Employee Stock Options in the EU and the USA

FINAL REPORT

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Glossary

ABI	Association of British Insurers
ASB	Accounting Standards Board
Approved option plans	Plans that have received the Inland Revenue's approval
CGT	Capital gains tax
CIS	Collective Investment Scheme
CSOP	Company Share Option Plan (previously known as the Discretionary Share Option Scheme or Executive Share Option Scheme)
EBT	Employee benefit trust
EENIC	Employee's NIC
EMI	Enterprise Management Incentive
ERNIC	Employer's NIC
EU	European Union
Form P11D	Statement of the employee's benefits and expenses (a report required from the employer)
FSA	Financial Services Authority
IAS	International Accounting Standards
IHT	Inheritance tax
LSE	London Stock Exchange
NIC	National Insurance Contributions
PAYE	Pay As You Earn (The tax withholding mechanism for employment income)
POS	Public Offer of Securities
RCA	Readily convertible assets (In general terms, assets (including shares) that are readily convertible into cash. RCA status is not restricted to listed shares.)
SAYE	Save As You Earn share option plan
SCEC	Inland Revenue Small Company Enterprise Centre
SD	Stamp Duty
SDRT	Stamp Duty Reserve Tax
SME	Small and Medium sized Enterprises
SVD	Inland Revenue Shares Valuation Division

UITF	Urgent Issues Task Force
UK GAAP	UK Generally Accepted Accounting Principles
UKLA	UK Listing Authority
Unapproved option plans	Plans that have not been nominated for Inland Revenue approval
VAT	Value Added Tax

Legislation glossary

CA1985	Companies Act 1985
CA1989	Companies Act 1989
DPA1998	Data Protection Act 1998
FA1980	Finance Act 1980
FA1984	Finance Act 1984
FA1988	Finance Act 1988
FA1999	Finance Act 1999
FA2000	Finance Act 2000
FA2001	Finance Act 2001
FSMA2000	Financial Services and Markets Act 2000
ICTA1988	Income and Corporation Taxes Act 1988
SI1993/744	Income Tax (Employments) Regulations 1993
SI1994/1212	Income Tax (Employments) (Notional Payments) Regulations 1994
SI1995/1537	The Public Offer of Securities Regulations 1995 as amended by SI2001/3649
SI2001/1004	Social Security Contributions Regulations 2001
SI2001/3649	The Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001
SSCBA1992	Social Security Contributions & Benefits Act 1992
TGCA1992	Taxation of Chargeable Gains Act 1992
TMA1970	Taxes Management Act 1970

United Kingdom

1. General remarks

1.1 Current position

1.1.1 Companies or groups of companies may introduce stock option plans. For ease of clarification, this analysis assumes a single company plan, unless stated otherwise. The company's objectives in setting up a stock option plan will have an impact on the category of stock option plan used and its detailed design features.

1.1.2 In the UK equity participation is now regarded frequently as an integral part of a company's employee reward strategy and the most common form of equity participation involves the use of stock options. Despite the legal and regulatory framework within which a company (depending on its circumstances) will need to operate, corporate experience (notably over the past 35 years) has culminated in a wide variety of stock option plan design. The fact that a UK company cannot own its own shares has not substantively restricted the use of stock option plans, although there are exceptions. Many companies mitigate the potential for shareholder dilution by the use of an employee benefit trust ("EBT") to acquire shares for use in their stock option plans.

1.1.3 In the taxation context, stock option plans in the UK can be divided into three categories.

- Plans that have received the Inland Revenue's approval ("approved option plans.").

- Plans that have not been nominated for Inland Revenue approval ("unapproved option plans").

- Enterprise Management Incentive ("EMI") options, which qualify for a particularly generous tax regime if certain conditions are satisfied. EMI options do not require Inland Revenue approval in advance of the option grant. The company simply notifies the Inland Revenue within ninety-two days of the option grant.

1.1.4 Within the approved option plan category, there are different types of approved option plans, namely Company Share Option Plans ("CSOPs") and Save As You Earn share option plans ("SAYE plans"). There are two further types of approved plan, namely the Share Incentive Plan and the Approved Profit Sharing Scheme but, as these are not option plans, they are outside the scope of this report. (The Approved Profit Sharing Scheme is being phased out).

1.1.5 Each type of approved option plan has its own particular features and stock options awarded under an approved option plan may receive tax-favourable treatment (relative to unapproved options) provided that certain conditions are adhered to. There is a formal Inland Revenue approval process, which must be undertaken before introducing and amending approved option plans. Additionally, there are tax rules governing aspects such as the eligibility of the company whose shares are to be used, the nature of the shares, the number of shares and the category of employee who is eligible to participate. There are also ongoing tax compliance obligations throughout the life of approved option plans.

1.1.6 Although options awarded under unapproved option plans do not benefit from the tax advantages associated with approved options, the absence of tax law requirements can generate more scope for flexibility regarding the nature of the employee's equity participation. However, tax rules aside, there may be other reasons (such as shareholder agreements governing the number of shares to be made available for option plans) that will affect the design of an unapproved option plan.

1.1.7 The EMI option regime was introduced in 2000 as part of the Government's proposals to encourage entrepreneurial activity. The EMI option initiative was developed on the back of detailed consultation with industry. Participation is restricted to employees of smaller, independent companies carrying on qualifying types of trade. EMI options benefit from a particularly attractive tax regime, assuming that the applicable conditions continue to be satisfied.

1.2 Scope

1.2.1 Except where mentioned otherwise, this analysis is based upon current UK tax law and practice. Where relevant, for example tax rates and bands, the commentary is applicable for the tax year ended 5 April 2003.

1.2.2 Some of the UK tax rules in relation to stock option plans are detailed. Therefore, unless expressly stated otherwise, the commentary makes the following assumptions.

- The employees are tax resident, ordinarily resident and domiciled in the UK throughout the period from the initial grant of the options through to the sale of the shares underlying the options.
- The employees do not have dual employments and do not undertake overseas duties.
- The shares acquired on the exercise of the stock options are shares of a company that is not a subsidiary of any other company.
- The shares acquired on the exercise of the stock options are immediately freely transferable, are not subject to any restrictions that are not applicable to shares of the same class held by non-employee shareholders, are not forfeitable or convertible and there is no scope for the employees to receive proceeds greater than the tax ("fiscal") market value of the shares on sale.

1.2.3 The commentary ignores any tax consequences of exchange rate fluctuations.

1.2.4 The commentary addresses the most common events in the context of a stock option plan. Therefore, it does not address option assignments, exchanges, cancellations, surrenders, releases and so on.

1.3 History of stock option plans

1.3.1 Over the latter part of the twentieth century, the tax treatment of stock options relative to other forms of employee reward was instrumental in determining the degree of popularity of stock options. Stock options are at present the most widely used category of employee equity incentive participation.

1.3.2 The tax treatment of stock options has evolved through statute and case law. By the 1950s, case law had established that the opportunity to acquire shares at less than their then market value by reason of employment is taxable income. A leading case is Weight v Salmon[1]. Consequently, stock option plans were introduced, based on the view that where the employee was granted a right to acquire shares at a future time, the taxable value of the right was the difference between whatever was paid for the right and its value when granted. In most cases, the exercise price was no less than the then market value of the shares under option, so that the immediate taxable value was very small, if any. This view of the law was supported in the leading case of Abbott v Philbin[2].

1.3.3 In response, the law was changed in 1966 to treat as income from employment the gain arising on most stock option exercises. As a result, many employers implemented other types of share incentive arrangements – share acquisition plans, designed to achieve an initially low share value, leaving the post-acquisition growth in share value outside the scope of income tax. The popularity of these share acquisition plans was instrumental in a change in political thinking about the use of employee share incentive plans generally. In 1972, legislative changes introduced scope for income tax-free capital growth in share value for what were known as authorised plans. These changes also resulted in "unauthorised plan" participants facing income tax charges on post share acquisition growth in share value.

1.3.4 The above authorisation procedure was subsequently withdrawn and there is now a variety of bespoke tax rules designed to bring capital gains realised by some employee share acquisition arrangements within the scope of income tax as employment income. However, and notably in relation to stock options, categories of tax-favoured plans have been introduced by successive governments. The forerunners of CSOPs and SAYE plans were introduced in 1984[3] and 1980[4] respectively. The EMI tax regime was launched much later, in 2000[5]. The EMI regime was designed to enhance entrepreneurial activity and therefore EMI plans

1 19 TC 174
2 (1960) 39 TC 82
3 Section 38 Schedule10 FA1984
4 Section 47 Schedule10 FA1980
5 Schedule 14 FA2000

target smaller independent companies. Alongside these tax-favoured plans, unapproved stock option plans continue to be popular.

1.3.5 The Inland Revenue have published statistics on employee share plans in the UK covering the period 1979-80 to 1998-99. According to the latest figures, 1,172 listed companies and 2,860 unlisted companies had a CSOP in place. 761 listed companies and 485 unlisted companies operated an SAYE. The Inland Revenue have not published detailed data on EMI plans but have noted that in the first year of operation to July 2001, 1,170 companies granted EMI options. Inland Revenue data indicates that, in the first two years of the EMI option regime, over 2,500 companies granted EMI options (this was the original target for the first three years) and more than 115 companies per month are deciding to operate EMI.

1.3.6 Other notable developments over more recent years include the following.

- The imposition of social security contributions (National Insurance Contributions or "NIC") on taxable income derived from stock options plans involving readily convertible assets ("RCAs"). In general terms, RCAs are assets, including shares, that are readily convertible into cash. RCA status is not restricted to listed shares – see section 6.1.7. CSOPs and SAYE plans are excluded from the NIC regime. Although the move to extend the scope of NIC was introduced in 1996, the major impact (notably for employers rather than employees) was experienced in 1999 when taxable gains on stock option exercises (rather than stock option grants) became liable to NIC. The following year, legislation was introduced to permit the transfer of employer's NIC ("ERNIC") on option exercise gains to employees.

- From November 1996, taxable gains arising on the exercise of options, other than CSOP and SAYE options, have been brought within the scope of the tax withholding regime Pay as You Earn ("PAYE") where the shares are RCAs. This has generated both new stock option plan operational issues and cash flow disadvantages for employee option holders relative to the previous position.

- This has been an enhanced level of scrutiny from institutional investors in the amount and nature of employee reward derived from employee equity participation, including stock option plans.

- This has also been an enhanced level of guidance from the Accounting Standards Board ("ASB") regarding the accounting treatment of stock options.

2. Key features of stock option plans

2.1 CSOPs

2.1.1 CSOPs are discretionary option plans in that, with limited exceptions, tax law permits the company to have discretion over which employees are granted stock options. (Tax law aside, the company will need to consider whether its employee selection policy is discriminatory (see section 8.2 below)). CSOPs are used widely by listed companies. They are also operated by unlisted companies but the share capital structure of some companies, particularly some unlisted companies, may not satisfy the eligibility requirements. CSOPs are also used by UK subsidiaries of overseas companies via an addendum to the parent companies' main option plans. In this way, adjustments can be made to the main option plan (without the need to launch a new option plan) such that employees of UK subsidiaries may benefit from the CSOP scope for favourable tax treatment. The adjustments only apply to options granted under the addendum and not to options granted under the main plan to employees working for other subsidiaries or possibly to some UK employees, see section 2.1.2.

