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HM Revenue and Customs company share option plan (CSOP)

NOVEMBER 2005

Contents

- Main principles of the CSOP
- What a CSOP involves
- What you can do with a CSOP
- Are the approval conditions a problem?
- Are the tax advantages worthwhile?
- The EMI alternative
- How Equity Incentives can help

Main principles of the CSOP

The HM Revenue and Customs approved company share option plan (CSOP) is an established method of providing share options to 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 HM Revenue and Customs 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, although if the company qualifies for EMI purposes, the EMI tax advantages are better.
- The CSOP helps solve the employer's national insurance contributions (NICs) problem.
- The employing company may get a tax deduction when a CSOP option is exercised.

What a CSOP involves

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

- A company establishes the plan (plan rules) and obtains HM Revenue and Customs approval of it.
- In the case of an unquoted company, the market value of the plan shares is agreed with HM Revenue and Customs before an option is granted.
- The board selects employees and invites them to participate (board meeting minutes).
- The selected employees are granted options to acquire shares in the company (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 plan 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 London Stock Exchange 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 plans 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.

Plan shares

The plan 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 plan 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 HM Revenue and Customs.

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).

From 18 June 2004, in order to achieve a tax-free exercise of a CSOP option, there is an express requirement that the avoidance of tax or NICs is not the main purpose (or one of the main purposes) of the arrangement under which they option was granted or is exercised.

A new tax regime applies to the acquisition of restricted shares and other securities from 16 April 2003. It is unlikely that plan shares will be subject to this regime or, if they are, that they will be adversely affected by this regime.

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 the income tax charge at up to 40% and employee's NICs at 1% that usually apply to 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 option holder 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 plan 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 £8,500 (2005/2006) 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. Once a CSOP option has been exercised (i.e. normally after three years) the normal taper relief period will start to run. Maximum taper relief should be available after two years ownership of the shares and means an effective CGT rate of 10% for higher rate tax payers.

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 12.8% (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.

A corporation tax deduction is available as a statutory right in respect of certain employee share acquisitions in accounting periods beginning on or after 1 January 2003. This relief should be available when a CSOP option is exercised. The relief is not restricted to acquisitions involving CSOP options. It is mentioned for completeness only in this briefing paper.

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 EMI arrangement is an attractive alternative for companies with gross assets not exceeding £30 million and which carry on a qualifying trade. Since its introduction in 2000, EMI options have proved 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 plan documentation and deal with the approvals procedure. We can assist with other aspects of establishing the plan and granting options under it.

This publication is not a substitute for detailed advice on specific transactions and should not be taken as providing legal advice on any of the topics discussed.

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Incorporates the equity incentives business of Field Fisher Waterhouse.

Registered in England No. 4238893. Registered office as above. Regulated by the Law Society.

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Who are we?

Equity Incentives has substantial experience in all aspects of employee benefits, including equity incentives. As a member of the HM Treasury advisory group, our managing director, Graeme Nuttall, helped HM Revenue and Customs develop and introduce the tax advantaged share incentive plan (or SIP) and the EMI 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.



Through the European Legal Alliance and other strategic relationships, we advise on implementing share plans in Europe and worldwide.

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