



# Employee share incentives in the UK



## **Executive summary**

Many companies, both listed and unlisted, establish share incentive schemes to enable employees and senior executives to become shareholders in the business for which they work. There are several types of scheme which are commonly implemented. Some schemes – particularly those which are available to a wide range of employees – attract generous tax reliefs.

Companies will have different objectives in designing a scheme. A private company which is approaching flotation may prefer schemes that not only enhance employees' opportunities to participate in the flotation but also lock them in for a period after flotation. A closely held private company may wish to allow employees to share in the capital growth of the company but will be concerned about dilution and a market for the shares. Each of them will have different objectives and concerns to those of an established listed company which may be prepared to operate more complex and varied arrangements. It may be seeking wider employee participation or want to supplement or replace existing schemes for its senior managers and executives.

This guide looks at the main types of share incentive scheme, concentrating on schemes which a listed company, or a company about to float, may wish to introduce.

### **Arrangements for executives**

Executive share option schemes have been used for many years by companies listed on the London Stock Exchange. Options granted under an executive scheme between 1984 and 1995 attracted generous tax relief, as a result of which no income tax charge normally arose on exercise of such options. Most listed companies adopted such schemes. In 1995 the tax relief was restricted, thus 'levelling the playing field' between executive share options and other share incentive schemes for executives. Important changes in tax treatment were also made in 1999 and 2003. The main features of executive share option schemes are described in section 2.

UK institutional shareholders in listed companies have developed detailed guidelines governing the usage of share options. These generally require a challenging corporate performance target to be satisfied before an option may be exercised – thus preventing an executive from benefiting from share price increases unless the company can demonstrate the achievement of demanding financial performance. In addition, the guidelines recognise that options are part of the annual remuneration package and should be granted on a phased basis rather than in a single block. They also impose limits on

the dilution of equity arising from share issues on exercise of options.

In 1995 the Greenbury Report recommended the use of a wider range of long-term share incentive schemes (rather than share options). Long-term incentive plans (LTIPs) are described in section 3. Many companies now operate both LTIPs and executive option schemes.

Companies also operate bonus matching schemes, under which executives receive part of their annual bonus in shares, on terms that extra shares will be provided if the underlying shares are retained for a number of years (and, usually, a performance condition is achieved) – see section 4. These schemes need not be linked to bonuses, and then operate as co-investment schemes.

There is also a trend towards requiring executives to build up significant shareholdings in their company in return for share scheme participation, so that their interests are more closely aligned with those of shareholders – see section 5.

To complete the picture, a highly tax-favoured discretionary share option scheme, the enterprise management incentive scheme (EMI scheme) is now available for small companies. This is designed broadly for entrepreneurs working in small high risk companies. EMI schemes are described in section 6.

#### **All-employee arrangements**

The UK government continues to provide generous tax reliefs to encourage share ownership by a company's workforce. Two main types of tax-favoured share scheme are now available and these are widely used by listed companies. They are:

- the savings-related share option scheme (or sharesave scheme) under which employees are granted an option to buy shares on favourable terms, using the proceeds of a savings account; and
- the share incentive plan (SIP) which involves three potential types of share allocation:
  - free shares – allocations of free shares to employees;
  - partnership shares – shares which employees may buy out of pre-tax salary; and
  - matching shares – free shares to match the partnership shares bought by an employee, on the basis of up to two free shares for every one partnership share bought.

Both of these schemes require Inland Revenue approval. Sharesave schemes and SIPs are described in sections 7 and 8, and their main features are compared in the appendix.

The SIP has grown out of the profit sharing scheme (PSS), which was introduced in 1979 to permit an outright distribution of shares to employees. However the PSS is being phased out: the last date for a tax-favoured appropriation of shares under a PSS was 31 December 2002.

**General**

Sections 9 and 10 deal respectively with the possibility of ‘paying’ non-executive directors in the form of shares, and alternative means of providing shares to satisfy options and corporation tax deductibility.

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## 1. Guidelines issued by institutional shareholders

Listed companies operating employee share schemes are expected to adhere to various guidelines and codes of best practice. This is because institutional shareholders are concerned to regulate and control the cost of such schemes – which is effectively borne by them as shareholders. These include:

- the Combined Code, reflecting the recommendations of the Higgs, Smith, Cadbury, Greenbury and Hampel Reports. The Combined Code, which is appended to the Listing Rules of the UK Listing Authority, was amended in important respects in July 2003. In their annual report, listed companies must confirm their compliance with the Combined Code, and justify any areas of non-compliance; and
- the guidelines issued by the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) which cover many practical aspects of share schemes' operation.

Compliance with these guidelines has been reinforced by the need for listed companies, from 2003 onwards, to obtain shareholder approval annually for their directors' remuneration report.

### **Corporate governance aspects**

The remuneration of directors of listed companies has been a political hot potato for a decade, and there have been frequent allegations that option schemes and LTIPs do not align participants' rewards with corporate performance. Schedule A to the Combined Code seeks to achieve this by setting out a number of provisions that companies should adhere to when designing performance-related remuneration. The key provisions are as follows.

- Listed companies that are putting in place a share incentive scheme should seek shareholder approval for the scheme if directors participate or if the scheme involves a new issue of shares. Such a scheme should preferably replace an existing scheme or form part of a well-considered overall plan. A private company approaching flotation which is adopting schemes to be operated post-flotation can do so without the need for shareholder approval.
- The eligibility of directors to participate in share incentive schemes should be considered by the Remuneration Committee.
- Options granted and awards made under share incentive schemes should not vest for at least three years. Directors should then be encouraged to retain the shares arising from their options or awards for a further period, subject to the need to sell sufficient shares to cover the cost of their acquisition and any tax liability that arises.

- Grants under all incentive schemes should be subject to challenging performance criteria reflecting a company's objectives. Grants under such schemes should be phased rather than awarded in one block.
- Benefits under share incentive schemes should not be pensionable.

#### **ABI guidelines**

The 'guidelines for share incentive schemes' issued by the ABI – most recently in December 2002 – are a comprehensive statement of institutional investors' guidelines for developing and implementing share incentive schemes. These guidelines constitute the 'rule book' for judging the acceptability of listed companies' share schemes. In operating an employee share scheme, a listed company is expected to adhere to both the spirit and the letter of the guidelines.

Many companies discuss their schemes in advance with the ABI, especially if there are potentially contentious features. Great care is needed in balancing the 'risk/reward' ratio of a scheme. Although some schemes come under fire for being too generous to key executives, institutional shareholders will back generous schemes where it is clear that demanding performance targets align executives' interests with those of shareholders.

Some features of the guidelines are as follows.

#### **Equity dilution**

The guidelines limit the percentage of new equity available under share schemes. The following limits are designed to protect existing shareholders by restricting the dilutive effect of share issues under share schemes:

- not more than 10 per cent of a company's equity may be issued or issuable under options granted or allocations made under *all types* of scheme in any 10-year period; and
- not more than 5 per cent of a company's equity may be issued or issuable under *executive or discretionary* share schemes in any 10-year period. This 'inner' limit may be exceeded where vesting is dependent on achievement of a more stretching performance condition with full vesting requiring at least top-quartile performance, or where a discretionary scheme has fairly widespread participation among employees.

The above percentages relate to newly issued equity. Options can also be satisfied using transfers of existing shares (eg from an employee trust), and such shares do not count towards the above limits because they are not equity dilutive. The ABI's current view is that shares transferred from treasury should count towards these limits.

Until recently, the ABI guidelines contained detailed flow-rate limits, in addition to the overall percentage limits, that companies were required to adhere to during the ten-year period referred to above. Remuneration committees are now required to ensure that ‘appropriate policies regarding flow-rates exist’ in order to spread the shares available evenly over the life of a scheme.

