

The David Pett Guide to Share Schemes

DAVID PETT & CO.
HELPING *SHARE* GROWTH



TAX, INCENTIVES AND
EMPLOYEE SHARE PLANS

1. EMPLOYEE SHARE SCHEMES FOR PRIVATE and UNQUOTED PUBLIC COMPANIES

The proprietors and directors of any independent company which qualifies to grant share options as **Enterprise Management Incentives (EMIs)** should consider the grant of such options to one or more key employees (on a selective basis). The grant and exercise of EMI options - which enjoy favourable tax treatment for both the option holder and the employer company - is an attractive way of allowing such employees to share in the growth in value to which they contribute through their labour.

Whilst the statutory rules governing EMI options allow for considerable commercial flexibility (there is no prescribed minimum option exercise price, and few restrictions on the circumstances in which such options may, by their terms, be exercised), the terms of an EMI option can be simple. For example, it is possible to grant such a share option on the basis that it may be exercised only in the event of an 'exit', when shareholders generally are able to realise the value of their investments. If the optionholder leaves the company for any reason before that time, or if he or she fails to attain any targets set for permitting exercise of the option upon an exit, then the option simply lapses without the need for further paperwork or management time. The 'cost' of providing the benefit of a capital gain in the hands of the employee is, in effect, borne by the shareholders by way of dilution of the value of their interests at the time of exercise/'exit', and is not a cash drain on the company itself. Furthermore, there is no dilution of shareholders' interests in the company until exercise is triggered by an 'exit' event.

For so long as there is no public market in shares in the company it may be possible to agree with HMRC Shares and Assets Valuation office that the "market value" for tax purposes at the time of grant of an EMI option is at a substantial discount relative to the "pro rata" value of a share (dividing the aggregate value of the issued share capital by the number of shares in issue). Upon an 'exit' optionholders would sell their option shares for a consideration equal to the (hopefully much higher) pro rata value. This uplift, from 'discounted' to 'pro rata' value, can offer a means of delivering substantially enhanced gains to employees in a highly tax-efficient manner.

An independent company, or a subsidiary of a listed company, which fails to qualify to grant EMI options by reason only of the fact that it has gross assets of more than £30 million or more than 250 employees or because it carries on disqualifying activities, may qualify to grant **CSOP options** and **SAYE options**.

A company which does not otherwise qualify to grant EMI options, for example it is not an independent company, is unlikely to qualify to grant other tax-favoured share options. So-called "unapproved" share options are potentially expensive in terms of the income tax and NICs which may be charged on the amount of any option gain. For this reason, a growing number of such companies are looking to alternative structures for allowing their executives and employees to benefit from future growth in share value.

An independent private company should also consider the adoption of a **Share Incentive Plan** as this may enable all qualifying employees to acquire and hold shares in a manner which allows tax-free gains to be realised upon a sale of the company or other "exit" event.

A company which does not qualify for any of the tax-favoured option schemes - possibly because it is, for example, under the control of a non-listed venture-capital fund or a limited partnership - could consider adopting a **Joint Share Ownership Plan** or ("**JSOP**"). This is an arrangement under which shares are acquired jointly by the employee and (typically) an employees' trust on the basis that, when the shares are ultimately sold (such as in the event of an "exit"), the disposal proceeds are divided between the joint owners so that the employee receives the amount of any growth in market value over the period of joint ownership (less a small "carrying cost"), and the trust receives the amount of the balance. The initial cost of the shares may be funded by way of a loan from the company, although care is needed if it is a "close company" as a loan to the trust can in these circumstances trigger a liability to deposit with HMRC an amount equal to 25% of the amount of the loan. Although the acquisition of an interest as beneficial joint owner may trigger a small upfront charge to income tax and NICs, the advantage of a JSOP is that any growth in value accruing to the employee is (if the appropriate tax election is made) taxed as capital gain, not income from employment.

