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EMPLOYEE OWNERSHIP LAWYERS

Unapproved Share Options: The What, Why and How

A guide to unapproved share options

What?

To understand unapproved share options it is helpful to compare them with 'approved' (or 'tax advantaged') share option plans. These employee option plans benefit from statutory tax advantages, and are designed for use in a variety of contexts such as attracting and retaining key staff, incentivising employees to achieve better performance etc. There are three key types:

- Enterprise Management Incentive (EMI)
- Save As You Earn Option Scheme (SAYE)
- Company Share Option Plan (CSOP)

The above are designed to be highly tax efficient, but are governed by detailed regulations. Certain conditions need to be met for a company to qualify for any of them. For example, the popular EMI share options require independence (statutorily defined), a maximum number of employees and gross assets, it must fall within certain trading activities and must grant options only to full time employees (statutorily defined). Where a company satisfies these prerequisites any employee reward from options can be free of Income Tax (IT) and National Insurance Contributions (NICs) which could otherwise involve a total tax take of up to 60 %.

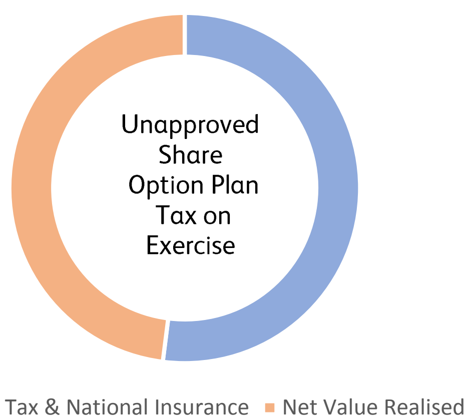

Figure 1 Unapproved Share Option Plan Tax on exercise

FEATURES OF OPTION SCHEMES

A recent survey of technology companies identified that over three-quarters of the companies operated option schemes. It is worth identifying at the outset the key structural features of an option scheme:

GRANT

An unlisted company can grant options at any time of its choosing, but the terms must be set out clearly in the documents issued to the employee. By granting an option, it is giving the employee a right (but no obligation) to acquire shares in the future at a price fixed at the outset.

VESTING

Full rights to exercise an option often kick in after a specified date, or accrue gradually over a period of time (in either case, normally so long as the employee remains in employment). See Figure 2

TIME OF EXERCISE

This can be after a period of time, or on the happening of an event such as a trade sale or share listing (IPO). A performance target might also have to be achieved based on company or (less frequently) individual targets

LEAVING THE COMPANY

The treatment of leavers might distinguish between "good" and "bad" leavers and between vested and unvested options, and there might be an overriding discretion exercisable by the board of directors.

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However where for eligibility or flexibility reasons a company is unable to grant tax-advantaged options (sometimes called approved options), it may still wish to grant so called unapproved options (non tax-advantaged options)

Why?

The trade-off for tax inefficiency is that the company enjoys the maximum scope in designing how its unapproved share options are to work. For instance, unapproved share options can be granted in company subsidiaries (including companies with a majority stake held by a private equity or venture capital investor), and can be granted to non-employees or non-executive directors.

Sometimes, unapproved share options are used alongside CSOPs to provide 'top-up' options over shares in excess of the £30,000 individual participation limits. Furthermore, they can also be issued over types of shares that do not qualify under the tax-advantaged plans.

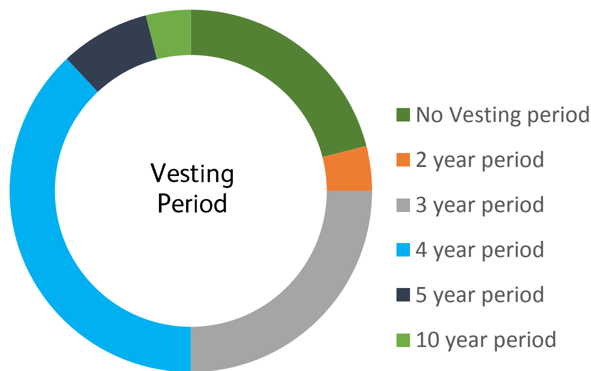

Figure 2 Proportion of Companies using different vesting periods

So what is the tax treatment of unapproved options?

Income tax is payable on the exercise of an unapproved option on the difference between the exercise price and the market value of shares at the date of exercise. Furthermore, National Insurance contributions (employee and employer) are also payable on exercise if the option shares are regarded as being convertible into cash (see Figure 1).

When the shares acquired on the option exercise are sold it is the increase in value from the date of exercise that will be subject to the more favourable capital gains tax (CGT) regime. Under tax-advantaged share schemes there is usually no income tax or NICs charge when an option is exercised (see Figure 3), and the whole increase in value above the exercise price is taxed under the CGT regime when the shares are sold.

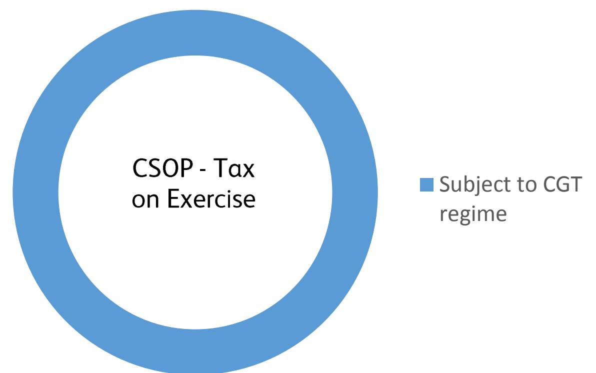

Figure 3 There is no tax on the exercise of an approved CSOP

How?

Unapproved Share Options can come in various guises but are most commonly simply called unapproved share options or, where the exercise price is zero or heavily discounted, long term incentive plans (LTIPs)

The table below illustrates the key differences between an (approved) CSOP, EMI share options and unapproved options. Tax efficiency will often be a factor in choosing the right kind of option scheme, but should not be the only one.

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Difference between EMI, CSOP and unapproved options

	EMI	CSOP	Unapproved SOP
Maximum value at date of grant	£250,000	£30,000	N/A
Who?	Full time employee or director and does not own more than 25 % of share capital	Employee or full-time director, and does not own more than 25 % of the share capital	No requirement for qualifying individuals
Exercise price	Can be below market value (but discount will be subject to Income Tax/NIC's)	Cannot be below market value	Can be any amount
Tax on Grant	No	No	No
Tax on Exercise (individual)	No, unless is less than market value at date of grant	No	(Individual) On the exercise of the option there **will be an income tax** liability on the difference between the market value of the shares at that date, and the price paid for them. NIC's may also be due
Tax on Exercise (Corporation)	Corporation tax deduction available for the company on options gains	Corporation tax deduction available for the company on options gains	Corporation tax deduction available for the company on options gains, if statutory requirements satisfied. Possibly also NIC's
Tax on Disposal	On disposal of the shares, the capital gains tax liability will be on the difference between the disposal proceeds and the market value of the shares when the options were granted. Entrepreneurs' relief available	On disposal of the shares, the capital gain is calculated by comparing the disposal proceeds to the price paid for the shares when the options were granted. Entrepreneurs' relief available only where more than 5 % held for more than 12 months	On the disposal of the shares, the capital gain is calculated by comparing the disposal proceeds to the market value of the shares when the options were excercised.

How can we help?

Postlethwaite Solicitors is a specialist law firm specialising in employee share schemes and employee ownership. Our focus is on helping you find the right design for your employee share scheme, then putting it in place. We work directly with companies or through other professional advisers on share schemes and employee ownership in its various forms. We know that your company or client faces its own unique challenges.

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