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Inland Revenue company share option plans

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Main principles of the CSOP

The Inland Revenue approved company share option plan (CSOP) is an established method of providing share options to executives or employees:

- The mechanics of how the scheme operates are familiar to many employees.
- There is no limit to the number of employees who can participate.
- A CSOP usually fits in with a company's incentive requirements although some compromises may be needed to satisfy Inland Revenue approval conditions.
- Each participant may only hold options with a value (at grant) of up to £30,000. Therefore, the CSOP may have to operate in conjunction with either or both an enterprise management incentives ("EMI") arrangement and an *unapproved* share option scheme.
- Some companies cannot establish CSOPs because of their ownership structure.
- Companies of all sizes and whatever their business can establish CSOPs.
- There are significant potential tax advantages for participants.
- The CSOP helps solve the employer's national insurance contributions (NICs) problem.

What a CSOP involves

In outline, a CSOP works as follows (with reference to typical documentation):

- A company establishes the scheme (scheme rules) and obtains Inland Revenue approval of it.
- In the case of an unquoted company, the market value of the scheme shares is agreed with the Inland Revenue before an option is granted.
- The board selects employees and invites them to participate (letter of invitation).
- The selected employees agree to participate (application form).
- The selected employees are granted options to acquire shares in the company within, usually, a ten year option period (option certificate).
- The option holders either exercise their options in whole or in part and acquire shares or allow the options to lapse (notice of exercise of option).
- Any shares received belong to the employee absolutely.

What you can do with a CSOP

A CSOP provides a participant with an opportunity to acquire shares. It involves a cost to the participants (the exercise price) but an option will not be exercised unless it is "in the money". The scheme can be operated on an *all employee* basis but is usually used on a selective basis. The scheme could attach certain objective conditions to the exercise of options and can provide for options to be exercised on achieving a target event or according to a vesting schedule. In listed companies, shareholders expect to see one or more performance conditions attached to every option granted to an employee.

The key question is does the incentive the company wants to provide fit within the CSOP framework?

Are the approval conditions a problem?

Framework

The CSOP incentive framework is as follows:

- Participation is only available to an employee or a full time (25 hours or more a week etc.) director of the company (or participating companies).
- The option exercise price must *not be* manifestly *less* than the market value at the time of the grant of the option.
- The market value of shares under option *at the time an option is granted* must not exceed £30,000 (options granted under other approved company share option schemes and executive share option schemes of the company or its associated companies are taken into account when calculating the £30,000 limit).
- The option rights must not be transferable (except on death).

- If an option is exercised three years or more after its grant then the exercise is tax free for the participant.

Scheme shares

The scheme shares have to meet certain qualifying conditions. They must be:

- ordinary shares,
- in a company which is not controlled by another company (unless, for example, it is a subsidiary of a listed company),
- fully paid up, and non-redeemable, and
- not subject to any restrictions other than restrictions attaching to all shares of the same class or certain employee pre-emption restrictions.

Other conditions

There are other approval conditions to meet. If there is more than one class of share the scheme shares must satisfy additional conditions. If the company is a close company (as defined for tax purposes) then a 25% or more shareholder (including options) cannot participate. The 25% limit applies in place of the previous 10% limit from 10 July 2003. Also, once a CSOP is established changes to key features of it must be approved in advance by the Inland Revenue.

There can be difficulties achieving what a private company wants in respect of early exercise provisions (i.e. what happens if an employee's employment ceases early through injury, disability or in other circumstances).

If the CSOP framework looks right, a company must then decide whether or not the tax advantages make a CSOP worthwhile.

Are the tax advantages worthwhile?

The CSOP provides a method of avoiding an income tax charge at up to 40% on a participant on the exercise of an option.

A tax free exercise can take place on or after the third anniversary and no later than the tenth anniversary of the date of grant. Before 9 April 2003 an optionholder had to wait a further three years from a tax free exercise before making another tax free exercise. This condition no longer applies, although the £30,000 limit continues to restrict the grant of options to each participant.

In a ten year period, an individual could *acquire* tax free shares with a total *initial* market value of £90,000 (i.e. £30,000 x 3 = £90,000). This assumes that sufficient shares are made available under the scheme to enable this to happen. It also assumes that each option is exercised on its third anniversary and replacement options over the maximum value of shares are granted immediately. In the tenth year, the individual could on this basis have a further £30,000 of shares under option. Therefore, in the ten year period, the total value of shares acquired *and under option* could be *£120,000*. The total amount the employee would have to pay to exercise these options would likewise be at least £120,000. The benefit of exercising the options would, of course, depend on how much the share price has increased.

From 9 April 2003, tax free early exercises can also be made, if permitted under the rules of the CSOP, should an optionholder's employment cease by reason of injury, disability, redundancy or retirement.

A participant who acquires shares tax free may have a capital gains tax (CGT) liability but this would only arise when the shares are sold.

Consideration given for the grant of the option (if any) and for the acquisition of the shares is taken into account in computing any capital gain or loss arising on a subsequent disposal of the shares.

The first £7,900 (2003/2004) of all chargeable gains in a tax year are exempt from CGT. Taper relief may apply to reduce the effective tax rate depending on the shareholder's circumstances and how many complete years the shares are held.

No employees' NICs are payable on the grant of CSOP options or on an income tax free exercise of an option. At one time all CSOP option exercises were free of NICs but this favourable treatment no longer applies.

As well as tax advantages to participants, there is a very important tax advantage for employers. In the case of an unapproved option, the employing company will usually face an employer's NICs charge when an option is exercised. This charge is currently 11.9% (without limit) of the difference between the exercise price and the market value of the shares acquired *at the time of exercise*. This liability is unquantifiable and is a major concern for many companies. In contrast, under a CSOP there is an exemption from NICs on most occasions when a CSOP option is exercised. If any employer's NICs are payable on an option exercise this liability may be passed on to the relevant employee.

The EMI alternative

Changes made to the CSOP tax provisions in the Finance Act 2003 have helped revitalise the CSOP. Nevertheless, the CSOP has a rival.

The enterprise management incentives (EMI) arrangement is an attractive alternative for companies with gross assets not exceeding £30 million and which carry on a qualifying trade. Introduced in the Finance Act 2000, EMI options are very popular. Key differences between EMI and the CSOP are:

- under EMI, each employee can hold options worth up to £100,000 at the time of grant.
- under EMI, when shares are sold CGT taper relief will normally start from the date options are granted.
- EMI can be introduced more quickly than a CSOP.

There are, however, extra complications involved in achieving and maintaining the tax advantages available under EMI that do not arise with a CSOP. There is also more paperwork both when EMI options are granted and when exercised. These factors must be considered carefully when assessing the EMI alternative. A separate briefing paper is available from Equity Incentives which provides more information on EMI options.

How Equity Incentives can help

We can advise whether or not a CSOP is possible for your company. We can help you decide whether or not it is worthwhile establishing a CSOP or whether another form of equity incentive is better suited. We can prepare all the scheme documentation and deal with the approvals procedure. We can assist with other aspects of establishing the scheme and granting options under it.

Who are we?

Equity Incentives has substantial experience in all aspects of employee benefits, including equity incentives. The Managing Director, Graeme Nuttall, was a member of the HM Treasury advisory group which helped the Inland Revenue introduce new share schemes including EMI. He drafted a private member's Bill which was enacted as the Employee Share Schemes Act 2002. Through the **Global reward plan group** we implement international share schemes.

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