Share Plans Update – December 2012

Over the last month the Government has released a steady stream of announcements on employee share plans. These included the following:

Enterprise Management Incentives (EMI)

- Entrepreneurs' Relief to be extended to all shares acquired through EMI options, with the one-year holding period starting at the date of grant of the options.
- The period during which EMI options can be exercised with tax relief after a 'disqualifying event' to be extended from 40 to 90 days.
- Proposal to extend eligibility to part-time 'academic' employees withdrawn.
- No need to enclose articles of association with option agreements.

Company Share Option Plans (CSOPs)

- Tax relief to be retained, following an investigation into relevance of CSOPs.

Share Incentive Plans (SIPs)

- Abolition of £1,500 pa limit to the value of Dividend Shares.
- More flexibility on accumulation periods could mean many companies will switch to buying shares annually, instead of monthly.

Savings-Related (SAYE) Share Option Schemes

- Employees can continue to participate while on secondment and sabbatical leave.
- 7-year options to be abolished.

All 'approved' share plans

- Self-certification to replace the present approval process in 2014.
- Confirmation that information can be sent to employees electronically.
- More flexibility on the definition of 'retirement'.
- Other 'good leaver' provisions for CSOP and SAYE to be aligned with SIP.
- Tax relief to become available following certain cash takeovers.
- The 'no material interest' eligibility requirement to be removed for SIP and SAYE.
- Restricted shares to be allowed for CSOP, SIP and SAYE.

Other

- Capital gains tax (CGT) exemption for those with 'employee shareholder' status.
- More flexibility for late payments of PAYE on employment-related securities.

Government response to Office of Tax Simplification's report on tax-advantaged share schemes

In March 2012, the OTS issued a large number of recommendations for improving the tax legislation for the tax-advantaged share schemes – EMI, CSOP, SIP and SAYE. HMRC accepted certain of these recommendations in a consultation paper in July and asked for views on the potential impact of some of the other proposals.

Following this consultation, in a Summary of Responses, issued on 11 December, the Government announced its implementation of many of the OTS proposals and published draft clauses, intended to be included in next year's Finance Bill.

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Self-certification to replace the approval process

Under current legislation, companies which want to introduce CSOP, SIP or SAYE schemes must first obtain formal approval from HMRC for all of the plan documents. This can be a lengthy process and delays in obtaining approval have increased over the last couple of years due to reductions in the number of share scheme advisers in HMRC's Employee Shares and Securities Unit.

The OTS recommended a move towards self-certification and the Government has accepted this. However, MM&K and other respondents to the July consultation paper expressed concern that the current legislation for these three plans contains many detailed requirements which are rather vague and allow HMRC effectively to make up their own rules about how they should be interpreted. For example, HMRC:

- do not allow performance conditions to be subject to the exercise of judgment as to whether or not they have been satisfied;
- do not allow companies to exercise any discretion on the entitlement of certain 'good leavers' on termination of employment; and
- object to arrangements offering a choice between cash and shares, even though the cash would be fully taxable.

For these reasons, HMRC's target date for implementation of self-certification has been delayed until 2014. In the meantime, they intend to investigate whether some of the existing approval conditions can be simplified and to improve their guidance on points of uncertainty.

Electronic communication of schemes

The OTS identified that some companies were uncertain about whether the information provided to employees about approved share plans could be sent electronically or accessed via secure websites, instead of hard copies being sent to them. In their Employment-Related Securities Bulletin Number 5, issued on 12 December 2012, HMRC confirmed that companies and trustees can make notifications electronically but must ensure that all participants receive them. Giving information on a web portal will satisfy this requirement if all participants are made aware of the information and updates given on the portal.

The OTS also drew attention to the uncertainty about whether a paper copy of a company's articles of association has to be included with EMI option agreements. The same Bulletin confirmed that it is not necessary to include a hard copy of the articles (or scheme rules or shareholders' agreements, where these exist) but option agreements must state where participants can access copies.

