



## Share Success

Your guide to employee share plans  
in the UK and beyond

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# Foreword



It is nearly five years since the last edition of “*Share Success*”, Deloitte’s guide to the structuring and delivery of share plans. By any measure five years is a long time, but this is particularly the case in the area of share plans. When we last published this guide, UK income tax rates were about to be increased from 40% to 50%. At the same time major restrictions were imposed on tax efficient pension funding. Unsurprisingly these changes gave companies cause to give serious consideration to structuring their remuneration arrangements to mitigate tax. In particular many companies looked at mitigating their tax exposure on share plans.

Since then the tax planning environment has changed dramatically. This was brought into particularly sharp focus two years ago when income tax rates were reduced from 50% to 45%. A number of high profile companies who used this as an opportunity to defer income to benefit from the lower rates, found themselves in the eye of a media storm. What in previous years might have been considered “good housekeeping” was in some circles re-characterised as abusive tax planning, which in turn had a reputational impact on the companies involved.

The purpose of this guide is not to comment favourably or critically on tax planning in the share plan arena. It is, however, intended to be an objective summary of the main types of share incentive arrangements which are operated by companies in the UK, whether they are listed or private. We have summarised the main features of such plans including their tax treatment. Since the last addition, we have significantly expanded the chapter on governance and disclosure to reflect market developments over the period. We have also added a section on the funding of share plans.

The one constant since the last edition of this guide remains the popularity of employee share plans. They continue to be an established and integral part of the remuneration packages operated by UK companies; 95% of FTSE 350 companies operate some form of share plan for their executives and employees.

The era of rapid change in the share plan space shows no sign of abating. In the financial services industry the regulatory environment continues to encourage the payment of remuneration in the form of shares, often deferred for significant periods. In the meantime the requirement to consider clawback arrangements has extended out of the financial services sector into the broader market and with effect from 1 October 2014 the UK Corporate Governance Code will require quoted companies to consider the inclusion of clawback in their variable remuneration arrangements. Dealing with the practicalities of clawback is therefore something that all listed companies will need to consider over the coming months.

The changes do not relate exclusively to executive arrangements. The tax breaks available for broad based plans have been significantly increased with effect from 6 April 2014. This change has been given widespread approval and it is perhaps overdue recognition for the benefits of broad based arrangements.

The aim of this guide is to provide an overview of the structuring of share plans and it is not intended to provide specific advice in what is a complex and fast moving area. We therefore strongly recommend that you consult your advisers on the specifics of any idea summarised in this guide and its relevance to your particular circumstances.

We hope you find our guide helpful and we would be happy to discuss any specific issues with you.

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# 1 Introduction

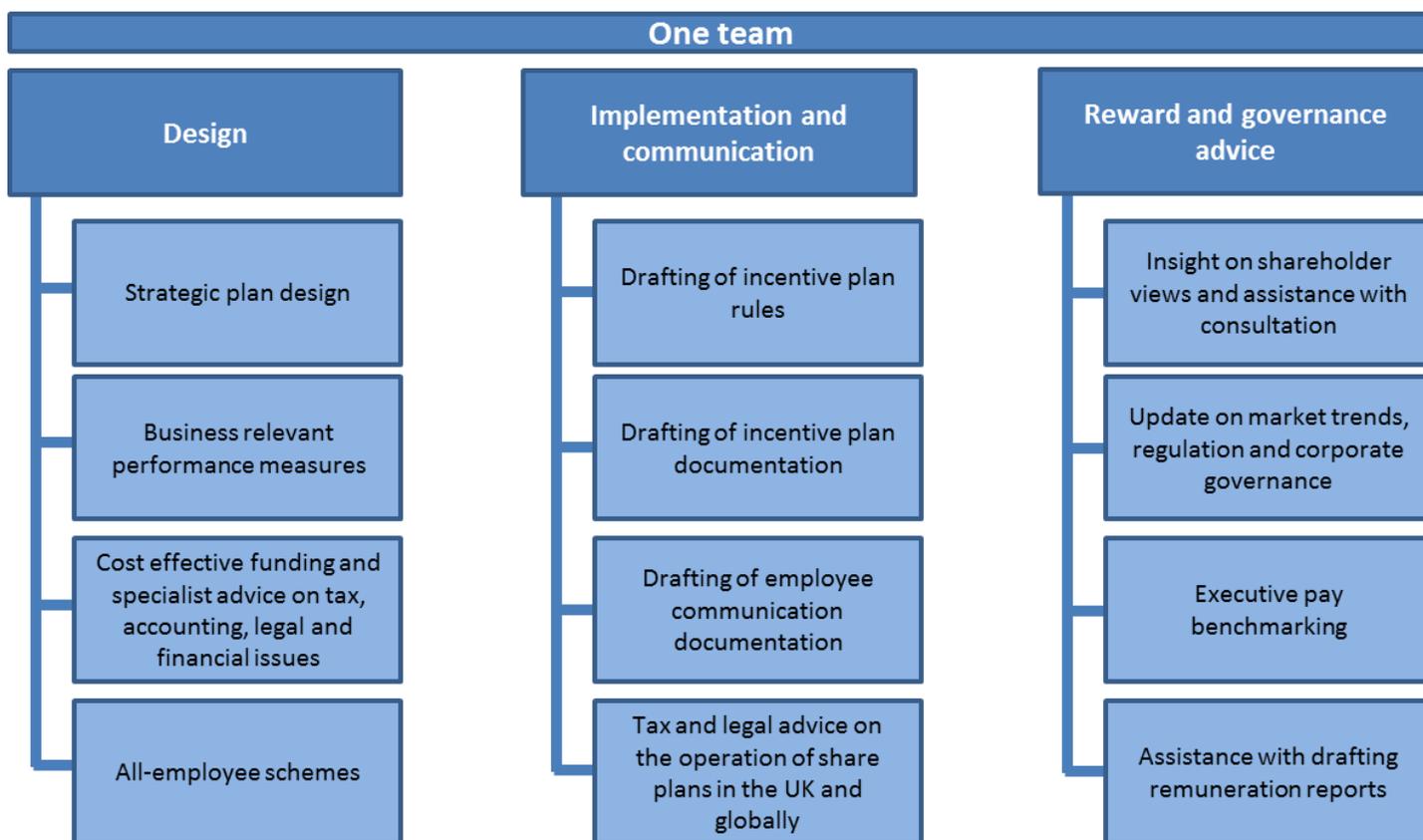
This guide is aimed at all those involved in designing, implementing and operating share plans whether for executives or for the wider workforce. It provides an overview of the types of share plans and other incentive arrangements available to companies operating in the UK and the key issues which are relevant to their introduction and operation.

The guide is structured as follows:

- chapter 2 principally focuses on listed companies and provides a summary of the types of share plan currently available, both for executives and for the wider employee population and outlines the basic tax treatment of these share plans;
- chapter 3 explores some of the share incentive arrangements which, although generally available for all types of companies, are more prevalent in smaller listed companies and in private companies;
- chapter 4 addresses when shareholder approval is required for employee share plans adopted by listed companies and the relevant disclosure requirements;
- chapter 5 looks at the key issues likely to arise when rolling out and operating employee share plans on an international basis; and
- chapter 6 provides a brief summary of the accounting and funding implications of operating employee share plans.

## How we can help

The share plans team at Deloitte provides a complete service from design, through to drafting and implementation of share plans in the UK and overseas and can advise on the relevant tax, legal, accounting and funding issues. The share plans team works closely with Deloitte's market-leading reward consulting team.



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# 2 Typical share plans in listed companies

In this chapter we explore the main types of share plans which are typically used in listed companies and their tax treatment. In chapter 3 we look at the share plans and other incentive arrangements that are more commonly found in private companies and also in smaller listed companies. In practice there is a certain amount of cross-over between the types of plans used in listed and private companies.

Section 2.1 focuses on executive share plans and section 2.2 focuses on broad-based employee share plans.

## 2.1 Overview of executive share plans

Discretionary or 'executive' share plans enable companies to provide share based incentives to executive directors and selected employees on a discretionary basis. Their aim is usually to motivate the employees who participate in them over the longer term whilst aligning their interests with the company and its shareholders. In section 2.1.1 we give a brief guide to the types of executive share plans used most commonly in the UK and then in sections 2.1.2 to 2.1.6 we look at tax-advantaged and other arrangements.

### 2.1.1 Executive share plans

#### Performance share plans (sometimes referred to as long-term incentive plans)

Performance share plans (PSPs) involve the award of free shares to participants conditional on the achievement of specified performance targets and continuous employment over a certain period of time (the vesting period), usually three to five years. If all conditions are met, the executive will profit from the whole value of the shares, not just the growth in value over the vesting period. Throughout this guide we refer to this type of award as a 'share award'.

In practice share awards are typically structured in one of two ways:

- A conditional right to acquire shares in the future (at no cost to the employee). The shares are delivered to the employee at the end of the vesting period provided the performance conditions have been met;
- A nil cost option. Provided the performance conditions are met, the individual can choose when to exercise the option and acquire the shares until the end of the exercise period (normally ten years from grant). This flexibility allows participants to defer the taxable event and exercise may be split over a number of tax years to mitigate income tax. By delaying exercise, participants can also benefit from gross roll-up of gains over the exercise period, rather than selling shares to meet the income tax on vesting and benefiting from gains on only a net number of shares in the future. From the employer's perspective, the timing of the employer's NI charge is out of the company's hands and the timing of the employer's corporation tax deduction for share based payments is deferred.

#### Key advantages

- The reward delivered is closely linked to the chosen performance measures.
- By paying in shares there is a link between remuneration and share price performance.
- Awards have an inherent value – they do not go "underwater".

#### Key disadvantages

- The inherent value means awards may have some value even if the share price goes down, although appropriate performance conditions may mitigate this.
- They do not incentivise share price growth as powerfully as market value options, but using a performance measure focused on delivering shareholder value may help.
- Performance share plans may be perceived as less attractive than market value options in some overseas jurisdictions although good communication can help address this issue.