One alternative to a JSOP is the creation and issue of so-called "flowering shares". Put simply, these are shares which, by their terms, are of little value unless and until (for example) the occurrence of a sale of the company for a total consideration which exceeds a specified threshold amount. Provided that the growth in value of the shares accrues only in accordance with the rights attaching to the shares from the outset, and subject to the statutory anti-avoidance provisions, any growth in value accruing to the employee on a sale of the shares should be taxable as capital gain, not income. By contrast with a JSOP, which typically uses

existing ordinary shares, a flowering share arrangement will normally involve the creation of a new class of shares and therefore some relatively complex changes to the articles of association. This type of arrangement may be particularly well-suited to a company whose managers are intended to receive, on "exit", a slice of the proceeds which will vary according to the level of aggregate proceeds achieved for the sale of the company.

2. GOVERNMENT-BACKED SHARE INCENTIVES

2.1 Enterprise Management Incentives

Relief from income tax and NICs is afforded to the whole, or part, of the gain realised upon the exercise of a share option granted by a qualifying company to an eligible employee - otherwise than for tax-avoidance purposes - and which complies with the requirements set out in Schedule 5 of the Income Tax (Earnings and Pensions) Act 2003 AND the grant of which has been notified to HMRC within 92 days ("**an EMI option**"). Instead, CGT is charged on any gain on sale of the option shares by reference to the exercise price paid (and any amount on which relief from income tax was not available at the time of exercise of the option). If all relevant conditions set out in the Corporation Tax Act 2009 are met, relief from corporation tax for the amount of gain realised upon exercise of an EMI option should also be available to the employer company. Bearing in mind that there can be a significant uplift in the market value of a small holding of shares in an unquoted private company (that said, an EMI company can, if all other conditions are met, be a quoted company) when all shares are sold upon an "exit event", from a minority interest basis of valuation to a pro rata basis, the combination of these reliefs means that EMI share options are currently the most attractive mechanism for a small company seeking to enable key employees to benefit from growth in value in a tax-efficient manner. Indeed, a company which qualifies to grant EMI options should always consider doing so before looking at any alternatives.

The option shares must be **non-redeemable ordinary shares**, but they **may be subject to restrictions**, whether in the articles of association or in the option agreement. They can be shares intended to be issued on exercise, or shares to be transferred by, or at the instruction of, the grantor.

The EMI regime was intended to allow **commercial flexibility**, and it does. By contrast with CSOP options, there is no period which must elapse before the option is exercised, and no requirements as to the minimum exercise price or as to when the option must be exercised. However, the relief is only given in respect of any gain representing growth in the market value of the option shares from the date of grant to the date of exercise or, if it occurs more than 40 days before the date of exercise, the occurrence of a "disqualifying event". For this reason, it is always desirable (although not strictly necessary) to determine and agree with HMRC Shares and Assets Valuation at or before the time of grant exactly what is the "market value" of a share in the EMI company as at the time of grant. Further, as the statutory limits on the grant of EMI options are expressed by reference to the "unrestricted market value" of a share, it is normally necessary to seek agreement as to both the "actual" and "unrestricted" market values of an option share as at the time of grant.

Qualifying companies

The company whose shares are put under option ("**the plan company**") **must be an independent company with gross assets of less than £30million** and the plan company, or group, must have **less than 250 employees** (full-time equivalent).

Any subsidiaries of which the EMI company has control must be 51% subsidiaries or, in the case of a property company, a 90% subsidiary.

The activities of the EMI company, or group, must not consist as to a substantial part (20%) of non-qualifying activities. These include:

- dealing in land, commodities, futures or shares etc
- dealing in goods otherwise than in the course of an ordinary trade of wholesale or retail distribution
- banking, insurance and other financial activities
- leasing and hiring

- receiving royalties or license fees (save in respect of intellectual property created by the company or group itself)
- legal or accountancy services
- property development
- farming or market gardening
- forestry, woodlands or timber production
- shipbuilding, coal or steel production
- managing hotels etc
- managing nursing or residential care homes
- acting as a "service company" in providing any such activities to an associated business.

Eligible employees

To be eligible to be granted an EMI option an individual must be a director or employee of the EMI company or of a qualifying subsidiary who is committed to spending at least **25 hours per week, or, if less, 75% of his or her working time** to the business of the group and must not have, or be deemed to have at the time of grant (only), a "material interest" (30%) in the EMI company.

