Family businesses – incentivising management

Family businesses have traditionally been reluctant to give equity to non-family managers. However, for family businesses competing not just for talented individuals but also for individuals who are the right cultural fit, equity incentives can play a key role in the recruitment and retention process.

Financial and non-financial incentives

Non-financial incentives are important for family businesses and include all the cultural elements that make employees want to stay, for example: flexibility, loyalty, inclusiveness and recognition. Financial incentives will include salary, bonus, pension, benefits in kind and equity. Well- structured bonus plans in particular can be useful to encourage and reward performance.

While it will not be as tax efficient as many equity arrangements, a cash incentive can be designed to mirror the effect of share ownership and it may help to bridge the gap between equity and cash incentives.

Equity

Equity incentives can work for family businesses. They contribute a sense of common purpose with the family, have no immediate cash flow impact and can help to lock in senior employees (aiding retention). A well-constructed equity incentive can also ensure:

- no loss of control (non-voting shares);
- very limited dilution of ownership (and the ability to buy the shares back)
- participation only in growth created from the date of issue of the equity; and
- minimal impact on dividend policy.

Equity incentives can also be very tax efficient for both the company and the employee.

Some issues to consider

- What are your key commercial aims (i.e. how will success be measured)? Is it appropriate for performance conditions to apply to the incentive?
- To whom equity should be offered - key executives only, all senior managers or even the entire workforce?
- How will individuals realise value from their awards? If the objective is for long term growth, the award may provide for shares to be bought back from employees when they leave at a price to be determined by the length of time the award has been held and/ or the reason for leaving. The company can also facilitate liquidity by providing an internal market for the shares.
- Typically no ready market will exist for the shares so thought should be given to a valuation methodology.

Shares or options?

If equity is to be made available to non-family members a key decision will be whether employees are offered shares or options (i.e. a right to acquire shares in the future at a set price, possibly subject to performance conditions).

Direct share ownership

When an employee is offered the opportunity to acquire a share in their employing company, then, broadly, if they pay less than market value for their shares they will be subject to income tax on the shortfall. Therefore the employee will have a funding requirement on acquisition, either to pay full value for the shares or to fund the tax liability which may arise. One way to avoid this is to create a class of shares which have very few rights until pre-set performance targets are met whereupon the shares typically rank equally with other shares. This has two benefits: firstly the initial value of the shares is low, making them affordable and secondly the performance conditions will incentivise the shareholder to work towards these targets.

Share options

Options to buy shares are popular as they are administratively straightforward, for example, lapsing if the employee leaves so no need to buy back shares; also there is no dilution prior to an option exercise and that event can be performance related. However, the employment tax charges on exercise of options can be significant and therefore it is normally worthwhile exploring some of the government-backed tax advantaged share option structures.

Enterprise Management Incentive (EMI) options are well known, popular, flexible and the most tax efficient option arrangement available to small and medium sized companies. EMI options may be granted over shares worth up to £250,000 at grant. The gains on exercise are taxed as capital, not income, provided the exercise price of the options is not less than the market value of a share at the grant of the option. Further, the conditions for Business Asset Disposal Relief (which reduces the rate of capital gains tax to 10%) to apply are relaxed in relation to EMI options making it easier for holders of EMI options to benefit from that relief on the sale of the shares they acquire on the option exercise.

Companies that are too large to qualify to grant EMI options may consider granting Company Share Option Plan options which have fewer qualifying conditions than EMI options but are less flexible and limit the value of the shares over which an option may be granted to £30,000.

All employee plans

EMI options and CSOP options can be granted on an all employee basis, but arrangements such as Save As You Earn (SAYE) or the Share Incentive Plan (SIP) provide further tax- advantaged solutions.

Summary

The right, highly performing non-family employees are critical to the success of many family businesses. To motivate these key individuals it is necessary to craft the right package of both financial and non-financial incentives. Equity is often the missing piece of the puzzle but, correctly structured, share incentives can drive best behaviour and add to the success of the business.

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