#### Longer vesting and holding periods

Almost half of FTSE 100 companies now incorporate longer time horizons for their performance share plans, either through performance periods of more than three years and/or a further holding period following the end of the

performance period. The most common holding period is [2] years, from the end of the vesting period.

#### *Malus and clawback*

The inclusion of malus and clawback provisions in employee share plans is continuing to rise allowing for incentive certain circumstances arise.

#### *Restricted share awards*

Instead of being structured as a conditional right or a nil-cost option, a share award could be structured as an up-front award of shares which are forfeited if performance and/or employment conditions are not satisfied. The employee becomes absolutely entitled to the shares only after the relevant conditions have been satisfied. Such awards are sometimes referred to as "restricted share awards" although in practice these are rare in UK listed companies.

Using an award of restricted shares allows the employee to pay income tax on the current value of the shares at the date of acquisition and then benefit from the more favourable CGT regime on any growth over the vesting period. An election (known as a 's431 election') should be made by the employee and the company within 14 days of the acquisition of the shares so that any future gain will be subject to CGT when the shares are eventually sold. s431 elections are described in the introduction to chapter 3.

The disadvantage of restricted shares for the employee is that cash has to be found to meet the upfront tax charge on the award or alternatively this needs to be taken out of the value of the share award, so that only the net number of shares remain over the vesting period. The tax paid is not refundable if the value of the restricted shares falls. As the value of each share in large plc's is normally already significant and the potential for further share price growth may be thought limited, the risk of paying the tax up-front versus potential return for the employee is often not as appealing as it might be in a small company with significant growth potential.

From the employer's perspective, no corporation tax relief is available for the gain on the value of the shares over the vesting period. On the other hand, the company does not pay employer's NI on this gain.

## Market value share option plans

Participants are granted an option to acquire a specified number of shares after a pre-determined date, typically three to five years from the date of grant. The purchase price per share is normally the market value at the date of grant and the extent to which a participant is able to exercise the option is typically subject to the achievement of performance conditions. If the performance conditions are met and the option vests, participants can exercise the option at the purchase price any time up to the expiry date, typically ten years from the date of grant. A market value share option therefore delivers the growth in value of the shares above the purchase price (as opposed to a share award, which delivers the whole value of the share).

Share option plans are more highly geared to share price performance than PSPs. Although share option plans are now significantly less prevalent than PSPs in listed companies, they are still used by many companies (particularly, but by no means exclusively, by AIM listed companies and high growth companies).

We often see that companies deliver market value share options up to the permitted limits under a Company Share Option Plan (CSOP) in order to benefit from beneficial tax treatment. Further details about CSOPs can be found in section 2.1.2.

### Key advantages

- Rewards a participant only when shareholders have seen the share price rise.
- Gears remuneration to share price performance.
- Simple and transparent.

### Key disadvantages

- If the share price falls no value is delivered, irrespective of the company's performance, unless the share price recovers.
- Geared rewards can be volatile and unpredictable.
- A greater number of shares are typically required to deliver an equivalent value to a PSP award and therefore market value options can be more dilutive than PSPs and reduce earnings per share. However, it is possible to mitigate this by delivering a number of shares equal to the value of the gain e.g. a company settles an option with shares equal in value to the market value of the shares on the date of exercise, less the exercise price. This is known as "net settlement" and in practice, it is typical to draft the rules of an option plan to allow for net settlement.

### *Long term vesting and holding periods, malus and clawback*

The comments made in respect of PSPs are equally applicable to market value share options and more details about malus and clawback is given on page 21.

## Deferred share plans

Part, or all, of the annual bonus award is deferred for a specified period of time, usually three or five years. This may be a requirement of the plan, or may be at the request of the participant. The deferred award is generally structured as a conditional right to acquire shares or nil cost option over shares to the value of the deferred award. The deferred part of the award may be deferred on a net (i.e. post-tax) or gross (i.e. pre-tax basis).

In some cases, although it is becoming increasingly unusual, deferred shares may be matched with additional shares which are conditional on the achievement of specified performance targets.

### Key advantages

- The deferral can act as a retention mechanism and when deferred into shares links the final reward of the participant with shareholder value via the share price movement.
- The deferral provides a link between a reward for annual performance (i.e. the annual bonus) and longer term sustainability (i.e. linking the reward to longer term share price performance).

### Key disadvantages

- The investment in shares is linked to annual bonus (i.e. if there is no annual bonus there will be no deferred share award). It is for this reason that deferred share plans are relatively rarely used as a substitute for long-term plans.
- Deferred share plans require particularly careful structuring in overseas jurisdictions in order to ensure that the tax is successfully deferred.

### Malus and clawback

The comments made about malus and clawback in respect of PSPs are equally applicable to deferred share plans and more detail is given on page 21.

## 2.1.2 Company Share Option Plan (CSOP)

A CSOP is an option plan which meets the conditions set out in UK legislation. Historically, companies were required to obtain HMRC's agreement that a plan complied with legislation but with effect from 6 April 2014, this will no longer be necessary and instead companies will self-certify that their plan is compliant. Options are granted to employees with an exercise price which cannot be less than the market value of the shares at the date of grant. The maximum value of shares held under option at any one time is £30,000 (measured at the date of grant).

If the option is exercised on or after the third anniversary of grant (or before in specific "good leaver" situations), there is no income tax or NI payable on the difference between the option price paid for the shares and the current share price. Any subsequent sale of the shares will be liable to Capital Gains Tax (CGT), subject to any available CGT annual exempt amount (currently £11,000 for the 2014/15 tax year), meaning that for most participants the gains will be tax free.

The CSOP is a "discretionary" plan. Not all employees must be invited to participate and the right to exercise the option may be subject to the satisfaction of performance conditions.

Although the available tax savings are relatively small, CSOPs are easy to understand and relatively straightforward to implement and administer.

### Example of a CSOP

**Option over £30,000 of shares with a £1 exercise price; tax rate (income tax and NI) 42% or 47% throughout. Market value at exercise £2.**

	Unapproved option		CSOP option
Gain on exercise (£1 per share)	£30,000	£30,000	£30,000
Income tax on exercise at 40% or 45%	£12,000	£13,500	Nil
CGT at 28% on disposal at exercise (assuming	Nil	Nil	£5,320

annual exemption available)			
Employee's NI at 2.0%	£600	£600	Nil
Employer's NI at 13.8%	£4,140	£4,140	Nil
<b>Net benefit to individual</b>	<b>£17,400</b>	<b>£15,900</b>	<b>£24,680</b>

### Key advantages

- CSOPs can be used on an *ad hoc* basis for employees of the parent company, its subsidiaries and 50:50 joint ventures, and, as long as the shares meet the legislative criteria, may also be used to incentivise UK employees of an overseas parent.
- Option holders have some control over when to crystallise their gain, as CSOP options may be exercised between the third and tenth anniversaries of grant.
- When share prices are low, there is an enhanced opportunity to “max out” the £30,000 limit, with potential for share price growth in the future.

### Key disadvantages

- For the individual employees, tax relief is limited to an aggregate of £30,000 worth of shares (measured at the grant date) under option at any one time, so CSOPs have limited application for the executive population. However, a CSOP can be used in conjunction with an unapproved plan to make larger awards.
- As award levels and exercise dates need to be monitored, administration levels are marginally increased, although administrators and registrars are familiar with the CSOP requirements.

## 2.1.3 “Approved” Performance Share Plan (APSP)

The APSP is a hybrid plan that aims to combine a share award plan (usually a PSP) with a CSOP, so that any gain on the first £30,000 of an award could be free of income tax and NI. This is illustrated in the example below.

An APSP award is usually made up of at least two and often three elements, as follows:

- a CSOP option, with a market value on grant of up to £30,000;
- a funding award used to fund the option exercise price; and
- a top-up award (which is usually structured as a conditional share award or a nil cost option), to the extent that the value of the APSP award exceeds £30,000 in total.

The APSP may be used on a discretionary basis, for example for executives only. However, companies have also used APSPs for their broader employee populations, where total awards may be less than £30,000 (thus falling within the CSOP limit). As long as the award vests on or after the third anniversary of grant or in specified “good leaver” circumstances, the growth on the first £30,000 of the award will be free of income tax and NI. The income tax and NI liability arising on the funding award will typically be satisfied by selling some of the shares acquired from the exercise of the CSOP option.

In order to avoid increased dilution or additional costs for the company, the funding award can be made over existing shares and an Employee Benefit Trust (“EBT”) can be used so that the shares subject to the funding award can be “recycled”. The APSP will still deliver shares if the share price does not increase or if the award vests in a way that does not afford tax beneficial treatment. In such cases, the CSOP option will lapse and the shares will be delivered via the funding award, albeit subject to income tax and NI.

### Example of an APSP

**Award over £30,000 shares with a £1 market value; tax rate (income tax and NI) 42% or 47% throughout. Market value at vesting £2.**

	PSP award		APSP award	
Gain on vesting (£2 per share)	£60,000	£60,000	£60,000	£60,000

Income tax on vesting at 40% or 45%	£24,000	£27,000	£12,000	£13,500
CGT at 28% on disposal at vesting (assuming annual exemption available)	Nil	Nil	£5,320	£5,320
Employee's NI at 2.0%	£1,200	£1,200	£600	£600
Employer's NI at 13.8%	£8,280	£8,280	£4,140	£4,140
<b>Net benefit to individual</b>	<b>£34,800</b>	<b>£31,800</b>	<b>£42,080</b>	<b>£40,580</b>

### Key advantages

- An APSP can usually be drafted to bolt on to an existing free share plan, such as a PSP, without further shareholder approval.
- Participants cannot lose - if the share price rises and the CSOP conditions are satisfied, the award vests in the usual way, but the gain on up to £30,000 worth of the award falls into the CGT regime. However, if the share price falls or the conditions are not met, the CSOP option lapses and the shares subject to the award are taxable in full in the usual way.
- APSP delivers a positive HR message, i.e. APSP provides the potential to increase pay-out.
- It is neutral from a corporation tax and accounting perspective, if structured properly.