Limits on the grant of EMI options

There is an **individual limit, of (currently) £120,000**, on the aggregate initial unrestricted market value, as at the date(s) of grant, of the shares over which EMI options may be granted to an eligible employee (or director). The value of any shares over which CSOP options are held by the individual are counted towards this limit.

There is a rule that if options have been granted to an individual up to that limit, he or she cannot, within 3 years thereafter, be granted any more options as EMI options (if, for example the first options lapse or are surrendered). To avoid this trap, EMI options are commonly granted over shares with an unrestricted market value which is just under the limit!

There is also an **overall limit of (currently) £3 million** on the aggregate initial unrestricted market value of shares in a company over which unexercised EMI options may be held by all employees.

Nature of the option

The option must take the form of a written option contract evidencing non-assignable and enforceable, albeit conditional, rights against the grantor - which can be the company or another entity such as an employees' trust or other existing shareholder. Exercise of the option may be performance-linked, but it must be capable of being exercised, if at all, within 10 years (and relief is not available if it is exercised after more than 10 years from grant) and must not be capable of exercise (by personal representatives) more than 12 months after the death of the optionholder.

Notification of grant to HMRC

It is vital that the grant of the option is notified to HMRC Small Companies Enterprise Centre within 92 days on the form available at **Form EMI1 - Notification of grant of an EMI option**, as it will not otherwise qualify as an EMI option.

"Disqualifying events"

The occurrence of a disqualifying event will curtail the amount of gain on which tax relief is given as, unless the option is exercised within 40 days after the occurrence of such an event, any growth in value accruing after the event will not qualify for relief. "Disqualifying events" include:

- a loss of independence of the company (save in the event of a takeover if the option is exchanged for a corresponding option over shares in the new holding company and that company, the terms of the exchange, and the optionholder all comply with detailed statutory requirements including that the new company satisfies the independence and "trading activities" tests, but not the £30m gross assets or the 250 employees test and the optionholder remains an eligible employee, and the new option grant is notified to HMRC within 92 days)
- the EMI company ceasing to meet the trading activities test
- the optionholder ceasing to be an eligible employee
- the optionholder not having, at the end of a tax year, actually met the "commitment of time" test
- the option terms being varied so as to increase the value of the shares under option or so that they cease to meet the statutory requirements
- the share capital of the EMI company being altered in certain specified ways
- option shares being converted to shares of a different class (unless certain conditions are met)
- the optionholder being granted a CSOP option taking him above the individual limit of £120,000 or
- the EMI company, having qualified as preparing to carry on a qualifying trade, not actually doing so within 2 years.

2.2 Company Share Option Plans (CSOPs)

Subject to detailed statutory requirements, a company may obtain HMRC approval of a scheme which provides for the grant, to selected employees and full-time directors, of rights to acquire shares in the company or its holding company which, if exercised within the statutory time limits, will qualify for relief from income tax and NICs on the option gain. Instead, CGT is charged when the option shares are sold on the amount of the difference between the proceeds of sale and the exercise price paid for the shares.

Exercise price

The exercise price must be set at the time of grant and be not less than the market value of the shares at the time of grant. There is a limit, of (currently) £30,000, on the initial market value (as at the date(s) of grant) of shares over which unexercised options may be held by a participant.

The plan company

The company whose shares are under option ("the plan company") must be independent or under the control of a non-close listed company, or the option shares must be listed on a recognised stock exchange.

The option shares

The shares under option must be fully-paid (as to their nominal or par value) non-redeemable ordinary shares which are not subject to restrictions other than those expressly permitted by the legislation or restrictions attaching to all shares of the same class. Certain restrictions, requiring shares to be offered for sale on leaving, are permitted provided they apply to all shares of that class including to shares acquired by an employee other than on exercise of a CSOP option.