#### **Phasing of grants**

The ABI now recognises that options form part of an executive’s annual remuneration package. The guidelines strongly encourage the adoption of phased grants made on an annual basis. The guidelines had until recently recommended that the value of outstanding (unexercised) options granted to an executive should not exceed four times his annual remuneration. This no longer applies. An annual limit is now the norm, the level of which needs to reflect the severity of the applicable performance target (see section 2).

#### **Recognition of the cost of the scheme**

The guidelines state that the financial cost of a share scheme should be disclosed at the time shareholder approval for the scheme is sought, including:

- the potential value of awards due to individual scheme participants on full vesting;
- the ‘expected value’ of an award at the outset bearing in mind the probability of achieving the stipulated performance target (any facility for retesting of the target being seen as increasing the expected value). This effectively involves taking a Black Scholes valuation for an option, and then discounting this to reflect the likelihood of the performance target being met. Obviously an option with a tougher target has a lower value of grant than an option with a softer target; and
- the maximum dilution which may arise through the issue of new shares to satisfy options.

Other institutional guidelines are explained in the rest of the guide.

#### **Shareholder approval for the directors’ remuneration report**

From 2003 the Directors’ Remuneration Report Regulations 2002 require listed companies to disclose extensive information about directors’ remuneration. This covers both policy matters (for example, why a performance condition was selected for an option scheme) and detailed factual information about share schemes and other matters. In addition, shareholders must vote on the remuneration report as an ordinary resolution at the company’s

AGM. Although the vote is only advisory a negative vote is effectively a no confidence motion in the Remuneration Committee.

## 2. Share option schemes

Share option schemes are a popular method of providing share incentive arrangements for executives. Under a share option scheme an employee is granted an option over a number of shares – that is, he is granted the right to acquire those shares at a future date (generally, between three and ten years after grant) at a price fixed at the date of the grant (usually the market price at that date). The employee thus benefits from any increase in share price between the date when the option is granted and the date it is exercised.

Since 1995 the tax benefits of Inland Revenue approved share option schemes have been restricted to the first £30,000 of options (measured in terms of the exercise prices of unexercised approved options). Such schemes are now used to provide the foundation layer for executive options (the excess over the £30,000 limit being granted under an unapproved scheme), and as self-standing schemes for more general participation by employees.

The following paragraphs describe, respectively, the main features of share option schemes which are not approved by the Inland Revenue, and those which are approved (that is, those which operate within the £30,000 limit). Both kinds of scheme can be operated on a wholly discretionary basis, in contrast to Revenue approved sharesave schemes or SIPs.

### **Unapproved share option schemes**

Maximum flexibility is achieved under unapproved arrangements – for example, flexibility as to the number of shares under option, the option terms and the absence of a need to meet the statutory conditions which apply to Revenue approved schemes.

The main features of a typical unapproved option scheme (by reference to the ABI guidelines) are as follows.

- Options should be granted only to bona fide employees and executive directors of a company or its subsidiaries, and should not be granted to non-executive directors.
- Options normally become exercisable in full on the third anniversary of the date of grant (provided any applicable performance condition has been met), and normally remain exercisable until the tenth anniversary of grant. This contrasts with typical US practice, under which options normally vest in tranches from the first anniversary of grant.
- Grants of options must be on a phased basis, rather than in a single tranche (for example, on commencing employment).

- The shares under option may be purchased at a price fixed at the time of grant (the exercise price). This exercise price must not be at a discount to the shares' market value at the date of grant.
- The exercise of options must normally be subject to the satisfaction of performance conditions set by the Remuneration Committee of the company. These should demonstrate the achievement of stretching and demanding financial performance of the company. There are broadly two types of performance target – *internal* targets which compare the company's year-on-year performance and *external* targets which compare the company's performance over a period to that of other comparable companies or the constituents of an index (such as the FT-SE 100 index).

Most option schemes adopt the first type of target, normally requiring the company's earnings per share growth over the three-year period prior to the exercise of the option to exceed a fixed percentage per annum margin over retail price inflation – the percentage margin being designed to set a challenging expectation by the company of its financial performance. The traditional 3 per cent annual margin is now insufficient where options are granted on a generous basis (in terms of salary multiple). If the target is satisfied, the option remains exercisable for the remainder of the option period irrespective of subsequent corporate performance. The practice used to be for there to be opportunities for the target to be retested using a moving base year (comparing years 0-3, then 1-4, 2-5 etc). However, the ABI guidelines now require that, if there is to be retesting of a performance target, this should be from a fixed base year (comparing years 0-3, then 0-4, etc). Any retesting should be of limited duration (for example, one or two annual retests only) and be sufficiently demanding to ensure that genuine performance has been achieved over the extended period.

The second comparative type of target is strongly preferred by the ABI. For the target to be satisfied in full, this normally requires the company's 'total shareholder return' (that is, share price growth plus the value of reinvested dividends) over the three-year period from the grant of the option to place the company in the top quartile (ie top 25 per cent) of the companies in the comparator group. This type of target is similar to that used under an LTIP – see section 3.

Any performance condition adopted by a company is required to be measured over a period of three or more years. The adoption of longer performance measurement periods and deferred vesting schedules is encouraged.

The ABI now recognises that it is unusual outside the UK for the *exercise* of an option to be dependent on meeting a performance

target. The guidelines now permit the performance condition to be applied prior to the *grant* of options, but only if, among other things, the company can clearly demonstrate that it is operating in a global environment which genuinely requires it to pay attention to international recruitment practice. The use of pre-grant performance conditions is relatively rare.

- The option usually lapses if the employee leaves employment before it becomes exercisable – although there is usually a 6 to 12 month post-leaving exercise period if the employee leaves as a ‘good leaver’ (retirement, ill-health, redundancy, etc).
- Options normally become exercisable early if the subsidiary for which the employee works is sold out of the group or there is a takeover of the parent company. The ABI recommends that in the event of a change of control options should only be exercisable to the extent the performance target has been satisfied, with the Remuneration Committee having power to adjust the outcome to bring about a result which reflects the company’s underlying performance. In the event of a takeover, the scheme rules also normally permit an employee to exchange his options for equivalent options over the acquirer’s shares (assuming the acquirer consents).
- The scheme must be approved by the company’s shareholders and should not be capable of granting options more than 10 years after such approval.

### **Tax treatment of unapproved options**

#### **Income tax**

No income tax charge arises at the time of *grant* of the option irrespective of the period for which the option can be exercised.

There is also no income tax charge when the option ‘vests’ ie first becomes exercisable. The employee is charged to income tax at the time of *exercise* of the option irrespective of whether he retains the shares acquired on exercise. Income tax is charged on the employee’s gain on exercise – the excess of the market value of the shares acquired on exercise over the amount paid for the shares.

Income tax is currently charged at 40 per cent on taxable earnings above around £30,000.

As an exception to the above regime, options granted to employees who are ‘resident but not ordinarily resident’ in the UK are liable to income tax in respect of the value of the option at grant.

Income tax is also chargeable where an option is cancelled or assigned in return for a payment. No charge to income tax normally arises where an option is exchanged for another option.

For option grants after November 1996, where the shares under option are 'readily convertible assets', this income tax liability must be accounted for under PAYE (deduction of tax at source). Most schemes expressly provide that the company is authorised to sell on the employee's behalf a proportion of the shares acquired on exercise, as the company is otherwise only permitted to withhold from the employee's normal earnings for the relevant month.

