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UK Tax–Favoured Share Plans: What's Next?

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The UK can claim to have among the best tax incentives in the world for employees to acquire shares in their employing companies. The three types of 'approved' share plan, together with Enterprise Management Incentives, provide valuable tax reliefs for a variety of different employee share acquisition arrangements.

However, many of these plans are based on legislation first introduced more than 30 years ago. Remuneration practice has changed considerably over this period. The All-Employee plans, in particular, have cumbersome structures which require complicated administrative arrangements. Moreover, the UK legislation is substantially different from that in other countries (with the exception of the Irish Republic), which can make extending share plans to employees around the world a complex exercise.

So what should the UK's new Coalition Government be doing about tax-favoured share plans? This article describes how we got to where we are now and suggests a way forward.

EMERGENCE OF ALL-EMPLOYEE SHARE PLANS

The founding blocks for All-Employee share plans in the UK were Approved Profit Sharing (APS) schemes, introduced in the Finance Act 1978, and approved Save As You Earn (SAYE) share option schemes, which were introduced in the Finance Act 1980. (Strictly, I should say "re-introduced". There was similar legislation in the Finance Act 1973, but this was repealed in 1974 by the incoming Labour Government.)

Part of the impetus for this legislation was an attempt to correct perceived faults in the capitalist system. A survey published by the *Financial Times* in 1975 revealed that only 3.8% of people of working age and above directly owned any shares. In addition, the 1960s and 1970s had seen significant disruption through industrial relations disputes. George Copeman, an early advocate of employee share ownership, argued:

> "There are two rewards to be reaped from business success ... – income and capital growth. These two rewards should both ... be shared with employees."

He went on to say the view that only income should go to employees was a basic cause of the industrial relations troubles in industry, noting that capital wealth had remained in relatively few hands. Copeman viewed this as being the Achilles' heel of the free enterprise system.[1]

It was believed that, if employees became direct owners of shares and could benefit in the growth in value of the business, they would identify more closely with the company and its success. In addition, they would be more likely to support reinvestment of profits in the business and a longer-term outlook.

The experience of one major company also influenced the design of the All-Employee share plans. Imperial Chemical Industries (ICI) was a pioneer when it first issued shares to its employees in 1954. The shares were made freely saleable. There were stories in the media of "stockbrokers at the factory gates" encouraging the employees to sell their shares. (This myth of employees selling shares was later proved to be largely false. ICI conducted a survey of its share register 17 years after the employee share plan was started. It was found that 37% of all the shares ever issued to employees were still in the same hands.)

A major principle of the new legislation was that employees should become entitled to direct ownership of shares in their employing company (or parent company). An indirect interest, for example through collective ownership, was considered a less effective way of engaging and motivating employees.

A second principle, based on the ICI experience, was that there should be a holding period before employees could sell their shares.

The Inland Revenue (as HM Revenue & Customs was then called) naturally imposed limits on the value of shares that could be acquired through the new All-Employee share plans, to restrict the cost to the taxpayer. A condition of the tax relief was that all employees should be eligible to participate and on an equitable basis. It also put in strict conditions on the type of shares which could be provided. These could only be ordinary shares (equivalent to common stock). As a counter against tax avoidance arrangements, shares could not have any restrictions attached to them that did not apply to shareholders generally. This concern with tax avoidance has continued to have a strong influence on share plan tax legislation ever since.

Approved Profit Sharing Schemes

Tax relief for APS schemes was introduced in the Finance Act 1978 as one of the conditions of the pact at that time between the Labour Government and the Liberal Party. Each employee could be awarded shares worth up to the *greater* of £1,250* and 10% of their taxable earnings (up to £5,000) in any tax year. The employees were required to leave the shares with the plan trustees for at least two years and, if they were left in for at least seven years, the shares could be withdrawn free of income tax. No national insurance (social security) contributions (NICs) were payable on the shares (see BOX 1 below for more details of APS schemes).

