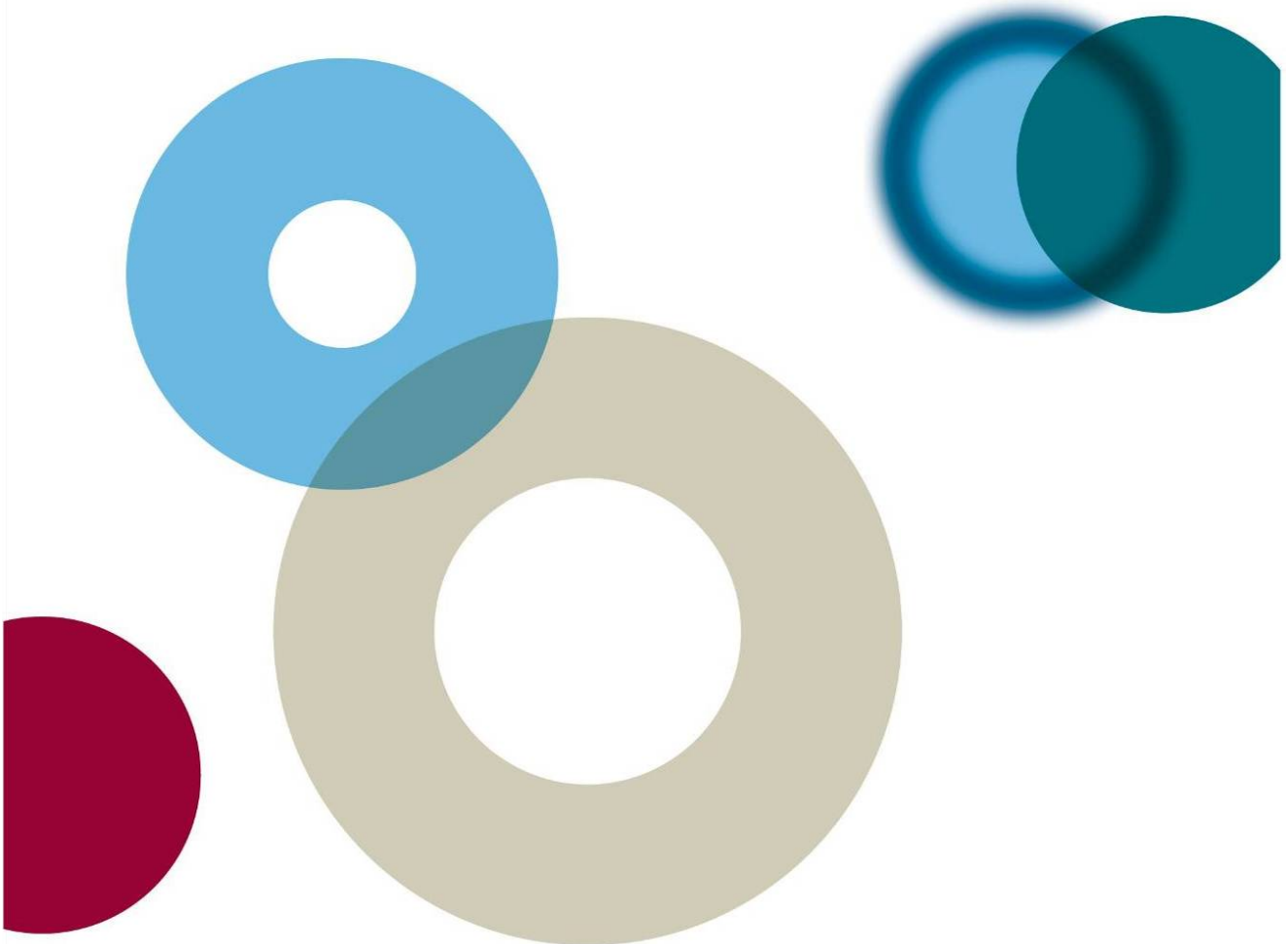




Practical Guide to Employee Share Plans

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Foreword

Employee share plans are all about motivation. Shareholders want management and wider staff to be motivated in their work and to increase the overall returns of the company. Employees want to feel valued and be rewarded if they work hard.

This guide explains what employee share plans are available to UK companies, how they operate, the benefits they deliver and the tax environment within which they sit.

I hope you find it helpful.

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It's good to share

Employee share plans take many forms but can be broken down into two basic concepts: the plans either provide share options or they provide awards of shares (for free or on beneficial terms).

Whichever form the plan takes, it will be structured to deliver some form of tax efficiency and to ensure that employees only receive a benefit if they remain employed for a specified period of time, typically three to five years.