2.1.2 A CSOP provides scope for employee participation in future growth in share value on a tax and NIC efficient basis. The grant of options at a discount to the then fiscal market share value of the underlying shares is not permitted[6]. At any one time, an employee is not permitted to hold unexercised CSOP options in respect of shares whose aggregate value exceeds £30,000. For this purpose, the value is calculated at the date of the respective option grant[7]. Many companies also operate unapproved option plans alongside approved option plans to grant further options in excess of this limit.

2.1.3 There is no minimum term for which the stock options must be granted. However the beneficial tax treatment that can be achieved via a CSOP will apply only if the option is exercised in a tax-favoured manner, the conditions for which are that the option must be exercised at least three years after it was granted and at least three years after the date on which the employee last exercised a CSOP option in a tax-favoured manner[8].

2.1.4 Options may not be granted for a term of more than ten years from the date of grant[9].

2.1.5 Eligibility for a CSOP option grant is restricted to someone who is at that time either a full-time director or an employee of the company[10]. These requirements need not be satisfied at the time the option is exercised.

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6 Paragraph 29 Schedule 9 ICTA1988

7 Paragraph 28(1) Schedule 9 ICTA1988

8 Sections 185(5)(a) and 185(5)(b) ICTA1988

9 Section 185(5)(a) ICTA1988

10 Paragraph 27(1) Schedule 9 ICTA1988

2.1.6 Where the CSOP involves the use of shares of a close company, an individual who has, or has had within the preceding twelve months, a material interest in the close company may not obtain CSOP options. Nor may an individual who later obtains a material interest exercise a CSOP option whilst he holds this interest or within twelve months of having such an interest[11]. In general terms, a close company is one that is under the control of five or fewer participators, or of participators who are directors[12].

2.1.7 There are requirements governing the type of shares that may be used[13]. The principal features of these requirements are summarised briefly below.

- The shares must be part of the ordinary share capital. They must also be of a class listed on a recognised stock exchange or be in a company that is not under the control of another company, or be shares in a company that is under the control of a non-close listed company[14].

- The shares must be fully paid up and not redeemable[15].

- Generally, the shares must not be subject to any restrictions other than restrictions that apply to all shares of the same class[16]. However, but subject to prescribed requirements, a restriction may be imposed by the company's articles of association requiring all shares held by directors and employees to be disposed of when they leave the company or, if later, when the option is exercised[17].

2.1.8 Subject to the comments made at section 2.1.7, there are no restrictions governing the type of company whose shares may be used for a CSOP.

2.1.9 CSOP options must be non-transferable, except on the death of the option holder, when the option holder's personal representatives may exercise them within twelve months of the option holder's death[18].

2.1.10 By concession, employees of a jointly owned company may participate in a CSOP established by one of the two joint owners, even though the joint owner does not control the jointly owned company[19].

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11 Paragraph 8 Schedule 9 and Section 187 ICTA1988
12 Paragraph 8 Schedule 9 and Section 414 ICTA1988
13 Paragraphs 10-14 Schedule 9 ICTA1988
14 Paragraphs 10 and 11 Schedule 9 ICTA1988
15 Paragraph 12(1)(a) and (b) Schedule 9 ICTA1988
16 Paragraph 12(1)(c) Schedule 9 ICTA1988
17 Paragraph 12(2) and (3) Schedule 9 ICTA1988
18 Paragraph 27(2) Schedule 9 ICTA1988
19 Extra Statutory Concession B27.

2.2 SAYE plans

2.2.1 Unlike the CSOP structure, SAYE plans are "all-employee" plans and they involve the employees who decide to participate in committing funds over a period before the option exercise. In effect, SAYE plans are approved option plans linked to an Inland Revenue approved savings contract with an approved savings provider, which is often a bank[20].

2.2.2 At the time an SAYE option is granted to an employee, he or she enters into the savings contract, which involves monthly deductions (normally from salary) of a fixed amount of between £5 and £250[21]. At the end of the savings contract (the "bonus date") a bonus, equal to a specified number of monthly contributions, is added to the total amount. The savings contract earns a tax-free bonus, the amount of this depending on the length of the savings contract. With effect from 1 September 2002, for a three-year contract the bonus is equal to 1.8 months contributions and, for a five-year contract, the bonus is equal to 5.7 months contributions. If an employee who has entered into a five-year contract retains his contributions in the savings plan for a further two years, the bonus is equal to 11 months contributions.

2.2.3 The number of shares under option is based on the anticipated total savings and bonus. The option exercise price is based on the fiscal market value of the shares at the date of the option grant and may be set with a discount of up to 20% of the then fiscal market value[22]. At the end of the option term, the employee has the choice of withdrawing his or her cash from the savings contract (together with the interest or bonus) or using the cash to exercise the SAYE option.

2.2.4 Any shares acquired on exercise of the SAYE option must be paid for with monies not exceeding the amount of the savings contract (together with any interest or bonus received)[23].

2.2.5 Under normal circumstances, SAYE options should not be capable of being exercised prior to the bonus date[24]. However, there are exceptions and these are described below. In these circumstances the number of shares that may be acquired will be limited by the amount of savings accumulated in the plan.

- If an option holder dies before the bonus date his options must be exercised, if at all, within twelve months following the death[25].

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20 Schedule 9 ICTA1988

21 Paragraph 24 Schedule 9 ICTA1988

22 Paragraph 25 Schedule 9 ICTA1988

23 Paragraph 16(1) Schedule 9 ICTA1988

24 Paragraph 17 Schedule 9 ICTA1988

25 Paragraph 18 Schedule 9 ICTA1988

- If an option holder ceases to be employed on the grounds of injury, disability, redundancy or retirement his options must be exercised, if at all, within six months of his so ceasing[26].

- If an option holder continues employment after reaching the maximum age for participation as stated in the SAYE plan rules, exercise of the option must be permitted within six months of the option holder reaching that age[27].

- If prescribed events such as the company over whose shares the option subsists being taken over occurs before the bonus date, the SAYE plan rules may permit employees to exercise their options within a prescribed period following the event[28].

2.2.6 Other than in the case of death, options must not be capable of being exercised more than six months after the bonus date[29]. A SAYE option is not transferable, except on the death of the option holder, when the option holder's personal representatives may exercise the option within twelve months of the option holder's death. If the death occurs within six months after the bonus date, the option may be exercised within twelve months after the bonus date[30].

2.2.7 With limited exceptions, an option cannot be exercised other than in the circumstances described in sections 2.2.5 and 2.2.6.

2.2.8 A SAYE plan must be open to all employees and full-time directors of the company who are chargeable to tax under Schedule E Case I (in general terms this encompasses employees who are resident and ordinarily resident in the UK for tax purposes) and who have been employees or full time directors during a qualifying period not exceeding five years prior to the option grant. [31]Other employees of the company may be invited to participate at the company's discretion. No aspect of the SAYE plan should discourage any category of prescribed employee from participating. Additionally, eligibility and participation must be catered for on a similar terms basis, although there is scope for the level of participation to be varied according to factors such as length of service, salary and so on[32].

2.2.9 Anyone who is not a director or employee of the company is excluded from participation in a SAYE plan. Additionally, where the SAYE plan involves the use of shares of a close company, an individual who has, or has had within the preceding twelve months, a material interest in the close company may not obtain options. Nor may an individual who later obtains a material interest exercise the SAYE option whilst he holds this interest or within twelve months of having such

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26 Paragraph 19 Schedule 9 ICTA1988
27 Paragraph 20 Schedule 9 ICTA1988
28 Paragraph 21 Schedule 9 ICTA1988
29 Paragraph 22(b) Schedule 9 ICTA1988
30 Paragraphs 22(a) and 18 Schedule 9 ICTA1988
31 Paragraph 26(1) Schedule 9 ICTA 1988
32 Paragraph 26(1) Schedule 9 ICTA1988

an interest[33]. In general terms, a close company is one that is under the control of five or fewer participators, or of participators who are directors[34].

2.2.10 There are requirements governing the type of shares that may be used[35]. The principal features of these requirements are briefly summarised below.

- The shares must be part of the ordinary share capital. They must also be of a class listed on a recognised stock exchange or be in a company that is not under the control of another company, or be shares in a company that is under the control of a non-close listed company[36].

- The shares must be fully paid up and not redeemable[37].

- Generally, the shares must not be subject to any restrictions other than restrictions that apply to all shares of the same class[38]. However, but subject to prescribed requirements, a restriction may be imposed by the company's articles of association requiring all shares held by directors and employees to be disposed of when they leave the company or, if later, when the option is exercised[39].

2.2.11 Subject to the comment at section 2.2.10, there are no restrictions governing the type of company whose shares may be used for a SAYE plan.

2.2.12 By concession, employees of a jointly owned company may participate in a SAYE plan established by one of the two joint owners, even though the joint owner does not control the jointly owned company[40].

2.3 EMI options

2.3.1 EMI options are targeted at employees of smaller, independent companies. The intention of the EMI option tax-favoured regime is summarised in the following comment extracted from the Inland Revenue's website "….[EMI options are] designed to help small higher risk companies recruit and retain employees with the skills that will help them grow and succeed…...[and]…to reward employees for taking a risk by investing their time and skills in helping small companies achieve their potential….".

2.3.2 The targeting of EMI is achieved through detailed tax rules (see annex to this report). Only employees in smaller independent companies carrying on qualifying trades can benefit from the tax reliefs provided by the EMI.

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33 Paragraph 8 Schedule 9 and Section 187 ICTA1988.
34 Paragraph 8 Schedule 9 and Section 414 ICTA1988
35 Paragraphs 10-14 Schedule 9 ICTA1988
36 Paragraphs 10 and 11 Schedule 9 ICTA1988
37 Paragraph 12(1)(a) and (b) Schedule 9 ICTA1988
38 Paragraph 12(1)(c) Schedule 9 ICTA1988
39 Paragraph 12(2) and (3) Schedule 9 ICTA1988
40 Extra Statutory Concession B27

2.3.3 Unlike SAYE plans, EMI options need not be granted on an "all-employee" basis. An option is capable of being an EMI option provided it is granted for commercial reasons in order to recruit or retain an employee in the company[41]. An EMI option may be granted to an "eligible employee"[42]. Again in the context of a single company arrangement, an employee is an eligible employee if he is an employee of the company[43] and he commits at least twenty-five hours a week to the company (or, if his working time is less, 75% of his total working time)[44]. However, an EMI option cannot be granted to someone who has a material interest in the company[45].

2.3.4 There is no minimum term for which the option must be granted. However, the option must be capable of being exercised within ten years of the date of grant (e.g. if the exercise of the option depends on the fulfilment of performance conditions, it must be possible to satisfy the conditions within ten years)[46].