Approved SAYE Share Option Schemes

The new Conservative Government further encouraged the growth of All-Employee share plans by introducing tax relief for SAYE schemes in the Finance Act 1980. Employees could save up to £50 per month over a five-year period. At the end of this period, they could exercise an option to use the proceeds of their savings (and a tax-free bonus) to buy shares at 90% of the share price at the start. Alternatively, they could leave their savings in the account for a further two years (earning an additional tax-free bonus) and buy a larger number of shares at the end of the seven years. Although there was no subsequent holding requirement for the shares, employees had to commit to the plan for a considerable period. No income tax or NICs were payable on the difference between the value of the shares when they were bought and the price paid (see BOX 2 below for more details of SAYE schemes).

Although employees who acquired shares through the APS and SAYE schemes were potentially liable to capital gains tax (CGT) when they sold their shares, most employees' gains were covered by the annual CGT exemption and so they could both acquire and dispose of their shares without any tax liability.

Over the years, the Government gradually improved the terms of these two All-Employee share plans. For example:

APS schemes. The limit to the value of shares awarded increased to the *greater* of £3,000 and 10% of their taxable earnings (up to £8,000) in any tax year and full income tax relief was given if the shares were left in the plan for only three years.

SAYE schemes. The limit to monthly savings increased to £250, the price discount was increased from 10% to 20% and a shorter three-year savings period was introduced.

DISCRETIONARY (OR EXECUTIVE) OPTIONS

The Conservative Government waited until the two All-Employee share plans had become established before introducing tax relief for Approved Discretionary Share Option Schemes in the Finance Act 1984. The model was the executive share option plans which were becoming prevalent at that time. These Discretionary

* €1 = £0.89; US$1 = £0.63 as at 15 October 2010

BOX 1 — **Approved Profit Sharing Schemes**

Introduced in the Finance Act 1978, these plans provided tax relief for awards of free shares to employees. They were discontinued in 2002, having been replaced by SIPs. By that time, employees could be awarded shares in their company worth up to the *greater* of £3,000 and 10% of their taxable earnings (up to £8,000). These shares had to be left with trustees for a retention period of two years and were exempt from income tax if the shares were left in the trust for at least three years. (There was never any NICs liability.) On disposal of the shares, there was a potential capital gains tax (CGT) charge on any increase in value since the original award date, but most employees would have been covered by the annual CGT exemption (£7,700 in 2002/03). The employing company could claim a corporation tax deduction for the cost of the shares awarded to its employees.

Shares had to be offered to all employees who met a qualifying period of service, not exceeding five years. They had to be awarded to participants on "similar terms", which could include variation for remuneration levels or length of service. Some companies offered matching offer plans, through which free shares were awarded to match shares that the employees had acquired through contributions out of their after-tax earnings.

BOX 2 — **Approved SAYE (or Sharesave) Share Option Schemes**

Introduced in the Finance Act 1980, these plans give employees the opportunity to save the funds needed to exercise share options. Employees can now save up to £250 per month for three or five years. At the end of the savings period, they become entitled to a tax-free bonus in place of interest. At the end of a five-year contract, they can leave their savings in the account for a further two years, after which they earn a second tax-free bonus. When they start saving, they are granted an option to acquire shares in their company at the end of the three-, five- or seven-year savings contract. The exercise price must be at least 80% of the share price at the time of grant. Participation must be offered to all employees who meet a qualifying period of service, not exceeding five years.

There is normally no income tax or NICs liability when options are exercised. On sale of the shares, there is a potential CGT charge on the difference between the sale proceeds and the price paid, but most employees are covered by the annual CGT exemption (£10,100 in 2010/11). The employing company can claim a corporation tax deduction for the difference between the value of the shares on the exercise date and the price paid by its employees.

BOX 3 **Approved Company Share Option Plans**

Introduced in the Finance Act 1984, the company can select which employees are granted options under these plans and the size of grant and other terms and conditions for each individual. Directors can only be eligible if they work at least 25 hours per week. An individual can be granted approved options over shares worth up to £30,000 – this is not an annual limit, but includes all options that are still subsisting. The option exercise price must be no less than the market value of the shares at the grant date.

