is reflected in the ordinary shares.

The reorganisation of the existing share capital has no tax consequences for the existing shareholders.

Because the ordinary shares have little or no value it is then possible to issue ordinary shares to key employees with no tax consequences for the shareholder/employee who would otherwise be chargeable to tax on any value at the time of acquisition.

To really drive future value creation, if desired a higher percentage of the issued ordinary share capital can be issued to the employee shareholder.

Shares With An Unpaid Call

In this scenario the existing class of shares is valued and the employee is issued shares at a subscription price equal to market value. To make the acquisition 'affordable' for the employee the shares are issued with an 'unpaid call', which effectively creates a debt owed by the employee to the company. When a company makes a loan to an employee/shareholder there are usually (but with some exceptions) significant tax disadvantages for both the company and the employee, but in the case of an unpaid call there are no tax costs.

There is no limit on the number or value of the shares issued to the employee although the unpaid call is a legally enforceable debt so there are real commercial risks to the employee.

The employee then benefits from any growth in value of the shares but carries the financial risk if the shares fall in value.

The use of an unpaid call to fund employee share acquisitions can be combined with Flowering or Freezer share arrangements.

Practical Issues

Executed properly, these structures can be implemented with no adverse tax consequences for the employee or for the original shareholders.

There is no stamp duty payable on a new issue of shares.

Whilst HMRC do not offer a pre-transaction valuation check for ordinary, freezer or flowering share arrangements it is still possible to achieve certainty as to the valuation.

Subject to meeting the qualifying conditions, Entrepreneurs' Relief will result in a 10% tax rate on any subsequent capital profit when the shares are sold by the employee.

To ensure that the employee only benefits from the shares whilst they remain an employee it is possible to impose stringent conditions in the Articles or in a separate shareholders agreement. These documents can effectively force the transfer of the shares at a nominal value in the event that the employee becomes a 'bad' leaver, and can impose other restrictions or performance conditions. There is significant flexibility as to the rights and restrictions that can be imposed on the shares/shareholder to meet any concerns that the existing shareholders may have.

Interested? Please call or email us to find out more.

OUR SPECIALIST SERVICES

Acquisitions

Whether a first time purchaser, a serial acquirer or an MBO/MBI team, we have the knowledge and experience to assist in all aspects of the acquisition process including:

target searches • target appraisal • valuations • funding • due diligence • negotiation • deal structuring • integration strategy.

Business Growth

Through our business growth services we provide external advice or hands-on interim management support to a wide range of clients. Our services include:

business plans • financial projections • refinancing • tailored MI • non-exec services • cash flow management • development strategy • turnaround.

Disposals

We specialise in advising on full, partial or structured exits, retirement sales, divestments and equity release. Our services include:

pre-sale advice and preparation • information memoranda • contacting targets • negotiating and structuring the deal • advising on post deal issues • accelerated M&A.

Reorganisations

The restructuring of a company or a group of companies involves financial, structural, strategic and tax based considerations. We are specialists in:

financial restructuring and refinancing • de-mergers • divestments • succession planning • capital extraction including company purchase of own shares.

Private Equity

We are very well connected to many private equity and venture capital funds and focus on matching the best placed investor to the right deal. We can help with:

pre-investment preparation • deliverable deal structures and IRR models • investor profiling • business plans and sensitised financial models • leading management presentations • negotiating the deal • project management • advising on post deal issues.

Specialist Tax

Understanding the tax planning opportunities and avoiding tax traps and pitfalls is at the core of all our planning work. We are specialists in:

all aspects of transaction tax • corporate reconstruction • share option arrangements • investment and reinvestment relief • tax effective income extraction • tax effective capital extraction • inheritance tax planning • specialist tax clearances.

CONTACT US

Talk directly with any of our senior team:



Jon Dodge FCA CF MEWI
m: 07775 696809
e: jd@jdc-corpfin.co.uk



Tony Longman CTA
m: 07342 887680
e: tl@jdc-corpfin.co.uk



Dave Howes ACA MBA
m: 07500 858143
e: dh@jdc-corpfin.co.uk



Chris Adlam FCCA
m: 07786 166927
e: ca@jdc-corpfin.co.uk



Raising the bar

Main Office

Dencora Court
2 Meridian Way
Norwich
NR7 0TA

Also at

3 Gray's Inn Square
London
WC1R 5AH

Contact

T: 01603 703177
E: info@jdc-corpfin.co.uk
www.jdccorporatefinance.co.uk