### Key disadvantages

- There is increased administration involved. However, administrators who regularly deal with CSOPs and free share plans have the capability to manage this.
- If the intended APSP population already holds CSOP options, so as to comply with the tax rules, there may be limited scope to implement APSP until those options have lapsed or have been exercised.

## 2.1.4 Phantom plans

A phantom plan pays a cash amount related to the increase in share price from the grant to the exercise date of the notional option or delivery date of the notional share award. These plans are fairly uncommon in UK listed companies, but may be used where conventional options or awards are not appropriate, such as for employees based in certain overseas jurisdictions. Plans may also be used for unlisted subsidiaries, business units or divisions where the phantom share price is based on the notional value of the entity and not the group as a whole (although sometimes in these circumstances, growth shares are used as described in section 3.3.2). Most plans will incorporate performance conditions in the same way as a standard share option/award plan.

### Key advantages

- Can be used where legal or other restrictions prevent the use of shares in a particular jurisdiction.

### Key disadvantages

- Cash cost to the company.
- If the award is cash settled the total charge in the income statement will equal the cash that is delivered to participants on vesting. Therefore, generally, they are expensive from an accounting perspective.
- Employees never own real shares.

## 2.1.5 Co-investment plans

Participants are invited to make an investment, often substantial, in company shares which will be matched after a period of time depending on company performance. The initial investment may in some cases be satisfied, at least in part, by the participants' existing shareholdings, but most plans will require at least some of the investment to be satisfied by newly purchased shares (sometimes funded from the deferral of bonus), or shares vesting from options or other share plans.

The advantages of co-investment plans are that they act as a strong "lock-in" or retention device and they align the interests of the participants with those of shareholders.

The disadvantages are that participants have to invest their own money and some executives could be rewarded more than others on account of greater resources (rather than better performance).

## 2.1.6 Jointly owned shares (JOSs)

JOSs are an arrangement designed to achieve a similar economic and tax effect to growth shares, which themselves as described at section 3.3.2, very broadly behave economically like options. As growth shares require the creation of a separate class of shares to be held by the employees and this is not usually feasible for a listed company, JOSs work by the interest in the share being held jointly between the employee and an EBT.

The typical approach is:

- The employer establishes or uses an existing EBT.
- The EBT and employee(s) jointly purchase the shares which would be held by the EBT during a vesting period.
- For these purposes the EBT is funded by the company by way of contribution or loan.
- The employee's interest in the shares is held jointly with the EBT and entitles him to the growth in value of that interest above a threshold (similar in concept to an option).
- It is anticipated that the employee would pay the market value of the interest on acquisition (and enter into a s431 election as described in the introduction to chapter 3).
- Following the vesting period, the employee is able to request the sale of the shares, with the proceeds of sale above the threshold being paid to the employee and the amount up to the threshold being used to refund the loan to the EBT.

The desired tax treatment is that the increase in value of the employee's interest in the shares is subject to CGT and free of income tax and NI.

Example of JOS

100,000 jointly owned shares with a listed price of £1 acquired for 15p per share (unrestricted market value of joint interest), with a £1.20 per share hurdle/threshold value. Tax rate (income tax and NI) 47% throughout. Market value at vesting £2.	Jointly owned shares
Gain on vesting (£2 per share less £1.20 less 15p)*	£65,000
Income tax on vesting at 45%	Nil
Employee's NI at 2.0% on vesting	Nil
Employer's NI at 13.8% on vesting	Nil
CGT at 28% on disposal at vesting (assuming annual exemption available - £11,000 for the tax year 2014/15)	£15,120
<b>Net benefit to individual</b>	<b>£49,880</b>

*\*Note: it is also feasible for the plan to be designed to deliver all or a proportion of the value up to the share hurdle/threshold value. Any value delivered up to the share hurdle/threshold value could be delivered to the employee as a normal incentive award. The value delivered in this form would be subject to income tax and NI when the value was realised.*

It should be noted that the JOS concept is known to HMRC and based on current legislation HMRC accept that such schemes are effective. It should, however, be noted that JOSs are only commercially effective, when substantial share price growth is anticipated.

## 2.2 Overview of all employee share plans

This section explores a range of share plans aimed at providing shares to all the employees of a company, rather than only the executive or management group. Whilst the structure may vary, the aim of these plans is broadly to providing a straightforward mechanism for employees to share in the ownership of the company.

Note that the worked examples in this section are based on a UK income tax rate of 40%. In practice, there are likely to be participants in these plans who pay lower rates of tax.

## 2.2.1 Share purchase plans

Under these plans, employees are offered the right to buy shares at an agreed price, either on a regular basis (for example, monthly) or at the end of a pre-determined period. The plans typically take the form of options backed up by a savings contract to meet the exercise price (such as Save As You Earn plans) or actual share purchase plans, where shares are purchased regularly over a period of time (such as Share Incentive Plans). A typical structure involves participants making regular savings/contributions which they then use to buy shares. When participants acquire shares, they often become entitled to a matching share from the company, for example buy two shares, get one free. An alternative structure involves employees being offered a discount, so that they acquire the shares at less than the market value and their employer funds the difference. This contribution from the company makes the plan more attractive than simply buying shares in the market and reduces the risk which employees are taking with their own money.

When deciding the amount that each employee can save to contribute to the plan, companies have the choice to allow employees to save up to a certain percentage of their salary (e.g. 5% of their salary) or up to a certain monetary amount (e.g. £150 per month).

Allowing employees to save a certain percentage of their salary generally requires more administration as the company will need to refer to each employee's salary to calculate the amount. From an administrative perspective it is therefore simpler to allow employees to select a fixed monetary amount of contribution. However, offering a fixed amount can represent a very different portion of income depending on the job level and the region of the world.

## 2.2.2 Share Incentive Plan (SIP)

A SIP is an all-employee share plan under which shares can be delivered to employees in up to four ways, namely:

- Free Shares (awarded by the company with a maximum value of £3,600 per tax year).
- Partnership Shares (purchased by participants from pre-tax salary with a maximum value of £1,800 per tax year).
- Matching Shares (free shares awarded in respect of the number of Partnership Shares acquired, at a maximum ratio of 2:1).
- Dividend Shares (shares acquired with cash dividends paid on SIP shares. A limit used to apply, such that only £1,500 of Dividend Shares could be acquired in a UK tax year, but this limit was removed with effect from 6 April 2013).

SIP shares must be held for a specified period of time (ranging from 3 to 5 years depending upon the type of shares delivered) in order for them to be released free of income tax and NI. In addition, SIP shares are not subject to CGT whilst they remain in the plan.

The SIP legislation provides that a company must establish a special UK resident EBT in order to acquire and allocate shares under the SIP.

### Example of a SIP vs an unapproved share purchase plan

**£1,800 Partnership Shares purchased and £3,600 Matching Shares awarded. Shares released 5 years after acquisition/ award. Tax rate (income tax and NI) of 42%. Market value increases from £1 to £2 during the 5 year period. Assumes CGT annual exemption available.**

	Share purchase plan	SIP
Annual (gross) contribution*	£1,800	£1,800
Value of Matching Shares	£3,600	£3,600
Income tax on vesting at 40%	£2,880	Nil
Employee's NI at 2.0%	£144	Nil
<b>Net value shares held at end of 5 year period</b>	<b>£6,264</b>	<b>£10,800</b>

\*Under the share purchase plan, it is assumed shares are purchased using funds from net salary (i.e. £1,044) which grow in value to £2,088.

### 2.2.3 Flexible SIPs

Flexible SIPs combine the free share element of a SIP with a 'flexible benefits' arrangement. Under this structure employees are given the opportunity to accept an award of tax favoured free shares in return for a corresponding reduction to their flexible benefits 'pot'. Those employees not wanting to accept the free share award would not have their flex 'pot' reduced and would be able to use it for other benefits, as normal.

Structured correctly, flexible SIPs allow employees to give up part of their taxable flex 'pot' in return for a tax efficient acquisition of shares (the tax benefits are dependent on the length of time the free shares are held).

From the company's perspective, a flexible SIP is an attractive tax efficient addition to their flexible benefit arrangements and, compared to the cost of providing an equivalent cash benefit, can generate employer's NI savings. In addition, where newly issued shares are used, the company can realise a cash saving based on the reduction in the employees' flexible benefits 'pot' that would otherwise be payable.

For increased flexibility and to encourage higher levels of participation (particularly amongst lower paid employees) it is possible to allow employees to choose the value of free shares they want to receive through their flex 'pot' (up to a maximum of £3,600).

As the shares delivered through flexible SIPs are subject to the SIP legislation, the opportunity to receive free shares must be made available to all UK employees.

Care is needed in structuring these plans to avoid creating a 'cash alternative' to the free shares award and to ensure that the 'all-employee' nature of the SIP is maintained, so as not to jeopardise the tax advantages available under the SIP legislation.

#### Example of a flexible SIP

£3,600 of the flexible benefits 'pot', subject to income tax and NI, is replaced with tax favoured free shares under a SIP. This assumes the free shares are held for 5 years.

