INTERNATIONAL

Simplifying Tax-Advantaged Share Plans in the UK

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My previous article in this magazine* provided some historical background on the UK's tax-advantaged employee share plans. I expressed the view that, although the UK could claim to have among the best tax incentives for employees to acquire shares in their employing companies, the legislation had not been updated sufficiently to take account of modern remuneration practices. The all-employee plans, in particular, had too many detailed requirements, which meant that non-UK companies extending share plans to their employees worldwide had to make special arrangements for the UK. I suggested a number of ways of improving the legislation.

A few months after the publication of my article (though not as a result of it!), the Office of Tax Simplification (OTS) was asked by the UK Government to undertake a review of the four tax-advantaged share plans in order to identify where they were complex and placed unnecessary administrative burdens on their users and to suggest ways in which they could be simplified. This article summarizes the main results of the review and comments on its effectiveness. The OTS's subsequent review of *unapproved* share schemes is not covered in this article.

THE OTS SHARE SCHEMES REVIEW

The OTS is an independent body which was established in July 2010 to provide expert advice to the UK Government on ways of improving and simplifying the UK's tax system. In July 2011, it was asked to examine the four tax-advantaged employee share plans:

- the approved Share Incentive Plan (SIP),
- the approved Save-As-You-Earn Share Option Scheme (SAYE),
- the approved Company Share Option Plan (CSOP), and
- Enterprise Management Incentives (EMI).

Further details of these plans are set out in the four boxes (see pages 16 and 17).

The OTS started this review in September 2011. During the following few months it gathered a great deal of evidence from employers, professional advisers, plan administrators, employees and government departments about the effectiveness of the tax-advantaged share plans and the complexities involved in operating them. Companies were found to be positive about the benefits of the tax-advantaged share plans but thought that they were over-complex and restrictive. With the help of a Consultative Committee of share plan experts, the OTS developed some detailed recommendations for simplifying the existing plans and removing inconsistencies between them, which were published in March 2012[1].

HM Revenue & Customs (HMRC) responded to these recommendations in June 2012 with a Consultation Document[2], which immediately accepted a few of the OTS's recommendations and sought further evidence in relation to many of the others. Following this consultation, a large number of the recommendations were accepted in HMRC's Summary of Responses[3] in December 2012 and have subsequently been implemented.

MAIN RECOMMENDATIONS OF THE OTS REVIEW

The OTS made three main recommendations in its report.

Abolition of the Approval Process

At present, companies cannot operate SIP, SAYE or CSOP without first obtaining formal approval for the plan from HMRC. Before giving approval, HMRC examines the plan documents in detail, including the rules, the grant or enrolment forms and explanatory materials, to confirm that the plan complies fully with the relevant legislation.

The process of obtaining HMRC approval can add a few months to the introduction of a new plan. This is partly because some of the approval requirements are expressed in very general terms. An example is:

> "The scheme must not contain features which are neither essential nor reasonably incidental to the purpose of providing benefits for employees and directors in the nature of share options."

* For further information, please see 'UK Tax-Favoured Share Plans: What Next?' by Michael Landon, *B & C International*, November 2010.

BOX 1

Approved Share Incentive Plan (SIP)

A SIP allows employees to acquire shares in their company in four different ways:

Partnership shares. Employees can contribute up to £1,500 p.a. from their salaries, before deduction of income tax and national insurance contributions (NICs). Shares can be purchased monthly or at the end of an accumulation period of up to 12 months.

Matching shares. The company can match each partnership share with up to two matching shares, i.e. worth up to £3,000 p.a. If it wishes, there can be a lower matching ratio, such as one matching share for every two partnership shares.

Free shares. The company can award each employee shares worth up to £3,000 each year. The shares must be allocated between employees on the 'same terms', which allows for variation by reference to remuneration levels, length of service or hours worked. Alternatively, awards can be based on the performance of business units.

Dividend shares. Dividends paid on shares held in the plan may be reinvested to acquire further shares for participants.

All employees must be eligible to participate provided they have been employed for a qualifying period of no more than 18 months (six months for partnership shares if there is an accumulation period).

Matching shares and free shares must be left in the plan trust for a holding period of between three and five years. The holding period for dividend shares is three years. A SIP can provide that matching and free shares will be forfeited if the participant leaves employment, except in certain special circumstances, before the third anniversary of the award date. Matching shares may also be forfeited if the corresponding partnership shares are taken out of the plan within three years.

