Bird & Bird

Discretionary Share Option Plans

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Introduction

Discretionary share options are an alternative form of share plan for executives and employees of listed companies in the UK. Discretionary share options are usually granted at an exercise price which is not less than the share price on the grant date and so allow participants to benefit only from future gains in contrast to long term incentive plans ("**LTIPs**") which enable participants to benefit from the whole value of the shares awarded.

Options tend to be granted over larger numbers of shares and to be subject to less demanding performance targets than the graduated and comparative targets which apply to LTIPs (as a quid pro quo for allowing participants to benefit only from share price gains). Consequently, companies often award options when their share price is relatively low or when more demanding targets would be inappropriate (e.g., for awards made to participants below board level).

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.

Option Plans – Key Features

The key features of discretionary option plans are:

- options become exercisable after a performance period (usually of at least three years) provided service and performance conditions are met;
- participation is at the discretion of the remuneration committee and is often open to employees below board level;
- awards are typically made annually based on a multiple of base salary;

- awards are invariably subject to performance targets which are often "cliff edge". This means the option becomes exercisable in full on achieving the target. A common target is to achieve a pre-set increase in EPS over the performance period (often in excess of the increase in the retail or consumer prices index over the same period);
- the exercise price is not less than market value on the grant date so participants benefit only from increases in value of shares above the exercise price;
- options are sourced by the direct issue of new shares to participants or by shares purchased in the market by an employee share ownership plan trust ("**ESOP**"). Shares can be sourced from treasury but it usually 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;
- some plans include 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.

Structuring Option Plans

We prefer to structure option plans in several parts. Part 1 contains the main plan rules and allows options to be granted in any jurisdiction without qualifying for special tax treatment. Subsequent parts contain the adaptations necessary for options to qualify for favourable tax treatment in jurisdictions where this is available or to comply with local regulations. Options granted to UK participants, for example, can be granted as CSOP or EMI options (see below) where the conditions are met up to the relevant individual limits with the balance being granted as non-qualifying options.

- Well drafted plans should include the following additional features:
- the rules should entitle the remuneration committee to "share settle" options on exercise. This means participants receive only shares with a value equal to the option gain on exercise (as opposed to the whole number of shares under option) for no payment. Share settlement has a number of advantages, for example: participants can exercise in a cashless manner, fewer shares are utilised for the purposes of the IA dilution limits and exchange control restrictions can be avoided;
- options should lapse at the end of the performance period to the extent targets are not met so freeing up shares for the purposes of the dilution limits;
- remuneration committees should be free to adjust options not only for variations in share capital but for special dividends and de-mergers to keep option-holders whole in these situations with the minimum of difficulty;
- the employer should be entitled to sell sufficient shares to fund any tax payable on exercise through withholding and to meet any employer's social security costs (where it is possible to pass these on to participants).

Some of these features are not permitted for tax qualified options: for example, CSOP and EMI options cannot be adjusted for demergers or special dividends and cannot be share settled. Where share settlement is not possible, a cashless exercise facility should be in place (professional administrators often offer this service in conjunction with web-based platforms).

Shareholder Approval

Option plans typically require prior shareholder approval when introduced by companies listed on the main market of the London Stock Exchange. The Listing Rules (broadly) require companies 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. 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 – Non-qualifying Options

Non-qualifying options granted to UK resident employees are subject to income tax on the spread on exercise. The spread is the difference between the market value of the option shares on the date of exercise and the exercise price. Both employees and employers national insurance contributions ("**NIC**") apply to the spread and pay as you earn ("**PAYE**") is required to be operated by the employer. Participants will usually sell all their option shares on exercise and part of the sale proceeds will be paid to the employer to enable it to operate PAYE.

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 £125,140;
- the top rate of employees NIC is2% and applies to income above £50,268 for 2023/24;
- 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 (employers NIC) + (£100 - £13.8 x 45%) + (£100 x 2%).

Capital gains tax ("**CGT**") may arise on the sale of the option shares but only on gains in excess of the value on exercise. In the normal course of events, if the option shares are sold immediately after exercise there should be no CGT to pay on the disposal.

Corporate Tax Deduction

A statutory corporation tax deduction is generally available on the exercise of options by participants (whether or not the exercise is tax-relieved) provided certain conditions are met. The relief is given to the employer for the accounting period of exercise on the spread.

Structuring Options Tax Efficiently

The tax rates on non-qualifying options make it important for employers to structure option plans tax efficiently. We have outlined four alternatives here:

- Enterprise management incentives ("**EMI**");
- Company share option plans ("**CSOPs**");
- Joint share-ownership plans ("**JSOPs**"); and
- Growth shares.

EMI and CSOPs are forms of tax-advantaged option plans which qualify for favourable tax treatment by statute. EMI is only suitable for smaller companies and the CSOP limits are relatively low. 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. Growth shares are an arrangement which replicate options commercially and are generally only available to AIM listed companies as opposed to companies on the full list. Separate fact sheets are available on each of these arrangements.

EMI

EMI plans are the most generous form of discretionary option plan. 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 options as EMI. If so structured, it should generally be possible for options to be exercised tax free and for gains on the sale of the option shares to be taxed as capital.

The conditions for business asset disposal relief ("**BADR**") are 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 BADR on gains made on the sale of their EMI option shares. Broadly, BADR 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 must be an officer or employee within the group and the company must be a trading company or holding company of a trading group. Where option-holders exercise within 90 days of cessation, the 24 month period is tested on cessation and BADR is either lost or preserved depending on whether they qualify at that point.

CSOPs

CSOPs are available to practically all listed companies but the individual limit is £60,000 (applied to the value of option shares on the grant date) and tax relief is generally only available if options are exercised more than three years after grant (or before then for certain "good" leavers or in connection with certain cash take-overs). Listed companies that operate CSOPs find the low limits often mean the bulk of their share-based awards do not qualify for tax relief. CSOPs are, however, attractive for companies that wish to make more board-based awards.

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 CSOPs and EMIs, no corporation tax relief is available for the employer. The high-income tax and NIC rates in the UK, however, make JSOP arrangements more attractive despite the absence of corporation tax relief. Listed companies with option plans should consider re-structuring future option grants as JSOPs.

Under JSOPs:

- the participant and the trustee of the company's ESOP jointly subscribe for shares;
- the shares are held 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;
- if performance targetsapply, 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 is excess of the threshold.

These arrangements replicate options commercially and can be introduced without seeking shareholder approval (if the option plan they are replicating contains the usual wording which permits amendments to secure more favourable tax treatment).

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 pegged to the listed share price above a "hurdle". Once vested, the growth shares can be exchanged for listed shares of the same value. These proposals replicate options as they deliver gains above a threshold in the same way as an option.

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 Guidelines of the IA. These restrictions do not generally apply to AIM companies.

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> *Chambers & Partners UK, 2022*

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Thank you

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