##### Employee position

	Salary	Flex Pot	Free shares	Total	Income tax/NI Savings on Flex Pot	
					Basic rate (20% tax +12% NI)	Higher rate (40% tax + 2% NI)
<b>Without using a flexible SIP</b>	£20,000	£5,000	-	£25,000	-	-
<b>Using a flexible SIP</b>	£20,000	£1,400	£3,600	£25,000	£1,152	£1,512

##### Employer position (market purchased vs newly issued shares)

	Reduction in cash cost of remuneration	Employer's NI saving at 13.8%	Total	Saving for 100 participants	Saving for 1,000 participants
<b>Using market purchased shares</b>	£nil	£497	£497	£49,700	£497,000
<b>Using newly issued shares</b>	£3,600	£497	£4,097	£409,700	£4,097,000

### 2.2.4 Save As You Earn plan (SAYE)

A SAYE plan is a HMRC tax advantaged option plan that must be offered to broadly all "UK taxpaying" employees (and may be offered to a wider employee base). The exercise price of the option may be discounted by up to 20% of the market value of shares at the date of grant and options may be exercised at the end of a three or five year savings period.

The option is attached to a savings contract, under which the employee agrees to monthly deductions from net salary over the savings period of up to a maximum of £500 per month. A tax free bonus (which is an amount of interest) may also be paid on the savings at the end of the term. At the time of publication, no bonus is paid on 3 year savings contracts but a bonus is payable on 5 year savings contracts. This is relatively low but the discounted exercise price and the significant tax advantages continue to make SAYEs attractive.

The savings are used to pay the exercise price and option holders normally have 6 months from the end of the savings contract to exercise their options. Provided that the SAYE option is exercised at the end of the savings period (or in specific “good leaver” situations), the difference between the exercise price and the share price at the time is not subject to income tax and NI. Any subsequent sale of the shares would be liable to CGT, subject to the exemptions mentioned above.

The participant may choose not to exercise his option to buy shares (for instance if the share price at the end of the savings period is lower than the exercise price, i.e. the options are underwater), in which case he can remove his savings, tax free.

## Example of a SAYE plan

**SAYE option over 9,000 shares with a £0.80 exercise price and 3 year savings contract. Tax rate (income tax and NI) of 42%. Market value at exercise £2.**

	SAYE option
Gain on exercise (£1.20 per share)	£10,800
Income tax on exercise at 40%	Nil
CGT at 28% on disposal at exercise (assuming annual exemption available)	Nil
Employee's NI at 2.0%	Nil
Employer's NI at 13.8%	Nil
<b>Net benefit to individual</b>	<b>£10,800</b>

## 2.3 Corporation tax relief

Part 12 of the Corporation Tax Act 2009 provides UK companies with a statutory corporation tax deduction for employee share plans. Broadly speaking, the relief is linked to the amount and timing of the income tax charge on the employee (or, in the case of a tax advantaged scheme, what that taxable amount would otherwise have been). Companies should ensure that this relief (and any applicable non-statutory relief) is claimed within the applicable time limits.

In addition, multi-national companies should consider using cost sharing arrangements so that the group benefits from any corporate tax relief that is available in respect of overseas employees (see section 5.4.2 below).

When income is deferred, for example in respect of an option or conditional share award, the impact of this deferral of corporation tax relief should also be taken into account when ascertaining the company's tax position.

## 2.4 NI transfer

Where a share plan involves an income tax and NI charge at the end of the vesting or exercise period, there is an inevitable level of uncertainty as to the amount of the employer's NI charge. This will typically be at least three years in the future or in the case of options, may be at any point between the third and tenth anniversaries of the award. Not only are share prices unpredictable, but NI rates may also change over that period. Therefore, in order to reduce this risk, companies often wish to hedge this NI liability.

A common way of doing this, especially amongst private, AIM and smaller listed companies is to transfer the employer's NI to the employee so the risk then falls on the employee and not the employer. Although the employee needs to agree to this at the outset, in practice it can be made a condition of the award itself. In addition, the employee receives income tax relief on the cost of the NI, so the effective cost is reduced. Companies can compensate their employees for taking on this obligation by increasing the size of the award.

## 2.5 Summary of the tax treatment of share plans

Except in the case of the tax advantaged share plans described above, the general position is that income tax and employees' and employer's NI will normally be due on the value of the shares received by the employees less the price (if any) paid by them.

If certain conditions are satisfied (and they usually can be), a UK employing company will also be entitled to a statutory corporation tax deduction when their UK employees benefit from share plans. The tax relief for share options will arise on the amount of the gain when options are exercised. For share awards, the employer should be able to claim a tax deduction for the value of the shares on the vesting date.

The general tax position for the employee and the UK employing company is set out in the table below:

Plan Type	Tax on Award	Tax on Delivery	Tax on Exercise	Tax on Disposal	CT Relief
<b>PSP</b>	Nil	Income tax on market value at delivery	N/A	CGT on gain* (nil if sold on delivery)	On market value at delivery
<b>APSP</b>	Nil	Gain on first £30,000 of award tax free. Remainder taxable on market value at delivery	Nil	CGT on gain* (attributable to first £30,000 of award, nil on remaining shares if sold immediately)	On market value at delivery
<b>Non tax-advantaged option</b>	Nil	Nil	Income tax on gain	CGT on gain* (nil if sold on exercise)	On gain on exercise
<b>CSOP</b>	Nil	Nil	Nil	CGT on gain*	On gain on exercise
<b>SAYE</b>	Nil	Nil	Nil	CGT on gain*	On gain on exercise
<b>SIP</b>	Nil	Nil	N/A	Nil if sold on removal from SIP	On market value at award of Free Shares and Matching Shares

\* CGT is generally payable on sales proceeds less the aggregate of the amount paid to acquire the shares plus the amount on which income tax is paid. This is subject to the CGT annual exemption (£11,000 for 2014/15).

## 2.6 Tax reporting

As from 6 April 2014:

- Companies are required to register their employee share plans (both before tax-advantaged and non-tax advantaged) with HM Revenue & Customs (HMRC). This is done through the PAYE Online service and must be done. For all plans operated between 6 April 2014 and 5 April 2015 the deadline for registration is 6 July 2015. However, in practice companies need to register their employee share plans in advance of 6 July 2015. This is because the company must also submit an annual return for the plan and this cannot be submitted before the plan is registered. The deadline for the annual return is also 6 July of the tax year following the tax year in which the plan is operated.
- Companies who wish to implement a tax advantaged plan are not required to receive approval of the plan from HMRC. Instead they are required to self-certify that their plan meets the conditions set down in the applicable legislation. This is done as part of the online registration process mentioned above.
- On an on-going basis, companies are obliged to file annual share plan returns (for CSOPs, EMIs, SAYEs, SIPs and non-tax advantaged share plans) online by 6 July following the end of each tax year in which the plan was operated.

# 3 Typical share plans in smaller listed and in private companies

In this chapter we explain the main types of share plans which are typically used in private companies and in smaller listed companies and their basic tax treatment. There is no reason in principle why smaller listed companies and private companies could not implement the arrangements in chapter 2 and this is often the case. However smaller companies are also often able to take advantage of certain tax efficient arrangements which are either unavailable to or thought unsuitable for larger companies. For example, the limits to qualify for the Enterprise Management Incentive Scheme (“EMIs”) are normally exceeded by larger companies and Employee Shareholder Status (“ESS”) is normally more appealing to smaller companies than larger ones, especially those with potential for high growth. Having said that, ESS is open to all companies, regardless of size.

It is often potentially advantageous for companies with a relatively low share value to offer employees the opportunity to purchase shares at the outset. The initial investment for the employee is normally manageable and if the arrangement is structured correctly any growth in value will be subject to CGT instead of income tax and NI. The shares purchased will normally be subject to the condition that they have to be sold by the employee if he leaves before a certain time and depending on the reason for leaving, he may receive less than market value for his shares. For the purposes of the relevant tax legislation, this condition is a “restriction” which reduces the value of the shares purchased by the employee.

To qualify for CGT on any growth in value of the restricted shares, the employee must pay the value of the shares ignoring the restriction when he acquires them or, alternatively, pay income tax and any NI due on the discount to the “unrestricted” market value. For this reason, it is typical for employees to enter into a joint election with their employer within 14 days of acquiring the restricted shares (a “s431 election”) to agree to pay income tax and any NI due on any discount to market value on acquisition. Making the election means that the whole amount of any future growth in value of the restricted shares should be subject to CGT and not income tax or NI.

In section 3.3 we look at two relatively common tax-efficient arrangements which utilise restricted shares. However, in sections 3.1 and 3.2, we first look at two tax advantaged arrangements, being EMIs and ESS.

## 3.1 Enterprise Management Incentive (EMI)

EMIs provide for the grant of tax-efficient options over shares in smaller companies (up to £30m gross assets employing fewer than 250 full-time employees or full-time equivalents) that meet certain trading requirements. Under an EMI scheme a qualifying company may grant options over shares with an aggregate value up to £3m. Any single employee may be granted an option over shares with a market value at grant up to £250,000. An EMI scheme allows individuals to be subject to CGT, rather than income tax, on all of their gains (assuming that the EMI options are not granted with a discounted exercise price). At the same time the employing company should benefit from a corporation tax deduction on exercise (essentially based upon the gain at exercise) assuming the statutory requirements are met at the time.

In addition, where an employee sells a share that has been acquired pursuant to an EMI option, the sale will automatically qualify for Entrepreneurs’ Relief. That is subject to the proviso that the period between grant of the option and sale of the shares is at least 12 months. Where Entrepreneurs’ Relief applies, the first £10m of lifetime gains will be liable to CGT at a rate of 10%.

## 3.2 Employee Shareholder Shares (ESS)

Following its consultation process, the Government moved forward with legislation to introduce the new “Employee Shareholder Shares” status. Under the legislation, which came into effect from 1 September 2013, individuals may be given (for nil cost) qualifying ESS worth between £2,000 and £50,000 in return for giving up certain employment rights.

Under ESS:

- the first £2,000 of qualifying shares (which could be restricted shares) is exempt from income tax and NI on acquisition and
- any excess over the £2,000 is subject to income tax and NI; and
- any growth in value of the first £50,000 of qualifying shares is exempt from capital gains tax.

