Employment - Overview of UK Share Option Schemes

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The Basics for Overseas Businesses

In the UK, the granting or exercising of share options, as well as the gift of existing shares to employees or directors, are taxable events which can lead to an employer/employee facing tax bills of up to 65% of any share value.

To avoid this exposure, it is vital to take professional advice and to consider adopting one of H. M. Revenue & Customs ("**HMRC**")'s approved tax-efficient option plans discussed in this Quick Guide.

Unapproved share options

Where a company grants share options to its employees without using one of the share option schemes approved by HMRC, the employee will be subject to Income Tax via Pay-As-You-Earn tax ("**PAYE**") and potentially National Insurance contributions ("**NI**") (i.e. social security payments) when they exercise the option, meaning that they convert the option into shares. At this time, the employer may also need to make an NI contribution.

It is possible to elect to transfer the employer's liability for the payment of NI contributions to the employee, but the election has to be approved by HMRC (please see 'Joint Elections' below).

In order to mitigate such charges, HMRC has approved a number of schemes to reduce the tax liability attributable to awarding share options.

Approved share option schemes

There are currently four HMRC approved share option schemes available. These are:

1. Share Incentive Plan (**SIP**)
2. Save as you Earn (**SAYE**)
3. Company Share Option Plan (**CSOP**)
4. Enterprise Management Incentive (**EMI**)

The first two of these, SIP and SAYE, are relatively low value schemes which are usually only used by very large organisations to incentivize a sizeable workforce. Where adopted, these schemes must be made available to all employees, including part-time employees who should be treated in the same way as full-time employees on a pro-rata basis.

The CSOP and EMI schemes are discretionary schemes allowing a significant award of share options with more favourable tax treatment than unapproved schemes.

1. Share Incentive Plan (SIP)

If a company decides to set up a SIP, it can choose to offer one of four types of SIP shares to its employees or a combination of these. The four types of SIP shares are: (i) free shares, (ii) partnership shares, (iii) matching shares, and (iv) dividend shares. Please note that in each instance it is actual shares being provided as opposed to options over shares.

The company is entitled to provide each employee with "**free shares**" up to a value of £3,600 per year with no income tax or NI consequences. Free shares can be awarded by reference to an employee's pay grade, performance, length of service, or hours worked.

Employees may also instead be offered the opportunity to purchase £1,800 or 10% of your income for the tax year, whichever is lower of "**partnership shares**" per year out of their pre-tax and pre-NI salaries. The company may then match these at a ratio of up to two "**matching shares**" for each partnership share purchased by the employee, effectively allowing a further £3,600 worth of 'free shares' to be given by the company each year.

The company may also permit an employee's dividend income to be reinvested and used to purchase further "**dividend shares**" in the company. There is no Income Tax charged on the dividends that are paid out.

All shares held under the scheme must be ordinary, non-redeemable and fully paid-up, but they can be subject to voting and disposal restrictions, and will also need to be held for at least five years before being sold.

The company will need to set up a trust to hold the shares, for a holding period between three and five years. However, Corporation Tax Relief can be obtained by the company for the cost of setting up and administering the scheme.

2. Save as you Earn (SAYE)

The SAYE scheme again has to be made available to all employees. However, the company can specify a qualifying period of employment of upto five years.

Under the scheme, employees are granted options to buy ordinary, fully paid and unrestricted shares (including voting rights) after three or five years' of service with the company at a discount of up to 20% of the current market value.

The employees will contribute between £5 and £500 per month for either three or five years in order to purchase the shares at the end of the option period. In effect, this means that the potential maximum value of shares under the scheme is £36,000 based on current market value (i.e. £500 x 60 months with 20% uplift).

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Provided that the minimum option period of three years is observed, there is no Income Tax charge on the grant or exercise of the option.

Companies will receive Corporation Tax Relief on the cost of establishing and administering the scheme, and at the date on which shares are issued.

3. Company Share Option Plan (CSOP)

CSOP's are discretionary insomuch as the employer company can choose which employees and directors it wishes to reward.

The maximum option-value is £30,000 per employee based on the market value at the date of the grant. The option period must be between 3 and 10 years.

Income Tax and NI are not due when the option is granted or exercised, making this scheme very tax efficient, however, a potential barrier to its use lies in the fact that any options issued must be in the ultimate parent company of a group, and must be of the same class as those held by the group controllers, and will not be subject to any restrictions in terms of voting rights, etc., thereby giving significant influence to any holders who exercise their option over shares.

4. Enterprise Management Incentive (EMI)

The EMI scheme is perhaps the most attractive approved scheme because it allows for up to £3 million of company share options to be granted to employees.

Individual employees may each be granted options up to a market value of £250,000, (calculated to take into account the value of any CSOP shares that may have already been issued to that employee).

The chief benefit of using an EMI Scheme is that no Income Tax or NI contributions are charged on the grant of EMI options, and, provided that (i) the exercise price is at least equal to the market value at the date of grant, and (ii) the options continue to qualify until the date of exercise (which must be within ten years from the date of grant), then there will also be no Income Tax or NI charge at the point of exercise.

Any cash cancellation payment paid in lieu of exercising the options will not enjoy the same tax treatment and will be subject to Income Tax and NI. Further, if options are granted at a discount on the market value, then there will be an Income Tax charge on the difference between the actual price paid at the time of exercise and the market value at the date of grant, together with a likely NI charge.

As with the CSOP, the EMI scheme is discretionary, and the options have to be for ordinary, irredeemable and fully paid-up shares in the ultimate group parent company. Unlike the CSOP, there are various eligibility criteria that must be met by both the company and its employees in order to qualify for the EMI scheme. Eligible employees must work for the company for at least 25 hours a week or 75% of their working time, and must not own more than 30% of the company.

Additionally, the employer company has to comply with a number of restrictions, so that at the time of grant, the gross assets of the group must not exceed £30,000,000 and the group as a whole must not have over 250 employees. The company must also be either (i) trading; (ii) carrying out a 'qualifying trade'; or (iii) be the parent company of a trading group. In this context, 'non-qualifying' trades include dealing in land, financial trading, receiving royalties, leasing, property development, hotel management and similar high-end asset-backed businesses. Other restrictions also apply depending upon the activities of the business.

As an additional incentive to usage of the EMI scheme, the exercise of EMI option shares fall within the 10% tax band entrepreneurs' relief for Capital Gains Tax purposes.

For more information on this topic please see our separate Quick Guide found here

Joint Elections

It is possible to complete a joint election to transfer the liability for payment of the employer's NI contributions arising on the exercise of an option, from the employer to the employee. Joint Elections are not enforceable unless they have been pre-approved by HMRC. Please note that where such an election is not made, the employer will have an unknown liability to consider and disclose in its annual accounts, which can create problems for accounting purposes.

Further information

When considering issuing share options to employees, it is imperative that careful consideration is given to the various schemes available to ensure that the most tax efficient method and commercially suitable plan is chosen.

Oury Clark would be happy to assist and advise you in this process, so if this is an area which you would like to receive further information, then please contact us to arrange a meeting.

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