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SHARE INCENTIVE AND OPTION SCHEMES

There are various share schemes that can be set up to incentivise employees. The tax considerations are always an important factor in determining what sort of scheme to implement.

PHANTOM SHARE SCHEMES

These are not really share schemes at all. The name describes cash bonus schemes where the amount of the bonus is calculated by reference to the value of the company's shares or options.

Phantom schemes have no tax advantages - the bonuses are subject to income tax and both employees' and employer's National Insurance Contribution (NIC). However, they are simple because they do not involve the shareholders giving up any of their control and the employees get a guaranteed reward which does not, for example, rely on them finding a buyer for their shares.

The employer will be able to claim a corporation tax deduction for the amount of the bonuses. This deduction will be available for the accounting period in which the liability to pay the bonus arises provided the employee receives the bonus within nine months of the end of that period.

The employer's costs in setting up a phantom scheme should be deductible for corporation tax purposes.

UNAPPROVED SHARE INCENTIVE SCHEMES

Unapproved share incentive schemes have no tax advantages. Under general tax principles, if an employee is, by reason of his employment, permitted to acquire shares at less than market value, he will be subject to income tax on the excess of the market value of the shares over the price he pays for the shares. The employee will therefore be exposed to tax charges at his top rate of tax on the acquisition of the shares - whether or not he sells, or can sell, the shares.

If the shares acquired are 'readily convertible assets' then the income tax charge will usually be collected via the PAYE system and there will additionally be a liability for both employers' and employees' NIC. Generally shares are readily convertible assets if they are quoted or if there are arrangements regarding their sale.

Provided certain tax elections are entered into, normal capital gains tax (CGT) rules will apply if an employee subsequently disposes of shares, with any amounts previously charged to income tax being treated as part of the acquisition cost which is deductible from the sale proceeds in calculating the chargeable gain or loss. Therefore there will only be CGT to pay if the shares have increased in value since their acquisition.

There is also the possibility of an income tax charge under the restricted securities regime on a disposal of 'employment-related' shares. This charge is not dealt with in this note - please see our briefing note 'Employee incentives - restricted securities regime'.

The employer will generally be able to claim corporation tax relief for an amount equal to the amount on which the employee is taxed, ie the difference between the market value of the shares and the amount paid for them. The relief only applies if the shares are ordinary non-redeemable shares, and certain other conditions need to be satisfied.

The employer's costs in setting up an unapproved share incentive scheme are generally viewed as not being deductible for corporation tax purposes by HM Revenue and Customs (HMRC) on the ground that the costs are capital expenditure.

UNAPPROVED SHARE OPTION SCHEMES

This term describes schemes under which employees are granted options to acquire shares by reason of employment, other than via any HMRC approved arrangement.

Like unapproved share incentive schemes, unapproved share option schemes have no tax advantages. If an employee is granted an option to acquire shares in the future, there will generally be no tax liability when the option is granted, but the employee will be liable to income tax when he exercises the option. The charge will be on the excess of the market value of the shares at the time of exercise over the price paid for them (including the price paid for the option, if any).

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As is the case with unapproved share incentive schemes, the tax charge arises at the employee's top rate of tax, whether or not the shares have been sold. Again as with unapproved share incentive schemes, if the shares are readily convertible assets the tax will usually be collected by deduction from the employee's salary, and there will be a liability to both employees' and employers' NIC in respect of the shares.

In response to concerns expressed by companies about the unpredictable employer's secondary NIC liability arising on unapproved share option gains, legislation has been introduced to allow the employer and employee to elect (in a form which has been approved by HMRC) that the whole or part of the employer's secondary NIC liability arising on such option gains be transferred to the employee. In this way companies can avoid being hit for a significant liability for which they have not been able to plan, in cash flow forecasts and budgets, with any certainty.

The same corporation tax relief arises as applies to unapproved share incentive schemes, subject to the same conditions, for the difference between the market value of the shares when issued and the amount paid for them.

The employer's costs in setting up an unapproved share option scheme are, as with unapproved share incentive schemes, generally viewed as not being deductible for corporation tax purposes by HMRC on the ground that the costs are capital expenditure.

APPROVED SAVINGS RELATED SHARE OPTION SCHEMES (OR SAYE SCHEMES)

Under these schemes an employee must make weekly or monthly payments of no more than £500 per month into a savings account with a bank or building society. These payments must continue for three or five years. The savings contract will generate a cash bonus at the end of three, five or seven years. At the same time as the savings contract is entered into, the employee is granted an option to subscribe for shares in the company and may use his savings to buy such shares (or, if he does not wish to buy the shares, he may withdraw the cash), together with any bonus or interest payable.