If the plan company has more than one class of ordinary shares, the option shares must be of a class the majority of which are held either (1) as "employee-controlled shares", or (2) by persons other than

directors/employees or employees' trusts or, if the plan company is a subsidiary of a listed company, that listed company or any of its associated companies.

CSOP options may be granted as rights to subscribe for new shares or to acquire existing shares, and may be granted either by the plan company or a shareholder or an employees' trust.

Corporation tax relief for option gains

If all relevant statutory conditions are met, the employer company should qualify for relief from corporation tax for the amount of the option gain, regardless of the fact that the economic cost of the grant and exercise of the option may have been borne by another person such as an employees' trust.

Performance-linking

The exercise of a CSOP option may be conditional upon the attainment of pre-set objective performance targets relating to the plan company (or group) or the optionholder.

When a CSOP option must be exercised to qualify for relief

Tax relief is available only if a CSOP option is exercised:

- in accordance with the plan rules at a time when the plan remains approved by HMRC; and
- not later than the 10th anniversary of the date of grant; and
- after the optionholder has died, or
- except when exercised after the optionholder has died, not before the 3rd anniversary of the date of grant; or
- if the rules so permit, within 6 months after leaving by reason of injury, disability, redundancy or retirement after a specified retirement age of not less than 55.

It follows that if, for example, the company performs well and is sold within 3 years of grant in circumstances in which options must be exercised or lapse, the benefit of the tax relief will be lost. Plan rules may, however, provide for options to be exchanged for fresh options in a new holding company in the event of a takeover (etc.) and, if detailed statutory conditions are met, the benefit of tax relief upon exercise of the new option may then be preserved.

Obtaining HMRC approval

It can take up to 6 weeks to secure HMRC approval of a CSOP (although in straightforward cases the timescale can be much less). Options must not be granted before formal HMRC approval has been given.

2.3 Share Incentive Plans (SIPs)

A qualifying independent company may obtain HMRC approval for a written plan, and establishment of a plan trust, on terms that provide for the company to invite **all eligible employees** (having a qualifying period of continuous service set by the company at up to 18 months):

- To purchase, or subscribe, for shares in the plan company using up to £1,500 of gross (pre-tax) earnings per tax year ("**Partnership Shares**"); and
- To accept an appropriation of shares (free of charge) on the basis, which must be the same for all qualifying employees, of up to 2 free shares for every 1 Partnership Share acquired out of gross salary ("**Matching Shares**"); and/or
- To accept an appropriation of shares (free of charge) with a market value of up to £3,000 per tax year ("**Free Shares**").

All such Partnership, Matching or Free Shares must be allowed to be held in the plan (i.e. by the plan trustee subject to the plan rules). Matching and Free Shares must be subject to a holding period set at between 3 and 5 years. The company may provide that Matching and Free shares be forfeited if the employee leaves within a period fixed at up to 3 years.

Awards of Free and Matching Shares may be linked to performance, although the statutory rules governing the basis of linking an award to the attainment of targets are complex and restrictive.

No tax is charged on the initial appropriation of Matching or Free Shares.

If any such shares ("**Plan Shares**") cease to be held in the plan, either because the employee leaves or in certain other circumstances, then there may be charges to income tax and NICs, unless the employee leaves by reason of injury, disability, redundancy, TUPE transfer, the employer company being sold outside the group, death in service, or retirement after a specified age of not less than 50.

If the shares cease to be held in the plan within 3 years, income tax (and, if relevant, NICs) is charged on the market value of the shares at that time. If it is more than 3, but less than 5 years, then tax is charged on the initial market value of the shares as at the time of acquisition (or, in the case of Partnership Shares, the amount deducted from salary to acquire them) or, if less, their market value at the time of withdrawal. No tax is charged on a forfeiture of Free or Matching Shares.

For so long as they remain as Plan Shares, the company may also permit the tax-free re-investment of dividends in more shares to be held in the plan ("**Dividend Shares**"), subject to a limit of (currently) £1,500 per tax year and a fixed holding period of 3 years.

For so long as Partnership, Matching, Free and Dividend Shares remain held in the plan, **any growth in value is entirely free of CGT!** This is a significantly more beneficial treatment than is afforded to CSOP, EMI or SAYE share options.