There is no income tax or NIC liability provided that the shares are left in the trust for at least five years (three years for dividend shares). Any increase in the value of the shares while they are held in the plan is exempt from capital gains tax (CGT). The employing company can claim a corporation tax deduction for the cost of awarding matching and free shares and for any discount given for partnership shares.

BOX 2

Approved Save-As-You-Earn (SAYE) Share Option Scheme

This plan gives employees the opportunity to save the funds needed to exercise share options from (after tax) salary. Employees can each save up to £250 per month for three or five years. At the end of the savings period, they can exercise options to acquire the company's shares within a six-month period. The exercise price must be not less than 80% of the share price at the time of grant. Participation must be offered on similar terms to all employees who meet a qualifying period of service, not exceeding five years.

There is normally no income tax or NIC liability when options are exercised. On sale of the shares, there is a potential CGT charge on the difference between the sale proceeds and the price paid; but most employees are covered by the annual CGT exemption (£10,900 in the 2013/14 tax year). The employing company can claim a corporation tax deduction for the difference between the value of the shares on the exercise date and the price paid by its employees.

BOX 3

Approved Company Share Option Plan (CSOP)

This is a discretionary plan that allows the company to select which employees are granted share options and decide the size of the grant and other terms and conditions for each individual. Directors can only be eligible if they work at least 25 hours per week. An individual can be granted approved options over shares worth up to £30,000 – this is not an annual limit but it includes all options that are still subsisting. The option exercise price must not be less than the market value of the shares at the grant date.

Provided that the option is exercised between the third and 10th anniversaries of grant (or earlier if the participant has left employment in certain special circumstances), there is no income tax or NIC liability on exercise. On sale of the shares, there is a potential CGT charge on the difference between the sale proceeds and the price paid; but this may be reduced or eliminated by the annual CGT exemption. The employing company can claim a corporation tax deduction for the difference between the value of the shares on the exercise date and the price paid by its employees.

BOX 4

Enterprise Management Incentives (EMI)

EMI is only available to smaller companies whose gross assets do not exceed £30 million and that have fewer than 250 employees. Companies in certain sectors, including land dealing, farming, leasing, banking, shipbuilding and coal and steel production, are excluded from operating EMI.

EMI is a discretionary arrangement that allows the company to select which employees are granted share options and the size of grant and other terms and conditions for each individual. To be eligible, an employee must work for the company for at least 25 hours per week or, if less, for at least 75% of his/her working time. An individual can be granted EMI options over shares worth up to £250,000 – this limit applies both to EMI (and any CSOP) options subsisting at any time and to the options granted in any three-year period. There is no minimum exercise price or holding period before an option can be exercised.

If the exercise price is no less than the market price of the shares at grant, there is no income tax or NIC liability at exercise. On sale of the shares, there is a potential CGT charge on the difference between the sale proceeds and the price paid; but this may be reduced or eliminated by the annual CGT exemption. The employing company can claim a corporation tax deduction for the difference between the value of the shares on the exercise date and the price paid by its employees.

HMRC has developed its own criteria for interpreting these provisions, which have changed over time and, even more frustratingly, sometimes differ between the officials dealing with the approval. It has also introduced its own rules (not set out in the legislation) that limit the extent to which companies can exercise their discretion, for example when deciding whether or not performance conditions have been met and how participants who leave employment early will be treated.

Even after a plan has been approved, companies must obtain clearance from HMRC for changes to key features and for adjustments to existing awards, for example to take account of a corporate transaction. Staff shortages in the relevant HMRC department have caused difficulties for companies in these situations where a response is required within a very short timescale.

The OTS recommended that the approval process should be abolished and replaced with a system of self-certification of these plans by the companies themselves. Not surprisingly, the Government has accepted this recommendation, as this has the potential to save it considerable costs.

Although companies have generally welcomed the move towards self-certification, there are concerns that they might accidentally fail to comply with all the provisions of the complex legislation and that this might result in penalties and the removal of the tax-advantaged status of the plan.

As a consequence, the introduction of self-certification has been delayed until April 2014. In the meantime, I understand that HMRC will be making extensive improvements to its guidance about how to meet the requirements for tax-advantaged status. I also anticipate that some further simplifications to the legislation will be required – over and above those discussed later in this article.

Further Investigation into the Relevance of CSOPs

One of the findings of the OTS review was that there had been a declining use of the CSOP over the previous 10 years. (Some HMRC statistics are quoted towards the end of this article.) It therefore recommended that further work should be carried out to investigate whether or not the CSOP was still relevant for UK business. The Government also accepted this recommendation, again not surprisingly, as the abolition of the CSOP could lead to additional tax revenue. HMRC's Consultation Paper asked the rather narrow question:

> "... whether there was any new economic evidence that the plan, as currently used, had a positive effect on productivity and economic growth and addressed market failures".

