Why use Employees’ Share Schemes?

- To recruit or retain and motivate employees
- Nurture employee loyalty
- “Research in the UK and US has shown a clear link between employee share ownership and improvements in productivity, particularly when combined with modern management practices which promote active employee participation” (HM Revenue & Customs (“HMRC”))
- That statement was supported by a Financial Times report that a study of 94 companies by Bradford University in 1999 found that equity incentives helped lift productivity by about 25%
- Cost effective and tax efficient
- There is no cash cost to the employer (other than the expense of National Insurance Contributions (“NICs”) in certain cases)

Benefits to the Employees

- The employees acquire a stake in the employer
- Opportunity to accumulate wealth
- Relatively risk free

*Share options give employees a one way bet: there is no up front cost of participation and employees only exercise their options where they stand to make a gain from the shares. Where tax approved schemes cannot be used, employees can still improve their tax position by accepting modest up front costs and risks.*

Disadvantages and risks

Disadvantages for the Employer & Shareholders

- Equity dilution

*Equity dilution can be managed by shareholders imposing limits on the shares that can be used for employee incentives*

- Impact on profit and loss account:

*Accounting standards require many companies to account for the cost of share options. Joint share ownership and nil paid schemes mentioned in this guide should not involve such accounting costs*

- Set up and administration costs
- Private companies should consider the impact of schemes on their articles of association and any shareholders’ agreement

Disadvantages for the Employee

- Dependency on growth in the value of employer’s shares
- Loss of benefits on cessation of employment
Schemes almost invariably have good and bad leaver provisions:

- Good leavers can be allowed to keep their benefits
- Bad leavers lose them

### Forms of Share Incentives

Share incentive schemes can be designed to meet given objectives. Share incentive schemes and arrangements broadly fall into the following three categories

#### Purchase and award of shares:

Employees are given the opportunity to acquire shares at full market value, at a discount to market value or no cost. Shares can be purchased or awarded under schemes such as:

- joint share ownership schemes;
- nil paid schemes;
- long term incentive plans and bonus schemes

Although the structure and tax treatment of such schemes is relatively complex, they are tax efficient alternatives where tax approved schemes cannot be used

#### Award of options:

Employees are given right to acquire shares in the future:

- over a fixed number of shares;
- at a price set at the time of grant

Schemes may take the form of

- tax favoured schemes; and
- unapproved share options

#### Phantom Share Awards

Phantom awards (often also called share appreciation rights) provide a method of awarding bonuses based in the growth in the value of the company’s shares. They can be used where shareholders do not want dilution of their equity; or they do not wish to disturb an arrangement such as a joint venture. Phantom awards do not give rights over shares. They involve a cash cost to the employer

### Approved & Unapproved Share Schemes

#### Approved

A scheme for which certain tax benefits are available to employees and employers. Currently they take the form of:

- Enterprise Management Incentives (“EMI”) Scheme
- Approved company share option plan (“CSOP”)
- Save as you earn share option scheme (“SAYE”)
- Share Incentive Plan (“SIP”)

#### Unapproved

- Everything else!
This note outlines the key features of EMI schemes, CSOPs, unapproved share option schemes and joint share ownership schemes. Details of other types of scheme can be provided on request.

Enterprise Management Incentives (EMI)
Outline
An EMI scheme enjoys significant tax advantages compared with other share incentive schemes.

- It is aimed at smaller “qualifying trading companies” with less than the full time equivalent of 250 employees and gross assets of £30 million or less.
- There is no limit on the number of participating employees.
- Maximum value of awards permitted under the scheme are:
  - £120,000 per employee; and
  - £3 million per company
- The option exercise price can be discounted to the market value of the shares at the date of grant.
- Qualifying trading companies are companies not carrying on disqualified trades, e.g. dealing in land, securities or commodities, property development, financial trades, leasing, receiving royalties or licence fees, ship building, coal and steel production, providing legal or accountancy services, operating hotel or nursing homes, farming or market gardening etc.
- Employees with more than 30% of the ordinary share capital of the company cannot participate.
- There is no advance HMRC clearance mechanism for EMI scheme documents. However, notice to HMRC of EMI options must be given within 92 days of the option grant.
- There are other detailed conditions and reporting obligations.