A share will be treated as a readily convertible asset if:

- it is capable of being sold on a 'recognised investment exchange'. This currently includes the London Stock Exchange, New York Stock Exchange and markets established by the London Stock Exchange (AIM and Tradepoint); or
- there are 'trading arrangements' in existence in relation to the shares under option or such 'trading arrangements' are likely to come into existence in accordance with any arrangements or understanding existing at the time. The reference to 'trading arrangements' will cover shares on overseas stock exchanges.

#### **Capital gains tax**

Any further growth in the value of the shares between exercise and the disposal of the shares will normally be subject to capital gains tax (CGT).

Although CGT is currently charged at similar rates to income tax, CGT is subject to a number of exemptions and reliefs, notably that (a) the first £7,900 (for the tax year 2003-04) of gain in a tax year is exempt from CGT, (b) if the employee retains the shares after exercise, they will attract taper relief when the shares are sold which reduces the percentage of the gain which is chargeable to CGT (the effective tax rate will, in appropriate cases, now only be 10 per cent after two years' ownership), and (c) transfers between spouses do not generally attract CGT.

#### **NICs**

Options granted prior to 6 April 1999 do not attract national insurance contributions (NICs – UK social security) unless the option exercise price is at a discount to the shares' market value at the grant date (which would be unusual). However, for options granted after 6 April 1999, the gain realised on exercise – computed in the same way as the employee's gain for income tax purposes – will attract NICs. In most cases, this will largely be a charge for the employer, not the employee. This is because an employer's NICs liability (currently charged at 12.8 per cent of earnings) is uncapped. In contrast, except for a new 1 per cent charge above the cap, an employee's NICs liability is capped by reference to annual earnings

and most holders of such options earn above the cap (around £30,000 per annum).

As a general rule, an employer may not recover its NICs liabilities from its employees. An exception to this rule applies to gains on options arising on or after 28 July 2000. The employer and employee may agree that the employer may recover its NICs liability from the employee. The way in which the employer is reimbursed, ie deduction from earnings or sale of shares arising from the exercise, is a matter for agreement between the employer and the employee. Where such an agreement is entered into, the employee will receive relief from income tax for the amount of employer's NICs borne by him upon exercise of the option.

In relation to options granted between 6 April 1999 and 19 May 2000, employers were able to give notice, no later than 11 August 2001, to cap the amount of NICs liability in respect of such options. The NICs liability was crystallised by reference to the market value of the shares under option on 7 November 2000 (as if the option had been exercised on this date). Where such an election has been made, any further gain that is realised on exercise will not attract any further NICs.

#### **Approved share option schemes – CSOPs**

Inland Revenue approval is needed for this type of scheme to which the £30,000 limit described above applies; these are known as Company Share Option Plans (CSOPs). Various conditions must be satisfied in relation to such a scheme, including notably the following.

- The typical features set out above in relation to unapproved share option schemes also apply to an approved share option scheme. These requirements remain relevant because the institutional guidelines from which they derive also apply to approved schemes. In order to qualify for Inland Revenue approval and therefore be eligible for favourable tax treatment, the scheme must also have the additional features set out below.
- The aggregate exercise prices of all outstanding (unexercised) *approved* options held by any individual at any one time must not exceed £30,000. (Where the exercise price exceeds the shares' market value at grant, the £30,000 limit relates to the shares' market value at grant rather than the exercise price.)
- The exercise price of an approved option must not be 'manifestly less' than the market value of a share on the date of grant – in other words, it cannot be granted at a discount.

- The shares used must satisfy certain statutory criteria – they must be fully paid up ordinary shares in a quoted company, or a company not controlled by another company, or a company controlled by a quoted company.
- The shares acquired under the scheme must not be subject to ‘restrictions’ – for example, it is not possible for the grantor to have a blanket right to repurchase shares on exercise.

Companies are increasingly extending this type of scheme to a significant proportion of their workforce – effectively providing an element (in many cases) of tax-free long-term pay to employees, under more flexible arrangements than a sharesave scheme offers.

### **Tax treatment of approved options**

#### **Income tax and NICs**

The main difference to an unapproved scheme is that no income tax or NICs charge arises on exercise of the option, provided the option is exercised between the third and tenth anniversary of grant.

If an option exercise occurs before the third anniversary of grant, a charge to income tax and NICs arises on the employee’s gain on exercise unless the employee ceased to participate in the scheme for a ‘good leaver’ reason (injury, disability, redundancy, or retirement at or above age 55). The tax benefit for good leavers is only available if exercise occurs within six months of the leaving date.

Scheme rules sometimes permit ‘early good leavers’ to exercise for a longer period (eg twelve months, or a time period linked to testing of a performance target). Exercise after six months (but before qualifying for tax relief after three years from grant) will attract income tax and NICs.

Early exercise often results from events outside the employer’s control – such as a takeover of the employer’s parent company, or the sale of the employer outside the parent’s group. These events seldom fall into the ‘early good leaver’ tax exemption described above (the main exception being where a business sale under TUPE also qualifies as a redundancy under the *Chapman v CPS Computers* principle).

Where an income tax charge arises, this will be calculated in the same way as for an unapproved option. The income tax and NICs charge must be accounted for under PAYE and both employer’s and employee’s NICs will become due on exercise. The company must operate PAYE to collect both the income tax and NICs liabilities.

The charge to NICs and the collection of income tax under PAYE on early exercise of options were introduced by the Finance Act 2003. The charges are retrospective and affect all subsisting and future

CSOP options. Scheme rules will now need to ensure that the employing company has the power to make the necessary arrangements for payment of PAYE upon exercise. Employers will be able to transfer their potential NICs liability to an employee by the way of the procedure described above for unapproved options. In the case of existing options the employee would need to consent (and care would need to be taken in persuading him to do so). For future option grants, the terms of grant could require the employee to bear any NICs liability.

Before April 2003 there were tougher conditions attaching to tax-favoured exercises: first, 'good leavers' exercising before the third anniversary of grant were subject to income tax; secondly, a three year window had to be left between two successive tax-favoured exercises. The flipside of the improved income tax treatment of early exercise by good leavers introduced by the Finance Act 2003 is the new NICs charge for other early leavers.

#### **Capital gains tax**

If an option is exercised at a time when no income tax arises CGT may, instead, be charged at the time the shares acquired on exercise are sold. The charge to CGT will arise on the gain arising on sale of the shares – being the excess of the disposal proceeds over the exercise price of the option.

As mentioned above, although CGT is currently charged at similar rates to income tax, it attracts a range of exemptions and reliefs and therefore offers a more favourable tax regime.

### 3. Long-term incentive plans

#### The present position

Following the Greenbury report in 1995, which recommended that companies place a greater emphasis on other types of long-term incentive scheme, there was a move away from share option shares as a method for rewarding executives towards long-term incentive plans (LTIPs). The main criticisms of the Greenbury report were that options conferred windfall gains reflecting general market movements and did not encourage directors to become long-term shareholders in the company.

Despite the Greenbury report, companies are increasingly reverting to share option schemes, often in conjunction with LTIPs. Where an executive does participate in both an option scheme and an LTIP in any year, the ABI requires that the participation should form part of a well considered remuneration policy. Participation in more than one scheme should not be designed to raise the prospects of payout – grants and awards under each should be scaled back accordingly to reflect the fact of participation in more than one scheme.

Although there is considerable flexibility in designing LTIPs, there are a number of common features. These include the following.