There are some tax advantages in using an approved savings-related share option scheme. Interest on the bank or building society account is exempt from tax. Provided that the option is not exercised within three years of the date of grant, there will be no income tax charge on the exercise of the option. CGT may, however, be payable by the employee on the sale of the shares to the extent that the sale proceeds exceed the amount (if any) paid by the employee for the grant of the option and the purchase of the shares. In general there will be no NIC liabilities for such schemes.

The basic advantage, therefore, is that the tax charge is deferred until the shares are sold, and then only arises at CGT rates, which are lower than income tax rates. Indeed, since the amounts earned will be relatively low, employees with no other capital gains may find that their annual CGT exemption removes the tax charge altogether.

There are many rules with which the scheme must comply in order to qualify as a SAYE scheme. The most significant, from an employer's perspective, is that all of the company's or group's employees (including part-time employees) who have served a qualifying period of service of up to five years must be eligible to participate in the scheme on similar terms (meaning that the amount of shares given may vary according to levels of pay, length of service and other factors).

The price at which options may be exercised must be stated at the time of the grant and must not be manifestly less than 80% of the market value of the shares concerned (at the time of invitation to participate). Generally options may not be exercised within three years of the date of grant.

SAYE schemes are no longer subject to prior approval by HMRC but the company must self-certify that the scheme qualifies under the SAYE rules.

The same corporation tax relief arises as applies to unapproved share incentive schemes, broadly subject to the same conditions, for the difference between the market value of the shares when issued and the amount paid for them.

The employer's costs in setting up an SAYE scheme are deductible for corporation tax purposes.

COMPANY SHARE OPTION PLANS (CSOPs)

CSOPs no longer require HMRC approval, but need to be self-certified by the company. CSOPs allow a

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company to grant options to its employees to subscribe for shares.

There are some tax advantages in using a CSOP. There is no income tax charge on the grant of the option. Provided that the option is not exercised within three years of the date of grant, there will be no income tax charge on the exercise of the option. CGT may, however, be payable by the employee on the sale of the shares to the extent that the sale proceeds exceed the amount (if any) paid by the employee for the grant of the option and the purchase of the shares. There will be no NIC liabilities in respect of such schemes.

The basic advantage, therefore, as with SAYE schemes, is that the tax charge is deferred until the shares are sold, and then only arises at CGT rates.

As with SAYE schemes, there are many rules with which the scheme must comply in order to be an eligible CSOP scheme. However, the notable difference between this and the SAYE scheme is that not all employees have to be eligible to participate in the scheme. The company can pick and choose the employees to which it wishes to offer shares, provided that, in the case of a director, he must be full-time (ie work more than 25 hours per week) and that the employee does not own more than 30% of the company (if it is close).

No employee can have options outstanding under CSOPs over shares worth more than £30,000. This value is determined at the date of grant of the option. The exercise price at which options may be granted must be stated at the time of the grant and must not be manifestly less than the market value of the shares concerned at such time. It is not uncommon for the exercise of the options to be subject to satisfaction of certain performance targets, but this is not essential.

The same corporation tax relief arises as applies to unapproved share incentive schemes, broadly subject to the same conditions, for the difference between the market value of the shares when issued and the amount paid for them.

The employer's costs in setting up a CSOP are deductible for corporation tax purposes.

ENTERPRISE MANAGEMENT INCENTIVES (EMIs)

EMIs were introduced as a form of share option scheme offering greater incentives with greater flexibility and less 'red tape' than the CSOPs referred to above.

The grant of an option under an EMI scheme must be notified to HMRC in order for the grant to qualify for EMI status.

Independent (ie not controlled by another company) trading companies or groups trading or preparing to trade wholly or mainly in the UK with gross assets not exceeding £30 million and who have less than 250 fulltime employees, can grant EMI options in order to recruit or retain employees. There are certain requirements regarding the type of trade carried on and the number of hours worked by the employee that must be satisfied before an employee can be granted an EMI option.

Employees can hold unexercised EMI options over shares worth up to £250,000 at the date of grant (options granted under CSOPs must also be taken into account here). There is an overall limit for the company of £3 million worth of unexercised options at any time.

EMI options must be capable of exercise within ten years after the date of grant.

EMI schemes generally enjoy the same tax advantages as CSOPs (ie no income tax or NIC on grant or exercise), provided that the exercise price for the shares is not less than their market value when the option is granted and provided that the requirements of the legislation continue to be met and no 'disqualifying event' occurs before the EMI option is exercised (although the tax advantages will not be lost if the EMI option is exercised within 90 days of a disqualifying event). If such requirements are not met at the relevant time, however, the option will be treated for tax purposes as if it was unapproved.

