Share Success
Your guide to employee share plans in the UK and beyond

October 2016
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Foreword

Foreword from Nick Hipwell

It has been an eventful two years since the last edition of “Share Success”. During that time we have seen an ever increasing focus on executive pay, of which employee share plans remain an important component. The Executive Remuneration Working Group published their final report on “pay simplification” in July and the new Prime Minister’s recent remarks about sharing the success of capitalism more equally among the workforce may herald a renewed focus on all employee plans. There has perhaps never been a more appropriate time for us to update our guide to designing, implementing and operating employee share plans.

Away from the media focus on executive pay, other important changes have happened. The Market Abuse Regulation has rewritten the dealing and disclosure rules which apply to employee share plans, companies in the Financial Services sector have been subject to a multitude of new regulations, the International Accounting Standards Board has issued guidance on the “net settlement” of withholding tax liabilities and next year there will also be a large number of companies putting their remuneration policies to shareholders for approval.

As if that was not enough, we also have Brexit to wrestle with. The impact of Brexit will no doubt feature in future editions of this guide and while we wait to see how that plays out for employee share plans, we have included all the changes highlighted above, along with many others, in this edition of Share Success.

The revised guide contains a brand new chapter on employee share plans in the FS sector in recognition of the sheer amount of regulation that is now applicable. All the other chapters from the previous edition of our guide have been retained, although these have been comprehensively updated and the format of the entire guide has been refreshed to keep it current and accessible.

Share Success remains a technical guide to employee share plans and while we have included the important facts, we have resisted the temptation to repeat the market practice data which is already so well laid out in our guides to Directors’ remuneration in FTSE 100 and 250 companies. Our Global Share Plan survey is the place to look for market practice applicable to employee share plans operated on a global basis, albeit that chapter 5 of Share Success provides an overview of the main technical points.

The area of employee share plans is complex and fast moving and while we hope that you find our guide helpful, it is not intended to provide specific advice. We therefore encourage you to consult your advisers about the content of this guide and please feel free to get in touch with me or any of the share plans team at Deloitte if there is anything that you would like to discuss.
1. Introduction

This guide is aimed at all those involved in designing, implementing and operating employee 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 and share dealing requirements;

• chapter 5 looks at the key issues likely to arise when rolling out and operating employee share plans on an international basis;

• chapter 6 considers the principal issues relevant to employee share plans operated by companies in the financial services sector; and

• chapter 7 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 executive reward consulting team.

One team

Design
- Strategic plan design
- Business relevant performance measures
- Specialist advice on the impact of tax, legal, regulatory, accounting and funding issues
- All-employee plans in the UK and globally

Implementation & communication
- Drafting of incentive plan rules and shareholder documentation
- Drafting of employee communications
- Tax and legal advice on the operation of share plans in the UK and globally
- Advice on the practical operation of plans, including establishing enrolment and compliance processes

Remuneration advice
- Insight on shareholder views and assistance with consultation
- Update on market trends, regulation and corporate governance
- Executive pay benchmarking
- Assistance with drafting remuneration reports and associated legal advice
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In this chapter we describe 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 implemented by private companies and also some smaller listed companies. In practice there is a certain amount of cross-over between the types of plans used in listed and private companies.

Discretionary or ‘executive’ share plans enable companies to provide share based incentives to executive directors and selected senior employees. Their aim is to align the interests of participants with those of the company and its shareholders and to motivate the participants to deliver value over the longer term.

All employee plans offer less generous individual reward than executive plans and are designed to allow all employees to have an ownership stake in the business.

The value of returns to employees will be dependent on the company’s share price and there is normally an element of discount or “matching” designed to make participation in the plan attractive to as many employees as possible. All employee plans can produce increased employee loyalty and depending on plan design, they often contain features which encourage employees to remain in employment in order to enjoy the full rewards available under the plan.

2.1 Performance share 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”). The vesting period is usually three years and is normally followed by a further period of, typically, one to two years, referred to as a “holding period”.

If all conditions are met, the executive will profit from the whole value of the shares. If a participant ceases employment before the end of the vesting/holding period the amount of value which they may be entitled to receive normally depends on the reason for their departure and when it occurs.

The delivery of shares is normally subject to malus and clawback provisions which may be triggered if certain circumstances occur. Malus provisions allow a company to reduce or extinguish the number of shares (or amount of cash) which would otherwise be delivered and clawback provisions allow a company to recover some or all of the shares or cash already delivered.

In practice share awards are typically structured in one of the two following ways although they may also be structured as restricted share awards, which are briefly considered below.

- 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 both the employer’s National Insurance (“NI”) charge and any available employer’s corporation tax deduction for share based payments is deferred.

Key advantages
- The reward delivered is closely linked to the chosen performance conditions.
- 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 can be used to align participant and shareholder interests.
- Share awards do not incentivise share price growth as powerfully as market value options, but using a performance condition 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 to address this issue.

Restricted share awards
Instead of being structured as a conditional right or a nil-cost option, a share award may 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 Capital Gains Tax ("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 at the beginning of 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 listed companies is normally already significant and the potential for further share price growth may be 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.

2.2 Restricted share plans
Restricted share plans (RSPs) are essentially the same as PSPs except that the share awards granted under RSPs are not subject to performance conditions. RSPs are used to reward and retain key employees and can be an important tool to assist recruitment.

The key advantages and disadvantages described in relation to PSPs are equally applicable to RSPs except in respect of the references to performance conditions.

2.3 Deferred share plans
Part, or all, of the annual bonus award is deferred for a specified period of time, usually two to three years, with the longer period being more prevalent. This may be a requirement of the plan or may be at the request of the participant and special rules apply in the financial services sector (see chapter 6). The deferred award is generally structured as a conditional right to acquire shares or a 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, deferred shares may be matched with additional shares which are conditional on the achievement of specified performance targets. This is, however, becoming increasingly unusual.