- They are often targeted at the most senior level of management.
- Awards are usually made on a rolling annual basis with three-year performance periods. An executive is typically promised delivery of the shares at a future date, usually at no cost, provided certain conditions are met. These conditions are usually two-fold – meeting performance criteria, and remaining in service for a set period (often three years).
- The executive benefits from any growth in the value of the shares which accrues during the deferral period. There is normally no exercise price; the shares are effectively free, so the executive profits from the whole value on release, not just the increase above the grant price, as is the case with an option scheme.
- Awards are usually subject to more stringent performance conditions than share options. Most FT-SE 100 companies operating an LTIP use growth in the company's 'total shareholder return' (share price growth plus the value of reinvested dividends) compared to that of a comparator group over the performance period as a performance measure. The identity of the companies in the comparator group is often the subject of debate. The FT-SE 100 constituents at the time of grant is a common group. Some companies prefer to measure themselves against a basket of competitors, or at least a market sector, to ensure that they will be

compared against companies with a similar economic cycle. In accordance with institutional investor guidelines, awards should not begin to vest at less than median performance within the comparator group. If performance is below median, no award vests. There is a ceiling – usually upper quartile performance – at which all shares vest. There will usually be proportional vesting where the actual performance falls between those two points.

- Many schemes also have a secondary internal performance measure (such as requiring the company's earnings per share to achieve a small margin over retail price inflation over the performance period) as an additional hurdle to the vesting of the award. The ABI has consistently advocated this on the basis that the company should be required to improve performance in absolute terms, not just improve its position against the comparators. This hurdle (which is similar to that used by many option schemes) should be easier for a company to clear than the main target described in the previous paragraph.
- Once the award vests, the number of shares to be released to the participant can be ascertained (and the tax charge usually arises at this point).
- Generally, awards are satisfied with existing (rather than newly issued) shares using a discretionary employee benefit trust to hold the shares. The company will need to finance the trust (by loan or gift) to hedge all or part of the obligations to transfer shares to the executive on maturity. There will normally be a profit and loss account charge for the value of the shares involved (this contrasts to the advantageous accounting treatment of share options – but it is possible that this may be withdrawn in the next year or so).

#### **Tax treatment**

There is no favourable tax regime: the tax treatment depends on how an award is structured. There are two main alternatives, as follows.

*Nil cost option* – an option to acquire shares at no cost. Where a nil cost option has been granted under an LTIP, the executive is normally charged to income tax on the value of the shares he receives when he exercises his option to call for the shares following vesting. The tax treatment is the same as for an unapproved option (see section 2 above). Accordingly the income tax charge will be deducted at source under PAYE.

On disposal of the shares, CGT will be payable on the difference between the sale price and the base cost of the shares (the market value of the shares on the date of exercise) although exemptions and reliefs may be available (see section 2).

In addition, the exercise of a nil cost option will give rise to a charge to NICs on the value of shares on exercise (see section 2).

- *Award of 'restricted securities'* – here the executive is awarded the shares outright but on the basis that the shares may be forfeited if the performance conditions are not met or the executive does not remain in service for a set period. The executive will become the legal and beneficial owner of the shares from the date of the award, although they will remain subject to a risk of forfeiture.

The tax treatment of restricted securities has been modified by the Finance Act 2003. The starting point is that restricted securities are taxed on grant on their restricted value (ie the reduced value as a result of the restriction) and again on the portion of the unrestricted value which was not originally taxed when the restriction lifts.

However, where the shares cease to be restricted within five years of the date of grant because the risk of forfeiture is lifted within that period (which will usually be the case as performance targets and/or the requirement to remain in service typically only apply for three years from the date of award) the shares are exempt from taxation on grant and will be only taxed when the restriction is lifted (usually when the executive becomes unconditionally entitled to the shares).

- Assuming the shares cease to be restricted securities within five years of the date of grant, there will be a charge to income tax on the value of the shares when the risk of forfeiture falls away – that is at the end of the performance period – or when the shares are sold (if earlier). The employee may, however, elect to pay income tax upfront on either the full value of the shares as if they were not subject to a risk of forfeiture or on the restricted value of the shares. If the employee elects to pay income tax on the full value, the shares will not be subject to further income tax when the risk of forfeiture falls away (but the executive will not be entitled to any refund if he loses his right to acquire the shares). Where income tax was paid upfront on the restricted value only the shares will be subject to income tax on the portion of the value which has not yet been taxed when the risk of forfeiture falls away. This income tax charge will be deducted at source under PAYE.
- There will also be a charge to NICs on the value of the shares when they cease to be subject to a risk of forfeiture – see section 2. However, at present, unlike an unapproved or nil cost option, the employer cannot seek to recover its liability to NICs from the employee.
- For CGT purposes, the base cost will be the shares' market value when they cease to be subject to a risk of forfeiture. Thus, if all the shares were sold at this point, there would be no charge to CGT.

However, the qualifying period for CGT taper relief commences from the time the executive becomes the beneficial owner of the shares – that is when the shares are awarded to him – even though the shares are within the scope of income tax until they cease to be subject to a risk of forfeiture. This contrasts to an option where taper relief will only begin to accrue if the shares are retained following exercise of the option.

## 4. Bonus matching schemes

At its simplest, the objective of a bonus matching scheme (BMS) is to encourage an executive to remain in employment by permitting or requiring him to defer all or part of his annual bonus, which is then invested in shares. In return for retaining those shares for a set period, and remaining in employment (and usually the company achieving a performance target), the executive will receive a number of 'matching' shares after the set period. Accordingly, the executive benefits from any increase in value of both categories of shares.

There are many variations on the above theme, including the following.

### **The executive's investment may be de-coupled from bonus**

A linkage to bonus is logical, as it restricts the value of the executive's eventual matching reward to bonus earned in the original bonus year. However, schemes are increasingly permitting executives to deposit existing shareholdings and/or permit participation in excess of annual bonus. These are better described as 'co-investment' schemes, but the concept is similar. Alternatively, these schemes can be regarded as an LTIP which requires the participant to build up a significant shareholding in the company.

### **The ratio of purchased: matching shares**

This typically varies between 1:1 and 4:1, but the appropriate ratio depends on a number of factors, including the generosity of the underlying bonus scheme, length of the retention period and severity of the corporate performance target linked to the matching shares. Some recent co-investment schemes have had a maximum matching ratio of four or five times the purchased share element – but matching at this level is dependent on exceptional TSR performance relative to a peer group; for sub-median performance the matching ratio might be zero. For these reasons, comparisons of 'headline' matching ratios are misleading.

### **Performance conditions attached to the matching shares**

In most modern BMSs, the matching element is conditional on company performance during the retention period. This can be a modest hurdle (for example, 3 per cent per annum real EPS growth), in which case a modest matching ratio would be appropriate. As mentioned above, a tough hurdle can, for exceptional performance, justify a high matching ratio. Some matching schemes are still in operation which have no performance hurdle (and generally have a modest matching ratio). This reflected traditional thinking that the bonus had been 'earned' in respect of a single year, and the matching element should be dependent solely on continued service. In recent

years, the ABI's view that a performance condition should apply to the matching shares has prevailed.

**The retention period prior to release of the matching shares**

A period of three to five years is customary, perhaps with a greater number of shares being available after the longer period.

**The desired tax profile**

A BMS does not attract favourable tax treatment: the executive will be subject to income tax on both the purchased and matching elements. However, there is some flexibility as to the timing of the tax charge.

There are two main alternatives.

**Route 1**

The executive invests his bonus (or his co-investment) in shares on a post-tax basis (that is, buying shares out of money which has suffered income tax under PAYE and NICs), but suffers income tax and NICs on the matching shares only if and when they are received. The number of matching shares to which he is entitled (which is usually structured as a nil cost option) is calculated on the basis of the pre-tax amount of bonus invested (to reflect the fact that those matching shares will be taxed in due course).

**Route 2**

The executive invests his bonus on a pre-tax basis. This may involve the executive 'sacrificing' part of the bonus before it is received, instead receiving a nil cost option to acquire both the bonus element *and* the matching element (to the extent it is due) at maturity. Income tax and NICs are charged when the shares are called for.