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Retirement age

The current legislation for approved share plans contains different provisions for the treatment of participants who retire. For example, the specified retirement age must be no less than:

- 50 for SIPs;
- 55 for CSOPs; and
- 60 for SAYE

While for SIP and CSOP participants can benefit from tax relief if they retire on <u>or after</u> the specified age, for SAYE retirement must be exactly on the date the participants reach the specified age or another age on which they are contractually bound to retire. Following the abolition of the default retirement age, it is questionable whether there is such a thing as contractual retirement age any more.

The OTS recommended a single approach to retirement for all three plans and that companies should be permitted to apply their own definition of retirement. The Government has agreed to accept these recommendations. Under draft clauses for Finance Bill 2013, references to the specified retirement age are to be deleted. HMRC will be publishing guidance next year on the circumstances in which a presumption can be made that an individual is retiring. It will not be possible for an employee to retire for the purposes of the scheme but not for any other purpose.

In the case of SAYE, employees will no longer be able to exercise options when they reach the specified age without actually retiring.

Harmonisation of other 'good leaver' circumstances for SIP, SAYE and CSOP

The legislation for the three types of 'approved' share plan provides for options to be exercised or shares to be withdrawn from the SIP trust with the benefit of income tax relief when employees cease employment in certain special circumstances, which are often referred to as 'good leavers'. However, there is inconsistency between these provisions for different plans. For example, SIP participants are 'good leavers', with income tax relief, if their employing company leaves the group or their business is subject to a TUPE transfer; but tax relief will not be available to SAYE or CSOP option holders if options are exercised in these circumstances.

The draft Finance Bill clauses will amend the 'good leaver' circumstances for SAYE and CSOP to align them with those which currently apply for SIPs.

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Tax treatment following cash takeovers

Under the SIP legislation, if employees accept (or are deemed to have accepted) a cash offer for their shares, this will result in an income tax charge for shares which have been held in the plan for fewer than five years. Similarly, if an SAYE or CSOP option is exercised within three years of the grant date following a takeover, the gain on exercise is subject to income tax. This can be considered unfair, as the change of control and terms of the offer will be outside the control of most employees. The OTS recommended that there should be an income tax exemption in these circumstances.

Draft Finance Bill clauses will allow payments for SIP shares and exercise of SAYE and CSOP options to be tax-free where there is a change of control of a company as a result of a general offer for cash made to holders of all shares in the company (or holders of shares of the same class as those acquired through the share plan). However, this exemption will not apply if the employees had an alternative choice of accepting shares in the acquiring company in exchange for SIP shares or options over shares in the acquiring company in exchange for the SAYE or CSOP options.

The 'no material interest' eligibility requirement

Individuals are not eligible to participate in a SIP, SAYE or CSOP if they already have a 'material interest' in the company, which is ownership of more than 25% of the ordinary share capital. For EMI, the figure is 30%. Several pages of complex legislation are needed to define 'material interest'.

Following the OTS recommendation, the draft Finance Bill clauses remove the material interest rules for SIP and SAYE completely and align the relevant percentage for CSOP and EMI at 30%.

Restrictions on shares

The requirements for SIP, SAYE and CSOP prevent the use of shares which are subject to restrictions. There are only limited exceptions, which include the ability to require employees of a private company to offer their shares for sale on leaving employment but only if certain detailed safeguards are inserted in the company's articles of association.

As recommended by the OTS, the draft Finance Bill clauses remove the prohibition on the use of restricted shares. The restricted shares will be valued for the purposes of the schemes – for example, participation limits - as if they were unrestricted and information will need to be provided to participants about the restrictions.

Restrictions on use of QUEST shares in SIPs

There are certain restrictions on using shares transferred from a qualifying employee share ownership trust for the purpose of a SIP. As tax relief for QUESTs was withdrawn many years ago, this is an unnecessary additional clause to include in the SIP Trust Deed and Rules. As recommended by the OTS, the draft Finance Bill clauses will remove this provision.

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New flexibility for SIP accumulation periods

Under the current SIP legislation, the purchase of Partnership Shares can either be every month or at the end of an accumulation period, which can last between two and 12 months. For monthly purchases, the price paid by the employees is the same as the share price on the acquisition date. However, where there is an accumulation period, the employees pay the lower of the share price at the start of the accumulation period and the share price when the shares are actually acquired. This is a feature taken from US 'section 423' employee stock purchase plans.