The employer company can claim relief from CT for an amount equal to the market value of the shares at the time they are acquired by the plan trustee, but the relief is given only at the time the shares are subsequently awarded as Free or Matching Shares.

SIP plan rules and trust deeds are necessarily relatively long and seemingly complex as they have to address such issues as what happens in the event of a rights issue, bonus or capitalisation issue, company reorganisation or reconstruction or a scheme of reconstruction or takeover of the plan company.

SIPs are commonly administered on behalf of larger companies by one of the commercial providers of trustee and administration services. In the case of smaller companies, it is perfectly feasible for such a plan to be administered internally, with occasional assistance from ourselves !

It is important to bear in mind that, whilst a plan can be terminated at any time, this does not mean that the company can immediately put an end to its commitment to maintain the plan trust and administration. A participant cannot be obliged to withdraw his shares from the plan if that would trigger a charge to tax. It follows that, unless participants can be persuaded to do so - possibly in return for an agreement by the company to fund the amount of any such tax - the plan must go into "run-off" for a period of up to 5 years.

Planning points

An independent unquoted company which qualifies to establish a SIP and has, or may create, a market in its shares should consider carefully establishing a simplified SIP which provides only for employees to acquire Partnership Shares out of gross salary. This allows employees to benefit from the generous tax reliefs afforded to SIPs and, if there is to be an "exit" event may allow employees to benefit from the uplift in share value (from a minority-interest to a pro-rata value) on exit in a manner which is entirely tax free!

Plan shares may be withdrawn after 5 years and either transferred to a registered pension scheme or sold and the proceeds transferred to such a pension scheme. Not only is tax relief given upon the initial acquisition of the shares, but also on any gains accruing whilst they are held in the plan, and again in relation to the contribution to the pension plan - a "triple win"!

2.4 Savings-related share option schemes (SAYE)

Independent companies (and certain subsidiaries of listed companies) may, if all statutory requirements are met, obtain HMRC approval of a written plan under which all eligible employees may be invited to apply to be granted an option to acquire shares in the group holding company (or subsidiary of a listed holding company) at the end of a fixed option period of 3, 5 or 7 years (as the company may permit and, if so permitted, as the

employee may choose). The price payable upon exercise of the option may be set at a discount of up to 20% of the market value of the shares at the time of grant. Options may be granted at regular intervals, or on one occasion only, but whenever invitations are issued they must be issued to all eligible employees. A qualifying period of continuous employment of up to 5 years may be set with the company also allowing other employees to join.

The share option is linked to a savings contract with a bank or building society under which the employee commits to making 36 or 60 monthly savings contributions of up to (currently) £250 out of net (after tax) pay and deducted from salary. The savings are augmented by a tax-free bonus, expressed in terms of a multiple of monthly savings, added at completion of the 36 or 60 savings contributions (and, in the case of a 7-year option, again after a further 2 years). At the end of the savings period (or, in the case of a 7-year option, two years thereafter) the employee may - but need not - exercise the option and purchase the shares at what is then hoped will be an undervalue. If the share price has fallen below the exercise price then the option can be allowed to lapse and the employee simply takes out his savings and bonus.

Any amount of option gain is (except in certain circumstances in which an SAYE option is exercised early) free of income tax and NICs. Instead, as in the case of CSOP options - but by contrast with a SIP - any gain (over the exercise price) realised on a disposal of the option shares is charged to CGT, subject to any available annual exempt amount. For many lower rate taxpayers the gain on a sale of the shares is effectively free of tax.

Such an SAYE share option scheme must be operated in conjunction with a savings carrier which may, but need not be, the same as the organisation responsible for the record-keeping and administration of the scheme. Now that the rates of bonuses payable under the savings contracts are relatively low (they are varied by HMRC from time to time for new contracts), the savings carriers/administrators will commonly expect to charge fees for administering the scheme and undertaking the necessary preparation of explanatory literature and application forms, etc.

