CHAPTER 34

SHARE INCENTIVE PLANS (SIPs)

34.1 Introduction

The SIP enables an employee to receive shares in his employer company in a variety of different ways.

ITEPA 2003, s.488 -515 & Sch 2

The various statutory provisions which deal with Share Incentive Plans collectively comprise the "**SIP code**". The rules dealing with tax charges and PAYE deductions on SIP shares are contained at Sections 488 to 515 of ITEPA 2003. The approval procedures and the general rules regarding the operation and administration of a SIP are given in Schedule 2.

34.2 Shares acquired from a SIP

Initially an employee can receive **"Free Shares"** with no income tax or NIC consequences. Free shares means exactly what you would expect – i.e. the employee receives them from his employer completely free without having to pay for them. As we shall see later, these shares can also be sold without the employee having to pay capital gains tax.

ITEPA 2003, Sch 2 Part 5

The SIP also enables employees to **purchase new shares** in their employer company and, at the same time, obtain income tax relief on the purchase. Shares purchased in this way under a SIP are known as "Partnership Shares".

ITEPA 2003, Sch 2 Part 6

If an employee purchases partnership shares under a SIP, he may be entitled to receive additional free shares. These extra free shares are known as "Matching Shares".

ITEPA 2003, Sch 2 Part 7

Finally, a SIP enables employees to **re-invest their dividends in order to purchase additional shares in the company**. These shares purchased out of dividend income are known as "Dividend Shares".

ITEPA 2003 Sch 2 Part 8

In this chapter we shall take a look at how a SIP works, and we shall study the tax and National Insurance implications of employees taking and disposing of free shares, partnership shares, matching shares and dividend shares.

Latest statistics show that there are approximately 860 SIPs in existence.

34.3 Operation of an SIP

SIPs are typically operated by quoted UK companies. The company will establish a UK resident trust and will transfer cash into that trust. The trustees will use the money to acquire shares in the company.

ITEPA 2003, Sch 2 Part 9

On acquiring the shares, the trust will then award shares to the employees. It is important to note that at this point in time – ie, when shares are awarded - **ownership of the shares does not pass to the employee**. The shares remain the property of the trust.

Instead the shares are effectively "ear-marked" for employees and will be officially transferred to the employee at a later date. The trustees hold the shares on trust for the employee until the employee wishes to withdraw them from the plan.

There is **never a tax charge at the point that the shares are awarded** to employees, but there may be **income tax and NIC implications** when the employee **withdraws the shares** from the plan at a future point in time. These tax implications will be considered later in this chapter. ITEPA 2003 s.490

34.4 Conditions for approval

Before an employer company can operate a SIP, **approval** must first be obtained from HMRC. The shares acquired by the trustees must be ordinary shares in the employer company although it is possible for the company to create a special class of "employee" shares purely for this purpose. ITEPA 2003, Sch 2 Para 26

The company's shares must normally be **listed on the Stock Exchange**. This means that the employer company will usually be a quoted plc. It is possible for the company to be an unquoted company as long as it is not controlled by another company or is under the control of a listed company. So, if the company's shares are not listed on the Stock Exchange, the company must either be a parent company and not controlled by another company or, the company must be under the control of a listed company. ITEPA 2003 Sch 2 Para 27

All of the employees of the company must be invited to participate in the Scheme. This includes part-time employees. ITEPA 2003 Sch 2 Para 8

It is possible for the employer company to exclude employees with less than 18 months service, although in practice most companies will invite all employees to participate, regardless of whether or not they have been with the company for 18 months. ITEPA 2003, Sch 2 Para 16

Employees are not eligible to participate in a SIP if they (together with their associates) have a "**material interest**" in the company (or have had a material interest at any time in the 12 months before the award of shares). "Material interest" in this context means an ability to control **more than 25%** of the ordinary share capital. ITEPA 2003, Sch 2 Paras 19-20

Finally, **the employees must be offered shares on similar terms**. This means that the award of shares to employees should not be weighted in favour of certain employees. The rules do permit the award of free shares and matching shares to be based on performance-related criteria, as long as those criteria are similar for all employees. ITEPA 2003, Sch 2 Para 9

34.5 Free Shares

An employer can award up to **£3,000 worth of free shares per annum** to participating employees. This award can be based on performance-related criteria. ITEPA 2003 Sch 2 Para 35

These free shares will normally remain within the plan for a minimum period of three years. This means that the trustees will retain legal ownership of the shares for at least three years before distributing them to employees.