Tax Treatment

On the grant of the option:

- There is no income tax or NIC.

On the exercise of the option:

- There is no income tax or NIC if the exercise price on grant was equal to the market value of the shares.
- If the exercise price was discounted, the discount to the market value of the shares on grant is subject to income tax and, if the shares are readily convertible, employer’s and employees’ NIC – see examples below.
- The amount paid for the shares forms the employee’s base cost for CGT purposes.

On the subsequent sale of the shares:

- CGT at 18% is payable on any difference between the sale proceeds and the base cost of the shares subject to the annual capital gains allowance (£9,600 for the tax year 08/09).
- Currently EMI options do not enjoy any favourable treatment under the entrepreneurs’ relief introduced in April 2008. However, shares acquired by the
exercise of EMI options by an employee who otherwise qualifies for entrepreneurs’ relief may qualify for entrepreneurs’ relief

Market value v discounted EMI options: tax treatment

Exercise Price (EP) = Market Value (MV) on the date of grant

Company share option plans (CSOP)

Outline
- The scheme is primarily used where EMI options cannot be granted
- The exercise price (set at the date of grant) must not be less than the market value of the shares at the date of grant
- The value of shares held under option at the date of grant by an individual cannot exceed £30,000
- Options cannot be exercisable within three years from their date of grant
- The scheme must be approved by HMRC prior to implementation
- Options must be over shares which must satisfy certain qualifying conditions

Tax treatment
On the grant of the option:
- There is no income tax or NIC
On the **exercise of the option**:

- No income tax or NICs due on exercise of options after the third anniversary of the date of grant

On the **subsequent sale of the shares**:

- Gains on shares acquired on the exercise of options free of income tax are subject to CGT subject to the annual capital gains allowance (£9,600 for the tax year 08/09)

**Unapproved share options**

**Outline**

- Unapproved schemes are normally used where EMI and CSOP schemes cannot be used
- Unapproved can more flexible than tax favoured schemes but apart from the income tax exemption on the grant of options, they do not enjoy any other tax advantages
- Their principal advantage is their relative simplicity

**Tax Treatment**

On the **grant of the option**

- Normally there is no income tax or NIC

On the **exercise of the option**:

- Income tax is payable on the difference between the market value of the shares at the date of exercise and the price paid ("option gain") whether or not the shares acquired by exercising the option are immediately sold
- The income tax may be payable under PAYE when the option gain would also be subject to NICs

On the **subsequent sale of the shares**:

- Any option gains not subject to income tax would be liable to CGT subject to the annual capital gains allowance (£9,600 for the tax year 08/09). In most cases, shares are immediately disposed of on the exercise of options and there is no further gain subject to CGT

**Joint Share Ownership Scheme ("JSOS")**

**Outline**

A JSOS gives a tax efficient alternative to an unapproved scheme. Under a JSOS:

- the employee pays to become joint owner of shares together with another shareholder, which is normally an employee benefits trust (EBT);
- the joint share ownership rights the employee acquires give the employee the right to the growth in value of the shares above a prescribed threshold plus dividends in certain cases, i.e. the employee has the future share of the fruits of ownership, known as the upper share rights ("USR");
that threshold is normally the market value of the shares on the date the employee acquires the USR and becomes a joint owner plus the carrying cost of the shares incurred by the EBT for acquiring the shares ("the threshold amount");

the price the employee has to pay for the USRs is a fraction of the value of the jointly owned shares on the date the USR is acquired

**Tax Treatment**

On the *acquisition of the USR* (and joint share ownership)