An example of how routes 1 and 2 work is as follows:

*Example* – in the following example, assume the bonus is £10,000 (£6,000 after income tax), the matching element is 1:4, the share price in year 1 is 100p and in year 3 is 200p. The following table shows the outcomes of both routes. In the table, (u) means underlying shares and (m) means matching shares.

	Route 1	Route 2
Year 1 position	(u) £6,000 invested in 6,000 shares.  (m) Right to call for 2,500 matching shares after 3 years	(u) £10,000 invested in 10,000 shares.  (m) Right to call for 2,500 matching shares after 3 years
Year 3 position	(u) 6,000 shares now worth £12,000 (growth in value subject to CGT – as reduced by taper relief only if shares sold).  (m) 2,500 shares called for (worth £5,000) (income tax on £5,000 in any event).	(u) 10,000 shares now worth £20,000 (income tax on £20,000 in any event).  (m) 2,500 shares called for (worth £5,000) (income tax on £5,000 in any event).

In both examples, it would in principle be possible to structure the matching share entitlement as restricted securities on which the executive elected to be taxed upfront. In practice an executive is unlikely to wish to do this, as the tax paid would not be recoverable if the matching share entitlement was lost (for example, by leaving employment).

#### **Penalties for leaving early**

The BMS needs to identify which categories of leaver should lose their matching element if they leave early. Typically, ‘good leavers’ – such as individuals who retire or leave through ill-health – would not lose their matching shares, but may be required to retain their underlying shareholding for the same period as if they had remained in employment.

Generally, voluntary leavers and employees dismissed for cause would lose their matching shares, but the Remuneration Committee

would typically have a broad discretion in this area. It would be unusual for a leaver to lose the shares purchased with his bonus.

**Arrangements for holding shares pending release**

Where the employee owns the shares pending release (as in route 1) there are two main alternatives – for the shares purchased with the bonus to be held either by a trustee on behalf of the individuals, or direct by the individuals (but with the certificates being deposited with the company secretary to police the retention obligation). For various reasons (notably, automatic pass-through of dividends), it is usually best to adopt the second alternative.

**Source of shares – existing or new issue**

Existing shares are customarily used for the underlying and matching element. Accordingly, at the time of the share award relating to the underlying element, the requisite shares will be purchased in the market. It is customary for the shares which are likely to be required for the matching element also to be purchased at that time, so that the company is not at risk of share price fluctuations during the retention period.

## 5. Executive share retention policies

### Overview

Institutional investors are supportive of companies which encourage executives to build up meaningful shareholdings in the companies for which they work. Schedule A to the Combined Code provides that directors should be ‘encouraged’ to retain shares received for a further period after vesting or exercise. The ABI guidelines state – rather optimistically – that the rules of incentive schemes should incorporate a requirement to retain a significant proportion of the shares emerging from such schemes with the target shareholding relating to the reward potential. The broad aim of such policies is that executives’ and shareholders’ interests should be aligned by requiring executives to hold ‘real’ shares as well as options and LTIPs. In other words, executives should suffer the ‘pain’ of holding shares – in terms of price fluctuations and tying up capital – as the price of participating in share incentive schemes.

Typically, the retention policy is targeted at executive directors (for whom a virtue of the policy is the required public disclosure of the personal shareholding) and other senior management.

Since 2000, ownership of ‘real’ shares has attracted CGT benefits in that shares owned by directors/employees qualify for accelerated taper relief, now (in appropriate cases) reducing the effective tax rate to 10 per cent after two years’ ownership.

Executives who are able to use exercised Revenue-approved CSOP options to achieve the target are in a favourable position, because they are able to invest in part on a pre-tax basis – in other words, the gain element is invested pre-tax, the subscription price element is invested post-tax. This is primarily relevant to executive options under the old four times earnings limit (that is, granted pre-July 1995); it is relevant to a lesser extent in respect of subsequent executive options (subject to the £30,000 limit) and sharesave options.

The following are the main practical issues which need to be addressed in designing a retention policy.

### **How large a shareholding is required?**

Usually this is expressed as a percentage of salary, and is largely a function of other design issues, such as the length of the build-up period – a target of 100 per cent of salary is common.

### **What build-up period should apply?**

There usually needs to be a fair degree of flexibility. Some policies, for example, only require the quota to be built up from shares emerging from share incentive schemes – eg by restricting the

number that can be sold following exercise of an option or vesting of an award.

**What shares count towards the retention policy?**

There are no hard rules, but it is customary that:

- personal holdings (including PEPs, etc) and shareholdings of family members, count towards the policy;
- where a company operates a bonus matching scheme, such shares count pending release; and
- the latent gain in unexercised in-the-money share options, once they have vested, sometimes counts.

**Pre-retirement reduction in quota**

As the retention policy may involve an executive having a disproportionate investment of his overall wealth in the company's shares – thereby being at risk of share price fluctuations – a sensible precaution would be to permit reductions in quota (or stop the build-up period) in the couple of years prior to retirement.

**How prescriptive should the rules be?**

In general, retention policies are non-prescriptive, conferring wide discretions on the Remuneration Committee in all the above matters.

## 6. Enterprise management incentive schemes

An enterprise management incentive scheme (EMI scheme) is another form of approved discretionary share option scheme designed broadly for entrepreneurs working in small high risk companies. There are a number of detailed qualifying conditions that must be met in order for a company to establish such a scheme. The consequence is that only small companies are able to establish EMI schemes. The main conditions are as follows.

- Only a qualifying company may establish an EMI scheme. In order to be a qualifying company the company must:
  - be independent (that is, not under the control of another company);
  - exist wholly for the purpose of carrying on a 'qualifying trade' – that is, a trade conducted on a commercial basis with a view to the realisation of profits – and must not consist wholly or as to a substantial part in the carrying on of excluded activities (for example, property dealing and development are excluded). At the time of the grant of an option the company must be carrying on such a qualifying trade or be preparing to do so; and
  - have gross assets (at the date of grant of an option) of no more than £30m.
- The purpose of the grant of an option must be to recruit or retain an employee and not for the purpose of a scheme or arrangement, the main purpose (or one of the main purposes) of which is tax avoidance.
- An employee may not hold 'unexercised qualifying options' over shares with a total market value of more than £100,000 at the time an option under an EMI scheme is granted. Options under an Inland Revenue approved CSOP will be treated as 'unexercised qualifying options' for this purpose. Options granted under a sharesave scheme may be ignored for this purpose.
- The maximum value of shares over which unexercised options under an EMI scheme may exist at any one time in respect of one company is £3m, measured at the date those options are granted.
- An employee is eligible to be granted options under an EMI scheme if he is a full-time employee of the company over whose shares the options will be granted or of a qualifying subsidiary.
- The shares available under an EMI scheme must satisfy the same statutory criteria as for an approved CSOP (see section 2).
- The option must be capable of being exercised at any time within the period of 10 years from the date of grant.

- The option must be granted by written agreement between the grantor and the employee. The option agreement must contain certain specified terms.
- The Inland Revenue must be notified within 92 days of the grant of the option. There is no requirement for prior Revenue approval.

If the various requirements for the grant of options are not satisfied, then the option will be treated as an unapproved option for tax purposes.

#### **Tax treatment**

There is no income tax or NICs payable on the grant of an EMI option.

If the option is granted at an exercise price at or above the market value of a share at the date of grant and is exercised within 10 years of the grant, it will not be subject to income tax on exercise.

However, if the option is granted at a discount to market value, it will be subject to income tax and NICs on exercise, on the amount of that discount (that is, the difference between the exercise price and the market value of the shares at the date of grant of the option (or, if less, the market value at the date of exercise)).