A feature of ESS is that it is possible to agree the value of the shares being acquired with HMRC prior to their acquisition by employees. By contrast, HMRC will not agree the value of shares acquired under a loan funding/deferred payment arrangement (see section 3.3.1) or a growth share arrangement (see section 3.3.2) in advance of acquisition and the value can only be agreed afterwards.

Where an individual becomes an Employee Shareholder, the employment rights being given up are:

- the right to request training or education;
- the right to claim flexible working;
- the right to claim unfair dismissal (except in certain circumstances, such as dismissal on grounds of race or gender); and
- the right to a statutory redundancy payment.

In addition, when returning from parental leave, the Employee Shareholder will be required to give their employer 16 weeks' notice (rather than 8 weeks).

ESS have significant tax advantages for employees, particularly in high-growth companies, particularly since ESS can be delivered in the form of growth shares (see section 3.3.2). Employees will, however, need to be aware of what employment rights are being given up and certain safeguards are included to provide them with some protection. Consequently, companies offering Employee Shareholder shares must:

- provide a written statement setting out the rights attaching to the shares being acquired and whether there are any restrictions attached. If there are several classes of shares, this would include a comparison of the dividend rights, voting rights and rights on a winding-up when compared to the 'largest' class of shares;
- pay the reasonable costs for the individual to receive independent legal advice in respect of the arrangements (irrespective of whether an individual subsequently takes up the status); and
- provide a seven day 'cooling-off period' (from the date the legal advice is received) for the individual to consider whether to accept the offer of the ESS.

Employers will not be able to force existing employees to move to employee shareholder contracts. However, they will be able to recruit new people solely on the new Employee Shareholder terms if they so wish.

### 3.3 Tax efficient share plans

The use of restricted shares is explained briefly at the beginning of this chapter, including the requirement for employees to pay the unrestricted market value of the shares that they acquire (or alternatively elect to be subject to income tax and any NI due on acquisition).

Depending on the market value of the shares, it may be difficult or unattractive for the employees to fund the cost of the unrestricted market value of the shares and the arrangements outlined in sections 3.3.1 and 3.3.2 are designed to address this issue.

Valuation of the shares to be acquired is often the first step in the process and this is considered in section 3.3.

### 3.3.1 Loan Funding/Deferred Payment

When it may be difficult or unattractive for the employee to fund the unrestricted market value of the shares, the simplest approach is normally for the employee to purchase shares at their unrestricted market value at the time of acquisition, but with the purchase being funded by an interest-free loan from their employer. An alternative approach is a deferred payment which allows the purchase price to be left outstanding, which would have similar tax implications as a loan.

In either case the employee is normally required to enter into a s431 election. If structured correctly the tax treatment will be:

- No income tax or NI on the acquisition of the shares;
- CGT on the eventual sale of the shares by the employee;
- Benefit in kind charges by reference to notional interest on the interest-free loan (except in certain cases, such as where the company is closely held, or employee controlled, for tax purposes); and
- No corporation tax relief on any subsequent growth in the value of the shares.

Where the company is closely held, there are further corporate tax implications that also need to be considered in connection with loans provided to shareholders. There are also corporate law issues to consider.

This arrangement requires participants to take on commercial risk. If the share price falls, the loan still has to be repaid or the shares paid-up. To the extent that the loan or the notional loan (where the purchase price is deferred) is not paid, income tax and possibly also NI is due. The employer could cover the employee's loss but this would lead to further income tax and NI charges on the additional benefit this would provide.

It is important to note that loan funding and deferred payment plans are potentially caught under the disguised remuneration legislation where a third party, such as an EBT, is involved in the arrangements. This means that any loan funding from a third party would trigger income tax and NI charges up-front on the full value of the loan. In that case the employing company would have an obligation to withhold the tax due through payroll and the tax could not be reclaimed, even when the loan is repaid. To avoid a charge under the disguised remuneration legislation, the loan funding should come from the employer or another group company.

### 3.3.2 Growth shares

In order to meet concerns with the risk attached to the loan funding or deferred payment arrangements described above, growth shares are structured to participate only in the increase in value of a company above a pre-set threshold. The main features of a traditional growth share are:

- Creation of a separate class of share; and
- That share class participates in the value of the company only above a threshold.

The purpose of the hurdle is to reduce the unrestricted market value of the shares at the time of acquisition to a level which the employee can afford to fund and/or is willing to risk.

The desired tax position is that the growth in value of the shares above the hurdle should be charged to CGT rather than income tax. A s431 election would normally be entered into, with the effect that income tax and possibly NI will arise on any excess of the unrestricted market value of the shares over the price paid for them. The design of the growth share and the price payable by the employees will be structured in a way which is intended to minimise or eliminate such excess value and valuation will be an integral part of the design process. It is not possible to agree the value with HMRC prior to the shares being issued but it is generally possible to obtain comfort after the issue of shares through a post transaction valuation check. (It should be noted that this is a discretionary service and HMRC are under no obligation to agree values in this way, although it is rare that they refuse.)

Growth shares are therefore similar to the jointly owned share arrangements described at section 2.1.6. Private companies could also implement a JSOS but in our experience, growth shares are used more frequently.

### 3.4 Valuation

In order for private companies to successfully implement the above arrangements, careful consideration must be given to the valuation of the shares, which unlike quoted companies, do not have a published price.

The parameters for 'market value' envisage a hypothetical transaction, between anonymous willing parties and HMRC will frequently accept significant minority discounts, where shareholdings confer little or no influence over the affairs of the underlying company. It is important to note that there are four different definitions of value which must be used in the valuation of shares used in employee share incentives for various tax purposes. It is essential therefore to consider taking appropriate professional valuation advice. In addition, there are complex standards governing the admissibility of information. This can often mean that the value which HMRC will be prepared to accept, from a tax perspective, is much lower than that which might be expected in a commercial scenario.

In the context of the valuation of minority shareholdings, the information standards can often mean that the information on which the valuation is based should be limited to published information. We have frequently seen examples of clients sending HMRC large amounts of confidential information and forecasts, thinking that this will be helpful to HMRC in their assessment of value. However, often, such information would be deemed inadmissible to the valuation exercise and the inclusion of it may mean that an unnecessarily high value is placed on the assets.

In order to ensure that the 'right' value is agreed with HMRC, it is necessary to have a thorough understanding of the legislation and case law which underpins fiscal valuation in the UK.

# 4 Approvals and disclosures

There are a number of shareholder approvals and disclosures which a listed company will have to consider before implementing or amending a share plan. This chapter contains a summary of these approval and disclosure obligations and also highlights briefly the key features which investors typically expect to see in a share plan. The views of investors are explained in much greater detail in the Deloitte guides: “Directors’ remuneration in FTSE 100 companies (September 2014)” and “Directors’ remuneration in FTSE 250 companies (September 2014)”.

## 4.1 Shareholder approval

### The Listing Rules

Before a company can implement a new share plan it will need to consider whether prior approval from its shareholders is required. The Listing Rules aim to prevent companies from using share plans to dilute existing shareholder value unless prior shareholder approval is obtained. Whilst technically the rules dealing with employee share plans only apply to UK-incorporated companies and their major subsidiary undertakings, non-UK incorporated companies listed on the London Stock Exchange also observe similar standards in practice. Whether shareholder approval is required depends on the nature of the plan, the source of the shares to be used in connection with the plan and whether directors can participate in the plan.

A share plan will require prior shareholder approval under the Listing Rules if either of the following conditions are met:

- awards may be satisfied with newly issued shares or treasury shares; or
- it is a long-term incentive scheme in which one or more directors of the listed company can participate.

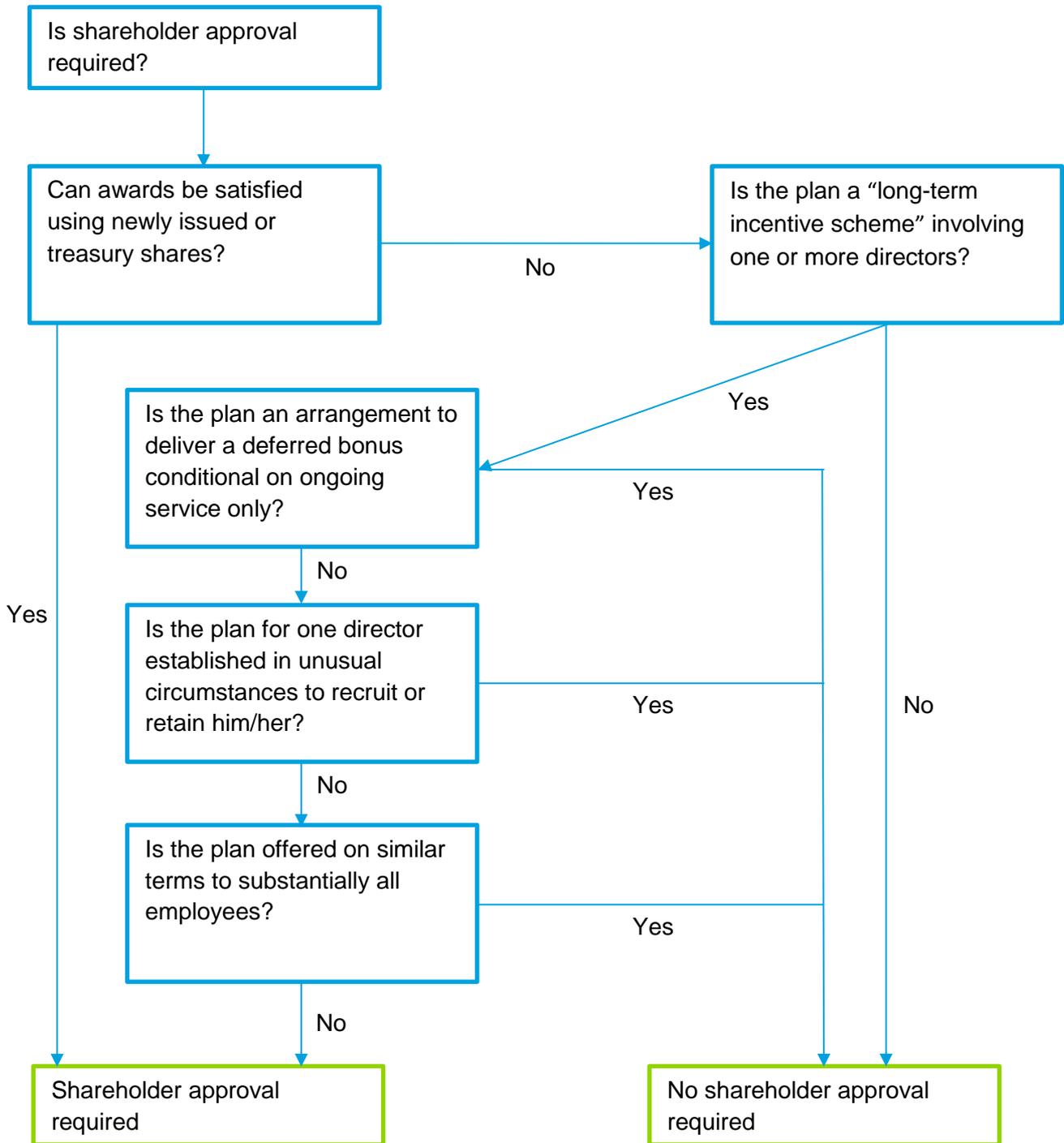
The first element of the test (i.e. the use of newly issued or treasury shares test) applies to all share plans, whatever their context.