The terms of the share option are prescribed by legislation and are relatively inflexible, particularly as regards the terms upon which options may be exercised, or must lapse or may be exchanged, in the case of early leavers or a takeover, etc.

According to the latest available HMRC statistics, there were, in 2007-08, approximately 830 "live" SAYE share option schemes under which options were granted to c. 520,000 employees.

Planning points

Care must be taken in the way in which an employee chooses to participate in an SAYE share option scheme. If, for example, an SAYE share option is taken on the basis of electing to make monthly contributions of, say, £250 and after a while the employee can no longer afford to make such contributions then, if more than 6 contributions are missed, the option lapses. By contrast, if the employee had taken out five separate savings contracts of £50 per month, each linked to a distinct option, then he or she would have the flexibility to allow one or more to lapse whilst keeping alive the remaining options, thereby reducing his or her monthly contributions.

Offering an exercise price with the full 20% discount can be expensive in terms of the associated accounting charges and, for this reason, many listed companies are restricting the benefit by choosing to offer only a smaller, or even no, discount to the market value at the time of grant. Whilst employee optionholders cannot be prevented from allowing their SAYE options to lapse if the share price has fallen (in order to take out a fresh option at a lower exercise price), this can trigger unforeseen and substantial accounting charges. Companies can avoid or reduce the risks of such charges. Please contact us for more details.

SAYE savings bodies / administrators

Currently (September 2009) it is understood that the following are willing to act as savings carriers and/ or administrators of SAYE schemes:

- Barclays
- Capita Share Plan Services (using Royal Bank of Scotland)
- Computershare (using Royal Bank of Scotland)
- Equiniti (using Lloyds Banking Group)

- HBOS and
- Yorkshire Building Society

3. JOINT SHARE OWNERSHIP PLANS

One idea which was first developed by David Pett and William Franklin in 2002, and which has since been successfully adopted by some 20+ companies, is that of the **joint share ownership plan** (or **JSOP**). Under a JSOP, an executive is invited to acquire, jointly with (typically) an employees' trust, a given number of shares on the terms of a joint ownership agreement (or JOA). By the terms of the JOA, when the jointly-owned shares are sold, the proceeds of sale are split between the joint owners so that the employees' trust receives their initial market value (plus a small "carrying cost") and the executive receives the balance, i.e. the growth in value less the carrying cost. The initial acquisition by the executive of his interest as a joint beneficial owner of the shares is a taxable event, but insofar as the executive does not pay the initial unrestricted market value ("IUMV") of his interest in the jointly owned shares, he is typically paid a grossed-up cash bonus of an amount sufficient to pay the income tax and NICs charged under PAYE on that acquisition. On the basis that the executive and his employer make the appropriate tax election, any future gain accruing to the executive is chargeable to CGT, not income tax, with no NICs. By contrast with traditional schemes, a JSOP necessarily involves the initial acquisition of shares, not merely the grant of rights to acquire them in the future.

The merits of the JSOP lie in the following features:

- there is no element of artifice in the arrangement: joint ownership of shares on such terms is the most straightforward way of allowing future growth in value to accrue to the employee, whilst ensuring that value accrued to the time of the award remains with the employees' trust;
- the tax treatment has been formally **accepted and acknowledged by HMRC** and is considered unlikely to be the subject of any challenge or even any change in the law;
- the IUMV of the executive's interest as joint owner is valued, for tax purposes, on a basis which is very different from that used to value share options for the purposes of the "share-based payments" accounting standards. The methodology developed and accepted by HMRC Shares and Assets Valuation for determining the IUMV generally produces a figure which is commercially acceptable having regard to the risk of the share price failing to achieve anticipated levels of growth;
- it is a relatively straightforward arrangement to establish, in terms of documentation, and to administer. A suitable joint owner is required, but this role is commonly assumed by an existing or newly-formed offshore employees' trust. (As no gain is anticipated in the trust, it is also possible to use a UK-resident employees trust.) If shares held by an existing employees' trust are to be used, a second trust may be required to act as co-owner, the existing trust retaining the bare legal title to the jointly-owned shares for ease of administration;
- the executive's entitlement to benefit from future growth in value of the jointly-owned shares may be performance-linked by means of granting the trust a call option to acquire the executive's interest exercisable, on a 'no-gain' basis, if and insofar as performance targets are not met. Likewise, if the employee leaves, his interest can be forfeited or bought back by means of the exercise by the trust of one or more call options;
- in the event of a takeover or other corporate event, the fact that executives hold joint ownership of existing shares, rather than contractual rights to acquire shares which may not yet be issued or have been acquired, can make it a great deal easier to deal with incentive awards in the context of any such corporate transaction;
- JSOPs have been accepted by institutional shareholders as having a proper place in the menu of alternative incentive structures and, provided they are properly used to deliver reasonable incentive benefits, will command their support;
- JSOPs can be used to address a problem of underwater share options and/or executive expectations unmatched by hard contractual commitments;