2.3.5 Notwithstanding this, the option agreement does not need to prevent the employee from exercising after ten years. However, if the employee does exercise the option more than ten years after the date of grant, (or in the case of a replacement option, ten years from the original date of grant) there will be no tax relief on the option exercise[47].

2.3.6 There is no maximum term for which the option must subsist. However the details of when the option may be exercised must be set out in the written agreement between the person granting the option and the employee[48].

2.3.7 EMI options are not assignable and, if an option is granted on the basis that exercise is permitted by a deceased option-holder's personal representatives, such an exercise is permitted not more than one year after the death[49].

2.3.8 There is no formal tax approval mechanism. However, unless notification of the grant is submitted to the Inland Revenue Small Companies Enterprise Centre ("SCEC") within ninety-two days after the grant, the option is not an EMI option[50].

2.3.9 EMI options can be granted at an unrestricted discount to the then fiscal market value of the underlying shares. The presence of a discount restricts the amount of tax relief.

2.3.10 No option that is part of a scheme or arrangement, the main or one of the main aims of which is tax avoidance, can be an EMI option[51].

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41 Paragraph 9 Schedule 14 FA2000
42 Paragraph 27 Schedule 14 FA2000
43 Paragraph 28 Schedule 14 FA2000
44 Paragraph 29 Schedule 14 FA2000
45 Paragraphs 30 – 36 Schedule 14 FA2000
46 Paragraph 39 Schedule 14 FA2000
47 Paragraph 42(2) Schedule 14 FA2000
48 Paragraph 40(2)(e) Schedule 14 FA2000
49 Paragraph 41 Schedule 14 FA2000
50 Paragraph 2 Schedule 14 FA2000

2.4 Unapproved option plans

2.4.1 Despite their comparative lack of tax efficiency, unapproved option plans are popular in the UK. Since they do not receive a special tax treatment unapproved plans do not have to fulfil special conditions (e.g. being broad based) and thus offer a greater scope for flexibility. They are used widely by both listed and unlisted companies. Many companies operate unapproved option plans alongside approved plans to grant further options in excess of the CSOP £30,000 limit.

2.4.2 Unapproved option arrangements are within the scope of NIC and also the tax withholding PAYE regime.

2.4.3 Although design features do not need to comply with tax law requirements, companies will wish to address the extent to which the plan design and operating aspects should take account of other legal and regulatory regimes. Examples of aspects from these other regimes are shareholder agreements governing the number of shares to be made available for option plans, whether employee selection policy for participation is discriminatory, institutional investor guidelines on the value of individual option grants, performance conditions, term requirements for option vesting and so on.

2.4.4 The following comments in relation to key features are made only in the context of tax and NIC law requirements.

- There is no minimum and maximum term for which unapproved options must be granted. However, tax and NIC consequences may arise on the option grant if the option is capable of exercise more than ten years after the date it was granted[52].

- Participation in an unapproved option plan is at the company's discretion. An unapproved option plan can be selective on participation and level of participation.

- There are no restrictions over the nature of the shares over which options may be granted, although the tax and NIC treatment described in this report assumes that the "shares" are shares or securities within the meaning of the relevant UK tax law.

- There are no restrictions on the type of company that may grant unapproved options, assuming that the company has share capital.

- There are no restrictions governing the value of shares in respect of which options may be granted to the employee.

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[51] Paragraph 9 Schedule 9 FA2000

[52] Sections19, 131 and 135(2) ICTA1988. Section 6 SSCBA1992 and Paragraph 3 Part IX Schedule 3 SI2001/1004

- The option exercise price may be less than the fiscal market value of the underlying shares at the date of the option grant.

3 Taxation: time of taxation

3.1 CSOPs

3.1.1 Generally, gains from a CSOP option are considered capital gains and are taxed on the disposal of the shares.. The option gain is only taxed at exercise if the qualifying conditions are not adhered to (i.e. if exercise takes place within three years after the option was granted and/or within three years of the date on which the employee last exercised a CSOP option in a tax-favoured manner).[53] The exercise of a CSOP option is not a chargeable event for NIC purposes[54].

3.2 SAYE plans

3.2.1 The exercise of a SAYE option is not a taxable event unless the exercise occurs within three years of the grant as a result of certain events such as the take over of the company[55]. The exercise of the option is not a chargeable event for NIC purposes[56].

3.2.2 The realisation of a capital gain on the disposal of shares acquired on the exercise of a SAYE option is a taxable event. However, there is scope after the SAYE option exercise to transfer up to £7,000 worth of shares to a tax-free fund and, in this case, the transfer does not constitute a disposal.

3.3 EMI options

3.3.1 Gains from EMI options are taxed as capital gains on the disposal of the acquired shares. Note that for EMI options taper relief is calculated from the date of grant (not exercise).

3.3.2 The exercise of an EMI option is taxable only in the following circumstances:

- The option is exercised more than ten years after the date of grant[57].
- The option exercise price is less than the fiscal market value of the underlying shares as at the time the option was granted[58].
- The option is exercised more than forty days after the occurrence of a disqualifying event[59].

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53 Sections 135 and 185(3) ICTA1988
54 Section 4(4) SSCBA1992 and Paragraph 13 Part IX to Schedule 3 SI 2001/1004
55 Sections 185(3) and (4) ICTA1988
56 Section 4(4) SSCBA1992 and Paragraph 13 Part IX Schedule 3 SI 2001/1004
57 Paragraph 42 Schedule 14 FA2000
58 Paragraphs 45 and 46 Schedule 14 FA2000

3.3.3 If the exercise of an EMI option is a taxable event and the underlying shares are RCAs, the exercise is a chargeable event for NIC purposes.

3.4 Unapproved option plans

3.4.1 It is unusual for the grant of an option to be a taxable event. However, there will be an income tax charge if the option has **both** of the following characteristics.

- The option is capable of exercise more than ten years after the grant date.
- The option is granted with an exercise price at a discount to (that is lower than) the fiscal market value of the underlying shares on the option grant date.

3.4.2 To the extent that the grant of the option is a taxable event and if either the option or the underlying shares are RCAs at the date of the option grant, the grant is also a chargeable event for NIC purposes[60].

3.4.3 The exercise of an unapproved option is a taxable event[61]. If the shares are RCAs, it is a chargeable event for NIC purposes[62].

3.4.4 The realisation of a capital gain on the disposal of shares acquired on the exercise of an unapproved option is a taxable event.

4 Taxation: taxable gain or value

4.1 Fiscal value

4.1.1 The concept of fiscal value is a feature of stock option plans in the UK. The background to this is described in Section 1.3.2. Tax law aligns the grant of approved CSOP and SAYE stock options with market value. EMI options need not be granted at fiscal market value. However, where EMI options are granted at less than market value, the amount of tax relief is restricted. In practice EMI options tend to be granted at market value. The taxation of unapproved stock options is also linked to fiscal value as described in Sections 3.4.1 and 4.5.2. It may also be necessary to ascertain market value for approved and EMI plans as described in Sections 4.2.1, 4.3.1 and 4.4.1 to 4.4.3.

4.1.2 In general, where shares are listed on a recognised stock exchange, the quoted price will represent fiscal value. Where shares are traded on a "junior" market such as the Alternative Investment Market (AIM), traded prices are usually taken as indicative of fiscal value.

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59 Paragraph 53 Schedule 14 FA2000

60 Section 6 SSCBA1992, Paragraph 3 Part IX Schedule 3 SI2001/1004 and Section 203F(2) ICTA1988

61 Section 135 ICTA1988

62 Section 4(4) SSCBA1992 and Paragraph 13 Part IX Schedule 3 SI2001/1004

4.1.3 It is usual for the market value of unlisted shares to be agreed with the Inland Revenue shortly before the grant of options for CSOP, SAYE and EMI purposes. This is achieved by the unlisted company submitting its financial accounts, together with a statement of value and any relevant supporting valuation evidence to the Inland Revenue. That documentation is then considered and most values returned are accepted as representing fiscal value. The Inland Revenue puts alternative values to the company where values are not acceptable. A mutually acceptable value is then agreed by negotiation.

4.1.4 Where a fiscal value is required for an unapproved scheme, it is usually determined following submission of the self-assessment return. However, as with approved and EMI plans, where options have been exercised and an income tax liability arises, the Inland Revenue will discuss the value of the shares immediately following that exercise[63].

4.1.5 Some unlisted companies operate unapproved stock option plans and grant options that can be exercised after 10 years (see Section 3.4.1). The Inland Revenue will consider, in advance of the grant date, the option price at which the company proposes to grant options. The Inland Revenue will comment on whether the price is not less than market value for those shares at the proposed option grant date[1].

4.1.6 To help employers operate PAYE on RCAs (see Section 3.4.2, 3.4.3 and 6.1.6), they may check with the Inland Revenue whether the amount on which they propose to operate PAYE is reasonable. This may involve considering the fiscal value of shares acquired following the exercise of an option under a stock option plan at a time when the shares are RCAs[64].

4.2 CSOPs

4.2.1 If the exercise of a CSOP option is a taxable event, the taxable amount is the excess of the then fiscal market value of the shares over the aggregate of the exercise price, any notional or actual selling costs of the shares acquired and any payment made for the grant of the option[65].

4.2.2 The first stage in calculating the taxable value on a disposal of the shares acquired on the option exercise is to identify the capital gain, which is the excess of the disposal proceeds over the aggregate of the option exercise price and the taxable amount (if any) on the option exercise[66]. For additional comment on capital gains, see section 5.3.

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[63] Tax Bulletin No. 26
[64] Tax Bulletin No. 36
[65] Section 135 ICTA1988
[66] Section 120(4) TCGA1992

4.3 SAYE plans

4.3.1 If the exercise of the SAYE option is a taxable event, the taxable amount is the excess of the then fiscal market value of the shares over the aggregate of the exercise price and any notional or actual selling costs of the shares acquired[67].

4.3.2 The first stage in calculating the taxable value on a disposal of the shares acquired on the option exercise is to identify the capital gain, which is the excess of the disposal proceeds over the aggregate of the option exercise price and the taxable amount (if any) on the option exercise[68]. For additional comment on capital gains, see section 5.3.

4.4 EMI options

4.4.1 If the EMI option exercise is a taxable event because the option is exercised more than ten years after the grant, the taxable value is the excess of the then fiscal market value of the shares over the aggregate of the exercise price and any payment made for the grant of the option[69]. The chargeable amount for NIC purposes is the estimated taxable amount.

4.4.2 If the EMI option exercise is a taxable event because the option was granted at a discount to the fiscal market value of the underlying shares at the time of the grant, the taxable value is the lower of the following.

- The amount of the initial discount less any price paid for the option grant.
- The excess of the fiscal market value of the shares on the exercise date over the aggregate of the price (if any) paid for the shares and the amount (if any) paid for the option grant[70].