Key advantages
• The deferral can act as a retention mechanism and when deferred into shares, links the final reward to the participant with shareholder value through 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 used relatively rarely 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.

The comments made about malus and clawback in respect of PSPs are equally applicable to deferred share plans.

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

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

Companies often 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 detail about CSOPs can be found in section 2.5.

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 below the purchase price no value is delivered, irrespective of the company’s performance, unless the share price recovers during the exercise period.
• Geared rewards can be volatile and unpredictable.
• A greater number of shares is 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 a market value option plan to allow for net settlement, although this approach is not permitted for CSOPs.

The comments made about malus and clawback are, in principle, equally applicable to market value share options. However in practice, because market value options are less commonly used by large UK plcs than PSPs and RSPs, fewer examples of malus and clawback provisions are seen in practice.

Example of CSOP

<table>
<thead>
<tr>
<th>Option over £30,000 of shares with a £1 exercise price; tax rate (income tax and employee’s NI) 42% or 47% throughout. Market value at exercise £2.</th>
<th>Non-tax advantaged option</th>
<th>CSOP option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on exercise (£1 per share)</td>
<td>£30,000</td>
<td>£30,000</td>
</tr>
<tr>
<td>Income tax on exercise at 40% or 45%</td>
<td>£12,000</td>
<td>£13,500</td>
</tr>
<tr>
<td>CGT at 20% on disposal at exercise (assuming annual exemption available)</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Employee’s NI at 2.0%</td>
<td>£600</td>
<td>£600</td>
</tr>
<tr>
<td>Employer’s NI at 13.8%</td>
<td>£4,140</td>
<td>£4,140</td>
</tr>
<tr>
<td>Net benefit to individual</td>
<td>£17,400</td>
<td>£15,900</td>
</tr>
</tbody>
</table>

2.5 Company Share Option Plan (CSOP)
A CSOP is a market value share option plan which meets the conditions set out in the applicable UK legislation. Historically, companies were required to obtain HMRC’s agreement that a plan complied with the legislation. With effect from 6 April 2014, this has not been necessary and instead companies 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 earlier in specific “good leaver” situations), there is no income tax or NI payable on the difference between the exercise 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 £11,100 for the 2016/17 tax year), meaning that for most participants the gains will be tax free.

The CSOP is a “discretionary” plan. This means that 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 generally straightforward to implement and administer.

Key advantages
• No income tax or NI on exercise (subject to qualifying conditions being met).
• CSOPs can be used on an ad hoc basis for employees of the parent company, its subsidiaries and 50:50 joint ventures, and, provided 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 because 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 date of grant) under option at any one time. As such, CSOPs may have limited application for the executive population although a CSOP can be used in conjunction with a non-tax advantaged market value option to make larger awards.
• As award levels and exercise dates need to be monitored, administration levels are marginally increased compared to some other discretionary plans, although administrators and registrars are familiar with the CSOP requirements.

2.6 Tax Advantaged Performance Share Plan (TAPSP)
The TAPSP is a hybrid plan which 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 can be free of income tax and NI.
A TAPSP award is usually made up of at least two, and often three, elements as follows:

- a CSOP option over shares 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 TAPSP award exceeds £30,000 in total.

Provided 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 funding award will be subject to income tax and NI but the employee does not need to find this because it will typically be satisfied by selling some of the shares acquired from the exercise of the CSOP option.

The funding award can be made over existing shares in an Employee Benefit Trust (“EBT”) which can be “recycled” to avoid increased dilution.

The TAPSP will deliver shares even 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 under the funding award, albeit subject to income tax and NI.

### Key advantages
- A TAPSP 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 and the gain on up to £30,000 worth of the award falls into the CGT regime. Even if the share price falls or the conditions are not met and the CSOP option lapses, the funding award will vest. In that case the shares subject to the award are subject to income tax and NI.
- TAPSP delivers a positive HR message because it provides the potential to increase the net value of the award.
- If structured properly, it is neutral from a corporation tax and accounting perspective.

### Key disadvantages
- There is increased administration involved compared to a standalone PSP or CSOP. However, administrators who regularly deal with CSOPs and free share plans have the capability to manage this.
- If the intended TAPSP population already holds CSOP options, there may be limited scope to implement TAPSP until those options have lapsed or have been exercised and there is room to grant more options within the £30,000 limit.

### Example of TAPSP

<table>
<thead>
<tr>
<th>Award over £30,000 of shares with a £1 market value; tax rate (income tax and employee’s NI) 42% or 47% throughout. Market value at vesting £2.</th>
<th>PSP award</th>
<th>TAPSP award</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on vesting (£2 per share)</td>
<td>£60,000</td>
<td>£60,000</td>
</tr>
<tr>
<td>Income tax on vesting at 40% or 45%</td>
<td>£24,000</td>
<td>£27,000</td>
</tr>
<tr>
<td>CGT at 20% on disposal at vesting (assuming annual exemption available)</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Employee’s NI at 2.0%</td>
<td>£1,200</td>
<td>£1,200</td>
</tr>
<tr>
<td>Employer’s NI at 13.8%</td>
<td>£8,280</td>
<td>£8,280</td>
</tr>
<tr>
<td>Net benefit to individual</td>
<td>£34,800</td>
<td>£31,800</td>
</tr>
</tbody>
</table>

**2.7 Phantom plans**

A phantom share award or nil-cost option gives the holder the right to a cash payment equal to the value of the shares to which the share award or nil-cost option relates. A phantom market value option gives the holder the right to a cash payment equal to the difference between the exercise price of the phantom option and the market value of the shares to which the phantom option relates.

Standalone phantom plans are not common in UK listed companies. However, it is standard practice to include within the rules of all types of executive share plan the ability to grant phantom share awards and phantom options. Phantom share awards and options are most often used where the grant of a conventional award would be impossible or not feasible because of legal restrictions in a particular jurisdiction.