- Normally there would be no income tax cost provided the employee pays the market value for the USR;
- The employee should make an election to ensure that future gains are not subject to income tax (known as s431 election). The election can create an income tax and NIC cost if the employee paid less than the unrestricted market value of the USR;
- if the price for the USR is left out standing, there is a benefit to the employee, which must be reported on the P11D and would involve an annual income tax cost to the employee and NICs for the employer for each year the price for the USR remains outstanding;
- there is a modest stamp duty cost

On the **subsequent sale of the shares** the EBT and the employee share the sale proceeds so that the EBT retains the threshold amount and the balance is paid to the employee

- Any gain accruing to the employee is subject to CGT, subject to the annual capital gains tax allowance, and not income tax provided the employee made a s431 election on the acquisition of the USR;
- Example 2 below demonstrates how the tax works for employees under the JSOS.

Further advice and guidance on EBTs and more detailed tax and non-tax issues can be provided on request
Acquisition of Restricted Shares – Example 1

Day 1
- Unrestricted Market Value of a share ("UMV") £100
- Restricted Market Value of a share ("RMV") paid by employee £90
- Discount 10%

Day n
- UMV £250
- Growth in Value of unrestricted shares ("GIV") £150
- Growth in Value of restricted shares ("GIVRS") £160
- Income Tax, NIC and Capital Gains Tax (subject to annual allowance) costs on Day n depend on whether or not an income tax election under s431 Income Tax (Earnings & Pensions) Act 2003 ("Election") was made within 14 days of Day 1

<table>
<thead>
<tr>
<th>Day 1, Tax on Discount</th>
<th>No Election</th>
<th>Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax @ 40% on discount (£10)</td>
<td>Nil</td>
<td>4.00</td>
</tr>
<tr>
<td>Employees' NIC @ 1% on discount</td>
<td>Nil</td>
<td>0.10</td>
</tr>
<tr>
<td>Employers' NIC @ 12.8% on discount</td>
<td>Nil</td>
<td>1.28</td>
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<tr>
<td>Sub-Total 1</td>
<td>Nil</td>
<td>5.38</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Day_n (&gt; 2 yrs), Total Tax</th>
<th>No Election</th>
<th>Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax @ 40% x 25 (i.e. 10% x UMV Day_n)</td>
<td>10.00</td>
<td>Nil</td>
</tr>
<tr>
<td>Employees' NIC @ 1% x 25</td>
<td>0.25</td>
<td>Nil</td>
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<tr>
<td>Employers' NIC @ 12.8% x 25</td>
<td>3.20</td>
<td>Nil</td>
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<tr>
<td>CGT on elected shares @ 18% on GIV = 18% x 150</td>
<td>N/A</td>
<td>27.00</td>
</tr>
<tr>
<td>CGT on unelected shares @ 18%: GIVRS – amount subject to IT on Day_n: 160-25 = 135 x 18%</td>
<td>24.30</td>
<td>N/A</td>
</tr>
<tr>
<td>Sub-Total 2</td>
<td>37.75</td>
<td>27.00</td>
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<tr>
<td>Total Tax</td>
<td>37.75</td>
<td>32.38</td>
</tr>
<tr>
<td>Net of tax amount due to employee</td>
<td>122.25</td>
<td>127.62</td>
</tr>
</tbody>
</table>

N.B. If the UMV on Day n is less than £100, tax paid by election on Day 1 is not repayable.
Acquisition of USR (Joint Share Ownership) – Example 2

Day 1

- Unrestricted Market Value of a share ("UMV") £100
- UMV of a USR paid by employee and accepted by HMRC (s431 election made) £1
- Carrying cost to the EBT per annum 2% simple

Day n (say n is 3 years later)

- UMV of the jointly owned share £250
- Growth in Value of unrestricted share ("GIV") £150