4.4.3 If the EMI option exercise is a taxable event because it is exercised more than forty days after a disqualifying event, the taxable value is determined as follows.

- Where the option was not granted at a discount, the taxable value is the excess of the fiscal market value of the shares at the date of exercise over the aggregate of the fiscal market value of the shares immediately before the disqualifying event and the amount if any paid for the option grant[71].
- Where the option was granted at a discount or at nil cost, in general terms the taxable value is calculated by increasing that discount by the excess of the fiscal market value of the shares when the option is exercised over the

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67 Section 135 ICTA1988

68 Section 120(4) TCGA1992

69 Section 135 ICTA1988 and Paragraph 42 Schedule 14 FA2000

70 Paragraphs 45 and 46 Schedule 14 FA2000

71 Paragraph 53(2) Schedule 14 FA2000

aggregate of the fiscal market value of the shares immediately before the disqualifying event and the amount (if any) paid for the option grant[72].

4.4.4 On the EMI option exercise, the chargeable amount for NIC purposes is the estimated taxable amount.

4.4.5 To the extent that arrangements have been made for the cost of any ERNIC on the option exercise (see section 7.3.4) to be transferred to the employee, the ERNIC is deducted in computing the taxable value on the exercise.

4.4.6 The first stage in calculating the taxable value on a disposal of the shares acquired on the option exercise is to identify the capital gain, which is the excess of the net disposal proceeds over the aggregate of the option exercise price and any amount charged to income tax on the option exercise[73]. Note that, for this purpose, the taxable amount on the option exercise is not reduced by any ERNIC that is paid by the employee on the option exercise. For additional comment on capital gains, see section 5.3.

4.5 Unapproved option plans

4.5.1 If the grant of an unapproved option is a taxable event, typically, the Inland Revenue will accept a taxable value equal to the excess of the then market value of the underlying shares over the option exercise price. (Tax law provides that this is the minimum taxable value[74].) However, where an option valuation methodology would produce a higher taxable figure, there can be a risk of that higher value being taxable. The amount chargeable to NIC is the estimated excess of the then fiscal market value of the underlying shares over the option exercise price.

4.5.2 On an unapproved option exercise, the taxable amount is the excess of the then fiscal market value of the shares over the aggregate of the exercise price, any notional or actual selling costs of the shares acquired, any payment made for the grant of the option, and the amount of any taxable income on the grant of the option[75]. The chargeable amount for NIC purposes is the estimated taxable amount. To the extent that arrangements have been made for the cost of any ERNIC on the option exercise (see section 7.3.4) to be transferred to the employee, the ERNIC is deducted in computing the taxable value on the exercise.

4.5.3 The first stage in calculating the taxable value on a disposal of the shares acquired on the option exercise is to identify the capital gain, which is the excess of the disposal proceeds over the aggregate of the option exercise price and the taxable amount on the exercise[76]. Note that, for this purpose, the taxable amount on the option exercise is not reduced by any ERNIC that is paid by the employee on the option exercise. For additional comment on capital gains, see section 5.3.

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[72] Paragraph 53(2A) & 53(2B) Schedule 14 FA2000

[73] Section 120(4) TCGA1992

[74] Section 135 ICTA1988

[75] Section 135 ICTA1988

[76] Section 120(4) TCGA1992

5 Taxation: type of tax

5.1 Summary

5.1.1 The types of tax to consider in the context of the employee are income tax, Employee's National Insurance Contributions ("EENIC") and CGT. Where the taxable event is the grant or the exercise of an option, income tax and, possibly, EENIC are relevant. CGT is the relevant tax where a capital gain is realised on the disposal of the shares acquired on the option exercise.

5.2 Income tax and EENIC

5.2.1 Any income tax that arises will be payable at the employee's marginal rate, which can be up to 40%. Income tax is payable on taxable income, which is calculated net of attributable allowances and reliefs. The available reliefs and allowances will depend on individual circumstances. For many individuals, the most common form of allowance exempts £4,615 of income. The tax rates and bands in respect of income from employment are as follows[77].

£0 - £1,920 of taxable income	10%
£1,921 - £29,900	22%
Over £29,900	40%

5.2.2 EENIC is charged at rates of 8.4% or 10%, but only on aggregate earnings below a contribution ceiling. As an example, for employees who are normally paid monthly, the 2002/03 monthly ceiling is £2,535. (There are different rules for employees who are directors). The government has announced proposals to impose from 6 April 2003 an additional 1% EENIC charge on all earnings above the contribution ceiling.

5.3 CGT

5.3.1 CGT is charged on disposals. Disposals include gifts and sales. Most gifts are treated as sales at market value but inter spouse transfers are not taxable. The calculation of the capital gain is explained in section 4 under the relevant plan type. However, CGT is a tax on chargeable gains, which are computed by deducting from capital gains allowable capital losses and any relevant CGT allowances and reliefs. Two of the principal reliefs are summarised below.

- The annual CGT exemption which exempts from CGT aggregate chargeable gains of up to £7,700 (for the year 2002/03) for each individual taxpayer.

- CGT taper relief, which reduces the capital gain by reference to the length of period the shares are owned by the taxpayer. There are two rates of taper relief – business rate and the (less generous) non-business rate. The rules are complex but for shares held by many employees in their employing companies the business rate of taper will apply such that, where the shares are held for at

[77] Section 1(2) ICTA1988

least two years, only 25% of the gain is chargeable to CGT. For most stock option plans, the period of ownership of the shares commences on the option exercise date. However, for shares acquired on the exercise of EMI options (where the rules for EMI status continue to be satisfied on the exercise date and, if relevant, the option is exercised within forty days of a disqualifying event) the ownership period for taper relief is deemed to commence on the date the EMI option was granted[78]. This adds to the already very attractive nature of EMI options.

5.3.2 Chargeable capital gains are taxed at 40%, 20% or 10%, depending on the taxpayer's level of income.

5.3.3 Where a taxpayer acquires shares of the same class in the same company on different events, complex CGT "matching rules" operate to identify share acquisitions and disposals.

5.3.4 In limited circumstances, and only where the shares acquired are in an unlisted company and are newly-issued shares (rather than purchased shares) a capital loss may be offset against income in computing taxable income for income tax purposes. The conditions for relief are stringent, including, for example, the shares must be in a trading company and there are requirements as to the type of trade carried on by the company[79].

5.3.5 As mentioned at section 5.3.1, inter spouse transfers of shares are not taxable events. In broad terms, the donee spouse is deemed to have acquired the shares at the donor spouse's cost. Each spouse has his or her own lower, basic and higher rate tax bands, annual CGT exemption and so on. Therefore, a married couple's aggregate CGT charge may be lower as a result of inter spouse gifts. Note that any such gift should be an outright, unfettered gift in order to be tax-effective. Additionally the possible impact on the rate of CGT taper relief should be considered.

5.4 Inheritance tax

5.4.1 In the UK there is no wealth tax. However, there is a tax (Inheritance tax ("IHT")) on gifts. There are two rates of IHT: 40% for gifts on death and 20% for lifetime gifts. However, most lifetime gifts are exempt from IHT if the donor survives the making of the gift by more than seven years. There is a nil rate IHT band for aggregate gifts of up to £250,000. For this purpose, gifts are cumulated for seven years to calculate the value of the donor's aggregate gifts.

5.4.2 There are several other IHT exemptions. One of the most common of these is the exemption from IHT for most gifts between spouses.

[78] Paragraph 57 Schedule 14 FA2000

[79] Section 574 ICTA1988

6 Issues for employees

6.1 Tax payment and reporting

6.1.1 The timing of the tax payment will vary, according to whether the tax is payable via PAYE or under the self assessment rules. CGT is always payable via self assessment but some taxable income from stock option plans is payable under the PAYE regime (see section 7.2).

6.1.2 The employee is required to report taxable income and capital gains in his or her self assessment tax return[80]. If a self assessment return is not issued by the Inland Revenue but the employee has realised chargeable capital gains, or the employee's income tax liability for the year has not been wholly discharged by the deduction of tax at source (for example, via PAYE), the employee must give notice to the Inland Revenue that he is chargeable to income tax or CGT. The notice must be submitted within six months from the end of the relevant tax year[81].

6.1.3 Where the taxable income attributable to stock options is within the scope of PAYE and the employee is satisfied that the value on which the company has operated PAYE is the taxable value, the income need not be identified separately from other employment income. The employee should note in the Additional Information section of the self assessment return that the stock option-related income has been taxed under PAYE and is reported in the Employment pages. However, if either PAYE is not applicable on the taxable event or the employee is not satisfied that PAYE has been operated on the taxable amount, the following details should be reported separately in the Share Schemes pages of the return: the name of the company and, where appropriate, the name of the option plan, together with the taxable amount on the event (e.g. the grant or the exercise) and details of the various components of the calculation of the taxable amount[82].

6.1.4 There is a reporting obligation for the employee on a disposal of the shares. However, there is a de minimis exemption on reporting of chargeable capital gains. For 2002/2003, no specific reporting is required if the employee's aggregate chargeable gains for the year do not exceed £7,700 and the aggregate proceeds of all chargeable assets disposed of during the year do not exceed £15,400[83]. Full details of the shares disposed of, including disposal proceeds, acquisition cost for CGT purposes, a statement on whether or not the shares are listed, full description of the shares and so on must be reported[84]. The information should be provided in the Capital Gains pages of the individual's self assessment return.

6.1.5 The self assessment return should be submitted by 30 September after the end of the relevant tax year if the employee wishes to have his or her tax liability

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80 Section 8 TMA1970

81 Section 7 TMA1970

82 Section 8 TMA1970, Inland Revenue Tax Bulletin 46 (April 2000), self assessment return guidance notes

83 Section 8 TMA1970 and guidance notes to the self assessment tax return

84 Section 8 TMA1970 requires completion of the self assessment tax return. The information to be provided is set out in the tax return.

calculated by the Inland Revenue. Otherwise, the employee must compute the tax liability. In most circumstances the latest date for submission of the self assessment return is 31 January following the end of the relevant tax year[85]. The tax due must be paid by 31 January following the end of the tax year in which the taxable event occurs and there may be an obligation to make interim payments. Otherwise, interest/penalty charges may arise.

6.1.6 Where, because of the application of the RCA rules, PAYE is applicable on a taxable event attributable to stock option plans, the PAYE amount itself may be additional taxable income of the employee if the PAYE amount is not made good by the employee to the relevant employer within thirty days from the date of the taxable event ("the 30-day rule"). This is so, even if the employee makes good the PAYE amount after the end of the thirty-day period[86]. Income tax due under the 30-day rule is payable via self assessment.

6.1.7 As mentioned at section 1.3.6, RCA status is not restricted to listed shares. The scope of RCA status is illustrated by examples given in the Inland Revenue Tax Bulletin No.46. One of the hypothetical examples in the commentary refers to a start up company whose articles of association contain "long stop" provisions whereby the employees are guaranteed a purchaser for their shares if there has not been a flotation or sale of the company by a "long stop" date, typically five to ten years after the employees' share acquisitions. The Inland Revenue commented that the more existence of the "long stop" provisions meant that the shares were RCAs.