Share options

The following are common share option plans:

- Enterprise Management Incentives (EMI)
- Company Share Option Plans (CSOP)
- ShareSave Plans (also known as Savings-Related Share Option Plans and SAYE Plans)
- Unapproved Share Option Plans (also known as Executive Share Option Plans)

These plans all work on the basis that an employee is granted a right to buy shares in his employer in the future at a price fixed now. The price is usually the market value of the underlying shares at the date of grant. The employee may exercise the right to buy the shares either in three years time or when the company is sold/lists, provided they remain in employment. Option plans tied to a company's sale or listing are often referred to as "Exit-Only" plans.

Options are attractive to employees because they are risk free - employees don't have to exercise but may if they wish. Options are attractive to employers because they are simple to operate.

Free share awards

The following are common share plans which provide shares for free or on beneficial terms:

- Long Term Incentive Plans (also known as Performance Share Plans) (LTIP)
- Share Incentive Plan (SIP)
- Nil-paid share arrangements (also know as partly paid or deferred payment arrangements)
- Growth share plans
- Joint ownership equity plans

These plans all operate in very different ways, but in one way or another they involve the employer giving away free shares to the employees or the employer assisting the employees in the purchase of shares. Again, employees are tied into a retention period and will have to sell shares back if they leave employment within three years.

These plans can sometimes offer a better commercial fit than option plans, because they deliver benefits more effectively linked to company performance.

The plans in detail

More detail on the available plans is set out below. Please note that all plans are discretionary (i.e. the board of a company can select which employee should participate) except ShareSave and SIP, which are all-employee share plans.

Share options

EMI, CSOP and Unapproved

EMI and CSOP are option plans which are specifically approved by HM Revenue and Customs. They confer particular tax reliefs on employees and employers, which ensure that employees are only subject to tax when they sell the shares acquired under the option plans.

Following the changes introduced in the 2010 budget, on the realisation of shares into cash under these plans, the employee will be taxed to capital gains at a rate of 28% (as opposed to being taxed to income at 41% or 51%). In addition, the employer will not be liable to national insurance and should receive corporation tax relief out of the arrangement.

Unapproved Share Option Plans are not HMRC approved but are more flexible than their approved counterparts. They have declined in popularity because the employee will be taxed at towards 50% overall. However, with the correct structuring unapproved option plans do allow employers to mitigate national insurance costs and claim corporation tax relief.

Although all the plans operate in a similar way, EMI is the obvious choice if available. This is because it delivers benefits at the 28% rate in a more flexible manner than CSOP. Note that if substantial awards are to be made under EMI (i.e. over 5% of the voting shares for certain participants), it may be possible to take advantage of the "Entrepreneur's relief" and obtain a 10% tax rate for the employee. However, EMI is only available to parent or single companies which have less than £30 million gross assets and less than 250 employees.

CSOP has no such limit and is more the preserve of listed plcs. However, the tax-approved options that can be granted under CSOP are relatively small and so CSOP options tend to be "topped-up" by option awards under Unapproved Share Option Plans.

ShareSave

ShareSave is a tax-approved share option plan, in which all staff must be offered participation. It works differently to the plans mentioned above.

Employees can save out of net pay up to the lower of £250 per month or 10% of salary into an approved savings account. They choose whether to save for a three, five or seven year period. At the same time they are granted an option over shares in their company, with an option price at a discount of up to 20% to market value.

At the end of the three, five or seven year savings period, provided the employee has remained in employment, they will receive a tax-free bonus on their savings (this is in lieu of interest and is prescribed by HM Revenue & Customs) and may, if they choose, then apply the savings and bonus in exercising the option at the option price.

Provided all conditions are met, any benefit received by an employee will be taxed at a rate of 18% (if the individual is a basic rate tax payer) and 28% (if the individual is a higher or additional rate tax payer). In addition, the employer should receive corporation tax relief on the benefit.

ShareSave plans are popular with listed plcs and larger limited companies. They can be put in place by parent or single companies, or the subsidiary company of a listed parent. The introduction of the 28% flat rate for CGT, has, however, rendered ShareSave potentially less tax efficient, particularly for basic rate tax payers, and it compares unfavourably to the Share Incentive Plan (see below).

Free share awards

LTIP

LTIPs are plans which are generally reserved for senior executives. They provide free shares of up to two or three times the executive's salary in return for exceptional performance.

Executives must remain employed for a three year period over which company performance is tested. LTIPs are not HMRC approved and all benefits are taxable to income. However, correctly structured they can allow employers to mitigate national insurance costs and claim corporation tax relief.

LTIPs tend to be implemented mainly by listed plcs. Due to the large rewards available under LTIPs, shareholders will be very concerned to ensure that the performance targets are appropriate to the business and sufficiently stretching.