Phantom plans may also be used for unlisted subsidiaries, business units or divisions where the phantom share price is based on the notional value of that entity and not the group as a whole (although sometimes in these circumstances growth shares are used, as described in section 3.5).

Most phantom plans will incorporate performance conditions in the same way as a conventional share award or option plan.
Key advantages

- Allows employees to participate in a share based incentive even where legal or other restrictions prevent the use of shares in a particular jurisdiction.
- Provides flexibility to align reward to the performance of particular subsidiaries, business units or divisions.
- 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, phantom awards are more expensive from an accounting perspective than conventional share awards and options.
- Employees never own real shares.

Key disadvantages

- Cash cost to the company.
- If the co-investment is intended to be funded from deferred bonus, the co-investment plan is dependent on the payment of a bonus.
- If the co-investment is intended to be funded from deferred bonus, the co-investment plan is dependent on the payment of a bonus.

2.8 Co-investment shares

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 acquired from other share plans.

Key advantages

- Co-investment plans act as a strong “lock-in” or retention device
- They align the interests of the participants with those of shareholders.

Key disadvantages

- Participants have to invest their own money and therefore some executives could be rewarded more than others on account of their greater resources rather than better performance.
- The typical approach is as follows:
- The employer establishes or uses an existing EBT.
- The EBT and employee jointly purchase the shares, which are held by the EBT during a vesting period.

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 threshold value.

Tax rate (income tax and employee’s NI) 47% throughout. Market value at vesting £2.

<table>
<thead>
<tr>
<th>jointly owned shares</th>
<th>Gain on vesting (£2 per share less £1.20 less 15p)*</th>
<th>£65,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income tax on vesting at 45%</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td>Employee’s NI at 2.0% on vesting</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td>Employer’s NI at 13.8% on vesting</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td>CGT at 20% on disposal at vesting (assuming annual exemption available – £11,100 for the tax year 2016/17)</td>
<td>£10,780</td>
</tr>
</tbody>
</table>

Net benefit to individual £54,220

*Note: it is also feasible for the plan to be designed to deliver all or a proportion of the value up to the share threshold value. Any value delivered up to the share 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.
• The EBT is funded to make the purchase by way of a loan from the company.

• The employee's interest in the shares is held jointly with the EBT and entitles the employee to the growth in value of that interest above a threshold (similar in concept to an option).

• The employee pays the market value of the interest in the shares on acquisition and enters into a s431 election (as described at the beginning of 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 is free of income tax and NI.

**Key advantages:**
• Provides a powerful incentive to employees to drive growth and to remain within the business.

• CGT treatment of gains.

**Key disadvantages:**
• More complex than a share award or share option.

• Only commercially effective and viable when substantial share price growth is anticipated.

The JOS concept is known to HMRC and, based on current legislation, HMRC accept that such schemes are effective.

**2.10 Share purchase plans**

Under this type of plan, employees are offered the right to buy shares either on a regular basis (for example, monthly) or at the end of a pre-determined period. A typical structure involves participants making regular contributions which are used to buy shares.

There is normally a “contribution” from the company, which can take one of various forms.

This contribution from the company makes the plan more attractive to employees than simply buying shares in the market and reduces the risk which employees are taking with their own money. Generally employees will be required to retain the shares which are purchased with their own contributions for a certain period (usually between one and three years) or they forfeit some or all of the shares acquired with the company contribution.

Examples of how the company contribution may be structured include:

• When employees acquire shares they are entitled to a number of “matching” shares from the company, for example buy two shares and get one free.

• The company adds a monetary matching contribution to the employee contribution and the total is used to purchase shares for the employee.

• The employee's contribution is used to purchase shares at a discount to market value and the company funds the difference.

When deciding the amount which each employee can contribute to the plan, companies may allow employees to save up to a certain percentage of their salary (e.g. 5%) or up to a certain fixed monetary amount (e.g. £150 per month). Allowing employees to save a certain percentage of their salary generally requires more administration than setting a fixed amount as the company will need to refer to each employee's salary to calculate the amount. However, offering a fixed amount can represent a significantly different portion of income depending on the employee's remuneration and this can be a major design consideration for a global share plan where salaries vary greatly by country. Some companies will vary the fixed amount by country.

Regardless of the method chosen, companies should also consider whether to build features into the plan which scale back the employee and/or employer contribution if the plan is over-subscribed and to guard against exchange rate movements leading to more shares being acquired than anticipated.

**Key advantages**
• Simple to communicate to employees.

• Creates employee loyalty and gives them a sense of ownership.

• Possible to control the maximum number of shares delivered and the cost of the free shares.

**Key disadvantages**
• Can be expensive to administer.

• Limited opportunities for tax breaks (dependent on design).

**2.11 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, being:

• 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); and

• Dividend Shares (shares acquired with cash dividends paid on SIP shares).

SIP shares must be held for a specified period of time (ranging from three to five years depending upon the type of shares delivered) in order for them to be released free of income tax and NI. 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.

Key advantages

- Tax breaks for UK employees and their employers.
- Easy to communicate to employees.
- Flexible “menu” of types of shares which may be offered.

Key disadvantages

- Requires investment by employees which may not be attractive to lower paid employees unless there is a generous match from their employer.
- Five year holding period before full tax breaks apply.
- Can be expensive to administer.

2.12 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 who do not wish 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.

Key advantages

- 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 benefits 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 employee’s flexible benefits ‘pot’ that would otherwise be payable.

Key disadvantages

- Care is needed in structuring these plans to avoid creating a ‘cash alternative’ to the Free Share 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 SIP vs a non-tax advantaged 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 employee’s NI) of 42%. Market value increases from £1 to £2 during the 5 year period. Assumes CGT annual exemption available. Excludes dividends.**

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

*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.

£3,600 of the flexible benefits ‘pot’, subject to income tax and NI, is replaced with tax favourled Free Shares under a SIP. This assumes the Free Shares are held for 5 years.