6.1.8 Unlike the position for other types of stock option, the employee is required (in conjunction with the company) to notify the Inland Revenue of the grant of an EMI option within the period of ninety-two days after the grant. Failure to comply with this notification requirement will result in the option being outside the EMI regime.

6.2 Cashflow issues

6.2.1 Cashflow issues are unlikely to arise for the employee at the date of the option grant because of the following.

- Most employees are not required to make a payment for the grant itself.
- As the grant of an option that is capable of exercise more than ten years after the grant is unusual, a tax liability on the option grant is comparatively rare.

6.2.2 Tax law does not provide scope for alleviating cashflow problems at option exercise. Where the option exercise is a taxable event, the tax liability arises regardless of whether or not the shares acquired on the exercise are sold immediately. In practice, where listed shares are involved, many employees realise the tax payable out of immediate share sales following the option exercise. Where

85 Section 8(1A) TMA1970
86 Section 144A ICTA1988

the shares are unlisted this can be more problematical, particularly if the unlisted shares are RCAs and the tax is payable immediately on the option exercise via PAYE.

6.3 Internationally mobile employees

6.3.1 The international aspect of the taxation of option plans is complex because the tax regimes in different jurisdictions vary. At the UK domestic law level, the following issues arise.

- A separate tax (including NIC) regime can apply in the case of options granted to internationally mobile employees.
- This separate regime can impact on the timing of the taxable event, the type of event that gives rise to a tax charge, the computation of the taxable amount and so on.
- The territorial scope of taxation of option arrangements varies across the different tax regimes.
- The relevance of each tax regime will depend on factors such as the following.
    (a) The tax residence, ordinary residence and domicile status of the employee.
    (b) The residence status of the employing company.
    (c) Whether or not options are granted in contemplation of future UK duties or, as the case may be, future overseas duties.

6.3.2 Where an option is granted to an employee who is not resident and not ordinarily resident in the UK and the option is not granted in respect of UK duties, in general terms neither the grant nor the exercise of the option is within the scope of UK income tax and NIC. Where an option is granted to a resident and ordinarily resident employee, the income tax and NIC rules described in this report apply, regardless of the employee's tax residence status at the time of the option exercise. There are different scenarios where an option is granted to an employee who is resident but not ordinarily resident in the UK (broadly, someone who is expected to be in the UK for less than three years). We must emphasise that the comments made in this section 6.3.2 are subject to the facts and circumstances of each case.

6.3.3 Aside from UK domestic law, the position of the employee and the company will also need to take into account aspects such as bilateral double taxation treaties and social security agreements.

6.3.4 Given the variety of types of circumstance that affect the UK position and unless there is critical mass, in our experience many companies address the position for internationally mobile employees on a case by case basis.

6.3.5 In March 2002, the OECD published a discussion draft regarding certain tax issues (excluding social security issues) in the cross border context of stock options[87]. The opening remarks of the discussion draft stress the preliminary nature of the contents and note that delegates involved in the drafting did not necessarily support all the conclusions included in the draft.

6.3.6 In another recent development, the Inland Revenue has sought to provide further guidance on the tax and NIC aspects of stock options in the context of internationally mobile employees. Articles on these topics were published in the Inland Revenue Tax Bulletins Nos.55 (October 2001) and 56 (December 2001). These articles generated a considerable amount of interest and there was also some concern that aspects of the Inland Revenue's interpretation of the cross border position had changed. Following a useful meeting between the Inland Revenue and practitioners in January 2002, a further article was published in Tax Bulletin No.60 (August 2002) and this article contains welcome clarification of some of the issues that had been raised by practitioners.

7. Issues for employers

7.1 Inland Revenue reporting obligations

7.1.1 As mentioned at section 1.1.1, the scope of this analysis assumes a single company option plan, where the company whose shares are used for the plan is also the employer of the participants, and the options are granted by the company. In the case of a corporate group option plan, the reporting obligations may vary as between the company whose shares are involved and the employer (if a different entity). In several instances, more than one corporate entity has a reporting requirement.

7.1.2 *CSOPs*

- The company is required to submit an annual CSOP return (Form 35) to the Inland Revenue. This contains, inter alia, details of all grants and exercises of CSOP options made during the previous tax year[88]. Reporting should generally be made by 6 July following the end of the relevant tax year. There is an element of duplication in the reporting requirements but we understand that the Inland Revenue have indicated that a single report may be submitted via Form 35[89].

- A taxable CSOP option exercise should also be reported by the company in the employee's annual Form P11D (statement of employee benefits and

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87 "Cross-Border Income Tax Issues Arising from Employee Stock-Option Plans"

88 Paragraph 6 Schedule 9 ICTA1988

89 Section 136(6) ICTA1988 and Section 85(1) FA1988

expenses) to be submitted by 6 July following the end of the relevant tax year[90].

- There is no reporting obligation for the company on the vesting of a CSOP option nor on a sale of the shares acquired on the option exercise.

7.1.3 *SAYE plans*

- The company is required to submit an annual SAYE plan return (Form 34) to the Inland Revenue. This contains, inter alia, details of all grants and exercises of SAYE options made during the previous tax year[91]. Reporting should generally be made by 6 July following the end of the relevant tax year. There is an element of duplication in the reporting requirements but we understand that the Inland Revenue have indicated that a single report may be submitted via Form 34[92].

- A taxable SAYE option exercise should also be reported by the company in the employee's annual Form P11D to be submitted by 6 July following the end of the relevant tax year[93].

- There is no reporting obligation for the company on a sale of the shares acquired on the option exercise.

7.1.4 *EMI options*

- In order for an option to be a qualifying EMI option, notice of the option grant must be given to the Inland Revenue in a form required or authorised by the Inland Revenue, containing a declaration signed by the company and the employee. The notice must be submitted within ninety-two days of the grant of the option[94].

- There is no reporting obligation for the company in respect of the vesting of the option.

- The company is required to submit an annual EMI plan return (Form 40) to the Inland Revenue. This contains, inter alia, details of all grants and exercises of EMI options and details of any disqualifying events during the previous tax year. Reporting should generally be made to the SCEC by 6 July following the end of the relevant tax year[95]. There are additional reporting requirements in relation to the exercise of an EMI option and the reporting

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[90] Regulation 46 SI1993/744
[91] Paragraph 6 Schedule 9 ICTA1988
[92] Section 136(6) ICTA1988 and Section 85(1) FA1988
[93] Regulation 46 SI1993/744
[94] Paragraph 2(1) and (2) Schedule 14 FA2000
[95] Paragraph 65(1) Schedule 14 FA2000

deadline is also 6 July following the end of the tax year of the option exercise[96].

- A taxable EMI option exercise should also be reported in the employee's annual Form P11D, to be submitted by 6 July following the end of the tax year of exercise[97].

- Where PAYE is applicable on the exercise of an EMI option, the company's end of year PAYE returns will include data relating to the exercise. The returns must be submitted by 19 May following the end of the relevant tax year[98].

- There is no reporting obligation for the company on a sale of the shares acquired on the EMI option exercise.

7.1.5 *Unapproved option plans*

- Tax law refers to "particulars" that need to be reported in the context of the option grant. The current Inland Revenue interpretation of "particulars" encompasses the name of the employee, his NIC number, details of the employing company, the date of the option grant, a description and the number of the shares, the exercise price per share and whether or not the option is capable of exercise more than ten years after the grant. There is no prescribed form for this reporting requirement. The report should be submitted within ninety-two days from the end of the tax year of the grant[99].

- Regardless of whether or not the option grant is a taxable event, current Inland Revenue practice is to require the company to note the option grant in Form P11D for the relevant tax year. This involves simply ticking a box in Form P11D if the employee has been granted an option. (This assumes that, if the option has not been granted by the employer, the option grant was facilitated or arranged by the employer. Otherwise, different reporting requirements may apply). Details of any taxable income arising under the "30-day" rule (see section 6.1.6) should also be included in Form P11D. The Form P11D should be submitted within ninety-two days from the end of the tax year of the grant. Where PAYE withholding operates on the option grant, the company's end of year PAYE returns will include data relating to the option grant. The returns must be submitted by 19 May following the end of the relevant tax year[100].

- There is no reporting obligation in respect of the vesting of the option.

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96 Section 136(6) ICTA1988 and Section 85(1)FA1988

97 Regulation 46 SI1993/744

98 Regulation 43 SI1993/744

99 Section 136(6) ICTA1988

100 Regulations 43 and 46 SI1993/744

- Particulars of the option exercise should be reported to the Inland Revenue within ninety-two days of the end of the tax year of the exercise. There is no statutory definition of "particulars". The Inland Revenue's current interpretation includes the employee's name and NIC number, the name of the employing company, the respective dates of grant and exercise of the option, the option exercise price, the fiscal market value on the exercise date, the number of shares, confirmation as to whether PAYE was operated on the exercise and notification of any ERNIC paid by the employee[101].

- The option exercise should also be reported by the company in the employee's Form P11D to be submitted by 6 July following the end of the relevant tax year. (This assumes that, for example, if the shares are not in the employing company, the employer facilitated or arranged the option exercise. Otherwise, different reporting requirements may apply). The Form P11D should also include the amount of any benefit arising under the "30-day rule" (see section 6.1.6). [102] Where PAYE withholding operates on the option exercise, the company's end of year PAYE returns will include data relating to the option exercise. The employer end of year returns must be submitted by 19 May following the end of the tax year[103].

- There is no reporting obligation for the company in respect of the sale of the shares acquired on the unapproved option exercise.

7.2 Withholding obligations

7.2.1 *CSOPs, SAYE plans, EMI options*

- The company has no PAYE withholding obligation in respect of the grant, vesting or exercise of CSOP options or the subsequent sale of the shares acquired on the option exercise. For EMI options there is a witholding obligation only if the conditions for the beneficial tax treatment have not been fulfilled (see 3.3.3). For details of the PAYE procedures, see section 7.2.4.

7.2.2 *Unapproved option plans*

- If the option grant is a taxable event, the company may have a PAYE withholding obligation in relation to the grant of the option. There is no PAYE withholding requirement unless the option is an RCA[104]. There is no withholding obligation in respect of the vesting of the option.

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101 Section136(6) ICTA1988 and Section85(1) FA1988
102 Regulation 46 SI1993/744
103 Regulation 43 SI1993/744
104 Section 203F ICTA1988

- There may be a withholding obligation for the company at the date of the option exercise. There is no PAYE withholding requirement unless the shares are RCAs[105].

- The following comments assume RCA status for the option or shares, as appropriate, and apply to withholding requirements at grant or at exercise.

  (a) For PAYE, withholding is at the employee's marginal income tax rate, taking into account any reliefs and so on notified to the company by the Inland Revenue via a notice of coding Form P2. (In the case of former employees, PAYE withholding will normally be at the rate of 22%).