- a JOA can include provision for the joint owners to exchange a proportion of their respective interests in vested jointly-owned shares so that each 'walks away' with the entire beneficial interest in a number of whole shares equal in value to their respective interests as joint owners. Such a provision has been requested by institutional shareholders, and assists in satisfying the auditors that a JOA is a "share-settled share-based payment" for accounting purposes.

That said, the JSOP is not a panacea: the employer company will not (as is typically the case with a share option or L-TIP award) benefit from CT relief for the amount of the gain realised by the executive. However, it is thought that, if the executive pays for the acquisition of his interest the full amount of its IUMV - albeit possibly on deferred terms as to payment - a CT deduction should be properly claimable for the amount of the share-based payments accounting charge associated with the awards. Further, the accounting charges associated with a JSOP will be broadly similar to those relating to comparable premium-priced share options.

A JSOP can also be used to deliver annual bonus awards. If existing shares are used, this should not require prior shareholder approval (as would normally be the case if a fully-listed company wishes to establish a JSOP to be used as a **performance-linked** long-term incentive plan for main board directors). A listed company could, for example, seek shareholder approval for the 'upfront' issue of a given percentage of new shares on terms that insofar as such shares do not vest, or are forfeited when an executive leaves early, such shares may be re-purchased (and cancelled) by the company, thereby protecting against unnecessary dilution.

4. ACCOUNTING FOR SHARE BASED PAYMENTS

All forms of employee (as well as other) share-based awards - referred to as "share-based payments" ("SBPs") - now give rise to an accounting expense, and a consequent reduction in profits, unless the company is small enough to qualify to prepare its accounts under the accounting standard for small enterprises (known as "FRSSE"). For UK companies, the rules for determining the timing and amount of the expense to be recognised are set out in the International Accounting Standard "IFRS2:Share-Based Payment", and the near-identical domestic standard, FRS20.

These standards contain two distinct regimes: the more complex is for an "**equity-settled share-based payment**" such as an award of shares, grant of a share option or acquisition by the employee of a joint beneficial interest in shares; the other is for a "**cash-based share-based payment**" such as a 'phantom' share option or an option which is intended from the outset to be settled in cash, or a cash bonus linked to the price of shares. In the case of an "equity-settled share-based payment", the accounting expense is determined by reference to the fair market value of the award at the time of grant, whereas, in the case of a cash-settled share-based payment, the total cost to be recognised can only be finally determined when the employee ultimately receives the benefit of the award, usually in the form of a cash payment after the award has become vested.

The overall accounting cost of a cash-settled share-based payment to be recognised by the company making the award will (or should) be broadly the same as the value of the benefit to the employee of that award. However, in the case of an equity-settled share-based payment, as the amount of the expense is determined at the time of making the award, that cost will not necessarily equate to the value of the benefit which the employee ultimately derives when, or after, the award has become vested. In some circumstances, for example, the employee may not ultimately receive any benefit whatsoever (e.g. because the share price falls below the exercise price of a share option), but the company will, nevertheless, still be required to recognise an accounting expense.