CGT may be payable if a gain is made on disposal of the shares subject to the benefit of the exemptions and reliefs referred to in section 2. Exceptionally, the shares acquired on exercise benefit from CGT taper relief from the date the option was granted not, as would usually be the case, from the date the option is exercised.

The beneficial tax treatment of EMI options only continues as long as no 'disqualifying event' occurs. Such events relate to the company's qualifying status, the employee remaining in employment and various other matters.

## 7. Sharesave schemes

Many listed companies operate sharesave schemes. This type of scheme involves two key elements:

- an agreement to make monthly contributions from after-tax pay for three or five years to a savings account with a bank or building society (itself a tax-favoured savings vehicle). The proceeds of this account are used to exercise the option; and
- the grant of an option to acquire shares in the employer (or its listed parent) on maturity of the savings account, at an exercise price which may be at a discount of up to 20 per cent of the shares' market value at the date of grant.

Other main features of sharesave schemes are as follows.

- a. The scheme must, broadly, be open to all UK employees, although a minimum service period of up to five years can be imposed.
- b. The shares available under a sharesave scheme must satisfy the same statutory criteria as for an approved CSOP – see section 2.
- c. All those who participate in the scheme must be permitted to do so on broadly similar terms.
- d. The employee can save between £5 and £250 per month. Although this amount cannot be reduced or increased following commencement, sharesave schemes are often operated annually (enabling a new contract to be taken out, provided the £250 monthly limit is not exceeded).
- e. The option is normally only exercisable within six months of the third, fifth (or, in certain circumstances, seventh) anniversary of grant. The exercise date must be selected by the employee in advance.
- f. If an employee leaves in certain favoured circumstances (injury, redundancy, retirement, etc), the option can be exercised early over a scaled-down number of shares. Otherwise the option generally lapses on leaving employment.
- g. There is no obligation to exercise the option, and the savings contract proceeds remain the employee's even if the option is not exercised.
- h. The savings contract is itself tax-favoured, in that the bonus earned on maturity (effectively the rolled-up interest) is tax-free.
- i. There need be no direct cost to the company in operating the scheme – most schemes operate by issuing new shares at the time of exercise.

## **Tax treatment**

### **Income tax**

Sharesave schemes are very tax-favoured. The main tax benefit is that there is no liability to income tax when an option is granted nor when an option is exercised provided the option is exercised after the third anniversary of grant.

In addition, there is no charge to income tax if a sharesave option is exercised before the third anniversary of the date of grant if the reason for exercise is the employee's cessation of employment by reason of injury, disability, redundancy, death, or upon his reaching (without needing to retire) an age specified in the rules which may be between 60 and 75. Only where the exercise is before the third anniversary of grant due to a takeover of the company, the disposal of the subsidiary for which the employee works or the voluntary winding up of the company will a charge to income tax arise on exercise. Where such an income tax charge arises on exercise it is calculated in the same way as for an unapproved option. Any charge to income tax will not be accounted for under PAYE; the employee is responsible for paying this income tax through self-assessment.

### **Capital gains tax**

Where there is no income tax charge on exercise, there may be a charge to CGT when the shares acquired on exercise are sold. This is calculated in the same way as for a CSOP option. However CGT is subject to the exemptions and reliefs referred to in section 2. In effect, therefore, these are tax-free schemes for most participants – perhaps requiring some care to achieve this if gains are significant.

### **NICs**

Options granted under sharesave schemes do not attract NICs on exercise.

## 8. Share incentive plans

The Share Incentive Plan (SIP) – formerly known as the employee share ownership plan – was created by the Finance Act 2000. It has three potential elements as follows:

- free shares – free shares with a maximum value of £3,000 a year;
- partnership shares – shares worth a value of up to £1,500 a year which are bought by employees with pre-tax salary; and
- matching shares – free shares to match the partnership shares to a maximum value of £3,000 per annum (with a maximum of two free shares for one partnership share).

All shares must initially be held in a UK resident trust. Employees who leave their shares in trust for five years pay no income tax or NICs on those shares and also pay no CGT on any growth in value while they are held in the trust.

### Free shares

Employees who are invited to participate in a SIP must be invited to do so on the ‘same’ terms. Despite this, allocations can be linked to individual, team, divisional or corporate performance measures. The SIP allows companies which award free shares linked to performance to set specific targets for separate groups of employees. The performance targets set for each different unit (and unit can mean an individual) must be based on business results or other objective criteria and be fair and objective measures of the performance of the unit to which they are applied.

The legislation permits two alternatives for awarding free shares on the basis of performance.

- Method 1 – Up to 80 per cent of the shares awarded can be linked to performance measures (provided the highest performance award to an employee is not more than four times greater than an award made to an employee on the ‘same’ terms).
- Method 2 – All shares may be awarded by reference to performance measures as long as the awards made to employees in each performance unit are made on the ‘same’ terms. The performance measure must be notified to the Inland Revenue.

The performance criteria must be fully disclosed to all employees ‘as soon as reasonably practicable’.

### Tax treatment of free shares

The free shares are free from income tax and NICs if they are held in trust for five years.

If the shares are withdrawn between three and five years, the employee will pay income tax (and NICs if applicable) on the lesser of the market value of the shares when they were first awarded and the market value of the shares at the date of withdrawal.

But, if they are held in trust for less than three years, income tax must be paid on the value of the shares when they are released from the trust.

Any income tax charge will be deducted at source under PAYE.

Any capital growth accruing while the shares are held in trust is free of CGT even if the shares are withdrawn within five years.

### **Partnership shares**

Up to £1,500 of pre-tax salary a year can be allocated to buy partnership shares. There are two alternatives for effecting these purchases, either:

- salary allocated to shares is accumulated for a period of up to 12 months with shares bought within 30 days of the end of the accumulation period; or
- shares are purchased out of deductions from salary with shares bought within 30 days of the deduction.

The £1,500 annual maximum is subject to a limit of 10 per cent of salary in the deduction period. The annual amount can be made as a one-off deduction from salary. Employers may decide whether all or part of an employee's total remuneration will be used when calculating the maximum percentage of salary to be spent on partnership shares.

Where employees buy partnership shares at the end of the accumulation period, the price at which the shares are bought will be the lower of the market value at the beginning or end of the accumulation period. Where there is no accumulation period, the purchase price will be the market value of those shares on the acquisition date.

Employees need to enter into 'partnership share agreements' to effect the deductions from salary. An employee may withdraw from a partnership share agreement at any time, in which case any partnership share money held on his behalf must be paid over to him.

Employees may participate in two SIPs run by connected companies in the same tax year, although not at the same time. This enables employees to continue to participate in a SIP where they have transferred from one company which operates a SIP to another company within the same group which operates a separate SIP.

**Tax treatment of partnership shares**

Partnership shares are free of income tax and NICs (both employer's and employee's) if they are held in trust for five years.

Partnership shares will cease to be held in trust either if they are withdrawn by the participant or if the participant ceases to be an employee.

If the shares are held in trust for at least three years, income tax (and NICs if applicable) is payable on the lower of the amount originally paid for the shares or their market value at release. The capital growth in the shares while they have been in trust is therefore free of income tax and NICs.

If the shares are withdrawn within the first three years, income tax (and NICs if applicable) are payable on the market value of the shares at the release date.

Any income tax charge will be deducted at source under PAYE.

The CGT treatment is the same as for free shares. Capital growth while the shares remain in trust is free of CGT. The shares can be held in the trust indefinitely whilst the participant remains an employee, so there is some scope for CGT planning.

