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A summary of HM Revenue & Customs approved share plans

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1. Introduction

The use of share and share option plans as an inducement for companies to recruit and retain highly skilled workers is well established.

The aim of this briefing note is to set out and explain the different types of tax advantaged (approved) plans available to employers and, in order to give a full picture, to summarise the main alternative “unapproved” plans. Where possible, companies should adopt approved plans since they benefit from a more favourable tax treatment. However, approved plans need to satisfy strict requirements and are subject to certain limitations so some companies may need to adopt an unapproved plan whether alone or in conjunction with an approved plan.

2. Approved plans

The approved plans consist of:

2.1 Company Share Option Plan ("CSOP")

Unlike SAYE and SIP (referred to below) which operate on an “all-employee” basis, under a CSOP the employer has complete discretion to choose which employees participate and at what level. The CSOP permits companies to grant tax advantaged options to each selected employee over shares with a market value not exceeding £30,000 (at the date of grant of the options). It works as follows:

(a) An employee is given an option to buy a number of shares at a fixed price. The price is fixed at the time the option is granted and must be not less than the current market value of the shares. This value is determined by HM Revenue & Customs (unless the company has shares traded on the main list of the London Stock Exchange).

(b) The plan is limited to full time directors working at least 25 hours per week and all other employees (including part time employees).

(c) Neither the employer nor the employees suffer any tax charge on the grant of the option. Equally, when the option is exercised, there is no income tax or any national insurance contributions ("NICs") payable on any increase in value of the shares between the date the option is granted and the date of exercise.

(d) In order to receive these tax benefits on exercise, the option must be exercised at least 3 years and not more than 10 years after its date of grant (except if an employee leaves for certain specified reasons).

(e) If the shares are later sold at a profit, capital gains tax may be payable, depending on the employee's individual tax circumstances. Taper relief is available to reduce the overall tax charge and this relief starts to run from the date the option is exercised.

2.2 Enterprise Management Incentives ("EMI") arrangement

This is an extremely flexible and tax efficient form of share option. EMI is typically used to attract or retain key individuals who are expected to make a significant contribution to their employer. There are a number of requirements which companies must satisfy to grant EMI options. These mean EMI is primarily aimed at assisting higher risk trading companies with significant growth potential, although it does have a much wider application.

EMI is strictly a qualifying arrangement, not an approved plan. There is no need for prior approval by HM Revenue & Customs and no need for a set of plan rules of general application. Companies can tailor individual options to individual employees.

Its main features are:

(a) Companies must be independent and carry on a “qualifying trade” wholly or mainly in the UK.

(b) The gross assets of the company must not exceed £30m.

(c) Options may be granted to any number of employees at any one time.

(d) An employee can hold at any one time options over a maximum of £100,000 worth of shares valued at the date the options were granted. As with the CSOP, this value is determined by HM Revenue & Customs (except for companies with main market listings). An employee may be granted an option under a CSOP and an

EMI but the combined value of options is limited to £100,000.

(e) The total value of all shares held under option must not be more than £3m.

(f) Individuals, whether new recruits or existing employees, must work for the company for at least 25 hours a week, or if less than 25 hours, for at least 75% of their working time.

(f) There are no rules about when options can be exercised or the price at which they can be granted. It is possible for companies to grant options at no or discounted cost to the employee rather than at their current market value, although this means there will be some tax charge when the options are exercised.

There is no tax charge for the employee on either grant or exercise of the option if the exercise takes place within 10 years of grant and there have been no disqualifying events up to exercise. Capital gains tax will be charged on any gain when the shares are sold, although taper relief will apply to reduce this tax charge. Significantly the taper relief will start to run from the date the options were granted. Therefore, if the options are held for 2 years from grant and shares subsequently sold, the effective tax rate on sale is 10%.

2.3 Savings Related Share Option Scheme ("SAYE Scheme")

This scheme is egalitarian in principle and must be open to all employees (except part-time employees) after a qualifying period of service. It is often used by publicly listed companies who have a large number of employees.