  (b) The company accounts to the Inland Revenue for the PAYE, including the NIC. As regards PAYE, company accounting is required regardless of whether or not the PAYE has been recovered from the employee. Accounting for PAYE and NIC to the Inland Revenue is required within 14 days of the end of the tax month in which the option is granted or exercised, as appropriate[106].

  (c) For withholding on grant, the company is permitted to deduct PAYE from actual cash payments made to the employee during the period from the option grant to the end of the tax month in which the option grant occurs. (The position for EENIC recovery is dealt with under different rules). Given the restricted recovery rights within tax law, companies are recommended to ensure that employees are contractually bound to make good PAYE (and EENIC) to the company[107].

  (d) For withholding on the option exercise, the company is permitted to deduct PAYE from actual cash payments made to the employee during the period from the option exercise to the end of the tax month in which the option exercise occurs. (The position for EENIC recovery is dealt with under different rules). Given the restricted recovery rights within tax law, companies are recommended to ensure that employees are contractually bound to make good PAYE (and EENIC) to the company[108].

- There is no withholding obligation on the sale of the shares acquired on the unapproved option exercise.

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105 Section 203FB ICTA1988
106 Section 203J ICTA1988 and regulation 8 SI1994/1212
107 Regulation 7 SI1994/1212
108 Regulation 7 SI1994/1212

7.3 ERNIC

7.3.1 For CSOPs and SAYE plans, there is no charge to ERNIC on the grant, vesting or exercise of the option, nor on the sale of the shares acquired on the option exercise. This is so, even if taxable income arises on the option exercise.

7.3.2 For EMI options, there is no charge to ERNIC on the grant and vesting of the options, nor on the sale of the shares acquired on the option exercise. If the option exercise is a taxable event and the shares are RCAs, ERNIC is charged on the estimated taxable value at the rate of 11.8%[109].

7.3.3 The position for unapproved plans is described below.

- If the option grant is a taxable event and either the option or the underlying shares are RCAs, ERNIC is charged at the rate of 11.8% on the estimated excess of the then fiscal market value of the shares over the exercise price[110].
- There is no charge to ERNIC on the vesting of the option.
- The option exercise is a chargeable event for NIC purposes if the shares are RCAs at the time of option exercise[111]. The amount chargeable to ERNIC is the estimated taxable value on the option exercise and the rate is 11.8%.
- There is no charge to ERNIC on the sale of shares acquired on the option exercise.

7.3.4 Unlike other types of employment income, arrangements may be made for ERNIC arising on the exercise of an option to be transferred to the employee[112]. The transfer can be effected in one of two ways.

- The employee indemnifies the employer by agreement.
- The employer and employee jointly elect for the liability for ERNIC to be transferred to the employee. (Given that the election process involves the transfer of liability for the ERNIC, an election must receive prior approval from the Inland Revenue).

7.3.5 The government has announced proposals to increase the ERNIC rate to 12.8% from 6 April 2003. It is worth noting that ERNIC charges are not restricted by a contribution ceiling.

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109 Section 4(4) SSCBA 1992 and Paragraph 13 Part IX Schedule 3 SI2001/1004
110 Section 6 SSCBA1992 and Paragraph 3 Part IX Schedule 3 SI2001/1004
111 Section 4(4) SSCBA1992 and Paragraph 13 Part IX Schedule 3 SI2001/1004
112 Paragraph 3A Schedule 1 SSCBA1992

7.4 Corporate tax deduction

7.4.1 As there is only limited specific UK tax law dealing with the availability of a corporate deduction for stock option plans, the availability, amount and timing of a corporate deduction is often based on general tax principles. The Inland Revenue are evaluating the merits of introducing a bespoke tax code for such deductions.

7.4.2 At present, the position can be summarised as follows. (The summary is in respect of trading companies. The position for investment companies may be different).

- The timing and amount of a corporate deduction follows Generally Accepted Accounting Principles ("GAAP") unless tax law overrides these principles. For example, there is old case law precedent that suggests that the dilution costs associated with the issue of new shares are not deductible[113].

- Where the share delivery mechanism is an EBT, carefully structured corporate gifts to the trustees should in principle be deductible. The timing of the deduction would tend to be governed by GAAP. Although the Inland Revenue's view is that there is specific tax law that could operate to defer the timing of the deduction to a later date, the Inland Revenue's current approach is, generally, not to apply this view where the EBT is used to deliver shares to employees.

- Many overseas companies charge their UK subsidiary companies for participation by the subsidiary's employees, the charging basis having been agreed at the time of the option grant. Again, properly structured, a corporate deduction should be available for the charge.

7.4.3 Some companies (notably corporate groups) implement procedures involving EBTs such that a corporate deduction is obtained for the gain realised by the employee on the option exercise. The procedures are such that, despite the availability of the corporate deduction, the gain is not a charge against the parent company's consolidated earnings for accounting purposes. Hitherto, use of these procedures has been restricted mainly to SAYE plans. However, there is increasing interest in the approach in the context of other types of stock option plans.

7.4.4 In the context of international corporate group stock option plans, the group should address the relevance of UK transfer pricing rules. Briefly, these rules may operate to adjust fiscal corporate profits or losses where re-charging of option costs is not made or re-charging is not on a basis that would be expected between independent entities acting on arms length terms. A recent decision of the UK tax commissioners on this topic has further encouraged companies to address transfer pricing implications of stock option plans.

7.4.5 Share plan operating costs are deductible for corporate tax purposes.

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113 Lowry v Consolidated African Selection Trust Ltd 23 TC 259

7.4.6 In the UK, there is no express tax rule in relation to stock option plans that restricts the availability of a corporate deduction where the value attributable to the stock option gain or value realised by an employee or a specified type of employee exceeds a specified monetary limit.

7.5 Other taxes

7.5.1 Value added tax ("VAT") should be addressed particularly in corporate group plans, notably where re-charging for costs may have VAT consequences. With careful structuring, there should be scope for VAT mitigation.

7.5.2 Stamp Duty ("SD") or Stamp Duty Reserve Tax ("SDRT") is payable on the transfer of existing shares. The rate for both SD and SDRT is 0.5% of the purchase consideration but SD is rounded up to the nearest £5 (minimum charge of £5). Where an EBT is used as the share delivery mechanism on an option exercise, the taxable value is the exercise cost, not the fiscal market value of the shares on the exercise. SD and SDRT are addressed in this section of our report because, in many cases, any attributable cost for the employee is met by the employer.

8 Legal and regulatory issues

8.1 Process/timeframe

8.1.1 The length of time required to establish and implement a stock option plan will vary from case to case. There are numerous factors that can impact on timing and the period could range from as little as one week to more than a year.

8.1.2 The design and implementation process will vary from case to case. Generally, the procedure will involve some or all of the following, although the list is indicative only.

- Establishing power to grant options (by reviewing and, if necessary amending, the company's constitutional documents).
- Drafting plan rules and ancillary documentation (option certificates and so on).
- Design of performance conditions, which may involve research into comparator company data.
- Submission of the plan rules to the relevant authorities, for example the Inland Revenue, the UK Listing Authority ("UKLA") and so on.
- Negotiation with the Inland Revenue regarding the fiscal market value of the shares, for example where an approved option plan involves options in respect of unlisted shares.

- Gaining shareholder approval (determined by any shareholder's agreement, the Articles of Association, or the UKLA Rules, where relevant).

- Circulation of a prospectus.

- Adoption of the plan by the board of directors.

- Obtaining formal approval of the plan by the Inland Revenue.

- Establishment of an EBT.

- Where corporate groups are involved, consideration of re-charge arrangements.

- Consideration of share sourcing issues.

8.1.3 Documentation generally required will include some or all of the following (although this is indicative only and will vary on a case by case basis).

- A set of rules containing provisions, many of which may be enabling provisions. The rules will cover aspects such as eligibility for participation, the price at which options may be granted, option term, requirements for option vesting, the implications of employment termination, corporate transactions and so on, and details of required consents for rule amendments, discretionary aspects and so on.

- Employee communication, for example an explanatory booklet.

- Letter of invitation, inviting employees to take up the offer of an option award.

- An application form, for employee option grant applications.

- An option certificate setting out the specific terms of the option contract.

- A Board resolution adopting the plan and so on.

- A shareholders' resolution agreeing to the adoption of the plan.

- An Inland Revenue approval letter.

- A notice of exercise for the employee to use when he or she wishes to exercise the option.

- EBT – associated documentation, such as the trust deed and agreements with the sponsoring company.

8.1.4 Guidance from the Inland Revenue is available on their website at http://www.inlandrevenue.gov.uk/shareschemes/index.htm

8.2 Employment law

8.2.1 UK law forbids discrimination in the provision of employee benefits between full-time and part-time workers of either sex unless the difference in treatment can be justified on "objective grounds". This defence will be difficult to demonstrate. As from October 2002 it will also be unlawful to discriminate against fixed term or temporary employees, although the defence of justification will again apply. As a matter of general principle, UK law outlaws discrimination on the grounds of sex, race and disability[114].

8.2.2 Often, when an employee leaves a company, he or she is allowed a period of grace in which to exercise the option, unless he or she has been dismissed for reasons such as gross misconduct. If the options do lapse the employee's rights will depend upon the terms of his or her employment contract and the stock option plan. In this instance, one would expect the stock option plan to prohibit a claim following the forfeiture of this award. Properly drafted exclusion clauses are valid in England and Wales but different legislation makes this more difficult to achieve in Scotland. However, it is unlikely that any contractual exclusions would override any statutory right that the employee may have. For example, a dismissed employee can claim unfair dismissal compensation of up to £51,700 and loss of option rights can be included within this despite the existence of exclusion wording[115].

8.2.3 There are strict rules on making deductions from an employee's wages, for example, in relation to the purchase price of shares or ERNIC, so careful drafting of the plan documentation is vital[116].

8.2.4 Consultation with trade unions or similar representative bodies is not normally required, unless a collective bargaining agreement or other contractual arrangement requiring consultation is in place.

8.3 Data protection

8.3.1 For the purposes of complying with the European Union Data Protection Directive, it is advisable that the employer obtains a signed consent and acknowledgement from the employee. The consent should acknowledge that the employer, through an appointed controller, holds or will hold information about the employee relating to the employee's employment and other personal information, and that the controller is authorised to disclose such data to the employer, or any of its subsidiaries, representatives and agents in any country, including those countries that do not have a level of data protection similar to the standards under the European Union Data Protection Directive.

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[114] Sex Discrimination Act 1975, Race Relations Act 1976, Disability Discrimination Act 1995, Part-Time Employees (Prevention of Less Favourable Treatment) Regulations 2000 and draft Fixed-Term Employees (Prevention of Less Favourable Treatment) Regulations 2002

[115] Micklefield v SAC Technology Ltd [1990] IRLR 218, Chapman v Aberdeen Construction Group plc [1991] IRLR 505. Levett v Biotrace International plc [1999] IRLR 375

[116] Employment Rights Act 1996

8.3.2 Any personal data transferred to countries outside the European Economic Area will be subject to an "adequacy" test, to ensure that those countries have adequate protections in place before the data can be lawfully transferred to it, or that the parties concerned should put in place contractual provisions for the treatment of the data in accordance with certain requirements[117].

