Bird & Bird

Long Term Incentive Plans and Deferred Bonus Plans

Introduction

*Long Term Incentive Plans ("**LTIPs**") (also sometimes referred to as "**Performance Share Plans**") are the most popular form of long term share award for senior executives of listed companies in the UK having progressively out-stripped the alternative of "market value" options over the previous 15 years or so. It has also become increasingly common over the same period for companies to make at least part of annual bonus awards to senior executives in the form of deferred shares.*

LTIPs and deferred bonus plans are similar in some respects as both involve free shares so we have dealt with both here. They are often of equal interest to investors when assessing the overall effectiveness of remuneration packages.

Regulatory Requirements

In devising these arrangements, companies on the full list of the London Stock Exchange are required to comply with the rules of the Listing Authority and the UK Corporate Governance Code and will usually wish to comply with the guidelines of representatives of institutional investors such as the Investment Association ("**IA**"). Banks, building societies and investment firms may also be required to comply with the Remuneration Code issued by the Prudential Regulation Authority and the Financial Conduct Authority.

Companies traded on AIM are required to comply with the AIM Rules for Companies and although the IA guidelines do not apply, they may choose to adopt similar principles for good governance reasons or to honour previous commitments to shareholders on governance issues. The UK Corporate Governance code does not apply to AIM companies but they may choose to comply with it or the less demanding code of the Quoted Companies Alliance.

LTIPs Key Features

The key features of LTIPs are:

- Awards entitle participants to free shares after a performance period (of at least three years) provided service and performance conditions are met;
- Participation is at the discretion of the remuneration committee and is usually confined to senior executives but may be extended to other employees;
- Awards are typically made annually, based on a multiple of base salary;
- Awards are invariably subject to comparative and graduated performance targets which are designed to be stretching in order to align the interests of participants and shareholders;
- Participants benefit from the "whole value" of shares subject to the award in contrast to "market value" options which are more geared in that they reward only increases in value from the grant date;

- Share awards are usually sourced using shares held in an employee share ownership plan trust ("**ESOP**") which can purchase or subscribe for shares. Awards can also be sourced using treasury shares but it makes no sense to do this as shares purchased in the market and held in treasury count towards the IA dilution limits whereas shares purchased in the market by an ESOP do not;
- More recently some plans have included a retention period of up to two years after vesting and (particularly in the financial services sector) malus and claw-back provisions triggered by business performance or personal misconduct.

LTIPs vs Market Value Options

LTIPs have become more popular than market value options because:

- Fewer shares are required (participants receive the whole value of shares so awards are generally made over lower multiples of salary);
- Accounting charges are generally lower (particularly for companies with volatile share prices which tend to have an exponential effect on the value of market value options);
- Options can be no incentive when "out of the money" whereas free share awards still have some value if the share price falls;
- Performance targets tend to be more demanding so (arguably) aligning better the interests of participants and shareholders.

Market value options should not be dismissed out of hand, however, as the tax treatment can be better; in addition they can result in the use of fewer shares if structured so as to be "share settled". A separate fact sheet is available on discretionary share options, which deals with these issues in more detail.

Different LTIP Situations

LTIPs can generally be structured in one of three ways:

Nil cost options

Participants are granted an option at the outset which becomes exercisable at the end of a performance period of at least three years to the extent service and performance targets are met. Options typically have a 10 year life. No tax is due until exercise so participants can retain the option after vesting and benefit from the upside on the gross number of shares subject to the award. This gives nil cost options an advantage over the other two ways of structuring LTIPs so we prefer to use nil cost options in the UK and other jurisdictions where possible.

Restricted stock units

Participants receive a promise or contractually binding right to receive free shares at the end of a performance period of at least three years to the extent service and performance targets are met. Participants are typically taxed on the receipt of the shares. LTIPs usually have to be structured as RSUs in the US, for example, as there is an up-front tax charge on the grant of discounted options but not on the award of RSUs.

Restricted stock

Participants receive beneficial ownership of shares at the outset but the shares are subject to forfeiture on cessation of employment or on failure to meet performance targets at the end of a performance period of at least three years. UK participants can elect to pay income tax on the value of the shares at the outset thereby benefiting from capital treatment on future gains. Restricted stock is rare in the UK, however, as the up-front tax cost represents a cash-flow disadvantage and the tax cannot be recouped if the shares are later forfeited.