This threat to the CSOP caused considerable dismay among companies, as it is the most popular of the three approved share plans and is considerably more flexible than SIP and SAYE. In my view, the main reasons for its reduced usage in recent years have been as follows:

- the £30,000* limit to the value of shares subject to options has not changed since 1995; and
- the CSOP only allows for grants of market-priced share options, which have become less popular, partly because of changes in accounting rules and partly because there has been less share price growth.

HMRC reported, in its Summary of Responses, that:

> "... no new economic evidence of the effect of the scheme on productivity or economic growth was received as part of the consultation ... most respondents provided evidence of how CSOP is currently used by businesses, and views on the benefits of the scheme".

As a consequence of a considerable lobbying effort, the CSOP was saved.

Merging CSOPs and EMIs

The OTS had obviously anticipated that the CSOP would in fact survive. In an apparent attempt to simplify the legislation further, it recommended the merger of CSOP

* €1 = £0.84; US$1 = £0.64 as at 4 September 2013

and EMI. This proposal had the potential to make CSOPs even more flexible by allowing CSOP options to be granted at a discount or at nil cost, as has always been the case for EMI options.

Unfortunately, the OTS recommended that a complicated two-stage implementation process for the combined plan should be adopted and that the two separate (£30,000 and £250,000) limits be retained, with all the current EMI criteria continuing for the higher limit to apply. The OTS's recommendation would ironically have resulted in greater complication. The Government decided not to proceed with the merger.

SUPPLEMENTARY RECOMMENDATIONS

The OTS suggested a large number of detailed recommendations for improving the legislation for tax-advantaged share plans. These included removing some unnecessary restrictions and increasing consistency between the separate plans. In the interests of saving space, I am only reporting here the recommendations that *were* accepted by the Government and have been implemented – mostly in the Finance Act 2013, which was enacted on 17 July 2013. These are as follows:

1. Retirement of participants. The legislation for SIP, SAYE and CSOP allows early withdrawal of shares or exercise of options with income tax relief if the participant retires. (This is unnecessary for EMI, as there is no minimum period before EMI options can be exercised with tax relief.) However, the retirement provisions differed between the three plans – for example, each had a different minimum retirement age. Furthermore, there was concern that the legislation was inconsistent with age discrimination regulations. All references to a retirement age have now been removed, which effectively allows companies to set their own definition of retirement.

2. Other 'good leavers'. SIP, SAYE and CSOP allow early withdrawal or exercise with tax relief in other 'good leaver' circumstances, such as injury, disability and redundancy. SIP also allows tax relief if the reason for leaving employment is that the participant's business or employing company leaves the group. This additional 'good leaver' provision has now been added to SAYE and CSOP.

3. Takeovers. SIP allowed participants to accept a takeover offer for their shares but employees were subject to an income tax charge if they accepted a cash offer for shares acquired in the previous five years. SAYE and CSOP allowed the exercise of options on a takeover but participants would be subject to income tax if options were exercised within three years of the date of grant. This income tax charge has now been removed where there is a cash offer and there is no opportunity to 'roll over' the share awards or options in exchange for rights over shares in the acquiring company.

4. Material interest rules. Where the company whose shares were used for a tax-advantaged share plan was a close company (controlled by a small number of shareholders), there were restrictions on participation by individuals with a material (at least 25%) interest in the company. These were set out in a large number of pages of complex legislation, even though there were very few people actually excluded. The material interest restrictions have now been removed for SIP and SAYE and, in the case of CSOP, the 25% figure has been increased to 30%, for consistency with EMI.

5. Restricted shares. The shares to be acquired through SIP, SAYE and CSOP could not be subject to restrictions, except in certain very limited circumstances. This has made the use of these plans difficult for some private companies. The limitations on using restricted shares have now been removed, though the nature of the restrictions must be explained to participants and SIP partnership shares must continue not to be forfeitable.

6. SIP partnership share accumulation periods. If SIP shares are purchased monthly, the price paid by the employee is the market value of the shares on the acquisition date. If the shares are acquired at the end of an accumulation period (between two and 12 months), the price paid was the lower of the share prices at the start and the end of that period. (This is similar to a US-type §423 employee stock purchase plan.) In practice, only a few companies have adopted accumulation periods, despite the cost savings of purchasing shares less frequently, because they would in effect have to pay the equivalent of any increase in the share price over each period and this potential cost would be unpredictable. The legislation has now been changed so that companies can use one of three prices: the price at the start of the accumulation period, the price at the acquisition date or (as applied before) the lower of the two prices.