The second element of the test does not apply to certain all-employee plans, such as HMRC tax-advantaged Share Incentive Plans (SIPs) and Save As You Earn (or SAYE) plans, and special one-off arrangements, established in unusual circumstances, for the recruitment or retention of a director.

In essence, a “long-term incentive scheme” is any cash or share-settled arrangement under which a condition (such as a performance condition or a continuing employment requirement) has to be satisfied over more than one financial year. Most arrangements under which participants defer all or part of their annual bonus into a share award which vests in the future are specifically excluded from this definition. However, shareholder approval will still be required if awards granted under such plans can be satisfied using newly issued or treasury shares or if the plan incorporates the grant of awards which are subject to further performance conditions.

In practice, for most kinds of share plan, a company will want to have the flexibility to use newly issued or treasury shares to satisfy awards. Even where this is not the case, for many of the arrangements covered in this report, a company will want to extend participation to the directors of the listed company as part of the normal operation of the plan. As such, shareholder approval will usually be required for a new share plan.

Is shareholder approval required?



## Investor views

Shareholders are likely to focus on some key facts when assessing the appropriateness of a particular incentive arrangement for a company. As a general rule, investors prefer employee incentive arrangements to:

- be simple, understandable for investors and executives and to provide clear line of sight over what needs to be achieved;
- include longer term vesting periods of up to five years and not less than three years (and some investors encourage additional holding periods following vesting); and
- include malus and clawback provisions, which may be invoked to reduce or recover the value of awards.

For financial years from October 2014 performance related remuneration schemes for executive directors must include provisions for the company not to deliver the remuneration in the first place (malus) or to recover some of the remuneration (clawback) in certain circumstances. This is a requirement of the UK Corporate Governance Code and it represents a strengthening of the previous version of the Code, which required only that companies give consideration to the use of the clawback in exceptional circumstances of misstatement or misconduct. It is now for companies to decide the circumstances in which malus and clawback may be triggered.

Clawback gives rise to a range of potentially difficult issues. An explanation of these issues is beyond the scope of this chapter. However, in summary the issues include: selecting the clawback “triggers”, setting the period of time for which clawback should be applicable, whether clawback should be applied on a gross or net of tax basis, how to document the clawback power, how to enforce it in practice and the risks of the power being unenforceable in the UK and overseas.

## 4.2 Amending existing share plans

The rules of discretionary share plans are generally drafted on a relatively flexible basis. However, if the rules need to be amended to accommodate a change in award structure or a change of a different type, a company has to consider whether shareholder approval is required for the proposed change.

Under the Listing Rules, a listed company cannot generally make amendments to certain provisions of its share plans without shareholder approval, if those amendments are to the advantage of participants.

The relevant provisions are:

- the class of participants;
- the overall plan limits;
- the limits per participant;
- participants’ entitlement to, and the terms of, awards; and
- the basis for adjusting awards in the event of a variation of share capital.

However, there is an exception from the requirement for shareholder approval. Shareholder approval is not required where the amendments are minor and where these are made “*to benefit the administration of the scheme, to take account of a change in legislation or to obtain or maintain favourable tax, exchange control or regulatory treatment for participants in the scheme or for the company operating the scheme or for members of its group.*”

As such, provided that the share plan rules include this (or similar) wording, changes to introduce nil-cost options or even to implement a HMRC tax advantaged schedule to an existing PSP, for example, will often fall within this exception and so will not require shareholder approval.

In addition, share plan rules will normally contain provisions to the effect that any amendments to the disadvantage of existing participants will require the express consent of either all or a majority of those participants (either by number or value of subsisting awards) before they become effective.

Where a share plan did not require shareholder approval in the first place, for example a deferred bonus plan which operates using market purchased shares only, then amendments to the plan should not normally require shareholder approval. However, changes which bring the arrangements within the scope of the requirements for shareholder approval, such as allowing awards to be satisfied by newly issued shares, would trigger a shareholder approval requirement.

## 4.3 Disclosures

The operation of an employee share plan will necessitate disclosure to the market under the Disclosure Rules and Transparency Rules and also the Directors' Remuneration Report (which forms part of a company's Annual Report and Accounts).

### Disclosure Rules and Transparency Rules (DTRs)

If awards over, or relating to, shares in a listed UK company are made to Persons Discharging Managerial Responsibility (PDMRs) or their connected persons these must be announced to a Regulatory Information Service (RIS). This is a requirement of the DTRs.

PDMRs include all directors as well as senior executives who have regular access to inside information and the power to make managerial decisions affecting the future development and business of the listed company. If awards granted to PDMRs are structured as conditional awards of shares, then the vesting of the awards triggers the requirement for a second announcement. If awards are structured as nil-cost options, the exercise of the awards should be disclosed to the RIS.

In practice, this announcement should be made by no later than the close of the dealing day after the day of grant (or vesting/exercise) of the award. It will need to give full details of the name of the PDMR (or connected person), the reason why an announcement is being made, the name of the listed company, a description of the award, the date of the transaction, the nature of the transaction (e.g. grant/vesting/exercise), the exercise price (if any) and the number of shares acquired/subject to the award.

### Directors' Remuneration Report

UK-incorporated listed companies are required to publish a Directors' Remuneration Report as part of their Annual Report and Accounts detailing the various elements of their directors' remuneration. The Directors' Remuneration Report has to be split into two principal parts: the Directors' Remuneration Policy (the "Policy Report") and the Annual Report on Remuneration (the "Remuneration Report").

The Policy Report is subject to a "binding" vote and the Remuneration Report is subject to an "advisory" vote.

Whilst the Remuneration Report must be subject to an advisory shareholder vote at every AGM, companies are normally only required to put the Policy Report to shareholders for approval every three years. However, a company will have to seek shareholder approval of its Policy Report earlier if changes to the existing Policy Report are proposed or if shareholders did not approve both the Policy Report and the Remuneration Report during the previous year. This means that if a company fails the annual advisory vote on its Remuneration Report at an AGM at which the Policy Report was not approved by shareholders the company must put its Policy Report to shareholders at the next AGM.

Once the Policy Report is approved, the company will only be able to make payments within the limits which the Policy Report allows and any director who authorises a payment outside of the limits is liable to indemnify the company for any loss resulting from it.

If shareholders vote against the Policy Report, the company can continue with the existing Policy Report and wait until the next AGM to seek approval of a revised Policy Report or convene an EGM to seek shareholder approval earlier.

In a year in which the Policy Report is not put to a shareholder vote, the Directors' Remuneration Report must indicate where the last approved Policy Report can be obtained.

The impact of this for employee share plans is that a plan (regardless of whether it is an executive or an all-employee plan) may only be operated in relation to directors within the terms of the Policy Report approved by shareholders. The fact that the plan may contain broader terms than those contained in the approved Policy Report and has itself been approved by shareholders under the Listing Rules does not alter the position.

In respect of employee share plans, the Remuneration Report must include:

- any bonus deferral;
- performance measures for variable remuneration and performance against these measures unless, in the opinion of the directors, that information is commercially sensitive;
- long-term incentive awards granted in the year (including the type of award, the vesting schedule of the award, any performance conditions applicable to an award, any exercise price and the face value of the award); and
- directors' total shareholdings and interests in shares including achievement of any share ownership guidelines.

# 5 Going global

In this chapter we explore the key issues likely to arise in rolling out and operating share plans on an international basis and provide practical tips on how best to manage such plans.

## 5.1 Global share plans

Many companies have operations in multiple jurisdictions and the performance of those overseas operations may be critical to the long-term financial success of the company. In order to attract, retain and motivate key employees across all business operations as well as to provide corporate 'glue', it is increasingly common to globalise plans.

Careful consideration should be given to the design of the plan. A key question is whether as part of the globalisation process the company will roll out an existing plan to the other countries or, alternatively, review the plan design in light of its broader population. Considerations which impact the design are not confined to different tax and legal treatments but also include local market practices. There is often no "one size fits all" approach and companies will always benefit from an open discussion on the design issues to determine what is the right approach for them, taking into account their business objectives and specific circumstances. The Deloitte Global Share Plan Survey provides insight into market practice on certain key design and implementation issues<sup>1</sup>.