Some companies have been reluctant to operate SIPs with accumulation periods because, if the share price increases over a period, the company itself will have to make up the difference between the price paid by the employees and the higher value of the shares when they are acquired. Not only is this an additional cost to the company but the potential liability is unknown (and uncapped).

The Government has accepted the OTS recommendation that the price to be paid by the employees can be specified by companies to be any of the following:

- the price at the acquisition date;
- the price at the start of the accumulation period (making the offer like a share option); or
- the lower of these two prices (as at present).

We think that many companies which currently operate monthly share purchase arrangements will decide to switch to annual purchases at the end of a 12-month accumulation period in order to save administration costs. The employees will be required to pay the full share price at the purchase date, which will mean that the company will not have an additional expense at that time. The employees will, of course, continue to benefit from making contributions from their pre-tax and pre-NICs salaries, so that the shares will cost them less in net pay.

Removal of the limits to reinvestment of dividends from SIP shares

There is a limit of £1,500 to the value of the dividends which can be reinvested in a SIP each tax year to acquire Dividend Shares. Now that many SIPs have been operating for more than 10 years, a growing number of participants are affected by this limit.

According to the latest ifs ProShare Survey, 8,920 employees received dividends on their SIP shares exceeding £1,500 in 2011. This number is likely to increase rapidly in the coming years, both as a result of SIPs having been operated for a longer period and partly as more companies recover from the recession and start paying dividends again.

Under a separate provision, if the dividends are not reinvested within three years they must be returned to the participants. Together, these requirements add to the complexity of administering SIPs. The draft Finance Bill clauses will implement the OTS recommendation to remove both the £1,500 limit and the three-year carry forward limit.

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Abolition of SAYE 7-year options

SAYE options can currently be granted for periods of three, five or seven years. However, the latest ifs ProShare survey showed that only 17% of companies with SAYE schemes currently offer 7-year options and fewer than 1% of outstanding SAYE options last for seven years. As recommended by the OTS, HMRC have announced that they propose to amend the SAYE prospectus in 2013 to remove the choice of 7-year options.

SAYE contributions during sabbatical leave or secondment

Contributions by employees into SAYE schemes must normally be made by deduction from salary. HMRC already allow contributions to be made directly to the bank or building society when the employee is on maternity, parental or adoption leave, a reservist called up for military service or on long-term sick leave.

As recommended by the OTS, HMRC announced in their Bulletin Number 5 that direct contributions will also be permitted if an employee is on secondment to another job or post in the same organisation or on sabbatical leave.

EMI options: exercise after a 'disqualifying event'

Under the EMI legislation, a 'disqualifying event' occurs in certain circumstances, including the company coming under the control of another company and the option holder leaving employment. In these circumstances, tax relief on exercise of an EMI option will only be available if the option is exercised within 40 days of the event. To give further flexibility, the draft Finance Bill clauses will extend this tax-free exercise period to 90 days.

Future of the CSOP confirmed

The OTS review noted that usage of CSOPs had declined significantly over the last 10 years and it had found it difficult to identify the types of companies which used CSOPs and why they did so. It recommended further investigation into the relevance of the CSOP for UK businesses.

This recommendation caused considerable concern for the many companies which do use CSOPs, which are by far the most flexible of the approved share plans. This was compounded by the Government's consultative paper, which merely asked if there was any new economic evidence on whether the CSOP had a positive effect on productivity and economic growth and addressed market failures. Evidence of this very limited nature was obviously very difficult to produce.

Fortunately, there was a strong response from companies, which demonstrated that CSOPs were a very useful form of reward, in particular for junior and middle ranked employees and, in some cases, for employees generally. The Government has therefore decided to retain CSOP as a tax-advantaged share option scheme available to a wide range of businesses.

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MM&K and others had pointed out that CSOPs could be made even more effective by increasing their flexibility further, in a similar way to EMI options, for example by:

- permitting options to be granted at nil-cost or with an exercise price below the share price at the grant date (while only giving income tax relief for any increase in value after the grant date); and
- allowing options to be exercised with income tax relief within three years of the grant date (where the plan rules permit).

