CHAPTER 33

INTRODUCTION TO SHARE SCHEMES

33.1 Introduction

This is the first of six short chapters which will cover all of the various types of share incentive schemes and share option schemes which are currently available. In order **for a share scheme to obtain tax and NIC advantages,** it must **first obtain approval from HMRC.**

At present there are four types of approved share schemes. In the next chapter we shall look at **Share Incentive Plans (SIPs).**

ITEPA 2003, s.488 -515 & Sch 2

The second type of approved share option scheme is called a **"Savings Related" Share Option Scheme.**

ITEPA 2003, s.516 -520 & Sch 3

We shall also look at approved "**Company Share Option Plans**" which are very popular in practice as they allow employers to offer share incentives to selected members of the workforce.

ITEPA 2003, s.521 -526 & Sch 4

Finally, we shall look at another type of share incentive, that being **Enterprise Management Incentives (EMI).**

ITEPA 2003, s.527 -541 & Sch 5

All of the above schemes, assuming they have Revenue approval, will have certain tax and NIC advantages. These low tax schemes generally enable a company to award shares to its workforce free of tax and National Insurance.

Share schemes which do not obtain HMRC approval are called **unapproved schemes**. The key difference between an approved scheme and an unapproved scheme is the lack of tax and NIC advantages offered where employees receive shares from an unapproved scheme. We shall look at unapproved schemes in a later chapter.

33.2 General Principles

When an employer company grants a share option to an employee, the employee is receiving a piece of paper which gives him the right to acquire shares in the employer company within a specified period of time.

It is important that you are comfortable with the term **"share option".** An **option** is a **right to acquire an asset in a given time window** – in this instance the asset is shares in the employer company.

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At some point in the future the employee will "**exercise**" this share option. This simply means that the employee will take up his right to buy shares in the employer company.

Only on the exercise of the option will the shares physically pass to the employee. Shares do not pass on the granting of an option. It is only at the point of exercise that the employee will actually acquire the shares.

These are the key features of a typical share option scheme. There are different types of share option scheme, and the ways in which an employee will acquire shares will differ from scheme to scheme. The detailed rules will be covered in later chapters.

33.3 Reasons for setting up schemes

There are three main reasons why an employer will install a share incentive scheme. Shares may be awarded to employees as **remuneration for services**. In essence, employees may be paid bonuses in share form rather than in cash.

Secondly, where the employee is being remunerated in share form, this will act as a **performance incentive**. The idea here is that the employee works hard, and by his effort the value of the shares in the company increase, thereby giving him additional profits.

Perhaps the most important reason why a company will install a share option scheme is for **the retention of their staff.** In the majority of the share option schemes we will look at, the employee is not allowed to exercise his options – and as such, is not permitted to acquire any shares – until he has been with the company for a minimum period of three years. In a world where workers are increasingly mobile, and regularly move from job to job, share incentive schemes are an effective way of retaining employees in the short to medium term.

33.4 *Gift of shares to employees*

ABC plc, an employer company, could give shares in ABC plc to one of its employees. This arrangement is **not** a share option. Note that the employee is not being given the right to buy shares – the employee is actually being given the shares themselves.

When free shares are given by an employer to an employee, there will normally be a charge on the employee at the date of the gift. If an employer transfers an asset to an employee at a nil or reduced cost, this will give rise to a taxable benefit in the hands of the employee.

The next thing to consider is whether the shares constitute a readily convertible asset. If the shares are in a company which is listed on a Stock Exchange – as will be the case for quoted companies such as ABC plc – the shares will be readily convertible.

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"Readily convertible" means that it is **easy for the employee to turn these assets into cash overnight.** If you remember back to your PAYE chapters, if an employee is remunerated in the form of a readily convertible asset, tax must be withheld at source under the PAYE system.

ITEPA 2003, s.702

Payments by way of readily convertible assets are also regarded as earnings for NIC purposes.

Moving on to **unlisted shares** - i.e. shares that are not quoted on a recognised Stock Exchange – as a general rule these will not be regarded as readily convertible assets. This is because it can be difficult to convert unquoted shares into cash as there is no recognised market for unlisted shares.

Generally speaking, unquoted shares will only be regarded as readily convertible assets if there is an **arrangement in place for them to be sold**. This means that if an employer gives unquoted shares to one of its employees, then subsequently assists the employee in selling the shares, the shares will be readily convertible.

An award of unquoted shares which are not readily convertible assets will not be regarded as **earnings for NIC purposes** and will not give rise to a NIC charge in the hands of either the employee or the employer. In addition, the gift will not be subject to PAYE.

Instead an award of unquoted shares will be treated as a benefit and the employee will suffer tax on the value of the shares through the self assessment system.

However, even if shares would not otherwise be considered readily convertible assets, they will be treated as such unless the employer can obtain a corporation tax deduction in respect of the award of the shares under Part 12 CTA 2009. Shares acquired under approved schemes will qualify for corporation tax relief. For shares acquired under unapproved schemes conditions must be met in respect of the type of shares and the company itself.