**Matching shares**

Partnership shares can be matched with free shares funded by the employer at a maximum of two free shares for each partnership share. Acceptable ratios would therefore include three free shares for every two partnership shares or one free share for every five bought. Matching shares are taxed in the same way as free shares.

**Dividends**

Dividends on free and partnership shares of up to £1,500 per annum can be rolled up on a tax free basis in the trust if they are used to acquire additional shares within 30 days of the date of receipt of the dividend (dividend shares). Dividend shares will be subject to a holding period of three years, after which they can be withdrawn without a charge to income tax. Where employees leave employment during the holding period income tax will be payable on the original dividend as if it had been received in the normal way but in the tax year in which employment ceases.

**Cessation of employment**

If a participant's employment ceases for any reason the trustees may, with the participant's agreement, transfer any shares he holds in the SIP to the participant (or someone else at his direction) or dispose of the shares and transfer the proceeds or retain the shares. In any event, unless the participant is a 'good leaver' (where the participant ceases employment due to death, injury, disability, redundancy,

change of control of the company for which he works, sale of the business for which he works or normal retirement) he will be forced to pay some tax if such cessation occurs within five years of allocation.

## 9. Shares for non-executive directors

The Hampel Report in 1998 was clear in its recommendation that listed companies should consider paying their non-executive directors (NEDs) in shares. This built on the comments made in the Greenbury Report and reflects common practice in the US.

Although the Combined Code did not expressly incorporate this recommendation, companies have relied on Hampel and it is now increasingly common for public companies to pay their NEDs either wholly or partly in shares.

The ABI guidelines support this approach by stating that it considers it beneficial for NEDs to have shareholdings and that this may be achieved through having their fees paid in the form of shares 'at the full market price'.

There are three broad ways in which NEDs can be paid in shares:

### **Route 1 – market purchase of shares**

The company introduces a policy that NEDs are required to invest a proportion of their after-tax fee in purchasing shares on the market. Such a policy would include a requirement or understanding that the shares are to be held until the NED leaves the board.

The NEDs would be required to give a standing instruction to the company secretary to arrange for the market purchase of shares, typically on a quarterly basis, using the after-tax amount of their fee. Any purchases would need to comply with the Model Code (usually falling within an exemption relating to regular share purchases), and would be arranged by the company secretary.

This route is fairly straightforward – it should not involve any change to the articles of association of the company, nor give rise to issues under sections 99 or 103 of the Companies Act 1985 (see route 3 below).

However, the market purchase of shares may be unattractive because cash leaves the company (in contrast to a new issue).

### **Route 2 – new issue of shares for cash consideration**

The company issues new shares to NEDs in lieu of a proportion of their fees as an allotment for cash, setting the subscription price for the shares by reference to the market price of the shares either:

- i. whenever an allotment is made (eg quarterly). The number of shares issued on each occasion is set by reference to the market price of the shares as at the date of payment (ie dividing the relevant amount of fee by this market price). The shares are simply subscribed at this price; or

- ii. at a fixed point in time (eg the price prevailing at the beginning of the year, following announcement of the previous year's results). This 'reference price' fixes the number of shares available to the NED for that year (ie by dividing the relevant amount of fee by the reference price).

The NED's cash fee is adjusted as necessary to ensure that the after-tax amount is sufficient to enable shares to be subscribed at their market price during the year. (This is preferable to permitting a subscription at undervalue, as the NED would be liable to income tax on any undervalue element.)

The reference price needs to be reset annually – over longer periods, share price volatility could result in substantial overpayment or underpayment to the NEDs. For this reason, it is not practicable to pay NEDs a 'pure' number of shares for a lengthy period.

### **Route 3 – direct allotment of shares in consideration for services**

Instead of paying NEDs a cash fee and using the fee to purchase or subscribe shares, route 3 involves the company arranging a direct allotment of shares to a NED in consideration of the NED's services. The number of shares would be fixed using a 'reference price', as in route 2 (ii).

This route may still provide an income tax benefit if there is a requirement to hold the shares for a specific period of time – for example, until the NED leaves the board. However, the shares would then be restricted securities, and their tax treatment would need to be considered in the context of the provisions discussed in section 3 above.

Section 99(2) of the Companies Act 1985 prohibits a public company from issuing shares in consideration for 'an undertaking given by any person that he ... should do work or perform services for the company or any other person'. To comply with section 99(2), the shares would need to be allotted in arrears as consideration for services already rendered (this is unlikely to be problematic as NEDs' fees are likely to be paid in arrears).

As this route involves an allotment for a non-cash consideration, section 103 Companies Act 1985 requires an independent valuation report to be prepared confirming that the consideration for the allotment is fair.

Route 3 is likely to involve a change to the company's articles, as the 'currency' of the payment is shares rather than cash.

### **Options for non-executives**

Whilst payment in shares is an increasingly common way of remunerating NEDs, option schemes for NEDs continue to attract

criticism from institutional investors. The Hampel Report opposed the grant of options to NEDs on the basis that 'the leverage inherent in the award of share options is inappropriate for non-executive directors'. The ABI in its February 2002 guidelines reiterated that NEDs 'should not participate in any form of share incentive scheme'. The revised Combined Code (published in July 2003) continues to be hostile to options but does set out the steps to be taken where NEDs are granted options. It provides that if, exceptionally, share options are granted, shareholder approval should be sought in advance and NEDs should be required to hold any shares acquired for at least one year after leaving the board. Holding share options may be relevant in determining whether a NED is independent.

## **10. Sourcing of shares to satisfy options, and corporation tax deductibility**

A company can source the shares necessary to satisfy options in a number of ways – from a new issue, from an employee benefit trust and from treasury. However the shares are sourced the company will qualify for the new corporation tax deduction, which is available for accounting periods beginning on or after 1 January 2003, if the requirements set out below are met. The relief applies to options and other types of share schemes.

Under the previous regime, employers were not generally entitled to a corporation tax deduction for the costs of providing a share scheme – mainly because of the principle that the issue of new shares at less than market value (for example, on exercise of an option) did not involve a cost, and did not therefore attract a deduction. However, a deduction could often be obtained with careful structuring – for example, the use of symmetry arrangements to satisfy options and, more generally, the routing of share acquisitions at market value through employee benefit trusts. These arrangements were often administratively inconvenient. QUESTs were a variation on the same theme, but could only be used with SAYE schemes.

### **Requirements for a corporation tax deduction**

The new relief secures a deduction for the cost of providing shares to employees in the following circumstances.

- The shares must be acquired in an accounting period starting on or after 1 January 2003 (although an option to acquire shares may have been granted, or the award of shares made, earlier than this).
- The deduction becomes available for the accounting period in which the employee acquires the shares.
- The employee must be chargeable to income tax on the acquisition of the shares (or would be chargeable except that the share acquisition is exempt from income tax under an Inland Revenue approved or Enterprise Management Incentive scheme, or the employee is not subject to UK income tax).
- The amount of the deduction is based on the market value of the shares at the date the employee becomes chargeable to income tax, less any contribution payable by the employee for the acquisition of the shares. Thus, if shares have a £3 market value, a deduction of £2 would be available where an employee pays £1 on exercise of an option. A deduction for £3 would be available if the employee

received the shares without payment – eg under a nil cost LTIP award.