SIP

The SIP is a tax-approved all-employee share scheme, which is made up of four parts: free shares, partnership shares, matching shares and dividend shares.

First, employees can receive free shares from a company of up to £3,000 per year.

Secondly, employees can buy partnership shares at the prevailing market price out of gross pay up to a maximum of £1,500 per year. In other words, higher rate tax payers have 40% (or possibly 50%) more purchasing power (and basic rate tax payers 20% more purchasing power) if they have the opportunity to buy partnership shares through a SIP rather than on the open market.

Thirdly, the company may award matching shares to those employees who buy partnership shares. Matching shares are additional free shares. The company doesn't have to offer matching shares but if it does, the maximum it may offer is two matching shares for each partnership share.

Finally, dividend shares are created through the re-investment of dividends paid on free, matching and partnership shares.

The company can pick which parts of the SIP to operate but must offer those parts it picks to all employees.

All shares must be held in the SIP for a minimum of three years and may be forfeited if the employee leaves. If shares are held in the SIP for five years or more, any sale of the shares by the employee is tax-free. In fact, the SIP is the only employee incentive scheme in the UK that offers the potential of a totally tax-free return.

Nil-paid or partly paid shares

Nil-paid share arrangements allow employees to become shareholders for a small upfront cost (typically the nominal value of the shares). The awards, however, are subject to the condition that the recipient employees must pay full market value at some later date.

Employees share the same risks and returns as the other owners of the business and, therefore, are incentivised to both maintain and improve company performance.

In effect, a nil-paid share works like a deferred payment arrangement.

They are not HMRC approved but any gain made on the sale of the shares by the employees may be taxed at a rate as low as 10% - provided the shares awarded confer at least 5% of the ordinary shares in issue and at least 5% of the voting rights in the company on the employee. In fact, following the changes in the 2010 Budget, nil paid share plans are now arguably more efficient than Enterprise Management Incentives (EMI).

Nil paid share plans are popular with companies who want to ensure key employees are brought into share ownership in a cost effective and tax efficient manner, but on terms which align their risk with the risks to which all the other shareholders are exposed.

Growth share plans

Growth share plans (sometimes known as freezer plans) are only appropriate to limited companies because of the need to create a separate class of shares through the company's articles of association.

Under a growth share scheme employees acquire a new class of shares in the company. The new class is only entitled to participate in any future increase in the value of the business. Because at the outset these shares are worth very little, the employee should only pay a small amount to acquire the shares.

Employees like growth plans because there is very little risk for them. If the share price falls they will have lost very little but if the share price rises they may make substantial gains.

Again, growth share plans are not HMRC approved but any gain made on the sale of the shares by the employees may be taxed at a rate as low as 10% with the same proviso as applies to nil-paid shares.

Joint ownership equity plans

Joint ownership equity plans (also known as Joint share Ownership Plans (JSOPs)) are becoming increasingly popular with listed companies.

The employee acquires a joint interest in a share along with the trustee of an employee share ownership trust. The employee is entitled to any growth in the value of the shares above, say, 4.00% interest each year (i.e. a carry cost). The trustee is entitled to the intrinsic value of the share (i.e. the value of the share on the date of award) plus the 4% carry cost. The employee's interest is therefore initially valued at a fraction of the market value of the share.

If the employee leaves during the life cycle of the plan (i.e. within 3 years), he or she forfeits their interest in the shares back to the employee share ownership trust. If appropriate, vesting of the plan can also be linked to performance.

At the end of the arrangement, dependent on performance conditions being met, the employee buys the trustee out of their interest and becomes the sole owner of the shares. The employee can then retain the shares or sell them in the market.

A small upfront income tax charge will be chargeable on the employee. When the shares are sold by the employee, any growth in the value of the shares above the carry cost should be subject to capital gains tax at 28%. You should note that HMRC are currently consulting on whether growth share plans amount to anti-avoidance for tax purposes. That consultation is due to end in 2012.

Employee trusts

Employee Share Ownership Trusts (ESOTs), sometimes called Employee Benefit Trusts, are not employee share plans but need to be mentioned.

An ESOT is often established to support an employee share plan. ESOTs warehouse shares providing an internal market for employees. ESOTs may be established on-shore or off-shore. An off-shore ESOT will assist the tax efficiency of a company's employee share plan arrangements but will cost more to establish and run.

Companies tend to use ESOTs when they wish to fully dilute the shareholder base for presentational reasons, "hedge" the costs of employee share plans or, more commonly, provide an internal market for the buying and selling of shares. ESOTs are also needed to operate a joint ownership equity plan.

This guide is simply a summary of the employee share plans available in the UK and is not intended to provide specific advice.