If an equity-settled share-based payment takes the form of an immediately-vested award of shares, then it may be relatively easy to determine the fair value of the award as this will typically be the market value of the award shares at the time it is made. However, a share option does not itself normally have a clearly defined market value at the time of grant. In this case, it is necessary to determine a theoretical fair value using advanced mathematics based upon what is known as the "Black-Scholes formula". This has six assumptions (or inputs). These are:

- the exercise price
- the market value of the option shares at the time of grant
- the expected life of the option
- the expected volatility of the share price

- the expected dividend yield and
- the risk-free rate of return.

Spreadsheet-based Black-Scholes calculators are now widely available on the internet to enable these calculations to be made. More complex forms of the formula, such as "binomial models" have been developed and there are versions that use so-called "Monte Carlo simulation techniques to determine such theoretical values. Collectively, these are known as "option-pricing theories". Despite their seeming differences, they are all based on the Black-Scholes formula.

If a share option has an unusual structure or vesting depends upon certain performance conditions, a Monte Carlo-based approach may be appropriate for accounting purposes. However, the standards do not specify the use of any particular form of option-pricing theory and, in most cases, a basic Black-Scholes approach will be sufficient.

As well as determining the basic fair value as at the time of the award, it is also necessary, in the case of awards which do not immediately become vested, to estimate the likelihood that the award will become vested to any extent, as this too is taken into account in determining the accounting expense. In this respect, the standards distinguish between three factors which might affect vesting. these are:

- service conditions (i.e. any requirement that the employee remain in service as a condition of vesting);
- performance conditions (e.g. conditions relating to the attainment of target levels of performance expressed by reference to growth in Earnings per Share ("**EPS**") or Total Shareholder Return ("**TSR**"), etc.) and
- non-vesting conditions (i.e. any conditions other than a service or a performance condition, such as the need to have made monthly savings under an SAYE savings contract).
- The interaction of these conditions and an option-pricing theory can be highly complex. For service, and non-market, performance conditions, the company is able to revise its estimate of likely vesting made at the time of grant so as to reflect the actual level of vesting. This process is referred to as "trueing up". A consequence of being able to "true up" is, for example, that if the business fails to meet a non-market performance condition (such as a EPS-based performance target) and none of the award shares become vested, there will be no overall accounting expense to be recognised. In the case of market-based performance conditions, such as performance targets linked to growth in share price or relative or absolute growth in TSR, the estimate made at the time of grant, of the level of vesting, cannot thereafter be changed, regardless of the actual level of vesting achieved.

Once the anticipated total cost of an equity-settled share-based payment at the date of grant has been determined, it is spread over the accounting periods making up the vesting period. For a cash-settled share-based payment, estimates of the accrued liability to date are made at the end of each accounting period. These are later revised when the ultimate liability becomes known.

For a cash-settled share-based payment, the accounting double entry that corresponds with the expense is a real liability recorded in 'Creditors'. However, in the case of an equity-settled share-based payment, the accounting expense is a notional cost and the corresponding double entry is in 'Shareholders' funds', not 'Creditors'.

Tax Rates on Employment Related Share Option Gains

	2008/09	2009/10	2010/11	2011/12
Employers Secondary Class 1 Rate Above Secondary Threshold	12.80%	12.80%	12.80%	13.30%
Employers' Primary Class 1 Rate Above Upper Earnings Limit	1.00%	1.00%	1.00%	1.50%
Aggregate Tax Charged for a 40% Rate Taxpayer as a Percentage of the Gain Realised (Assuming No Transfer of Burden of Employers' NICs)	53.80%	53.80%	63.80%	64.80%
Effective Rate of Tax for a 20% Tax Rate payer if Burden of Employers NICs Transferred to Optionholder	31.24%	31.24%	31.24%	32.14%
Effective Rate of Tax for a 40% Tax Rate payer if Burden of Employers NICs Transferred to Optionholder	48.68%	48.68%	48.68%*	49.48%*
Effective Rate of Tax for a 50% Tax Rate payer if Burden of Employers NICs Transferred to Optionholder	N/A	N/A	57.4%*	58.15%*

* **Note:** This assumed that the employers' NICs are recovered from the optionholder before 5 June in the following year so that relief from income tax is available for the amount of employers' NICs borne

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