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THE "SHARES FOR RIGHTS" PROPOSAL: A TAX-FAVOURED EMPLOYEE SHARE SCHEME FOR PRIVATE EQUITY PORTFOLIO COMPANIES?

PRIVATE EQUITY

George Osborne announced on 5 December that his "shares for rights" proposal will be implemented in April 2013 as originally planned. Anyone who is currently considering offering shares to employees or executives in their portfolio companies should consider the "shares for rights" proposal.

Despite the criticism it has received, this opportunity to acquire shares which can then be sold tax free could be attractive to portfolio company employees, who are not usually able to benefit from existing tax-favoured share schemes.

Sharing the equity ownership of portfolio companies with their management teams is fundamental to the private equity model and sponsors are familiar and comfortable with dealing with the issues involved in buying back shares from employee "good" and "bad" leavers.

Private equity sponsors now have the potential opportunity to be early adopters of the "shares for rights" proposals and, alongside entrepreneurs' relief, it could become an important part of management team tax planning.

To benefit from the new proposal an employee has to give up certain employment rights in exchange for shares in their employer (or its parent company) worth at least £2,000.

These "employee shareholders" must give up the right to claim unfair dismissal (except for reasons that are automatically unfair, for example whistle blowing or discrimination) and the right to statutory redundancy pay.

They will also have more limited rights to request flexible working or time off for training, and employee owners returning from maternity leave or paternity leave (although not those returning at the end of their maternity leave) will need to provide more notice of the date they will be back in the office.

The idea of giving up employment rights in exchange for illiquid shares in a portfolio company will not be for everyone. But it looks like it will be possible for companies to give employee shareholders who give up these statutory rights equivalent contractual protection. That could, for example, include a longer notice period and a contractual redundancy arrangement.

Draft tax legislation is expected shortly, but it is currently envisaged that the proposal will be open to all employees, whatever their level of shareholding or seniority, which means that the management team in a portfolio company would also be able to participate and benefit from the capital gains tax free treatment. There is also no limit on the type of share which may be offered. So the proposal would extend to geared shares, such as growth shares and sweet equity (although the interaction with the current BVCA/HMRC memorandum of understanding will need to be considered carefully).

While the shares may ultimately be sold tax free, income tax (and potentially National Insurance contributions) will likely arise when they are acquired. The proposal envisages that employee shareholders acquire shares in exchange for giving up their rights and do not make any additional payment. That would mean the full value of the shares would be taxed on acquisition. We suggested in our response to the consultation that credit should be given for the value of the rights given up. If HMRC agree that the rights given up can be deemed to have a value of £2,000 (or more), employees could participate without suffering a dry tax charge.

Although suggested in the consultation process, it appears unlikely that HMRC will be willing to agree valuations upfront. It may well be necessary to get a third party valuation to ensure everyone understands the amount of tax which will be payable and that the shares are worth at least £2,000, and therefore satisfy the minimum valuation requirement. If the shares awarded are worth more than £50,000 at the time they are given to the employee shareholders, the excess will be subject to capital gains tax in the normal way. A valuation will also therefore establish how many shares benefit from the capital gains tax exemption.

We will be updating you once we have more details.

CONTACT DETAILS
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