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Employee Incentives for Start-Up Founders

Equity is a great way of recruiting and retaining employees in your business and aligns the interest of your employees with its shareholders. It is also cost effective in circumstances where companies are typically utilising their cash in growing the company. There are two main ways of providing equity to employees, either (i) giving an award of shares now; or (ii) giving a right to acquire equity (on favourable terms) in the future.

Upfront shares

- Management acquiring shares up front rather than on an exit
- No cash cost to the company
- Can be tailored to amend voting rights and rights to dividends
- Possible to give management a separate classes of shares
- Management may need loans to acquire equity
- Tax charge if shares are acquired on a discount but tax treatment on disposal may be capital
- May be more difficult to buy-back shares from leavers

Share options

- Option to acquire shares at 'exercise price'
- Option exercisable within a specified timeframe or on a specific event such as an "exit"
- Exercise price can be set at low or nominal value
- Leavers are dealt with easily with options lapsing on cessation of employment
- Risk of losing share options can be an additional incentive
- Company may qualify for various tax-advantaged schemes in the UK such as EMI

Issues to consider when determining the terms of any scheme

Key scheme criteria

- Who will be able to participate in the scheme? If the class of participants includes consultants or EoR employees, this may impact the design of the scheme.
- When should options be exercisable? Only on an exit or an earlier milestone?
- Should a leaver retain some or all of their shares?
- How will this impact the cap table?
- Will the participants pay to acquire shares?

Tax

- What are the tax implications for each scheme in each relevant jurisdiction?
- Is a tax advantaged arrangement available?
- Will the tax-treatment be income or capital? Will employer social security contributions arise?
- Will there be tax relief for payments and gains for the company? A corporation tax deduction may be available in the UK on an amount equal to the option gain.
- An external valuation may be required where employees are acquiring equity outright. This will have an impact on the upfront costs of the scheme.

Any questions? Get in touch

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