Deferred Bonus Plans

Deferred bonus plans are typically structured in one of two ways:

Compulsory arrangements

Participants are given no choice, part of their annual bonus is paid in deferred shares which are forfeited on cessation of employment during a service period of up to three years. These awards are not typically subject to performance targets. Compulsory deferral arrangements have become far more common than voluntary arrangements over the last 5 years or so.

Voluntary arrangements with a matching element

Participants may opt to take part of their annual bonus as a deferred award of shares with companies offering a matching award of free shares to encourage take-up. The matching element of the award is typically subject to service requirements and to performance conditions measured over a performance period of up to three years.

Other key features

Other key features of deferred bonus arrangements are:

- Plans can be structured as nil cost options, restricted stock units or even as restricted stock in the same way as LTIPs;
- Participation is at the discretion of the remuneration committee and is often extended beyond senior executives;
- Participants opt-in to voluntary plans before their bonus has been determined to avoid a tax charge at that point (although the recent Rangers Case raises questions as to whether this is treated as a "redirection of earnings");
- Awards are usually sourced using shares purchased in the market and held in an ESOP;
- More recently plans have included malus and claw-back provisions particularly in the financial services sector.

Shareholder Approval

The Listing Rules (broadly) require companies listed on the full list to seek shareholder approval for plans sourced using new issue shares or in which main board directors are eligible to participate and which measure performance over more than one financial year. Consequently LTIPs typically require shareholder approval whereas deferred bonus plans do not if structured correctly.

No such rules apply to AIM traded companies but they may be obliged to seek shareholder approval for good governance reasons or due to prior commitments to shareholders.

Tax Treatment

The tax treatment of LTIPs and Deferred Bonus Plans depends on how they are structured:

Nil cost options

No income tax arises until the option is exercised, pay as you earn ("**PAYE**") and National Insurance contributions ("**NIC**") will arise at that point if the shares are readily convertible assets. Participants will typically sell all their shares on the date of exercise and part of the sale proceeds will be paid to the employer to enable it to operate withholding.

Restricted stock units

No income tax arises until participants become unconditionally entitled to the shares, PAYE and NIC will arise at that point if the shares are readily convertible assets. Participants will typically be required to sell sufficient shares on vesting to fund the tax withholding liability.

Restricted stock

No income tax arises on acquisition (assuming the forfeiture conditions lift within 5 years of acquisition). Income tax arises instead when the forfeiture conditions lift on the full value of the shares at that point. PAYE and NIC apply if the shares are readily convertible assets on each tax point. Alternatively, participants can make an election pursuant to section 431(1) ITEPA 2003 to pay income tax on the "unrestricted market value" of the shares within 14 days of acquisition with the result that subsequent gains on sale are taxed as capital. Participants do not usually make such elections, however, as they have to fund the tax from their own resources and it cannot be reclaimed if the shares are later forfeited.

Disguised Remuneration

Care needs to be taken when structuring LTIPs and Deferred Bonus Plans to avoid unwelcome tax charges arising under the so called "**disguised remuneration**" rules. These impose PAYE and NIC charges on the provision of benefits by a "**relevant third person**" by reason of employment. An ESOP is a relevant third person for these purposes (and is required to source free shares) so care needs to be taken to avoid the rules triggering early PAYE and NIC charges. As a general rule the usual solution is to keep the trustee "blind" as to the identity of participants until the shares are required to be transferred to participants.

Corporation tax deduction

A statutory corporation tax deduction is available on the exercise of options, vesting of restricted stock units or on the receipt or vesting of restricted stock (whichever event is taxable) provided certain conditions are met. The relief is generally given to the employer for the accounting period in which the tax charges arise in the hands of participants on the amount assessed to income tax in their hands.

Structuring LTIPs and Deferred Bonus Plans Tax Efficiently

The top rates of income tax and NIC are as follows:

- The top rate of income tax for individuals is 45% and applies to income in excess of £150,000;
- The top rate of employees NIC is 2% and applies to income above £50,000 for 2020/21;
- The rate of employers NIC is 13.8%

The employers NIC can be passed on to participants by agreement or election and if it is passed on it can be deducted from the amount assessed to income tax. The effective tax rate for an additional rate taxpayer who is not required to pay employers NIC is 47% whereas this increases to 54.59% if the employers NIC is passed on.