Provided that the option is exercised between the third and the 10th anniversaries of grant, there is no income tax or NICs liability on exercise. On sale of the shares, there is a potential CGT charge on the difference between the sale proceeds and the price paid, but this may be reduced or eliminated by the annual CGT exemption. The employing company can claim a corporation tax deduction for the difference between the value of the shares on the exercise date and the price paid by its employees.

Schemes were considerably more flexible than the All-Employee ones. The company could choose which individuals would be granted share options and the size of the grant and other terms and conditions could vary for each participant. In practice, they have been used mainly for grants to executives.

Income tax relief was given on the exercise of these approved options provided that they were exercised at least three years after the grant date. The gains were subject to CGT on disposal of the shares, but the CGT rate at the time was 30%, compared with a top income tax rate of 60%, and so there was a significant advantage. The maximum value of shares over which options could be granted to any individual was the *greater* of £100,000 and four times taxable earnings. This four times earnings limit was similar to what was permitted at the time by institutional investors. In retrospect, it was extremely generous.

1995 Changes

The beneficial tax treatment for Discretionary Share Options lasted just over 10 years, although its attractiveness had been reduced in 1988, when the top income tax rate was reduced to 40% and the CGT rate was aligned with the individual's marginal income tax rate. The advantages of approved options were then that the tax charge could be deferred until the shares were sold and then reduced by the annual CGT exemption (£5,000 in 1988/89) – perhaps for more than one tax year and including the spouse's exemption.

By the mid-1990s, there was considerable bad publicity about excessive executive pay – which has continued ever since! As part of the Government's response to this, it commissioned the Greenbury Report on remuneration of directors in public companies. The recommendations of this report, published in 1995, included the removal of tax relief for Discretionary Share Options on the grounds that:

– it was no longer necessary to provide tax incentives for executive options because they had become an established part of executive remuneration; and

– there was no longer a case for different tax treatment to favour share options over the other types of executive long-term incentive plan which were becoming more common.

The Government at first accepted the recommendation. However, there were vociferous objections from certain employers, notably the food retailer ASDA, which had offered Approved Discretionary Share Options to its employees generally. As a result, the Government agreed to maintain tax relief for these plans, which it re-named Company Share Option Plans (CSOPs), but reduced the value of shares that could be subject to options to £30,000 (see BOX 3 above for more details of CSOPs).

SIPs AND EMI PLANS

The new Labour Government, which came into office in 1997, was initially enthusiastic about promoting share plans. A consultation paper on Employee Share Ownership, which it issued in December 1998[2], supported:

"... employee share ownership schemes which involve the widest range of employees for two reasons:

- Productivity. Employee share ownership has a contribution to make towards increasing Britain's productivity ... by harnessing the ambition of employees to see the company in which they work succeed.

- Fairness. The All-Employee tax-advantaged schemes promote enterprise for the whole workforce and not just a few senior staff. They help all employees to share in the success of the company."

It went on to say:

> "Employee share ownership can have important benefits for employees. These benefits mean that employees are often keen to participate in employee share schemes. They become more aware of their company's aims and objectives, more committed to their company and aware of its overall performance. On a personal level, employees feel that share schemes help them to save for the future and help to introduce them to holding shares more generally."

The consultation paper went on to say that the current share plans did not promote long-term shareholding of shares effectively. In particular, research confirmed that the majority of SAYE scheme participants disposed of their shares as soon as they were able to. The Government wanted to encourage the longer-term holding of shares by employees and to encourage more companies, particularly smaller and unquoted ones, to offer All-Employee share plans.

Following the consultation, tax relief was introduced for two new share plans in the Finance Act 2000.

Approved Share Incentive Plans

The first new plan was originally called the All-Employee Share Ownership Plan (AESOP), though it was renamed the Share Incentive Plan (SIP) in a re-launch two years later. It was heralded as "the most tax-advantaged All-Employee share scheme ever seen in the UK".