**Example of a flexible SIP**

**Employee position**

**Income tax/NI savings on Flex Pot**

<table>
<thead>
<tr>
<th>Salary</th>
<th>Flex Pot</th>
<th>Free shares</th>
<th>Total</th>
<th>Basic rate (20% tax +12% NI)</th>
<th>Higher rate (40% tax +2% NI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Without using a flexible SIP</td>
<td>£20,000</td>
<td>£5,000</td>
<td>–</td>
<td>£25,000</td>
<td>–</td>
</tr>
<tr>
<td>Using a flexible SIP</td>
<td>£20,000</td>
<td>£1,400</td>
<td>£3,600</td>
<td>£25,000</td>
<td>£1,152</td>
</tr>
</tbody>
</table>
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.

2.13 Save As You Earn (SAYE) plan
A SAYE plan is a HMRC tax advantaged option plan which must be offered to broadly all “UK taxpaying” employees but which 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 the shares to which it relates 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.

**Key advantages**
- Tax breaks for UK employees and employers.
- Easy to communicate to employees.
- Employees cannot lose.

**Key disadvantages**
- Savings carrier required.
- Relatively high number of shares required to deliver modest gains.
- Careful design required to guard against accelerated accounting charge if employees cancel savings contracts.

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 three year savings contracts although a bonus is payable on five year savings contracts. This bonus 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 six 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” circumstances), 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.

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

<table>
<thead>
<tr>
<th>Income tax/NI savings on Flex Pot</th>
<th>Reduction in cash cost</th>
<th>Employer’s NI (13.8%)</th>
<th>Total</th>
<th>Saving for 100 participants</th>
<th>Saving for 1,000 participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Using market purchased shares</td>
<td>£nil</td>
<td>£497</td>
<td>£497</td>
<td>£49,700</td>
<td>£497,000</td>
</tr>
<tr>
<td>Using newly issued shares</td>
<td>£3,600</td>
<td>£497</td>
<td>£4,097</td>
<td>£409,700</td>
<td>£4,097,000</td>
</tr>
</tbody>
</table>

### Example of a SAYE plan

<table>
<thead>
<tr>
<th>SAYE option over 9,000 shares with a £0.80 exercise price and 3 year savings contract. Tax rate (income tax and employee’s NI) of 42%. Market value at exercise £2.</th>
<th>SAYE option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on exercise (£1.20 per share)</td>
<td>£10,800</td>
</tr>
<tr>
<td>Income tax on exercise at 40%</td>
<td>Nil</td>
</tr>
<tr>
<td>CGT at 20% on disposal at exercise (assuming annual exemption available)</td>
<td>Nil</td>
</tr>
<tr>
<td>Employee’s NI at 2.0%</td>
<td>Nil</td>
</tr>
<tr>
<td>Employer’s NI at 13.8%</td>
<td>Nil</td>
</tr>
<tr>
<td>Net benefit to individual</td>
<td>£10,800</td>
</tr>
</tbody>
</table>
The participant may choose not to exercise his option to buy shares, in which case he can remove his savings, tax free. He may choose to do this if the share price at the end of the savings period is lower than the exercise price.

An important decision for companies which operate SAYE plans is how frequently to invite employees to participate in them. A risk for companies to consider is that if the share price has fallen since the last SAYE invitation, employees may withdraw from participation, reclaim their savings and begin savings under a new SAYE option contract linked to a SAYE option with a lower exercise price. This has negative accounting implications for the company (see section 7.1.4) and many companies choose to address this risk by curtailing the rights of employees who have withdrawn from existing SAYE savings contracts to participate in future invitations.

2.14 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 plan, what that taxable amount would otherwise have been).

The tax deduction for share options will arise on the amount of the gain when options are exercised and for share awards, the tax deduction applies to the value of the shares delivered. Companies should ensure that this relief (and any applicable non-statutory relief) is claimed within the applicable time limits and also be aware that longer term vesting periods and/or holding periods favoured by investors will delay the timing of corporation tax deductions.

Multinational 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).

2.15 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 and, in the case of options, may be at any time up to the tenth anniversary of the date of grant. Not only are share prices unpredictable, but NI rates may also change over that period. In order to reduce this risk, companies often wish to hedge this NI liability.

A common way of achieving this 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. The employee receives income tax relief on the cost of the employer’s NI, so the effective cost is reduced and a company may choose to compensate their employees for taking on this obligation by increasing the award.

2.16 Tax registration and reporting
There are various tax reporting and registration obligations which must be met.

Companies that 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 out in the applicable legislation. This is done as part of the online registration process mentioned above.

In addition to the registration requirement, on an on-going basis, companies are obliged to file annual share plan returns (for CSOPs, EMI, SAYE, SIPs and non-tax advantaged share plans) online by 6 July following the end of each tax year in which the plans are operated.

Taxable income from share plans operated by most companies must be included in payroll. Under ‘Real Time Information’ reporting, data and tax payments must be provided to HMRC no later than 14 days after the end of the tax month in which the taxable event occurred.
## 2.17 Summary of the UK tax treatment of share plans