Before any plan is offered globally, companies should give consideration to the following three key questions:

- Can the company operate the plan legally in the jurisdiction?
- What are the tax consequences of offering the plan in the jurisdiction?
- Can the plan be implemented on time and operated efficiently and at an acceptable cost?

## 5.2 Legal compliance

Before making share plan awards to employees overseas, it is essential to understand the legal issues which might apply. Understanding the issues and putting them in context is important in order to appreciate how these issues can affect the operation of a share plan.

There are certain issues that prevent a company from offering employees participation in a share plan, or at least can mean the time or expense required to deal with the issues will be prohibitive. Securities law restrictions and foreign exchange controls have the potential to fall into this camp because these restrictions are rules which must be complied with if a share plan is to be offered in a country without breaching the law. Securities law and foreign exchange issues are considered briefly below.

### 5.2.1 Securities law

Shares are securities, which is why companies must think about securities law for share plans. The purpose of securities laws is to protect the public when they are offered the opportunity to invest in securities and most countries have laws in place to regulate the offer of shares to individuals in that country. Given the investor protection purpose of the law, it is often the case that if shares are delivered free of charge, for example as a share award, local securities laws will not apply. In addition, it is common for an exemption to be available under local securities law when participation is only offered to a limited number of individuals or the total price of the shares which are offered is below a certain threshold. Also, there is often an exemption for

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<sup>1</sup> The Deloitte Global Share Plan Survey is available to participants only. If you are interested in participating, please contact Marie Elise Darge ([mdarge@deloitte.co.uk](mailto:mdarge@deloitte.co.uk)).

offers of shares made only to employees of the company and its subsidiaries, with the logic behind the employee offer exemption being that the offer is made to a 'closed group' of investors and not to the public at large.

The exemptions can be straightforward but that is not always the case and it often depends on the circumstances of the company making the offer and the form of the awards granted to employees. For example in the European Union (EU), most EU countries are in agreement that both an award of free shares and the grant of share options are not caught by the relevant securities law. However, where the securities law applies, exemptions from the requirement to prepare a prospectus (which is an onerous process) are available if participation in the share plan is offered to a small number of investors or if the purchase price of the shares offered falls below a certain value. These "small" offer thresholds are quite low and most share plan offers will not qualify. There is an exemption for employee share plan offers in the EU and this applies regardless of the size of the offer but unfortunately this exemption is only available if the company's shares are listed on a main EU stock exchange or the company is headquartered in the EU.

In practice, whether securities laws are significant "road blocks" often depends on whether an exemption applies automatically or, alternatively, if the company has to apply for an exemption. Applying for an exemption can be onerous and the formalities involved sometimes increase depending on the number of individuals to whom participation in the plan is offered or the value of the shares to be purchased.

Where securities laws are considered to be insurmountable or too difficult to comply with in the context of the share plan, it is normally possible to offer the plan on a cash ("phantom") basis as an alternative. This can, however, give rise to other issues (for example funding and accounting concerns) and using a phantom alternative does not solve applicable securities law issues in all countries.

## 5.2.2 Exchange control

There are a significant number of countries which have burdensome foreign exchange requirements which make it difficult or, in some cases, impossible for companies to transfer funds in order to operate a share plan globally. These issues are not confined to share purchase plans and also have an impact on cost sharing arrangements in the case of other plans, for example a PSP.

It is important, however, to distinguish between exchange controls which may prevent the transfer of funds and reporting obligations. There are many countries which, although they do not restrict the transfer of funds, require the amounts remitted to be reported to the appropriate authorities. These reporting obligations are sometimes onerous, although are normally straightforward and often the responsibility of the bank which makes the transfers.

Depending on the original structure of the plan, it may be possible to offer it in an alternative form which achieves the objectives of the plan without breaching exchange controls.

## 5.2.3 Other legal issues

In addition to securities and exchange control issues, there are also other legal risks that a company should be aware of. Employment law issues generally fall into the category of risks. These risks are not "road blocks", in that they do not typically prohibit the operation of a share plan, but they may expose a company to additional risks. Employment law risks are wide and varied but one of the biggest issues is whether in participating in an employee share plan, an employee can acquire rights to participate in the plan in future, either at all or on certain terms. The other key issue is whether an employee can successfully claim for lost rights under an employee share plan after his employment ends. The basis for these claims is that participation in the share plan has become part of the employee's terms of employment and in most cases, a company will want to try to keep participation in a share plan separate from the employment contract. To support this, express wording is normally added to the rules of share plans to state that participation in the share plan is separate from the employment contract and that the employee does not acquire a right to future participation, continued employment or compensation for lost rights on termination of employment.

Other legal risks which companies should bear in mind are to make sure that they are compliant with local data protection laws, considering whether funds can be deducted lawfully from employees' salaries in order to acquire shares under a share

purchase plan and whether a binding agreement to participants in a share plan can be made electronically. Whilst these legal risks are not going to drive a company's policy on employee share plans, it is important that companies know what the risks are and guard against them as effectively as possible within the confines of what is commercially acceptable. The challenge for a company is striking the right balance between managing the risks and achieving the company's commercial objectives.

Companies will need to ensure that they remain compliant with their legal obligations in respect of both domestic and internationally mobile employees. For example, a company may operate share based incentives in country A but, due to legal issues, phantom awards in country B. Companies will need to determine what should happen where the employee moves from country A to country B during the life of an award.

### 5.3 Tax compliance

The tax treatment of share plans may vary from country to country. For example, the income tax point may differ for a share award or option, depending on the country in question. There may be social taxes due on share incentives in one country but not in another. The requirement for the employer to withhold any taxes may also differ based on the country in question.

It is critical for companies to understand and consider how to fulfil their compliance requirements. Many companies obtain external advice prior to the grant of share awards and prior to the likely tax point (e.g. vesting for a share award). As would be expected, some of the technical issues can be complex, for example in relation to deferred compensation for US or Canadian employees.

Fulfilling tax (and legal) compliance requirements does not necessarily mean incurring substantial adviser fees. The cost may be reduced by reviewing the technical position less frequently than every year or focusing on the countries where there have been major changes, rather than reviewing every country annually.

There are free resources which can be used to consider the basic positions in many countries. For example, Deloitte offers GA<sup>TM</sup> Equity, which sets out the implications of operating various types of share plans in over fifty countries and is updated regularly. Deloitte also prepares alerts when there is a substantial change in the legal and tax legislation or practice which impacts the operation of share plans.

As important as checking the tax and legal positions, is establishing processes to implement the advice. For example, a process for selling shares to fund tax charges and ensuring that local payrolls have enough information to meet their reporting obligations.

Employers face an increasingly complex challenge to comply with withholding and reporting requirements when share plan awards are made to employees who are internationally mobile. Historically, many tax authorities were satisfied provided that the correct taxes were paid at the tax return stage. However, we are seeing an increase in tax authorities proactively checking to ensure that, where withholding is required, this is operated on the correct amount and at the correct time. As such, failure to put processes in place to enhance compliance could result in penalties from multiple country tax authorities as well as damage to reputations. There is also internal pressure for organisations to deliver awards, net of tax withholding, to their employees within a very tight time-frame.

Deloitte GA<sup>TM</sup> Incentives can assist with the international tax compliance issues that arise, as it calculates the taxes payable in each location. The calculations are automated and large volumes of transactions can be processed on the same day. This helps companies by identifying for each award how much tax is payable, so that shares can be sold to fund the taxes. There is no delay to the employees in receiving their shares because of the tax complexities, and companies can meet their compliance requirements in each location.

## 5.4 Maximising tax efficiencies

### 5.4.1 Tax efficient plans

Some countries seek to promote employee share ownership by allowing shares delivered through employee share plans to be taxed in a beneficial manner, provided certain conditions are met. Examples include the US and France.

In certain instances, tax efficiencies can only be delivered if some of the key terms of the plan are changed (e.g. a change in the length of the vesting period or imposition of a holding/restriction period after vesting). In these cases, companies should consider if the tax savings justify the change and whether an amended plan would continue to fulfil its original objectives. It can also be more complex to administer multiple plans rather than a single global plan. In some cases, a tax efficient plan may have lower limits or be less generous than a global plan.

### 5.4.2 Cost sharing agreements

In order to maximise the tax effectiveness of a share plan, it is common to share the costs of providing shares under a global share plan with the local employer. This is on the basis that benefits are being delivered to employees of the local employer and therefore it is appropriate for the employer to bear the cost of providing this benefit. In many countries, assuming the arrangements are structured properly, the local employer can obtain a corporate tax deduction for this cost.

On an overall group basis, a cost sharing approach allows for corporate tax deductions to be claimed without cash leaving the group and, in many cases, without any adverse implications for the UK parent company, the local employer or the employee.

#### *Example*

A share award is made to a German resident over 1,000 shares with an aggregate face value of £1,000. The accounting value\* of this award is £900.

The UK parent company enters into a cost sharing arrangement with the German employer under which the employer pays £900 to the UK parent company.

The German employer should obtain a corporate tax deduction for this £900. Assuming a corporate tax rate of 30%, this leads to a deduction of £270 for the German company.

There should be no adverse tax implications for the UK parent company.

\* It is typical to restrict cost sharing arrangements to the accounting value of the share awards as opposed to the face value, following HMRC guidance on the matter.

In spite of the obvious benefits of cost sharing agreements, in our experience, some UK listed companies still do not implement such cost sharing arrangements. In some cases, companies may not have considered the costs of providing share plans to be sufficiently material to warrant implementing a recharge policy. However, the use of share plans continues to increase and these costs are no different from other employment costs which are normally cross-charged within an organisation (e.g. in respect of mobile employees).

The administrative burden of implementing cost sharing agreements can also be seen as challenging, not least calculating the amount due from each employing company. However, a combination of increased expertise in this area and the development of high quality technology has improved the situation significantly.

