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Equity incentives: News from Capital Strategies on share-based rewards

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In brief

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How does the Budget affect companies with existing share plans?

One of the most common questions in the lead up to the Budget this year was *How will all this affect my share plan?* The aim of this newsletter is to answer that question in relation to the four main approved share plans: the Company Share Option Plan, the Profit Sharing Scheme, the Save-As-You-Earn Share Option Scheme and the QUEST.

Company Share Option Plan

Before the Budget, the Company Share Option Plan, or CSOP, was the only Inland Revenue approved plan that allowed a company complete discretion as to which employees should participate and how much they should receive. The CSOP remains untouched by the Budget, but is in effect supplemented by the Enterprise Management Incentives Plan, a new discretionary share option plan which has been covered in detail in previous editions of eQUITY INCENTIVES. The main differences between the CSOP and EMI are:

	CSOP	**EMI**	
Who can participate?	As few as one employee or as many as all employees	Between one and fifteen employees	
Which companies can establish it?	Any company	A company must have gross assets of less than £15m, be a trading company, not carrying out certain excluded activities, trading in the UK and, if a group, have only qualifying subsidiaries	
How much can employees receive?	Any one employee can hold options at any one time over shares worth up to £30,000	Any one employee can hold options at any one time over shares worth up to £100,000	
What type of shares can be used?	Shares must conform with regulations set out in legislation	Any type of shares, including non-voting and forfeitable shares provided they are ordinary shares, non-redeemable and not convertible	
Can performance targets be used?	Corporate performance targets can be used	Either corporate or individual performance targets can be used	
When can options be exercised?	After three years and before ten years and no more frequently than every three years	Any time before the tenth anniversary	
At what price can options be granted?	Only at the market value of the shares or the date they were granted or at a premium to that market value	At market value, at a discount to market value, at nil cost (i.e. an employee can call for them free) or at a premium	
What is the tax treatment?	If the time limits are complied with, there is no income tax or national insurance on the employee when he exercises and he will pay capital gains tax when he sells	For market value or premium options, no income tax or national insurance on exercise and capital gains tax on sale but with business assets taper relief dating back to the date the option was granted	For discounted or nil-cost options, income tax and national insurance on the difference between the market value at the date of grant and the exercise price only, the rest chargeable to capital gains tax on sale with business assets taper relief dating back to date the option was granted

If you have a CSOP, you can still establish an EMI Plan and may wish to do so as an extra incentive for your key staff. If your staff already hold CSOP options, they can receive EMI options but the amount they can receive is reduced by the value of the CSOP options they receive. So if an employee holds £30,000 of CSOP options, he can only receive £70,000 of EMI options.

For further information on EMI, visit our dedicated website at http://www.emi-online.co.uk or email ruth.wooffindin@capitalstrategies.co.uk.

Profit Sharing Scheme

Whereas the CSOP has in effect been supplemented by the EMI Plan, the Profit Sharing Scheme (PSS) has been replaced by the New All Employee Share Plan. The Budget is phasing out the PSS – a company will not be able to establish a PSS after 5 April 2001 and no more tax free appropriations may be made by a PSS after 5 April 2002.

In its place, the New All Employee Share Plan (which the Finance Bill refers to as the ESOP) allows a company to offer:

- free shares tax-free
- shares for purchase by employees from pre-tax salary (Partnership Shares), and
- free shares (Matching Shares), also tax-free, in proportion to the number of Partnership Shares an employee buys

A company can choose which of these to offer – the Free Shares element is the most similar to the PSS but even so there are some changes:

- the annual limit is a fixed £3,000, which for those employees who earn over £30,000 will be lower than the limit under the PSS
- shares must be held with the ESOP for five years before they are completely free of income tax on withdrawal, though the income tax is mitigated after three years
- employees can be required to forfeit their shares if they leave within three years of receiving them
- employees must withdraw their shares from the ESOP if they leave the company
- if an employee keeps their shares within the ESOP until he sells them, he will pay no capital gains tax
- shares used for the ESOP can be non-voting and/or have limited dividends
- shares can be distributed according to objective performance measures

The big attraction for companies includes the following:

- Partnership Shares allow creation of employee share ownership without any cost to the company;
- Free Shares can be allocated according to performance;
- Non-voting shares can be used;
- the company need no longer see the phenomenon which was particularly unpopular with the PSS – allocating shares on Monday to an employee who left on Tuesday but who remained entitled to them.

At first glance, the plan may look less attractive to employees then the PSS - for example they have to hold their shares for longer to avoid income tax, and the overall value limits are less. But the fact that any capital gains tax can be avoided is very attractive. In addition, employees have the ability to buy Partnership Shares from their pre-tax salary and get further Matching Shares if they do so, which makes the ESOP more attractive.

For more information on the new ESOP, visit our website at http://www.esop.co.uk or email ruth.wooffindin@capitalstrategies.co.uk. If you are concerned about the effect of the Budget on your PSS and wish to discuss this, please call Ruth Wooffindin on 020 7256 8000 or email her, again at ruth.wooffindin@capitalstrategies.co.uk.

Save-As-You-Earn Share Option Scheme

The future of the Save-As-You-Earn Share Option Scheme (SAYE) caused a great deal of concern amongst many companies, particularly quoted companies. The SAYE Scheme has not been affected by the Budget and will continue as before. A company will be able to have both an SAYE Scheme and an ESOP and an employee will be able to participate in both.

QUEST

The QUEST is the qualifying, or statutory employee trust. It will remain available following the Budget but as with the PSS, CGT rollover relief will be unavailable after 5th April 2002. The new ESOP however has both of its main tax advantages:

- corporation tax relief on the cost of providing shares; and
- capital gains tax rollover relief for shareholders who sell their shares to the ESOP

For those companies with a QUEST that held shares at the date of the Budget, they will be able to transfer those shares to the new ESOP, as they currently can with the PSS. If your company has a QUEST, but distributes the shares from it using an SAYE Scheme, then you are unlikely to be affected but otherwise you will need to look closely at your employee ownership structure to decide how it should work in the future. For example, you will need to consider future changes in the following situations:

- if your aim is to continue using QUEST to buy shares with CGT rollover relief, or
- if you wish to transfer shares to an ESOP for free distribution

If you have a QUEST and are unsure about the consequences of the Budget on your company, please contact Ruth Wooffindin on 020 7256 8000 or email her at ruth.wooffindin@capitalstrategies.co.uk.

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If you want to find out more about using share schemes generally to incentivise your employees, contact Robert Postlethwaite on (+44) (0) 171 256 8000 or email him on robert.postlethwaite@capitalstrategies.co.uk

For more information about Capital Strategies please visit our website www.capitalstrategies.co.uk.

Incorporates the equity incentives businesses of **FIELD FISHER WATERHOUSE** and CAPITAL STRATEGIES.

Equity Incentives Limited 35 Vine Street London EC3N 2AA
Tel: +44 (0)20 7861 4717 Fax: +44 (0)20 7488 0084
E-mail: info@equityincentives.co.uk Website: www.equityincentives.co.uk CDE: 823

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