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>Tax on Award</th>
<th>Tax on Delivery</th>
<th>Tax on Exercise</th>
<th>Tax on Disposal</th>
<th>CT Relief</th>
</tr>
</thead>
<tbody>
<tr>
<td>PSP/RSP (conditional rights to acquire shares)</td>
<td>Nil</td>
<td>Income tax and NI on market value at delivery</td>
<td>N/A</td>
<td>CGT on gain* (nil if sold on delivery)</td>
<td>On market value at delivery</td>
</tr>
<tr>
<td>TAPSP</td>
<td>Nil</td>
<td>Gain on first £30,000 of award free of income tax and NI. Remainder subject to income tax and NI on market value at delivery</td>
<td>Nil</td>
<td>CGT on gain* (attributable to first £30,000 of award; nil on remaining shares if sold immediately)</td>
<td>On market value at delivery</td>
</tr>
<tr>
<td>Non-tax advantaged option (nil-cost or market value)</td>
<td>Nil</td>
<td>N/A</td>
<td>Income tax and NI on gain</td>
<td>CGT on gain* (nil if sold on exercise)</td>
<td>On gain on exercise</td>
</tr>
<tr>
<td>CSOP</td>
<td>Nil</td>
<td>N/A</td>
<td>Nil</td>
<td>CGT on gain*</td>
<td>On gain on exercise</td>
</tr>
<tr>
<td>SAYE</td>
<td>Nil</td>
<td>N/A</td>
<td>Nil</td>
<td>CGT on gain*</td>
<td>On gain on exercise</td>
</tr>
<tr>
<td>SIP</td>
<td>Nil</td>
<td>Nil</td>
<td>N/A</td>
<td>Nil if sold on removal from SIP</td>
<td>On market value at award of Free Shares and Matching Shares</td>
</tr>
</tbody>
</table>

* CGT is generally payable on sale 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 (£11,100 for the tax year 2016/17).
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 tax treatment. There is usually 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 these companies are also frequently 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 Enterprise Management Incentive options are normally exceeded by larger companies and Employee Shareholder Shares, although available to all companies regardless of size, is normally more appealing to smaller companies, especially those with scope for high growth.

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 affordable 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 they are acquired 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 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.

### 3.1 Enterprise Management Incentive (EMI) options

EMI provides for the grant of tax-efficient options over shares in smaller companies, being those with gross assets not exceeding £30m, fewer than 250 full-time employees (or full-time equivalents) and which 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 option allows individuals to be subject to CGT, rather than income tax and NI, 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 should 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 and the employee/director and trading requirements are met. 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)

The legislation to introduce Employee Shareholder Shares came into effect on 1 September 2013. Under the legislation, individuals may be given (i.e. free of charge) 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 minimum 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 up to a maximum gain of £100,000. Any gain in excess of £100,000 is taxed at the individual’s applicable rate of 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 3.4) or a growth share arrangement (see section 3.5) in advance of acquisition.
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. ESS can also be delivered in the form of growth shares (see section 3.5). 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 ESS must:

- provide a written statement setting out the rights attaching to the shares being acquired, whether there are any restrictions attached, the dividend rights, voting rights and rights on a winding-up and if there is more than one class of shares, comparing those rights with 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 are not able to force existing employees to move to employee shareholder contracts. However, they are able to recruit new employees solely on Employee Shareholder terms if they so wish.

### 3.3 Tax efficient arrangements

The use of restricted shares is explained briefly at the beginning of this chapter, including the benefits of employees paying the unrestricted market value of the shares that they acquire (or alternatively electing 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 3.4 and 3.5 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 3.6.

### 3.4 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 for the employee 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 or deferred payment (except in certain limited cases, 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 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.
3.5 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 usually set at a premium to the current market value.

The purpose of the threshold 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 is willing to risk.

The desired tax position is that the growth in value of the shares above the threshold 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 to the extent that the unrestricted market value of the shares exceeds 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 whether before or after the shares are issued.

Growth shares are therefore similar to the jointly owned share arrangements described in section 2.9. Private companies could also implement a JOS arrangement although in our experience, growth shares are used more frequently.

3.6 Valuation
In order for unlisted companies to successfully implement the above arrangements careful consideration must be given to the valuation of the shares which, unlike shares in listed companies, do not have a published share 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 apply 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 different from that which might be expected in a commercial scenario.

HMRC will no longer agree share valuations after the transaction (other than as part of tax favoured arrangements). Therefore an independent valuation is an important aspect of any private company share incentive, not least to demonstrate the employer has discharged its obligation to account for its ‘best estimate’ of any employment income.
4. Approvals, disclosures and share dealing

There are a number of shareholder approvals and disclosures which a listed company must consider before implementing or amending a share plan. A listed company’s senior employees will also be restricted in when they can deal in the company’s shares and this will affect how any share plan is operated. This chapter contains a summary of these obligations and also highlights briefly the key features which investors typically expect to see in a share plan.

4.1 Shareholder approval

4.1.1 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 listed 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) applies to all share plans, regardless of the context.

The second element of the test does not apply to certain all-employee plans, such as HMRC tax advantaged Share Incentive Plans and Save As You Earn plans, or 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 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 guide, a company will wish 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.

4.1.2 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 clarity in respect of what needs to be achieved for a plan to deliver value;
- 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 1 October 2014, performance related remuneration plans 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 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 and 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; and
- how to enforce clawback in practice and the risks of the power being unenforceable in the UK and overseas.
Is shareholder approval required?

- Is shareholder approval required?
- Can awards be satisfied using newly issued or treasury shares?
- Is the plan a “long-term incentive scheme” involving one or more directors?
- Is the plan an arrangement to deliver a deferred bonus conditional on ongoing service only?
- Is the plan for one director established in unusual circumstances to recruit or retain him/her?
- Is the plan offered on similar terms to substantially all employees?

Shareholder approval required

No shareholder approval required
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 a share plan which are advantageous to participants, without shareholder approval.

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 they are made to benefit the administration of the plan, to take account of a change in legislation or to obtain or maintain favourable tax, exchange control or regulatory treatment for participants in the plan or for the company operating the plan or for members of its group.

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 of participants or the number of shares to which their subsisting awards relate) 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 frequently necessitate disclosure to the market through a stock market announcement (in accordance with the EU Market Abuse Regulation (the “MAR”) and also in the Directors’ Remuneration Report (which forms part of a company’s Annual Report and Accounts).

4.3.1 Stock market announcement
The MAR came into effect in the UK on 3 July 2016. It effectively replaces the Disclosure and Transparency Rules, which previously prescribed when a listed company must notify the market of transactions which its senior management had undertaken in the company’s shares.