ITEPA 2003 s.702(5A)

Corporation Tax Act 2009, Part 12

For example, B Ltd is controlled by A Ltd. If B Ltd awarded shares to its employees, even though the shares are not listed they would still be considered readily convertible assets. B Ltd cannot get a corporation tax deduction in respect of the shares under as the shares do not meet the conditions of s.1008 CTA 2009.

Corporation Tax Act 2009, s.1008

33.5 PAYE implications of share gifts

ITEPA 2003, s.696

When **shares** which are readily convertible assets (or treated as such) **are gifted by a company** to one of its employees, the **market value of the shares is treated as PAYE income** from the employment **at the date of the gift.** This amount is entered on to the PAYE deduction card by the employer.

Tax is calculated on these deemed earnings in the normal way. This means that we pretend that the market value of the shares is earnings subject to PAYE and we calculate the tax to be withheld using the employee's tax code. The resulting tax figure is then deducted from gross cash pay in the particular month.

There is no restriction on the amount of tax to be withheld in this instance. You will recall from your PAYE chapters, that when a "K" code is in operation, the amount of tax to be withheld cannot exceed 50% of the gross pay for the period. This rule does not apply in the case of tax on readily convertible assets. The effect of this will be that, in the majority of instances, the employee will be left with no net pay for that particular period.

If the tax to be withheld under PAYE exceeds the gross amount of cash pay for the month, the employer will do two things.

ITEPA 2003, s.222(1)(b)

Firstly, the employer is required to **pay all of the tax** that should be deducted, to HMRC on the normal due date. You will recall that the normal due date for tax under PAYE is 14 days after the end of the tax month – i.e. **by the 19th of the month.** Having paid all of this tax to HMRC, the employer will **then have to recover any additional tax from the employee.**

ITEPA 2003, s.222(1)(c)

If the employee fails to reimburse the employer for the tax deducted within **90 days** of receipt of the shares**,** this additional tax is itself subject to Class 1 NIC as earnings for the period in which the 90th day falls. The unpaid tax should also be reported as a benefit on the employee's P11D at the end of the year. This is a logical principle because the tax on the readily convertible asset is the employee's liability and, if the employer settles this liability on behalf of the employee, this will give rise to an additional benefit.

An alternative would be to enter into a loan arrangement. In essence, the employer lends the employee the money to meet the PAYE liability, then allows the employee to reimburse this amount in instalments over a pre-arranged period. In this case, there will be a loan between the employer and the employee. This will give rise to a loan interest benefit.

Illustration 1

In January 2011, ABC Plc transferred shares worth £20,000 to an employee. The employee has a gross monthly salary of £3,000. The figure to be entered on the PAYE deduction sheet is the gross earnings for January 2011, which is the cash salary plus the market value of the shares – these total £23,000. Tax on this £23,000 will be calculated in the normal way using the employee's tax code. Here we assume that the tax to be withheld comes out to be £8,500. In practice this figure will be ascertained from the employer's tax tables.

This will leave the employee with net earnings of £14,500 in the period.

	£
Gross earnings	23,000
Less: income tax	(8,500)
Net earnings	£14,500

The employee's gross cash pay for the month is £3,000. However, the employer will need to deduct total tax under PAYE of £8,500 and pay this amount to HMRC no later than 19 February 2011. The employer will duly deduct £3,000 from the employee's gross cash pay, leaving the employer with a net deficit of £5,500.

	£
Gross cash pay for month	3,000
Less: tax due	(8,500)
Deficit	**£(5,500)**

The effect of this is twofold. Firstly, the employee is left with no net cash pay for this particular month. The second implication is that the **employee now owes his employer tax of £5,500.** The employee should reimburse the outstanding tax liability within **90 days**.

If the employee does not reimburse this liability within 90 days the £5,500 will be an additional benefit in the hands of the employee. In addition, it will be treated as additional earnings for Class 1 NIC purposes.

33.6 NIC implications of share gifts

As for PAYE, if the shares are readily convertible assets they will be regarded as **earnings for Class 1 NIC purposes** so the employee will be liable for Class 1 primary National Insurance Contributions.

Employees have an upper earnings limit for Class 1 purposes so earnings in excess of this limit will only be charged at the additional rate of 1%. Therefore, the value of a readily convertible asset will give rise to a reduced NIC liability on the employee if his other earnings in that particular month are above the upper limit.

Any employee NIC due in respect of the shares should be deducted from cash payments to the employee in the same month. If there is insufficient cash pay, the NIC due can be collected from subsequent cash payments made in the same or the following tax year.

Similarly, payment in the form of a readily convertible asset will also constitute earnings for Class 1 secondary NIC purposes. There will always be a Class 1 secondary NIC charge on the employer at the full rate because there is no reduced rate for employer's contributions.

An award of unquoted shares which are not readily convertible assets will not be regarded as **earnings for NIC purposes** and will not give rise to a NIC charge in the hands of either the employee or the employer.