On £100 of gain an additional rate taxpayer who is require to pay employers NIC would pay £54.59 calculated as follows: £13.8 + (£100 - £13.8 x 45%) + (£100 x 2%).

These tax rates make it important for employers to structure LTIPs and Deferred Bonus Plans tax efficiently. There are several alternatives of which we have considered three here:

- Joint share-ownership plans (“**JSOPs**”);
- Enterprise Management Incentive Plans ("**EMI**"); and
- Growth shares.

JSOPs are arrangements designed to replicate option plans commercially and can be used by any listed company. HMRC has confirmed JSOPs are effective for tax purposes and need not be disclosed as a tax avoidance scheme. EMI is a form of tax-advantaged option plan which qualifies for favourable tax treatment by statute but is only suitable for smaller companies. Growth shares are an arrangement designed to replicate options commercially are only likely to be suitable for AIM listed companies rather than companies on the full list. Separate fact sheets are available on each of these arrangements.

JSOPs

JSOPs are available to practically all listed companies without any limit on the size of individual awards and it is common for listed companies to use them. In contrast to EMIs, no corporation tax deduction is available for the employer. The high income tax and NIC rates in the UK, however, make JSOPs attractive despite the absence of corporation tax relief. Listed companies with LTIPs and Deferred Bonus Plans should consider structuring awards so gains are delivered through linked JSOP arrangements.

- The participant and the trustee of the company's ESOP jointly subscribe for shares;
- The shares are held jointly in undivided shares as tenants in common on terms set out in a JSOP agreement;
- The participants interest entitles them to gains made on the sale of the shares in excess of a threshold;
- Participants elect to pay income tax on the value of the interest on acquisition, subsequent gains are taxed as capital;
- Performance targets apply so that participants forfeit the interest to the extent targets are not met after a performance period (usually of three years);
- Once the shares vest the participant is entitled to require the shares to be sold and to receive consideration in excess of the threshold.

These arrangements allow participants to benefit from capital gains tax treatment on gains made in excess of the threshold. The full value of the shares is delivered through a linked nil cost option which is exercised at the same time as the jointly owned shares are sold, the extent to which it can be exercised is capped at such number of shares as have a value equal to threshold.

The arrangement replicates LTIPs and Deferred Bonus Plans commercially and so can be introduced without seeking shareholder approval (if the LTIP they are replicating contains the usual wording which permits amendments to secure more favourable tax treatment).

EMI

EMI plans are the most generous form of discretionary option plan in the UK. Tax relief is available whenever options are exercised with no minimum holding period for the shares. Options may be granted up to a limit of £250,000 per employee. EMI is only available to smaller companies, however, with gross assets of less than £30 million and fewer than 250 full-time (or full-time equivalent) employees that meet certain "trading activities" tests. Companies that qualify should structure their LTIPs as nil cost EMI options to qualify for tax relief. If so structured, only the value of the shares on grant is subject to income tax on exercise. Gains in excess of market value on grant are generally taxed as capital on the sale of the shares. The conditions for entrepreneurs' relief ("**ER**") were relaxed as they apply to shares acquired pursuant to the exercise of EMI options with the result that it will usually be possible for participants to claim ER on gains made on the sale of their EMI option shares. Broadly, ER can be claimed if the EMI option was granted more than 24 months prior to the disposal of the option shares and in that period the option-holder is an officer or employee within the group and the company is a trading company or holding company of a trading group.

Where option-holders exercise within 90 days of cessation, the 24 month period runs to the date of cessation so leavers can still benefit from ER

Growth Shares

It is possible for AIM companies to create a new class of growth shares in an intermediate holding company the economic value of which is generally pegged to the listed share price in excess of a hurdle. Once vested, the growth shares can be exchanged for listed shares of the same value. These proposals only deliver gains above the hurdle so a linked nil cost option to acquire listed shares is required to deliver the value up to the hurdle.

It is not generally feasible for companies on the full list to use this sort of arrangement as it requires shareholder approval and the use of subsidiary shares is not recommended by the IA guidelines. These restrictions do not generally apply to AIM companies.

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Chambers UK, 2019

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Other Fact Sheets Available:

Growth Shares

Company Share Option Plans

Discretionary Share Option Plans

Employee Share Markets

Entrepreneurs' Relief

Enterprise Management Incentive Plans

Share Incentive Plans

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