7. SIP dividend share limit. The SIP legislation specified a limit to the value of dividends that could be reinvested to acquire dividend shares of £1,500 p.a. As some SIPs have been operating for 13 years, an increasing number of participants had become affected by this limit. The limit has now been removed.

8. Abolition of SAYE seven-year options. SAYE plans have for many years been able to offer employees options that can be exercised three, five or seven years after the date of grant. However, according to a recent survey by *ifs* ProShare, only 11% of companies offer seven-year options and less than 1% of SAYE options granted last for seven years. The seven-year choice has now been removed.

9. SAYE participation while on certain types of leave. Contributions by employees to SAYE must normally be by deduction from salary. HMRC already allowed contributions to be made directly if the employee was on maternity, parental, adoption or long-term sickness leave or was a reservist called up for military service. This facility is now also allowed if an employee is on secondment or sabbatical leave.

10. EMI disqualifying events. Under the EMI legislation, a 'disqualifying event' occurs in certain circumstances, notably when the company is taken over or the participant leaves employment. In these cases, tax relief on exercise of an EMI option was only available if it was exercised within 40 days of the event. This period was found to be too restrictive and it has now been extended to 90 days.

ASSESSMENT OF THE OTS REVIEW

The OTS review of tax-advantaged share plans achieved a substantial amount, considering that it only lasted six months. As set out above, it identified a large number of improvements which could be made to the existing legislation and many of these have been implemented. Companies will welcome the additional flexibility available in the design and operation of these plans.

However, these measures are unlikely to be sufficient to reverse the decline in participation in these share plans over the last 15 years. TABLE 1 shows the number of employees who were granted share awards or options through tax-advantaged plans during the tax years 1997/98 and 2011/12.

In 1997/98, roughly one million employees participated in both the all-employee plans: approved Profit Sharing Schemes (which were replaced by SIPs) and SAYE. There are now fewer than 400,000 employees participating in new awards each year under SIP and SAYE. Similarly, grants of share options under the discretionary plans have fallen from 330,000 employees for CSOPs in 1997/98 to about 43,000 in CSOP and EMI combined.

If the Government wishes to increase employee share ownership substantially, this will only be achieved through tax-advantaged share plans. Some possible further improvements are suggested, as follows:

1. Remove the remaining uncertainties about the conditions to be met for the plans to qualify for tax relief; otherwise, companies may be reluctant to accept the new self-certification arrangements. This requires clearer guidance from HMRC and replacement of some of the more general conditions with more explicit ones.

2. Further reduce the number of requirements for tax relief, particularly for SIP and SAYE, to allow greater flexibility for companies to design plans that meet their business requirements. Other countries with tax-advantaged share plans – such as the USA, France and Australia – have been able to keep their list of qualifying conditions considerably shorter than the UK's.

TABLE 1 Tax-Advantaged Share Plans

Type of plan	*No. of employees* 1997/98	2011/12
	'000	*'000*
Profit-sharing	960	–
SIP – free shares	–	380
SIP – partnership shares	–	336
SAYE	1,170	380
CSOP	330	25
EMI	–	18

NOTE: In the case of SIP partnership shares, HMRC's figures for the number of allocations have been divided by 12 because most partnership shares are acquired monthly.

Source: Employee share schemes statistics, HMRC website, figures for 2011/12 published on 28 June 2013

3. Review the plan limits on a regular basis, to ensure they keep up with inflation. The current individual participation limits were set in 1991 for SAYE, 1995 for CSOP and 2000 for SIP.

4. Reduce the period before SIP shares can be removed free of tax from five years to three years.

5. Extend the tax benefits of CSOP to other types of conditional share award (including restricted stock units), in line with current remuneration practice.

6. Make it easier to transfer shares acquired through share plans directly to other tax-relieved savings arrangements, such as Individual Savings Accounts (ISAs) and pension plans.

Employee share plans can play a key role in promoting economic growth through rewarding and motivating employees. The Government can assist this process by building on the success of the OTS review and by adding greater flexibility through reducing the detailed conditions to be met to qualify for income tax relief. Ω

References

[1] 'Review of tax advantaged employee share schemes: Final report', Office of Tax Simplification, March 2012.
[2] 'Consultation: Office of Tax Simplification's report on tax advantaged employee share schemes Consultation document', HMRC, 27 June 2012.
[3] 'Consultation: Office of Tax Simplification's report on tax advantaged employee share schemes Summary of Responses', HMRC, December 2012.

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