- There is no relief for the expenses of establishing, administering or borrowing for the purpose of a scheme, and the deductibility of such expenses continues to follow the normal rules.
- The deduction will only be available if the shares satisfy certain requirements which mirror the requirements of the approved share scheme legislation. The shares must be fully paid up, non-redeemable ordinary shares. They must be shares of a class listed on a recognised stock exchange, or shares in a company that is not under the control of another company, or shares in a company that is under the control of another company whose shares are listed on a recognised stock exchange.
- The deduction will be offset by any corporation tax relief previously obtained in respect of the shares. So, for example, where shares have been warehoused in a trust for an LTIP award and a deduction was obtained several years ago when monies were contributed to the trust, that deduction will reduce the statutory deduction that can be obtained when the LTIP award is exercised/released.
- The corporation tax relief for SAYE options sourced through a QUEST will end for new payments made in accounting periods beginning on or after 1 January 2003. As a result, most companies will wish to wind up their QUESTs as soon as the ‘pipeline’ of shares which have already been hedged in the QUEST (and a deduction sought) has dried up. Where shares to meet SAYE options are not already in the QUEST – but are available to be called by the QUEST under a back-to-back subscription agreement – then the existing arrangement should generally be unwound and the new statutory deduction relied on.
- The new rules do not affect the more generous corporation tax relief available under the Share Incentive Plan legislation.

This new deduction will interlock with draft accounting proposals (set out in the Accounting Standards Board’s FRED 31) under which the ‘cost’ of option would be charged to the profit and loss account. The deduction will be determined on the basis set out above, rather than using the amount determined under the accounting standard.

### **Sourcing of shares**

#### **New issue of shares**

Traditionally new shares were issued direct to optionholders on exercise of options. In these circumstances no cash cost is borne by any group company in relation to the option.

### **Transfer of existing shares**

Where shares are purchased on the market to satisfy options, this is done via a discretionary employee share ownership trust (ESOT). In order to avoid adverse UK tax consequences, the ESOT would normally have a non-UK resident trustee (eg Jersey).

Where an ESOT is used to satisfy options, the tax position of optionholders is largely unaffected. The transfer of shares by the ESOT to the optionholder involves a stamp duty charge (at 0.5 per cent of the option price paid); this does not arise on a direct issue of shares to the employee. This is technically the optionholder's liability (as transferee), but would in practice be paid by the company or the ESOT. This payment of stamp duty on the employee's behalf is technically a taxable benefit in kind.

### **Use of ESOT as a 'warehouse'**

An ESOT may purchase existing shares on the market and 'warehouse' these shares pending exercise of options. This avoids equity dilution as a result of option exercises. Typically, the ESOT would purchase these shares with an interest-free limited recourse loan from the company. Assuming the shares are purchased at around the time the options are granted to executives, the exercise monies flowing in from the executive on exercise will be sufficient to enable the loan to be repaid. This does not prevent the employer from claiming a corporation tax deduction on exercise, assuming the relevant conditions described above are met. (But, equally, the company's achievement of matching will not prevent an accounting charge arising under FRED 31.)

Under this structure the company takes the risk of a permanent share price fall, such that options are never exercised. In this event, the permanent diminution in value would be charged to the group P&L account.

### **'Symmetry' arrangements**

An alternative mechanism to satisfy options with an ESOT is to use a 'symmetry' arrangement. Here, there is no loan. Instead, at the time of exercise of an option, the employing company (usually a PLC subsidiary) pays to the ESOT the 'cost' of the option. This amount, together with the executive's exercise monies, is used by the ESOT to subscribe new shares at market value. Thus, if an option is granted with a £1 exercise price and is exercised when the share price is £3, the ESOT would subscribe shares at £3 using a £2 payment from the employer plus the £1 from the employee; the ESOT would then transfer the shares to the employee in satisfaction of the option. Following the introduction of the new corporation tax relief, symmetry arrangements will be primarily relevant to non-UK employees.

**Holding shares in treasury**

From 1 December 2003 companies will be permitted to hold their own shares in treasury under the Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003. The company may purchase its own shares, hold them in treasury, and subsequently either cancel them or sell them back into the market. For tax purposes, shares purchased into treasury will be treated as if they had been cancelled and shares sold out of treasury will be treated as newly issued. While they are held in treasury, shares will be treated as if they do not exist. This may be a useful tool for companies to use to satisfy options.

## 11. Appendix

### Comparison of sharesave schemes and share incentive plans

Issue	Sharesave	Share incentive plan
<b>Benefit to employee</b>	Ability to acquire shares after three, five or seven years, under an option granted at 20 per cent discount to price in year 1 using savings contract proceeds.	Immediate receipt of free, matching and/or partnership shares, but on terms that free and matching shares must be held under the plan for at least three years. Tax relief for partnership shares is available if the shares are held under the plan for five years.
<b>Long-term or short-term benefit</b>	Relatively long-term: a voluntary leaver during the three, five or seven years will normally be unable to exercise the option (and a 'good leaver' only gets a partial benefit).	Relatively long-term: the shares must be held under the plan for five years to receive full tax relief. If a participant's employment ceases, the trustees may, with the participant's agreement, transfer any shares he holds in the plan to the participant (or someone else at his direction) or dispose of the shares and transfer the proceeds or retain the shares.
<b>Tax treatment of employee</b>	Any increase in value above the exercise price is normally only within the CGT net when shares sold – ie generally a tax-free scheme for most participants due to the annual CGT exemption.	<ul style="list-style-type: none"> <li>• Free shares – If held in trust for five years, no income tax and NICs are payable. Any capital growth accruing while the shares are held in trust is free of CGT even if the shares are withdrawn within five years.</li> <li>• Partnership shares – If held in trust for five years, no income tax or NICs are payable. Capital growth while the shares remain in trust is free of CGT.</li> <li>• Matching shares are taxed in the same way as free shares.</li> </ul>

Issue	Sharesave	Share incentive plan
<b>What if the share price falls?</b>	Employee is wholly protected – his savings contract can continue, and there is no obligation to exercise the option.	Employee suffers the loss.
<b>What are the limits on individual participation?</b>	Employee can save up to £250 per month.	Participants can receive: <ul style="list-style-type: none"> <li>• free shares with a maximum value of £3,000 a year;</li> <li>• partnership shares of up to £1,500 a year; and</li> <li>• free matching shares – to match the partnership shares to a maximum value of £3,000 per annum (with a maximum of two free shares for one partnership share).</li> </ul>
<b>Different benefits for different employees?</b>	In practice, an employee’s earnings are likely to dictate his level of savings, so the £250 per month limit is self-policing.	Benefits can be linked to length of service, remuneration, etc as long as participation is on the same terms.
<b>Eligibility</b>	Basically open to all full-time and part-time UK resident employees, and all full-time directors, but company can impose a service period of up to five years.	Basically open to all full-time and part-time UK resident employees, and all full-time directors. Companies may impose a service period which varies for each element of the SIP. The maximum service periods are as follows: <ul style="list-style-type: none"> <li>• in the case of free shares – up to 18 months ending on the date of the award; and</li> <li>• partnership and matching shares – if there is no accumulation period – 18 months ending with deduction of the monies. If there is an accumulation period – six months ending with the start of the accumulation period.</li> </ul>

Issue	Sharesave	Share incentive plan
<b>Entitlement to dividends</b>	No, until exercise option.	Yes from outset.
<b>Cost to company</b>	<p>Start up costs are tax deductible for company. Share acquisitions financed by employee savings. No cash cost to company if using new issue shares – only the dilution of equity arising from permitting exercise at a discount to the share price.</p> <p>If existing shares are to be used the cost of providing these will qualify for the statutory corporation tax deduction.</p>	<p>The costs of setting up a SIP are tax deductible for the company provided the SIP is not operated before Revenue approval. The trustees running costs (including interest costs) are also deductible for corporation tax purposes.</p>
<b>ABI limits on subscriptions for shares</b>	<p>In any 10-year period, a limit of 10 per cent of equity share capital can be issued or issuable under the scheme and any other scheme, of which 5 per cent is normally reserved for executive schemes. Lapsed options can be reused.</p>	Same.

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