The Government said that:

> "This new plan is a cornerstone of the drive to tackle the productivity gap and promote a high investment Britain, a Britain where we reward enterprise and provide fairness for all. Only by pursuing both enterprise and fairness together can we equip Britain for the future and secure rising living standards for everyone."

SIPs were closely based on the APS schemes, which they replaced, but have a number of advantages including the following:

- Shares (called 'free shares') can be awarded to employees with reference to the performance of business units, or possibly even that of individual employees.
- Employees can make contributions to buy shares ('partnership shares') from their salaries before deduction of income tax and NICs.
- Shares bought with employee contributions can be matched with further tax-relieved shares ('matching shares').
- Dividends can be reinvested into the plan ('dividend shares').
- Shares can be left in the plan trust indefinitely while the participant remains employed and any increase in the share value during this time is exempt from CGT.
- When participants leave employment, their shares cease to be subject to the plan, and so there is no longer a need for companies to hold shares for employees who have left.

One disadvantage, compared with APS schemes, is that employees are not able to take their shares out of the plan tax free until five years after the acquisition date. As mentioned above, although the equivalent period for APS schemes had started as seven years, it was gradually reduced to three years. The five-year period for SIPs has been found to discourage some employees from participating.

A few improvements were made to the SIP legislation up to 2003. However, the limits to the size of awards have not been increased and the five-year period has remained unchanged (see BOX 4 below for more details of SIPs).

Enterprise Management Incentives

The second new plan introduced by the Finance Act 2000 was the Enterprise Management Incentive (EMI)

BOX 4

Share Incentive Plans (previously known as All-Employee Share Ownership Plans)

Introduced in the Finance Act 2000, SIPs allow employees to acquire shares in their company in four different ways:

Partnership shares. Employees can buy shares through deductions from their pre-tax and pre-NICs salaries of up to £1,500 p.a. (or 10% of taxable earnings, if less). Shares can be purchased monthly at the then current market price. Alternatively, they may be purchased at the end of an accumulation period of up to 12 months. If there is an accumulation period, the employees pay the lower of the share prices at the beginning and the end of the period.

Matching shares. The company can match each partnership share with up to two matching shares, i.e. worth up to £3,000 p.a. If wished, there can be a lower matching ratio, e.g. one matching share for every two partnership shares.

Free shares. The company can award each employee shares worth up to £3,000 p.a. The shares must be allocated between employees on the "same terms", which allows for variation by reference to remuneration levels, length of service or hours worked. Alternatively, the shares can be awarded based on the performance of business units.

Dividend shares. Dividends paid on shares held in the plan, up to £1,500 p.a., may be reinvested to acquire further shares for participants. Matching shares and free shares must be left in the plan trust for a holding period of between three and five years. The holding period for dividend shares is three years. A SIP can provide that matching and free shares will be forfeited if a participant leaves employment, except in certain special circumstances, before the third anniversary of the award date. Matching shares may also be forfeited if the corresponding partnership shares are taken out of the plan within three years.

There is no income tax or NICs liability provided that the shares are left in the trust for at least five years (three years for dividend shares). Any increase in the value of the shares while they are held in the plan is free from CGT. The employing company can claim a corporation tax deduction for the cost of awarding matching and free shares and for any discount given for partnership shares (if there is an accumulation period). All employees must be eligible to participate provided that they have been employed for a qualifying period of no more than 18 months (six months for partnership shares if there is an accumulation period).

plan. This is a share option plan, though options can be granted with an exercise price at a discount to the share price at grant. EMI plans are aimed at encouraging high-quality managers to join small high-risk companies. Individuals can be granted options over shares worth up to £120,000 each (originally £100,000), which is significantly higher than under a CSOP. They have a similar tax exemption to the CSOP, relief from income tax at exercise, but without the three-year waiting period before they can be exercised. They are, however, only available to smaller companies. There is a gross assets limit of £30 million, originally £15 million (see BOX 5 below for more details of EMI plans).