Under the MAR, all Persons Discharging Managerial Responsibility (PDMRs) must notify the listed company which employs them and the FCA of any transactions in the company’s shares which they undertake within three days of the transaction taking place. A PDMR’s “connected persons” (spouse, dependent children and other relatives that live with the PDMR) also have the same obligation to make these notifications.

For these purposes, PDMRs are the company’s directors and any other senior executives who have regular access to inside information relating to the company and have the power to take managerial decisions affecting the company’s future developments and business prospects. From a share plans perspective, transactions in the company’s shares would include the grant of share awards, the vesting of conditional share awards and the exercise of share options.

The listed company is also required to notify the stock market through a stock market announcement of each transaction using the information given to it by the PDMR. If the individual does not notify the company of a transaction until shortly before the three-day deadline set by the MAR for the company to notify the market (as the deadline for the employee to notify the company and for the company to notify the market is the same), this will present timing challenges for the company. Therefore, in practice under the company’s share dealing policy, companies will often require PDMRs to notify the company within one or two days of the transaction taking place. Also, in practice, companies will often notify the FCA of share dealings undertaken by PDMRs on their PDMR’s behalf.

4.3.2 Directors’ Remuneration Report
UK incorporated listed companies are required to publish a Directors’ Remuneration Report as part of their Annual Report and Accounts which gives details of 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 the Remuneration Report at the previous AGM (assuming the Policy Report was not approved by shareholders at that meeting).
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 to directors within the limits set by the Policy Report 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 at an earlier date.

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 this position.

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

- 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, any performance conditions applicable to the award, any exercise price and the face value of the award); and
- directors’ total shareholdings and interests in shares, including the achievement of any share ownership guidelines.

4.3.3 Share dealing
The MAR has also altered the restrictions applicable to when PDMRs can deal in their company’s shares.

The MAR replaces the Model Code (which applied to companies listed on the Main List of the London Stock Exchange) and AIM Rule 21 (which restricted how the directors of AIM companies could deal in the company’s shares).

Under the MAR, PDMRs are prohibited from dealing in the company’s shares within the period of 30 days prior to the announcement of the company’s results. However, as a matter of practice, companies are implementing share dealing policies which are more onerous than the obligations under the MAR. In order to protect PDMRs from any suspicion of insider trading, companies are commonly requiring that PDMRs do not deal at any time when the company has unpublished information that could materially affect the share price or, in some circumstances, during the entire period from the end of the relevant financial period to the point at which results are announced.

These prohibitions are usually subject to some prescribed exemptions, for example, in relation to the operation of all-employee share plans and regular acquisitions of shares under trading plans. The scope of these exemptions will be set out in the company’s share dealing policy and although there is common practice, policies will differ between companies.
5. Going global

In this chapter we explore the key technical and practical issues likely to arise in rolling out and operating share plans globally.

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.

While plans operated globally by multinationals often have many features in common, except where those features are dictated by legislation, the overall design of most plans remains bespoke.

Careful consideration should be given to the design of the plan to ensure that it serves the company’s commercial objectives and is capable of being operated efficiently and at an acceptable cost. The use of newly issued, treasury or market purchased shares, the ability to operate a recharge arrangement and design features which mitigate the risk of exchange rate movements are all important factors in the cost of operating a plan globally.

Legal and tax compliance is a key factor in the design and operation of share plans and also has an impact on cost.

An overview of the main issues in more than fifty countries is available free of charge from Deloitte in GA™ Equity. Deloitte also prepares regular “Global Reward Updates” which highlight significant changes to legal and tax issues which have an impact on employee incentive plans.

As well as being aware of the local rules, companies have to balance complexity and the merits of local variations to the design (normally to accommodate local legal or tax issues and occasionally cultural concerns) against simplicity and ease of communication of a plan to employees.

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 into context is important in order to appreciate how these issues can affect the intended operation of a share plan.

There are certain issues which 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 consider the impact of securities law on 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 (although not always) the case that if shares are delivered free of charge, local securities laws will not apply.

In addition, it is common for an exemption to be available under local securities law when participation is offered only 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 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. Where 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 many share plan offers will not qualify.
There is also 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 currently available if the company is headquartered in the EU or the company’s shares are listed on a main EU stock exchange.

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 a 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. It can also mean that employees do not feel fully included in the plan.

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 they 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 laws 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 issues are not “road blocks”, in that they do not typically prohibit the operation of a share plan, although 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 participate 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 plan awards varies from country to country. As an overview of the general position, in most countries taxes are not due at the time of award and instead taxes are typically due at the point that the employee receives ownership of the shares to which the awards relate or, in the case of options, at exercise. However, this is a generalisation and the point at which income tax is due, as well as whether social taxes apply to share incentives and the requirements for the employer to withhold any taxes and provide reports to the tax authorities differ between countries.

Many companies obtain external advice prior to the grant of share awards and again before the tax point. The technical issues can be complex and tax authorities are increasingly focussing on compliance with employer withholding obligations. To satisfy compliance obligations accurately and on time it is important to establish processes for selling shares to fund tax charges and to ensure that local payrolls have sufficient information to meet their remittance and reporting obligations.
Employers face a particularly 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, tax authorities are becoming increasingly proactive in 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 Incentives calculates the taxes payable in each location and can therefore assist with the international tax compliance issues. The calculations are automated and large volumes of transactions can be processed on the same day. This helps companies by identifying how much tax is payable in respect of each award so that shares can be sold to fund the taxes. There is no delay for the employees in receiving their shares because of the tax complexities and companies can meet their compliance requirements in each location.

5.4 Maximising 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 the amount of the award is limited or one or more 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). This generally leads to increased administration and in these cases, companies should consider if the tax savings justify the changes and whether an amended plan would continue to fulfil its original objectives.

5.4.2 Cost sharing agreements
In order to maximise the tax effectiveness of a share plan, it is common to share (or recharge) 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 and documented 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.