EMI option shares are subject to normal CGT rules and on a sale of the option shares, capital gains tax will be payable on any gain over the market value of the shares at the date of grant (subject to the availability of the annual CGT exemption). CGT is usually charged at either 10% (for a basic rate taxpayer) or 20% (for a higher rate taxpayer). However, Business Asset Disposal Relief may be available to option holders disposing of shares acquired through EMI options, enabling shareholders to sell their shares at a CGT rate

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of only 10% for gains of up to £1 million provided certain qualifying conditions are met. Normally the relief (formerly known as Entrepreneurs' Relief) is only available if a shareholder holds 5% of the ordinary shares, entitling them to at least 5% of the income and voting rights, and at least 5% of either the assets of the company on a winding up or the disposal proceeds if the company is sold, and has done for two years prior to the sale of the shares. However, with shares acquired via EMI options these requirements are absent provided the EMI options were granted more than two years before the sale of the shares.

The same corporation tax relief arises as applies to unapproved share incentive schemes, subject to the same conditions, for the difference between the market value of the shares when issued and the amount paid for them.

The employer's costs in setting up an EMI scheme are, as with unapproved share incentive schemes, generally viewed as not being deductible for corporation tax purposes by HMRC on the ground that the costs are capital expenditure.

SHARE INCENTIVE PLANS (SIPs)

SIPs involve the company setting up a trust for the benefit of its employees and require self-certification by the company that they satisfy the eligibility criteria. The trust acquires shares generally with funds acquired from the company. There are three main types of share which can be used in a SIP:

- free shares - each employee can receive free shares worth up to £3,600 each year;
- partnership shares - an employee can use up to £1,800 per year of his pre-tax salary to buy partnership shares; and
- matching shares - each employee can receive matching shares at a ratio of up to two matching shares for each partnership share bought.

Companies can also allow, or require, an employee to use dividends from his or her plan shares to buy further shares (dividend shares) in the company through the SIP.

A SIP must be open to all eligible employees. A company can specify a qualifying period of service before employees can take part in a SIP. For free shares, the qualifying period must not exceed 18 months.

All employees who take part in a SIP must do so on the same terms. Performance conditions can be imposed on awards of free shares.

Companies can require employees to hold free and matching shares within the trust that forms part of the SIP for up to five years. Dividend shares must normally be held for three years. Companies can also require employees to give up some or all of their free or matching shares if they leave, for certain reasons, within three years of the date on which they are awarded the shares. Partnership and dividend shares may also be subject to forfeiture provided that the employee will receive at least the price they paid for the shares or, if lower, the market value at the date of forfeiture.

The tax advantages of a SIP are in fact greater than those of any other share scheme. There is no income tax or NIC provided the shares are left by the employee in the SIP for at least five years (three years in the case of dividend shares). Furthermore, if the shares are left in the SIP until they are sold then the employee will pay no CGT on their disposal - an advantage not available under any other scheme.

A specific statutory corporation tax deduction is generally given to a company for SIP shares equal to the market value of the shares when they are acquired by the trust.

The employer's costs in setting up a SIP are deductible for corporation tax purposes.

GROWTH SHARE SCHEMES

Growth Share Schemes are a particular type of unapproved share incentive scheme that involve creating a separate class of shares whose rights are such that they have little or no current value, but have the potential to benefit from future growth in value, or a realisation in value, of the company. The aim of such schemes is to deliver CGT treatment for the shareholder on any gain on sale of those shares for a minimal up-front cost to the shareholder on subscription for those shares. These schemes are increasingly used in conjunction with employee shareholder schemes and are covered in detail by our briefing note 'Incentivising executives: growth share schemes'.

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EMPLOYEE TRUSTS

Anyone establishing a share incentive or share option scheme should also consider whether to establish an employee trust. For SIPs the establishment of a trust is a necessary part of the scheme but for other schemes it is not. However, it may be desirable commercially to have a trust.

The most common purpose of the trust is to establish a market for the shares. The trust can acquire shares not only by subscribing for them but also by purchasing them from existing shareholders (thereby avoiding the dilution of existing shareholders which would result from a subscription). The trust can transfer shares to employees entitled to them under the terms of the relevant scheme and can later buy them back when the employees wish to sell. Without a trust the employees would either have to find an existing shareholder wishing to purchase the shares, or sell the shares to an outsider (which may be commercially undesirable), or sell the shares back to the company (which can give rise to legal and tax problems). The main drawback with a trust is that shares held by it must generally be used to benefit employees and this can cause difficulties on a company sale where there are unallocated shares still left owned by the trust.

Many employee trusts are established offshore in an attempt to avoid possible capital gains tax problems. All trust arrangements should nowadays be reviewed to ensure that they do not fall foul of the 'disguised remuneration' rules.

FURTHER INFORMATION

For further information, please get in touch with your usual Penningtons Manches Cooper contact.

FIND OUT MORE

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This factsheet is intended to provide a general summary of the law in this area rather than comprehensive guidance or legal advice. Legal advice should be sought in relation to specific circumstances. The law and practice in this note is stated as at May 2021.

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