ASSESSMENT OF TAX-FAVOURED SHARE PLANS

There has been a considerable amount of research over the years, which has suggested that there are positive benefits from employee share ownership. For example, a report on share plans by the accounting firm KPMG, published by the Inland Revenue in October 1991, found that, “Schemes had a positive effect on employees’ attitudes, productivity and staff retention”. Another study published by HM Revenue & Customs (HMRC) in September 2008[3] made the following findings:

- 87% of employers with SAYE schemes and 82% of those with SIPs reported positive effects on relations between the organization and its employees.
- 51% of employers with SAYE schemes and 50% of those with SIPs reported that the plans had had a positive effect on productivity.

Many factors affect the success of businesses and it is impossible to establish a clear link with the operation of share plans but it is generally accepted that they have contributed towards improved industrial relations, employee loyalty and productivity.

How widespread have tax-favoured share plans become? TABLE 1 opposite shows first how popular the approved share plans were in 1997/98, when the Labour Government came to power. More than 1,300 companies operated both types of All-Employee share plan, each type with roughly one million participating employees. More than 4,000 companies granted options under approved CSOPs.

The Government introduced SIPs in 2000 with the aim of encouraging more companies, particularly smaller and unquoted ones, to offer All-Employee share plans. However, the figures show that in 2008/09, fewer companies operated SIPs than the number that had awarded shares under APS schemes 11 years earlier. Moreover, the average number of employees per company who were awarded free shares under a SIP was 3,278 in 2008/09, compared with the equivalent figure of 720 for APS schemes in 1997/98. This suggests that SIPs are operated, on average, by much larger companies than APS schemes had been.

The number of companies with SAYE schemes has fallen by 39% since 1997/98, but the average number of participants has only fallen slightly. These have historically been operated more by larger companies and this position does not seem to have changed.

The number of CSOPs operated has more than halved and the average number of participants per company has fallen dramatically, from 74 to 19. This probably reflects partly how much the £30,000 individual grant limit has fallen in value since it was introduced in 1995 and partly the more general shift away from share options to performance share and deferred share awards.

EMI plans have, however, been extremely successful. More than 2,500 small companies, with gross assets below £30 million, granted EMI options in 2008/09. They have therefore successfully met the objective of extending share plans to smaller companies. With an average of nine participants per company, these are not normally offered to employees generally. In line with the Government’s purpose of introducing EMI plans, they seem to have been used primarily to incentivize management.

IDEAS FOR IMPROVING THE LEGISLATION

The new share plan legislation introduced in 2000 has clearly not met the objectives of dramatically increasing the number of companies operating All-Employee share plans and particularly of extending these plans to smaller companies. I recommend that the new Coalition Government should consider taking

BOX 5 — **Enterprise Management Incentives**

Introduced in the Finance Act 2000, these plans can only be operated by companies whose gross assets do not exceed £30 million and have fewer than 250 employees. Companies in certain sectors, including financial services and property, are excluded from operating them.

The company can select which employees are granted options and the size of grant and other terms and conditions for each individual. To be eligible, an employee must be required to work at least 25 hours per week or, if less, at least 75% of his/her working time for the company. An individual can be granted approved options over shares worth up to £120,000 – this limit applies both to EMI options subsisting at any time and to the options granted in any three-year period. There is no minimum exercise price or holding period before an option can be exercised.

If the exercise price is no less than the market value of the shares at grant, there is no income tax or NICs charge on exercise. On sale of the shares, there is a potential CGT charge on the difference between the sale proceeds and the price paid, but this may be reduced or eliminated by the annual CGT exemption. The employing company can claim a corporation tax deduction for the difference between the value of the shares on the exercise date and the price paid by its employees.