It is also the case in a small number of jurisdictions that operating a recharge can affect the tax position, including changing the tax point for an employee or causing social security or withholding obligations which would not apply if a recharge was not

operated. However, it is often the case that these charges are outweighed by the potential corporate tax savings for the local entities.

## 5.5 Administration

Expanding a share plan to overseas locations will invariably increase administration. Many companies outsource the day-to-day operation of a plan to professional administrators, especially if the plan is being offered in multiple countries.

If planning to roll out a plan on a global basis a company should enter into discussions with administrators at an early stage. In our experience, an important factor which will determine the success of the expansion of a share plan to other countries is the strength and capabilities of the administrator. It is therefore worth speaking to a number of professional administrators in order to compare their offerings and to ultimately choose the right partner.

## 5.6 Managing the process

Rolling out a share plan to other countries can seem like a daunting and complicated affair. It does not have to be. With upfront organisation, planning and sufficient time allowed, it is possible to implement a global share plan that delivers the company's requirements.

The most successful implementations are generally the ones where the different functions (e.g. HR, tax, legal, company secretarial, finance, payroll, internal communication) are involved from the early stages of the process. It allows the various aspects of implementing and operating employee share plans and their interaction (e.g. the impact of cost sharing arrangements on the social security costs) to be considered and dealt with early.

With many stakeholders involved, and depending on the number of countries in which it is considered to roll the plan out, having a dedicated project manager should help to achieve a smooth and efficient implementation. The project manager will, amongst other things, devise a detailed and integrated project plan, highlighting any dependencies (e.g. between the design and the tax/legal review) and keep track of all issues, actions and decisions.

# 6 Accounting and funding

## 6.1 Accounting

When a company operates a share plan it is required to account for the expense under International Financial Reporting Standard 2 (IFRS 2) or its UK GAAP equivalent, FRS 20. This can represent a significant cost and therefore considering the impact of a share plan on the income statement can be one of the key factors in its design and implementation.

The accounting cost is not impacted by the source of the shares. Shares can be newly issued, purchased in the market or delivered from treasury. The funding choice can have an impact on the economic cost of the plan and we address some of the considerations in this chapter.

### 6.1.1 Summary of accounting treatment

Under IFRS 2, the fair value of the award must be calculated at the grant date and charged as an expense to the income statement, spread over the vesting period of the award. The fair value is an estimate of the price of a share based payment in “*an arm’s length transaction between knowledgeable, willing parties*”, calculated using a recognised option pricing model such as a ‘Black Scholes model’, a ‘binomial model’ or a ‘Monte Carlo simulation’.

As a minimum, the chosen model must take into account: any applicable exercise price, the current share price, the expected life of the award, the risk free rate of interest, share price volatility and dividend yield. The fair value of each award does not change once it has been calculated at grant, although the amount charged to the income statement may vary based on the number of awards which ultimately vest. This will depend on the type of conditions attached to the award.

### 6.1.2 Service conditions

If a share award is subject to continued employment, this is a service condition. Where an employee leaves prior to the date of vesting and their award lapses, this would be failure to satisfy a service condition and the accounting charge for that award can normally be reversed. However, if an employee leaves following the date of vesting, the accounting charge cannot be reversed, even though the award may lapse.

### 6.1.3 Performance conditions

The type of performance condition can have a significant impact on the accounting charge. For the purpose of IFRS 2, performance conditions are vesting conditions which require an employee to meet specified performance targets in relation to the company’s operations while completing a specified period of service. IFRS 2 distinguishes between market based performance conditions (e.g. total shareholder return) and non-market based performance conditions (e.g. earnings per share).

In the case of a non-market based performance condition, the IFRS 2 charge is adjusted at the balance sheet date to reflect the company’s expectation of the extent to which the performance condition will be achieved. At each balance sheet date, the company reviews this calculation and adjusts the charge to reflect its revised expectation. In practice, this means that the IFRS 2 charge will be ‘trued-up’ over the life of the award so that the cumulative expense represents the extent to which the award actually vests. If the award lapses in full, then the charge can be reversed in full.

In the case of a market based condition, the fair value calculation at grant should take into account the likelihood that the performance condition will be achieved. This means the charge expensed from the date of award will take into account the likelihood of the performance condition being achieved and cannot be changed over the life of the award, i.e. it is not ‘trued-up’. Therefore, if a market based condition is used, the accounting charge will still have to be recognised even if the full award lapses and employees do not receive shares.

### 6.1.4 Non-vesting conditions

If a share award has a condition attached to it which would not be classified as a performance condition or a service condition, for example the requirement to continue to save under a SAYE contract, this should be classified as a non-vesting condition. If the vesting of awards is dependent on the satisfaction of targets that are not accompanied by a service condition (for example, the company listing) and/or targets that do not relate to the company's performance, this should also be classified as a non-vesting condition.

Non-vesting conditions are treated in the same way as market based conditions. The fair value calculation should take into account the likelihood that the non-vesting condition will be achieved and the expense recognised would not be reversed if the non-vesting condition was not met and the award lapses.

### 6.1.5 Equity-settled or cash-settled awards

A share based award can either be equity-settled or cash-settled and this can have significant impact on the accounting charge. Generally, an award will be cash-settled where there is an obligation to settle the award in cash or the employee has the choice of having the award settled in cash.

In the case of an equity-settled share based award, the fair value is measured at the grant date and the expense recognised is only adjusted to "true-up" when awards lapse because of leavers and/or failure to satisfy a non-market condition.

If the award is cash-settled, then the treatment is different and can be much more variable than equity settled awards. The fair value is measured at the grant date, but is then also re-measured at each subsequent balance sheet date until the cash is delivered. The total charge in the company's income statement will equal the cash that is delivered to participants on vesting.

### 6.1.6 Balance Sheet

The corresponding entry to the balance sheet differs depending on whether the award is equity or cash-settled. If the award is equity-settled, a credit is recognised against shareholders' funds. If the award is cash-settled, an accrual is recognised for the amount of cash that the company is expected to pay on exercise/vesting

### 6.1.7 Group accounting

Where an award is made by a company within a group, the treatment will depend on whether the award is made over the parent company's shares or the subsidiary's shares and which company grants the awards. The expense should be recognised in the group company that is receiving the employee's services.

Broadly, where the award is made over the parent company's shares by the parent to the subsidiary's employees, the award will be treated as equity-settled in the accounts of the subsidiary which receives the employee's services and in the consolidated accounts. However, where the award is made over the parent company's shares by the subsidiary to its employees, the award will be treated as cash-settled in the accounts of the subsidiary company and equity-settled in the consolidated accounts.

UK parent companies can put in place an arrangement to recharge the share scheme costs to their subsidiaries. Provided the amount recharged does not exceed the IFRS 2 fair value of the relevant awards, it is not normally recognised in the income statement of the parent and the receipt by the UK parent company should not be taxable in the UK.

The treatment of the recharge and any specific requirements in each country in which subsidiaries are incorporated must be considered further before a recharge arrangement is entered into (see also section 5.5.2).

## 6.2 Funding

As mentioned above, the source of the shares used to satisfy awards will not impact the accounting cost, but can have a significant impact on the "real" costs of both cash and dilution.

Companies need to consider how they will satisfy awards made to employees. If they have approval from shareholders to do so, new shares may be issued or treasury shares may also be used. If there is no shareholder approval to use newly issued or

treasury shares then the company will need to buy shares in the market. EBTs are normally used to hold the shares before they are delivered to employees in any case.

If shares are newly issued in bulk, the cash cost per share can be minimal. However, the dilutive impact can be large. Conversely, if shares are purchased from the market, the cash cost can be large, with zero dilutive impact. Companies have to balance these competing interests.

Companies, particularly those experiencing significant growth or decline, would often prefer to keep the cash cost low, so as to be able to use the cash elsewhere in the business as required (such as investing in capital or paying suppliers). However, existing shareholders may not agree to the dilution of their holdings through the use of newly issued shares in order to reduce the necessary cash outlay.

Treasury shares may be used by some companies as this allow a company to buy its own shares from the market and hold them without requiring an EBT. However, they may not be suitable for all companies as they can only be used if shareholders have approved the plan.

### **6.2.1 Cost control**

In order to help manage the costs of satisfying awards made under employee share plans, the company can develop a hedging strategy. This would include identifying the number of shares likely to be required to satisfy existing and future awards under all of the company's share plans. This requires various factors to be taken into account and assumptions to be made about various issues including share price movements, satisfaction of performance targets and leaver rates.

### **6.2.2 Internal hedging**

By purchasing shares in advance of the delivery date and holding those shares, a company can effectively fix the cash cost of providing the shares to employees. A variety of approaches can be taken, including purchasing shares at the date of grant or purchasing shares in several tranches during the vesting period. The shares are normally held in an EBT offshore with the trustees agreeing to waive dividends.

By purchasing in advance, the company can manage the risk of the share price increasing, but will also lose the opportunity to purchase shares at a lower price if the share price falls. It is also committing cash in advance of the shares being required to satisfy the share plan awards and involves taking risk on the number of shares which will ultimately have to be delivered under the plans.

### **6.2.3 External hedging**

For large listed companies that also operate sizeable share plans, it may be possible to enter into hedging arrangements with a third party (typically a bank). There are several different structures that can be adopted, including call options, forwards and total return swaps. These are more complex than internal hedging and, unlike internal hedging, can also have significant accounting consequences (depending on the structure used).

# Glossary

APSP	Approved Performance Share Plan
CGT	Capital Gains Tax
CSOP	Company Share Option Plan
CT	Corporation Tax
EBT	Employee Benefit Trust
EMI	Enterprise Management Incentive Scheme
ESS	Employee Shareholder Shares
FCA	Financial Conduct Authority
HMRC	HM Revenue & Customs
IFRS 2	International Financial Reporting Standard 2
JOS	Jointly Owned Shares
NI	National Insurance
PSP	Performance Share Plan
SAYE	Save As You Earn
SIP	Share Incentive Plan

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