8.3.3 If the data protection laws are contravened, the Magistrates Court may impose a fine of up to £5,000, and an unlimited fine may be imposed by the Crown Court[118]. It is even possible for the company, a director or the individual concerned to be considered liable for breaches of the data protection legislation[119]. In the year to 31 March 2001, 129 cases were considered for prosecution. Of these, 21 were successfully convicted. Offences ranged from unlawful procurement of data, to registration failure, inadequate, irrelevant and excessive use of data, unsecured data and unfair processing. The maximum fine imposed was £3,000.

8.4 Stock Exchange issues

8.4.1 If the company's shares are listed in the Official List of the UKLA, a stock option plan may need to be approved by an ordinary resolution of the shareholders of the company in general meeting prior to the plan's adoption. A listed company is required by the UKLA Rules to issue a circular to shareholders where the plan involves the use of unissued shares or the plan falls within the definition of a "long-term incentive scheme"[120]. Chapter 13 of the UKLA Rules sets out the requirements for documents such as a circular prepared by listed companies in connection with employee share plans, including stock option plans. Generally, if a document complies with the requirements of Chapter 13, the company need not file draft documentation for approval by the UKLA[121]. In practice, shareholder approval may also be sought by unlisted companies because of shareholder agreements, the company's articles of association or the commercial need to obtain investor approval and so on.

8.4.2 All stock option plans of a listed company, which involve or may involve the issue of new shares or which fall within the definition of a "long-term incentive scheme" must be filed with the UKLA. In addition, those plans that have "unusual features" will need to be approved in advance by the UKLA[122]. Filing must be undertaken generally at the time the shareholders meeting is called to approve the plan[123]. There is no filing or registration requirement for the stock option plan of an unlisted company.

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117 DPA1998

118 Section 60 DPA1998

119 Section 61 DPA1998

120 General rules can be found in Paragraph 14.21 Chapter 14 UKLA Rules and Chapter 13.14 UKLA Rules, paragraphs 13.13 – 13.17

121 Chapter 13 UKLA Rules

122 Chapter 13 UKLA Rules

123 Chapter 13.2 UKLA Rules

8.4.3 Companies with a primary listing on the UKLA Official List should be aware of shareholder dilution guidelines issued by institutional investor representatives (see section 10). Although the guidelines have no legal force, if they are breached shareholders may be less inclined to approve the adoption of a new plan[124].

8.5 Securities law

8.5.1 Offers of unlisted securities "to the public" are subject to regulation under the Financial Services and Markets Act ("FSMA") 2000 and, if an offer is made in the UK for the first time and is not within one of the relevant exemptions, the offer can only be made if a complying non-listing prospectus is issued. An offer is not considered to be "to the public" if one of the exemptions in SI1995/1537 (the Public Offer of Securities ("POS") Regulations) applies. SI1995/1537 require that when unlisted securities are offered to the public in the UK for the first time, the offeror must register and publish a prospectus, which must comply with the contents requirements of SI1995/1537[125]. Under SI1995/1537, an offer of securities to any section of the public is to be regarded as made to the public[126]. However there are several exemptions from this. In particular there is an exemption of an offer by a company of its own securities or the trustees of an employee trust to "qualifying persons"[127]. A "qualifying person" includes a bona fide employee of the issuer or of a body corporate in the same group[128].

8.5.2 Other notable securities law issues to consider when preparing a stock option plan for UK participants are as follows.

- Financial promotions: anything which communicates an invitation or inducement to engage in investment activity is a "financial promotion". Financial promotions can only be issued by persons authorised under FSMA 2000 unless its content has been approved by a person authorised under FSMA 2000. An exemption to this rule may apply where the financial promotion is made by a company for the purpose of an "employee share scheme" and relates to instruments such as shares or options issued by that company[129].

- Collective Investment Schemes ("CIS"): CIS can only be marketed in the UK if the scheme is a regulated CIS and if the scheme is marketed by a person authorised under FSMA 2000[130]. Many stock option plans will meet the definition of a CIS under FSMA. An exemption to this rule may apply where the CIS is an "employee share scheme". If this exemption applies, the plan will not be considered to be a CIS and the above restrictions will not apply.

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124 Chapter 1 UKLA Rules
125 SI1995/1537 as amended by FSMA2000 (Consequential Amendments and Repeals) Order 2001, SI 2001/3649
126 Regulation 6 SI1995/1537
127 Regulation 7(2)(o) SI1995/1537 as amended by article 504 SI2001/3649
128 Regulation 7(12) SI 1995/1537
129 Section 21 FSMA2000 and Section 60 FSMA (Financial Promotion) Order 2001
130 Section 235 FSMA2000, Section 8 FSMA (Collective Investment Schemes) Order 2001

- Regulated activities: certain activities are regulated and can only be performed by a person authorised to do so under FSMA 2000. These activities include dealing in investments, arranging deals in investments and providing investment advice[131]. In the course of establishing and running a stock option plan, one or more of these activities may take place. Without an exemption, they would need to be undertaken by an authorised or exempt person. An exemption to this requirement may apply for the activities of dealing in investments and arranging deals in investments where these are taking place in connection with an "employee share scheme". However, this exemption does not extend to the activity of providing investment advice.

8.5.3 If the UKLA considers that an issuer has breached any provision of the UKLA Rules, it may impose on the issuer a financial penalty or publish a statement censuring the issuer subject to the provisions of FSMA 2000. If the UKLA considers that an issuer has breached any provision of the UKLA Rules and that a person who was at the material time a director of the issuer was knowingly concerned in the breach, the UKLA may impose on that person a financial penalty or publish a statement censuring that person subject to the provisions of FSMA 2000[132].

8.5.4 There is a considerable amount of interest in the draft European Directive on Prospectus requirements ("the proposed Directive"), which would introduce a single set of disclosure rules for all issues of securities for trading in the EU. In the context of employee shares, there was concern in the UK that the proposed Directive as originally drafted did not provide for exemptions for employee share plans as are currently permitted under the POS Regulations. In early 2002, the European Parliament rejected a proposed amendment whereby such plans would qualify. However, draft amendments published in August 2002 contain provisions about share plan exemptions and these will be examined carefully in the UK.

8.6 Financial assistance

8.6.1 There is a general prohibition against UK companies providing financial assistance to third parties for the acquisition of the company's own shares or those of its subsidiaries. This prohibition applies regardless of the timing of the assistance (i.e. before, at the same time as, or after)[133]. For these purposes, financial assistance includes the following[134].

- Financial assistance given by way of a gift.

- Financial assistance given by way of a guarantee, security or indemnity, other than an indemnity in respect of the indemnifier's own neglect or default or by way of release or waiver.

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131 Section 19 FSMA2000, Section 71 FSMA (Regulated Activities) Order 2001
132 Paragraphs 1.8 and 1.9 Chapter 1 UKLA Rules
133 Section 151 CA1985
134 Section 152 CA1985

- Financial assistance given by way of a loan or any other agreement.

- Any other financial assistance given by a company the net assets of which are thereby reduced to a material extent or which has no net assets.

8.6.2 Financial assistance is a criminal offence, which can result in fines for the company and the directors of the company and even imprisonment of the directors[135].

8.6.3 There are specific exemptions in relation to the operation of employee share plans. A company is not prohibited from giving financial assistance for the purpose of an acquisition of shares in it or its holding company if it is provided in good faith in the interests of the company for the purposes of an "employees share scheme". Most employee share acquisitions will fall within the terms of the exemption, but one-off arrangements for non-executive directors require particular care[136].

8.6.4 Private companies are not prohibited from giving financial assistance where the shares acquired are shares in that private company or, in the case of a subsidiary, in the parent company and the conditions outlined at section 8.6.5 are complied with. The parent company in these circumstances must also be a private company.

8.6.5 The financial assistance may only be given if the company has net assets which are not thereby reduced or, to the extent they are reduced, if the assistance is provided out of distributable profits. Unless the company giving the financial assistance is a wholly owned subsidiary, a special resolution of the company in general meeting is required to approve it. The directors are also required to make a statutory declaration containing prescribed particulars set out in Section 156 CA1985. Specific timescales are set out in the legislation as to when the financial assistance can be provided in the acquisition of shares.

9 Sourcing shares for stock option plans

9.1 Summary

9.1.1 In the UK, shares for stock option plans are sourced from either existing shares or the issue of new shares. At present, the use of treasury shares is not available (see section 9.2). Corporate strategy on stock option plan financing (new issue or market purchase) is determined principally by the following considerations.

- Earnings per share.
- Cashflow.
- Shareholder dilution.

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135 Section 151(3) CA1985

136 Section 153(4)(b) CA1985 and Section 743 CA1985

9.1.2 Many companies use both newly issued and market purchase shares for their stock option plans. For unlisted companies, the scope for market purchase is in principle limited. However, the use of EBTs (see section 9.3) can create additional flexibility. EBTs are used extensively also by listed companies. Shareholder attitude to dilution may also have a major impact on share sourcing (see section 10). Stock option plan financing strategy can have a significant impact, for example where as in recent months some companies have encountered falls in market capitalisation.

9.2 Treasury shares

9.2.1 A limited company may not acquire its own shares by purchase unless authorised to do so by statute, but the shares so acquired must immediately be cancelled. However, the government has issued a consultation document in line with its stated intention to allow UK companies to hold treasury shares[137]. More recently, the government has published responses to the consultative document and draft regulations are awaited.

9.2.2 A company (regardless of where it is incorporated) that is an English company may not hold shares in its English parent company.

9.3 EBTs

9.3.1 The concept of a trust is recognised in the UK. The use of EBTs in conjunction with employee share incentive arrangements, including stock option plans, is widespread. The EBT is effectively a share sourcing mechanism, the trustees either purchasing shares in the market or subscribing for newly issued shares. Generally, funding of the EBT is provided by the sponsoring company.

9.3.2 Typically, an EBT is a discretionary trust for the benefit of employees and former employees of the company and their dependents. The extent to which (if at all) any of the potential beneficiaries actually receives a benefit from the EBT is at the discretion of the trustees, who act in a fiduciary capacity. In many cases, the EBT trustees will be professional trustees (for example, a trust company or corporation) or a subsidiary of the sponsoring company. The operation of the EBT, for example the nature of the trustees' dispositive and administrative powers, is governed by the EBT deed, (which is executed typically by the trustees and the sponsoring company) and by trust law.

9.3.3 Some of the advantages of EBTs are listed below.

- Where the EBT purchases existing shares in the market the stock option plan can be operated without diluting existing shareholders' interests.

- An EBT can provide a marketplace for shares where, for example, the shares are unlisted.