TABLE 1 Companies Operating Share Plans and Number of Participants

	1997/98			2008/09		
	Companies	*Participants*	*Average no. of participants per company*	*Companies*	*Participants*	*Average no. of participants per company*
Profit sharing (APS)	1,334	960,000	720	n/a	n/a	n/a
SIP						
Free shares	n/a	n/a	n/a	180	590,000	3,278
Partnership shares	n/a	n/a	n/a	420	354,000	843
Matching shares	n/a	n/a	n/a	270	234,000	867
SAYE	1,310	1,170,000	893	800	640,000	800
CSOP	4,480	330,000	74	2,150	40,000	19
EMI	n/a	n/a	n/a	2,550	22,000	9

NOTE: HMRC's figures for number of participants in SIP partnership share and matching share awards have been divided by 12 because the statistics refer to the total number of awards each year and these shares are normally awarded monthly. Free shares are normally awarded once a year.

Source: HM Revenue & Customs website

the following measures to improve the legislation for tax-favoured share plans.

Keep the Individual Limits Up To Date

The current participation limits for individuals were set in 1991 for SAYE schemes, 1995 for CSOPs and 2000 for SIPs. Over the years, these plans have gradually become less attractive as a result. It may not be a good time now for increases in these limits, in the light of forthcoming government expenditure cuts. However, the principle of updating limits on a regular basis, to keep them in line with inflation, should be adopted as soon as practicable.

The current £30,000 limit, which applies to all subsisting CSOP options, is confusing for many companies and adds to the complexity of record keeping. An annual limit would be much easier to administer. For example, the annual limit could be set at £10,000 or there could be a limit of £30,000 for all CSOP options granted over a rolling three-year period.

Relax the Detailed Provisions of the Legislation

The conditions for approval by HMRC of SIPs and SAYE schemes are extremely detailed and prescriptive. As a result, the plans can be cumbersome and costly to administer. This makes them unsuitable for smaller companies. In addition, it is more difficult for plans set up by parent companies in other jurisdictions to extend their home country plans to their UK employees. Completely separate plans normally have to be set up for the UK, which means that many companies decide not to offer shares to their UK employees.

SIPs could be simplified, as follows:

- Combine the limits for free and matching shares.
- Remove the 2 for 1 cap on matching shares (while keeping within the £6,000 limit for both free and matching shares).
- Remove the need for SIPs to be operated with a trust.
- Allow shares to be withdrawn tax-free after three years.

SAYE schemes could be simplfied, as follows:

- Allow options to be exercisable at any time between three and 10 years from grant.
- Allow different kinds of savings accounts, including those offering variable rates.
- Allow the maximum number of shares under option to be fixed at grant. At the moment, where the option exercise price is set in a foreign currency, HMRC will not allow the number of shares under option to be determined at the grant date.

These are just examples of the many simplifications that could be made.

Extend Discretionary Share Awards

Tax relief can be given for grants of discretionary share options under the CSOP legislation; however, there is no equivalent tax relief for discretionary share awards. The CSOP legislation should be expanded so that tax relief is also given on the vesting of share awards, but only in respect of any increase in share value after the grant date. This will then mirror the position for French qualified share awards, as well as EMI options granted at a discount.

Allow Subsidiary Company Shares to be Used

The approved share plan legislation has always prevented plans being operated using shares in subsidiaries of unlisted companies. A further restriction was imposed this year on CSOPs, so that companies can no longer offer options over shares in the subsidiaries of listed companies. This restriction has

unnecessarily prevented stand-alone subsidiary companies from providing direct incentives for their employees in a company whose performance they can influence, rather than in some distant parent. In addition, companies that are taken over by private equity consortia have been forced to abandon their approved share plans.

SHARE PLAN LEGISLATION COULD PLAY A PART

This is a difficult time for British industry. The Government needs to use all the tools available to help it to boost productivity. Making these few basic enhancements to the share plan legislation could play an important role in achieving the desired recovery and future economic growth. Ω

References

[1] George Copeman, Peter Moore and Carol Arrowsmith, *Shared Ownership*, Gower, 1984. This book has been drawn on for some of the other information in the first section of this article (on the emergence of All-Employee share plans).

[2] 'Consultation on Employee Share Ownership', issued by the Inland Revenue on 18 December 1998.

[3] 'Evaluation of Tax-Advantaged Share Schemes', prepared for HMRC by the National Centre for Social Research, September 2008.

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