All employees must participate on the same basis which means that employees who fulfill the same objective criteria must be treated in the same way. It works as follows:

(a) Employees take out a save-as-you-earn savings contract saving between £5 and £250 per month. Shares are then bought (i.e. when the option is exercised) using the proceeds of the savings contract. The price of the shares is fixed at the time employees receive their options under the SAYE scheme and must be not less than 80% of the market value of the shares at that time;

(b) Employees do not have to exercise their options. At the time at which their savings contract matures they can decide whether to keep the proceeds of the contract and the (tax free) bonus paid to them on its maturity or to use the proceeds to buy the shares when exercising the option;

(c) The SAYE saving period must be for either 3, 5 or 7 years.

2.4 Share Incentive Plan ("SIP")

This type of plan works through the use of a UK trust to which the employer provides funds. It allows for three types of share award as follows:

(a) Free shares: companies can give each of their employees up to £3,000 worth of free shares each tax year. If those shares are held in the plan for 5 years they will be released free of income tax.

(b) Partnership shares: employees can be given the opportunity to invest part of their pre-tax salary in shares worth up to a maximum of £1,500 each tax year.

(c) Matching shares: employers can give employees up to two extra free shares for every one partnership share bought by an employee. If these shares are held in the scheme for 5 years they will be released free of income tax.

The SIP can be more complex to administer than other types of share plan. It is the only plan that permits the tax free award of shares to employees (at no cost to those employees).

3. Other types of employee benefit arrangement

There are a number of other "unapproved" or "non-qualifying" plans which can be used as incentives for employees. Here is a brief outline:

3.1 Long-term incentive plan ("LTIP")

An LTIP typically involves performance-related awards and bonus awards. LTIPs are common in listed companies, in order to comply with corporate governance guidelines, where they are used mainly for rewarding senior executives. The vesting of LTIP awards is often connected to performance conditions such as growth in earnings per share or total shareholder return.

3.2 Unapproved discretionary share option plan

Often used in conjunction with a CSOP (particularly where the options would exceed the £30,000 ceiling), this type of plan can contain largely similar terms to the CSOP for ease of administration. Being unapproved it does not need to comply with statutory requirements and is therefore highly flexible. However, it is not as tax efficient for the employee as an approved plan: there is an income tax charge on exercise of the share options and depending on the circumstances also a PAYE/NIC charge for the employer and employee.

These tax charges can prove extremely costly for the employer. However, an employer can pass this NIC liability to the employee and put in place arrangements to ensure recovery of any payments made under PAYE.

3.3 Employee share ownership plan ("ESOP")

This is a trust established by a company for the benefit of its employees and which typically operates in conjunction with one or more other types of plan. An ESOP is ideally suited to situations where the company wishes to acquire shares from an existing shareholder and warehouse them for future distribution. It is common for the trust to be set up and run off-shore so that there is no ultimate capital gains charge on the sale of the shares.

4. Summary

A variety of share and share option plans are available to employers. Clearly certain plans may be unsuitable for some companies and others may not be able to establish approved plans as they do not satisfy the qualification requirements. This briefing note provides an overview only. More detailed information is available from us on the particular plans referred to in briefing note.

Further useful information in relation to approved and unapproved option plans is also available on the HM Revenue & Customs website at www.hmrc.gov.uk/shareschemes.

Who are we?

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As a member of the HM Treasury employee ownership advisory group, the head of our team, Graeme Nuttall, helped HM Revenue and Customs develop and introduce the share incentive plan (SIP) and the enterprise management incentives arrangement. He also drafted the Employees' Share Schemes Bill, a successful private member's bill enacted as the Employees Share Schemes Act 2002 that increased the tax effectiveness and democracy of SIPs.

The Field Fisher Waterhouse Equity Incentives team has substantial experience in all aspects of employee benefits, including equity incentives. We have particular expertise in advising on creating and sustaining employee ownership solutions for a variety of businesses.

Through our German and Belgium offices and our other overseas affiliated and associated offices we advise on international share plans.

EQUITY INCENTIVES

www.equityincentives.co.uk

Our Equity Incentives website is a valuable information source on different types of employee share and share option plans and includes a number of briefing papers, case studies and other helpful information.

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