In spite of the potential benefits of cost sharing agreements, not all companies implement them. In some cases, companies may not have considered the costs of providing share plans to be sufficiently material to warrant implementing a policy, at least not in all countries. 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 cost sharing 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 true 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.

When planning to roll out a plan on a global basis, a company should enter into discussions with administrators at an early stage. 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.
5.6 Managing the process
Rolling out a share plan to other countries can seem like a daunting and complicated task. It does not have to be. With upfront organisation, planning and sufficient time, 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 communications) 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 liabilities) to be considered and dealt with early.

With many stakeholders involved, and depending on the number of countries concerned, having a dedicated project manager may be appropriate. The project manager will, amongst other things, devise a detailed and integrated project plan, highlighting any dependencies (e.g. between the plan design and the legal and tax review) and keep track of all issues, actions and decisions.
6. Share plans in the financial services sector

In this chapter, we consider the key issues affecting employee share plans operated by listed and private companies in the financial services sector.

6.1 Overview
There are specific rules governing remuneration in the financial services sector. Although there are some differences in the rules applicable to firms in the banking, asset management and insurance sub-sectors, the rules generally relate to deferral, payment in shares or other non-cash instruments, retention periods and performance adjustment (including malus and clawback). Share plans therefore continue to play a core part in the overall reward strategies of financial services firms by constituting a key tool for enabling firms to satisfy those requirements.

6.2 Key requirements

EU regulation
Under EU rules, firms must defer a proportion of the variable remuneration which is awarded to “material risk takers” (broadly, those members of staff whose professional activities could impact a firm’s risk profile).

- Firms in the banking and asset management sectors must generally defer a minimum of 40 to 60 per cent of variable pay over at least three to five years. At least 50 per cent of that pay (taking into account both the portion paid upfront and the portion deferred) must be paid in shares or, for certain firms, other non-cash instruments. These shares or instruments must themselves be subject to a six month holding period after vesting (increasing to 12 months for firms in the banking sector from 1 January 2017).

- Firms in the insurance sector are subject to less prescriptive requirements, but must still defer a “substantial proportion” of variable pay awarded to material risk takers over at least three years. In the UK, the Prudential Regulation Authority (PRA) has confirmed that deferral of less than 40 per cent is unlikely to be considered substantial.

In addition, the Capital Requirements Directive (CRD IV) which applies to banks, building societies and investment firms, restricts the amount of variable pay which may be awarded to a material risk taker to one times their fixed pay (the “bonus cap”), although this limit can be extended to two times fixed pay with the approval of shareholders.

UK rules
The EU provisions affecting the banking and asset management sectors have been implemented in the UK through rules published by the PRA and the Financial Conduct Authority (FCA).

Following the results of the EU Referendum in June 2016, the PRA and FCA have confirmed that existing rules will continue in force and that firms should continue to prepare for the introduction of forthcoming EU legislation applicable to them. How the rules will evolve once the UK ceases to be a member of the European Union remains to be seen.

The PRA and FCA currently allow smaller firms (namely, those that do not have relevant total assets exceeding £15 billion or which are limited licence or limited activity investment firms) to disapply both the bonus cap (in the case of firms in the banking sector) and the rules on deferral, payment in instruments, retention and performance adjustment. From 2017, firms will need to ensure that they are able to justify the disapplication of these provisions as appropriate in their particular circumstances.

For larger banks, the PRA Rulebook and FCA Handbook impose more stringent requirements for deferral for particular categories of staff than is required under the EU provisions:

- For individuals identified as “senior managers” under the PRA and FCA Senior Manager Regime (for example, executive directors or heads of overseas branches), variable pay must be deferred over at least seven years, with no vesting before the third anniversary of grant and vesting no faster than on a pro-rata basis.

- For PRA-designated “risk managers” (in effect, those who have responsibility for managing or supervising risk-taking or significant risk functions who are not caught by the Senior Manager Regime – such as the heads of material business units and their direct reports, or the heads of functions such as Legal, IT, Finance and HR), deferral must be over five years, with vesting no faster than on a pro-rata basis.

- For any other material risk taker, variable pay must be deferred over three to five years, with vesting taking place no faster than on a pro-rata basis.

6.3 Long-term incentive plans
One key issue at present for firms in the banking sector is the changes that may need to be made to the structure of long-term incentive plans following the publication by the European Banking Authority of its Guidelines on sound remuneration policies under CRD IV (EBA Guidelines) in December 2015.
Due to take effect from 1 January 2017, the EBA Guidelines distinguish between awards which are based on past performance and awards which are based exclusively on future performance conditions. Under the EBA Guidelines, where an award is based exclusively on future performance conditions: (i) the deferral period will be treated as starting only on vesting and not on grant, and (ii) the award will have to be counted towards the bonus cap in the final year of the performance period (and not in the year of grant).

Firms which award variable pay well below the level of the bonus cap may be less concerned about having to count an award towards the bonus cap in the final year of the performance period. Most firms, however, are likely to be reluctant to start applying the deferral period from the date of vesting, given the extension of the payout horizon that this would mean for an award.

In order to treat the deferral period as starting from the date of grant (and to count share awards towards the bonus cap in the year of grant), firms will have to take steps to ensure that share awards granted under long-term incentive plans:

- are based on at least one year’s prior performance;
- have a forward-looking performance period of at least one year;
- are capable of being reduced if performance conditions are not met; and
- are subject to a deferral period which ends at least one year after the last performance condition is assessed.

The PRA and FCA have to date not provided any formal guidance on how they expect firms to apply these provisions (for example, how to make an award based on at least one year’s prior performance to a new joiner).

6.4 Dividend equivalents
A further key issue for firms in the banking sector is the new restriction which the EBA Guidelines impose on the payment of dividends or interest, and dividend equivalents, in respect of the deferral/vesting period. It will no longer be possible for firms to pay to material risk takers dividends on restricted shares during the deferral/vesting period or dividend equivalents, either during the deferral/vesting period or on a rolled-up basis at the end of the period.