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[137] Section 143 CA1985 and the Department of Trade and Industry consultation paper

- An EBT may provide scope for achieving both a corporate tax deduction for effective dilution and enhanced earnings per share.

10. Role and influence of existing shareholders

10.1 A significant proportion of UK listed shares is held by institutional investors such as pension funds and insurance companies. Given that employee share plans, including stock option plans, involve shareholder dilution and/or the use of shareholder funds, institutional investors display an active interest in stock option plans. Guidelines issued by the Association of British Insurers ("the ABI") comprise probably the most widely used framework within which institutional investor views are communicated (although there are other high profile organisations). Over several years, the ABI's Investment Committee issued interpretative papers. In 2001, these were consolidated into a single document, which was updated in February 2002. The ABI has committed to re-issue these guidelines annually, to ensure that they are consistent with market practice. The guidelines cover a number of aspects, including shareholder voting, levels and frequency of grants, performance conditions and the nature of employee/director participation.

11. Accounting

11.1 Stock option arrangements are accounted for in accordance with the provisions of UK GAAP. Specific guidance has been issued by the ASB regarding the following.

- The date of the option grant for accounting purposes (Urgent Issues Tax Force ("UITF") Abstract 30).
- The amount and timing of charges to the company's profit and loss account (UITF Abstract 17).
- Consolidation of shares held by an EBT with the company's financial statements (UITF Abstract 13).
- Accounting for ERNIC costs (UITF Abstract 25).

11.2 Accounting for stock options is the subject of ongoing review, both in the UK and in conjunction with accounting standards setting bodies outside the UK. As European Law requires all European Union ("EU") listed companies to use International Accounting Standards ("IAS") in place of national standards from 2005 accounts onwards, there is considerable interest in the ongoing debate about the stock option accounting methodology that will be used by IAS.

11.3 The current position can be summarised as follows.

- Where options in respect of unissued shares (other than SAYE options) are granted at a discount to the then fair market value of the underlying shares, the discount is charged to the company's profit and loss account. The timing of the charge will vary according to the design feature of the specific stock option plan. (On the basis of the tentative conclusions reached by the IAS board – see section 11.2, it would appear that the current exemption for SAYE options will be short-lived and that the option pricing methodology may differ from the approach envisaged under UITF 17).

- Where the share delivery vehicle is an EBT, shares held by the trustees are consolidated with the company's balance sheet until such time as the risks and rewards associated with the shares rest with the employee and not the company. Broadly speaking, the period over which the book cost of the shares is written off via the company's profit and loss account will vary according to the design features of the specific stock option plan.

11.4 In the UK, the use of treasury shares is not available at present.

12. Miscellaneous

12.1 Foreign exchange control filings

12.1.1 There are no foreign exchange control filing requirements in relation to stock option plans.

12.2 Ownership of shares in overseas companies

12.2.1 There are no restrictions on employees holding foreign shares or options in respect of foreign shares.

12.3 Transfers of shares to employees

12.3.1 The company operating the stock option plan will be required to transfer, or procure the transfer of, the shares to the employee. Once the company has complied with any internal or regulatory procedures required, the mechanics of the transfer of the shares is, in general terms, as follows:

- In the case of newly issued shares a form 88(2) is completed to register the employee as the owner of the shares.

- If the shares are transferred from an EBT stock transfer forms will need to be completed. For comment on SD or SDRT, see section 7.5.2**.**

12.4 Employee shareholders

12.4.1 Generally an employee will not have any rights over the shares (or be able to enjoy the benefits thereof) prior to his acquisition of them (that is, on exercise of the option).

12.4.2 Subject to the articles of association and agreements between shareholders, the standard formalities to enable the employee to transfer his shares are as follows.

- Stock transfer forms are executed by the transferor stating the number of shares, the transferee and the consideration.

- The new owner pays SD (see below) and has the stock transfer form physically stamped.

- The new owner sends the stamped forms to the Company Secretary (together with the old share certificate).

- The Company Secretary updates the statutory registers to reflect the transfer of the shares.

- A share certificate is issued to new owner.

12.4.3 Shares are transferable in a manner provided by the company's articles of association but subject to the Stock Transfer Act 1963, that is the provision of a proper instrument to enable the transfer. A stock transfer form is used for these purposes. The transferor also needs to enter the name of the transferee in its register of members. The stock transfer form specifies the person by whom the transfer is made, the full name and address of the transferee, the consideration and a description of the number and amount of the securities. SD at the rate of 0.5% of the value of the shares (subject to a minimum charge of £5) is payable by the transferee[138]. Where share transfers are effected electronically (see section 12.4.4) and SDRT is applicable, the rate is again 0.5% but there is no minimum charge.

12.4.4 Shares can also be dematerialised and transferred electronically, typically through a settlement and clearing system such as that operated by CRESTCo in London. Securities held by this system only exist electronically. While there are no certificates and no stock transfer forms, securities are held by the CREST system in a register which represents legal title to the shares. The CREST system ensures that purchasers receive their stock once payment is made, and vendors of stock receive payment upon delivery. CREST also calculates and collects SDRT due on transactions on behalf of the Inland Revenue.(CRESTCo, 2000) The value of investments held in the CREST system is approximately €3 trillion (CRESTCo, 2002).

12.5 Hypothecation

12.5.1 In the UK, tax revenues from employee stock option plans are not hypothecated.

13. Special points of note

13.1 Mitigation techniques

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[138] Paragraphs 1 and 3 Schedule 13 Finance Act 1999

13.1.1 There are no specific rules whereby the income tax and NIC charges are mitigated on the basis that income accrues over more than one year.

13.1.2 As regards capital gains realised on the disposal of shares, see section 5.3.1 for details of the impact of the length of the share ownership period on the CGT charge.

13.2 Special provisions for SMEs

13.2.1 The very attractive EMI option regime is specifically targeted at smaller companies. See in particular sections 1.3.4, 2.3, 3.3, 4.4 and 5.3.1.

Note: Individual country reports have been prepared covering employee stock options in the EU and the USA. These individual reports are of a general nature and subject to change based on individual circumstances. PricewaterhouseCoopers has also provided the EU with an overview report. This overview report sets out the basis on which the individual reports were prepared and should be referred to as necessary. In particular, it should be noted that the information in the reports is current as at 1 January 2002, unless otherwise stated. In the case of certain known subsequent changes, reference may be made on occasion but a full update exercise has not been carried out. Further information can be obtained from PricewaterhouseCoopers.

Further information regarding employee stock option plans can also be obtained from the Inland Revenue (http://www.inlandrevenue.gov.uk/shareschemes/index.htm)

Annex: Overview of conditions to be fulfilled by companies wanting to operate an EMI

- Requirements to ensure that the company is independent and that, where a corporate group is involved, the subsidiaries meet substantive economic ownership and control tests. Only "qualifying companies" may use EMI options. A company is a qualifying company provided it meets certain conditions, including the following.

  (a) The company must not be a 51% subsidiary of another company or under the control of another company (or of any other company and any other person connected with that company), even if it is not a 51% subsidiary of that other company. In addition, no arrangements can be in existence by which the company could become such a subsidiary or fall under such control. The term "control" is widely defined[139].

  (b) If the company has one or more subsidiaries, each of the subsidiaries must be a "qualifying subsidiary"[140]. A qualifying subsidiary is one where the company using EMI options (or one of its subsidiaries).

    (i) Possesses not less than 75% of the issued share capital of the subsidiary and not less than 75% of the voting power in the subsidiary[141].

    (ii) In the event of a winding up of the subsidiary, or in any other circumstances, would be entitled to receive not less than 75% of the assets of the subsidiary[142].

    (iii) Is beneficially entitled to not less than 75% of any profits of the subsidiary that are available for distribution to the shareholders of the subsidiary[143].

  Additionally, no other person should have control of the subsidiary and there must exist no arrangements by virtue of which any of the above conditions would cease to be met[144].

- Requirements to ensure that, at the time of the EMI option grant, the company's gross assets (or, where relevant, the gross assets of the group) do not exceed £30 million[145].

- Requirements that effectively exclude from eligibility companies involved to a substantial extent in certain types of activity. Using as an example here a single company arrangement, the company must exist wholly (ignoring

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139 Paragraph 13 Schedule 14 FA2000
140 Paragraph 14 Schedule 14 FA2000
141 Paragraph 15(2)(a) Schedule 14 FA2000
142 Paragraph 15(2)(b) Schedule 14 FA2000
143 Paragraph 15(2)(c) Schedule 14 FA2000
144 Paragraph 15(2)(d) and (e) Schedule 14 FA2000
145 Paragraph 16 Schedule 14 FA2000

incidental purposes) for the purpose of carrying on one or more "qualifying trades" and be carrying on a qualifying trade or be preparing to do so[146].

(a) A trade is a qualifying trade if all of the following tests are met[147].

(i) It is carried on wholly or mainly in the UK.

(ii) It is conducted on a commercial basis and with a view to the realisation of profits.

(iii) It does not consist wholly or to a substantial part in the carrying on of excluded activities.

(b) The following are excluded activities[148].

(i) Dealing in land, in commodities or futures or in shares, securities or other financial instruments.

(ii) Dealing in goods otherwise than in the course of an ordinary trade of wholesale or retail distribution.

(iii) Banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities.

(iv) Leasing (including letting ships on charter or other assets on hire) or receiving royalties or licence fees.

(v) Providing legal or accountancy services.

(vi) Property development.

(vii) Farming or market gardening.

(viii) Holding, managing or occupying woodlands, any other forestry activities or timber production.

(ix) Operating or managing hotels or comparable establishments, or managing property used as a hotel or comparable establishment.

(x) Operating or managing nursing homes or residential care homes, or managing property used as a nursing home or residential care home.

- Requirements that limit the aggregate value of shares under EMI options sponsored by the company to £3 million[149].

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146 Paragraph 17 Schedule 14 FA2000
147 Paragraph 18(1) Schedule 14 FA2000
148 Paragraph 19(1) Schedule 14 FA2000
149 Paragraph 11 Schedule 14 FA2000

- Requirements that set an individual employee participation limit of £100,000 in terms of the aggregate value (calculated at the time of the option grant) of shares under the employee's subsisting EMI options (and there may be further limits where the employee also participates in a CSOP)[150].

- Requirements that the shares involved must be fully paid up, non-redeemable ordinary share capital[151].

- Requirements to ensure that the EMI option favoured tax regime is restricted where the option is exercised more than ten years after it was granted or where certain "disqualifying events" occur after the EMI option grant[152]. Examples of disqualifying events are loss of corporate independence, failure to meet the trading activities requirements, prescribed alterations to the share capital of the company within Paragraph 49 Schedule 14 FA2000, the employee ceasing to be eligible, certain changes to the terms of the option, certain conversions of shares, the grant of a CSOP option that takes the option holder over the statutory EMI limit and so on.

[150] Paragraph 10 Schedule 14 FA2000
[151] Paragraph 38(1) Schedule 14 FA2000
[152] Paragraph 47 Schedule 14 FA2000