<table>
<thead>
<tr>
<th>Day</th>
<th>Income Tax &amp; NICs</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 1</td>
<td></td>
<td>Nil</td>
</tr>
<tr>
<td>Day n (&gt; 2 yrs)</td>
<td>Income Tax &amp; Nics</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td>Threshold amount paid to the EBT</td>
<td>106</td>
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<tr>
<td></td>
<td>Amount payable to the employee</td>
<td>144</td>
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<tr>
<td></td>
<td>CGT @ 18% on GIV payable to the employee = 18% x 144</td>
<td>25.92</td>
</tr>
<tr>
<td></td>
<td>Total tax</td>
<td>25.92</td>
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<tr>
<td></td>
<td>Net of tax amount due to the employee</td>
<td>118.08</td>
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</tbody>
</table>

N.B. This is a simple example. The annual CGT allowance has been ignored, but any taxable gains would take it into account. If the restricted market value of a USR on Day 1 is less than its UMV the calculations may be more complex.

More information
Tarlochan Lall, Partner
+44 (0)20 7203 5051
tarlochan.lall@charlesrussell.co.uk

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# Outline tax comparison of Employee Share Incentives

<table>
<thead>
<tr>
<th>EVENT</th>
<th>SHARES</th>
<th>UNRESTRICTED SHARES</th>
<th>RESTRICTED SHARES (indefinite restriction &gt; 5yrs)</th>
<th>UNAPPROVED OPTION</th>
<th>APPROVED CSOP OPTION</th>
<th>EMI OPTION</th>
<th>USR (Joint Share Ownership) (See Example 2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GRANT OR PURCHASE</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>EXERCISE</td>
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<tr>
<td>&quot;CHARGEABLE EVENT&quot; e.g. restriction removed or varied</td>
<td></td>
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</tr>
<tr>
<td>DISPOSAL OF SHARES (another chargeable event)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## UNRESTRICTED SHARES
- Income Tax ("IT") on unrestricted market value ("UMV") less price paid for the shares
- Ownership period starts for entrepreneurs’ relief
- NIC on under value if the shares are readily convertible assets

## RESTRICTED SHARES
- IT on restricted market value ("RMV") less price paid
- CGT and NIC as for unrestricted shares

**ITEPA election made within 14 days of acquisition:**
- UMV – RMV = "Discount" subject to IT
- Future growth in value ("GIV") within CGT, not subject to IT; or
- No election

## UNAPPROVED OPTION
- No IT

## APPROVED CSOP OPTION
- No IT provided the option cannot be exercised more than 10 years after grant

## EMI OPTION
- No IT provided the option cannot be exercised more than 10 years after grant

## USR (Joint Share Ownership)
- IT on unrestricted market value ("UMV") less price paid for the USR
- NIC on under value if the shares are readily convertible assets
- NB: if UMV paid by employee for the USR, no IT or NIC

**ITEPA election made with 14 days of acquisition**

## GRANT OR PURCHASE

### N/A

## EXERCISE

### N/A

## "CHARGEABLE EVENT" e.g. restriction removed or varied

### U MV x % Discount (for restriction removed) subject to IT

## DISPOSAL OF SHARES (another chargeable event)

### Gain is subject to CGT after annual allowance, currently £9,600
- Entrepreneurs’ relief may be available

### UM V x % Discount for any remaining restriction subject to IT
- Balance within CGT
- Entrepreneurs’ relief may be available

### RESTRICTED SHARES – No election

### UM V x % Discount for restriction removed subject to IT

## "CHARGEABLE EVENT" e.g. restriction removed or varied

### RESTRICTED SHARES – No election

### UM V x % Discount (for restriction removed) subject to IT

### REstricted shares – No election

### If shares restricted and no ITEPA election – consider IT
- Gain is subject to CGT after any annual allowance, currently £9,600

### Gain is subject to CGT after annual allowance, currently £9,600

### If shares restricted and no ITEPA election consider IT
- Gain is subject to CGT after annual allowance, currently £9,600

### Gain is subject to CGT after annual allowance, currently £9,600

## NB
- If option shares are restricted, see acquisition of restricted shares and consider ITEPA election