Firms may therefore wish to consider alternative ways in which to deliver value to participants in place of dividend equivalents, including changes in the valuation methodology applied to awards, the application of a discount rate calculated in accordance with specific EBA rules and/or the making of structural changes to variable pay awards.

6.5 Malus and clawback
Firms in the banking and asset management sectors are obliged to apply appropriate malus and clawback provisions to awards of variable pay. Within the insurance sector, malus is expected.

Firms in the banking sector are subject to the most extensive requirements. They must ensure that the firm’s criteria for applying malus and clawback cover, in particular, situations where the employee participated in or was responsible for significant losses to the firm, or failed to meet appropriate standards of fitness and propriety.

As a minimum, malus must be applied where:

a. there is reasonable evidence of employee misbehaviour or material error;

b. the firm or relevant business unit suffers a material downturn in its financial performance; or

c. the firm or relevant business unit suffers a material failure of risk management.

Firms must make all reasonable efforts to operate clawback in the case of (a) and (c) above.

The EBA Guidelines provide that malus or clawback should also be applied (i) where there are significant increases in the firm or business unit’s economic or regulatory capital base and (ii) where any regulatory sanctions have been imposed and the conduct of the individual contributed to the sanction. The EBA Guidelines state that clawback should be applied, in particular, where the individual contributed significantly to subdued or negative financial performance or where there was fraud or other conduct with intent or severe negligence which led to significant losses.

Under UK rules, share awards granted to material risk takers by larger firms in the banking sector must now be subject to clawback for seven years from the date of award. For “senior managers” identified under the Senior Manager Regime, firms are obliged to extend the clawback period to up to ten years where, at the end of the seven year period, there is an internal or external investigation underway that could potentially lead to the operation of clawback.
7. Accounting and funding

7.1 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 under IFRS 101 and FRS 102. 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. However, the funding choice can have an impact on the economic cost of the plan and we address some of the considerations in this chapter.

7.1.1 Summary of accounting treatment

Provided the awards are accounted for as equity-settled (see section 7.1.5), 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 on the expected future performance of the company and is 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 an equity-settled award does not change once it has been calculated at grant (other than if there is a modification to the award), 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.

7.1.2 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 a 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.

7.1.3 Performance conditions

The type of performance condition can have a significant impact on the accounting charge. For the purposes 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). However, adjustments can be made to the accounting cost for any awards that lapse due to failure to meet a service condition or a non-market based condition.

In the case of a market based performance 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 have to be recognised even if the full award lapses and employees do not receive shares. However, adjustment can be made to the accounting cost for any awards that lapse due to failure to meet a service condition or a non-market based condition.

In the case of a non-market based performance condition, the IFRS 2 charge is adjusted at each 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.

7.1.4 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.

7.1.5 Equity-settled or cash-settled awards

A share based award can either be equity-settled or cash-settled and this can have a 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 based performance 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.

### 7.1.6 Balance sheet

The entry in 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 vesting or exercise.

### 7.1.7 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.

### 7.2 Funding

The source of the shares used to satisfy awards will not have an impact on 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 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.

If shares are newly issued, 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, but there is no dilution. 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. However, existing shareholders may not agree to the dilution of their holdings through the use of newly issued shares.

### 7.2.1 Cost control

A company may wish to develop a hedging strategy to manage the costs of satisfying awards made under employee share plans. 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. The strategy requires various factors to be taken into account and assumptions to be made about certain issues, including share price movements, satisfaction of performance conditions and leaver rates.

### 7.2.2 Internal hedging

By purchasing shares in advance of the delivery date, 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 offshore EBT, with the trustees agreeing to waive dividends.

By purchasing shares in advance, the company can manage the risk of the share price increasing. However, the company will lose the opportunity to purchase shares at a lower price if the share price falls. The company will also be committing cash in advance of the shares being required to satisfy the share plan awards and this involves taking risk on the number of shares which will ultimately have to be delivered under the plan.
7.2.3 External hedging
For large listed companies which operate significant share plans, it may be possible to enter into hedging arrangements with a third party, typically a bank. There are several different structures which 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.

7.3 Net settlement
Many jurisdictions oblige employers to withhold the amount of an employee’s tax liability due on a share-based payment (such as shares delivered on the vesting of a share award) and to pay the amount deducted to the tax authorities.

To meet this obligation, some companies deduct from the total number of shares to be delivered to the employee a number of shares with a value equal to the employee's tax liability. The company then pays the amount withheld to the tax authorities from its own resources. This is known as 'net-settlement'.

The International Accounting Standards Board (IASB) was asked to consider whether the portion of the share-based payment that is withheld under net-settlement should be classified as a cash-settled or equity-settled share based payment. Following a period of consultation, it was agreed that IFRS 2 should be amended such that where a share-based payment is net-settled by withholding a specified portion of the shares to meet a statutory withholding obligation, the transaction should normally be accounted for as equity-settled in its entirety. This will however not apply to shares withheld in excess of the amount required to satisfy the tax obligation. The final amendments to IFRS 2 were issued in June 2016 and companies are required to apply the amendments for annual periods beginning on or after 1 January 2018. Earlier application is permitted. Based on our latest Global Share Plan Survey, 33% of companies always net-settle executive share awards with a further 29% of companies sometimes net-settling awards. As such, these changes may have an impact on a large number of companies and we also expect other companies to start net-settling awards given the reduction in income statement volatility. Net settlement also has a number of advantages compared to the other alternatives (such as ‘sell to cover’) including reduction in share usage, elimination of sales in the market to cover tax and removal of dealing costs. Where a company net-settles their share-based payments it is important to take appropriate advice to consider, for example, the impact on cash and the availability of a corporate tax deduction.
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