Interestingly, the Government noted that many of the changes recommended by the respondents to the consultation had the potential to make CSOP even more attractive, flexible and simple for businesses and participants. There may therefore be scope for further lobbying to make the CSOP even more relevant to businesses and consistent with modern remuneration practice.

Extension of CGT Entrepreneurs' Relief to EMI options

Entrepreneurs' Relief allows capital gains realised on disposal of shares in a trading company to be taxed at a reduced rate of 10% provided that the individual had for the previous year worked for the company and owned at least 5% of the ordinary shares. Entrepreneurs' Relief is subject to a lifetime limit in the first £10 million of gains.

As announced earlier this year, legislation will be introduced in Finance Bill 2013 to extend this relief to shares acquired through the exercise of an EMI option, even if the employee does not hold 5% or more of the ordinary shares. The 12-month minimum holding period will still apply; but the Government has now confirmed that it will start on the date on which the EMI option was granted. (This follows the same principle for EMI options as used to apply for business assets taper relief.)

The new rule will apply to EMI options exercised on or after 6 April 2012 provided that the shares are disposed of no earlier than 6 April 2013 (and at least 12 months after the option grant date).

Proposal to extend EMI to 'academic employees' abandoned

Earlier this year, the Government proposed to allow academics who worked partly for a research institution and partly for an EMI qualifying company to be granted EMI options, even though they did not meet the normal requirement to work 25 hours per week (or 75% of their working time, if less). Following a consultation exercise, the Government has announced that it does not intend to proceed with this proposal.

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Tax relief for 'employee shareholder' status

A new employment status, known as 'employee shareholder', is to be created by the Growth and Infrastructure Bill. Staff with this status will lose certain of their employment rights, such as unfair dismissal, flexible working, training and redundancy pay. The main aim of the proposal is to remove perceived barriers which are deterring businesses from hiring new employees.

As an incentive to employees to agree to this new status, employers will be required to give them shares worth at least £2,000. As a further incentive, capital gains on those shares will not be subject to CGT when they are sold.

On 11 December 2012, the Government provided further details of the CGT exemption together with draft clauses for Finance Bill 2013. The exemption will be available for shares which were worth up to £50,000 at the time of their original receipt.

This new employment status will only be attractive to individuals in a limited range of circumstances. Employees are likely to be subject to income tax on the value of the shares when they receive them. Alternatively, if the shares are potentially forfeitable, the income tax charge will arise on the value of the shares at the time when the restrictions are lifted – which could mean that no part of the gain will be subject to CGT in any case. As individuals can make up to £10,600 worth of capital gains each year without any CGT liability, the CGT exemption will only be attractive if there is potential for substantial growth in the share price at the time when the shares are acquired.

For this reason, we understand that the Government is considering waiving income tax and NICs on the first £2,000 in value of shares awarded to individuals with 'employee shareholder' status.

More flexibility of meeting PAYE deadlines

When payments are made to employees, employers are required to deduct PAYE and to account for it within strict deadlines. This can cause particular problems where employment income is paid to employees in the form of employment-related securities – for example on exercise of a share option. It is sometimes necessary for companies or trustees to consult employees as to how the tax liability is to be paid – eg by selling some or all of the shares. Due to the delay in obtaining these instructions, there is a risk of incurring penalties and interest for late notification and payments, which may be increased by the introduction of real time information (RTI).

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In its Employment-Related Securities Bulletin Number 4, issued on 26 November 2012, HMRC stated that they would "take a common sense approach to deciding whether we agree that employers have a reasonable excuse for not telling us on time about any tax and NICs due on employment-related securities, or for not paying this tax and NICs by its due date. In assessing whether we agree that employers have a reasonable excuse, HMRC is not expecting employers to depart from currently accepted practice in relation to arrangements sometimes referred to as 'sell to cover', 'sell all', 'self fund' or 'hold all'."

HMRC expect that the late reporting will normally take place no later than the next regular monthly payroll date and that the payment will normally be made to HMRC within normal PAYE deadlines for that month.

This Share Plans Update is intended to give readers an overview of recent share plan developments. Companies should take appropriate professional advice on their particular circumstances before taking action on any of these issues.

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