The employer must set a holding period for each award of free shares during which the plan shares must be held in trust. This is generally three years but can be extended to five by the employer. The holding period automatically comes to an end if the employee leaves the company. ITEPA 2003 Sch 2 Para 36

The income tax and National Insurance implications of a withdrawal of free shares depend on **how long** the shares have been held within the plan.

There is **never a charge to income tax or NIC when the shares are originally awarded** by the trustees to the employee. There is only ever a potential charge to income tax or National Insurance on the actual withdrawal of shares from the plan. ITEPA 2003, s.505

If an employee **calls for the shares within three years** there will be an income tax **charge on the market value of the shares at the date they are withdrawn from the plan**. Here the market value of the shares at the exit date will "count as employment income" for tax purposes. Remember the shares can only be withdrawn within three years (the holding period) if the employee is leaving the employment. ITEPA 2003, s.505(2)

If the shares are readily convertible assets, for example shares in a quoted company, there will also be a Class 1 NIC charge and the income tax and NIC charge will be dealt with under PAYE – ie tax & NIC will be withheld at the point of withdrawal. The rules we looked at previously in relation to operating PAYE and NIC in respect of shares also apply to the removal of shares from a SIP.

PAYE will normally be operated by the company, although HMRC will require PAYE deductions to be made by the trustees where they "are of the opinion that it is impracticable for the employer company to make a PAYE deduction". ITEPA 2003, s.511

If the shares are **withdrawn** from the plan **between three and five years** from the date they were awarded to the employee, the income tax charge will be on the **lower of the market value of the shares at initial allocation and the market value of the shares at the date of withdrawal.** ITEPA 2003, s.505(3)

Assuming the shares increase in value over the period, the lower of these will be the market value at initial allocation. Again, any tax and NIC will be dealt with under the PAYE system if the shares are readily convertible assets.

If the shares are **withdrawn** from the plan **more than five years** after they were originally awarded, there is **no income tax or NIC charge** at the date of withdrawal. Therefore the free shares can be awarded and withdrawn totally free of tax and NIC as long as they remain within the plan for at least five years.

34.6 Partnership shares

An employee can buy up to **£1,500 worth** of partnership shares every year. This equates to £125 of shares each month. This is irrespective of the number of free shares he has been awarded. ITEPA 2003 Sch 2 Para 46

The amount of partnership share money deducted from an employee's salary **cannot exceed 10% of that employee's salary**. Therefore an employee earning less than £15,000 per annum will not be permitted to purchase £1,500 of partnership shares.

The scheme may stipulate a minimum amount of salary which must be used to purchase partnership shares. This minimum cannot be greater than £10 per month. ITEPA 2003, Sch 2 Para 47

The employee will **surrender salary** in order to purchase partnership shares and the amount of salary surrendered is deducted from gross remuneration before PAYE and NIC is calculated. ITEPA 2003, s.492

PAYE is applied to the net amount thereby giving the employee **tax relief at source** on the money used to purchase the partnership shares. This means that in the case of a higher rate taxpayer, he will be purchasing shares for £1,500 but in doing so will save 40% of that amount – i.e. £600 – in income tax at source.

If an employee chooses to purchase partnership shares, the salary used to buy those shares will **continue to count as relevant earnings** for the purpose of making pension contributions.

Any partnership shares purchased **may be withdrawn from the plan at any time**. So whilst the employer can prohibit the withdrawal of free shares within three years (unless the employee is leaving the employment), the company cannot prevent the employee from withdrawing his partnership shares.

Again the tax position as at the date of withdrawal depends on how long the shares have been held within the plan.

If the partnership shares have been in the plan for **less than three years** there will be **an income tax charge on the market value of the shares at the date of withdrawal**. ITEPA 2003, s.506(2)

If the partnership shares have been within the plan for between **three and five years**, the income tax charge will be on the **lower of the cash salary used to purchase the shares and the market value of the shares at the date of withdrawal**. Again, assuming the shares go up in value, the original salary used to purchase the shares will be the lower of these, and this will be charged to income tax when the shares are withdrawn. ITEPA 2003 s.506(3)

If the shares are readily convertible assets, there will also be a charge to Class 1 NIC and the amounts due will be collected via PAYE.

As is the case for free shares, if the partnership shares remain **in the plan for at least five years**, there is **no tax or NIC charge** at the date they are withdrawn.

34.7 Matching shares

An employer can "match" any partnership shares bought by employees by offering **up to two additional free shares for every one partnership share purchased** by the employee. Therefore, only employees who purchase partnership shares can be awarded matching shares. ITEPA 2003, Sch 2 Paras 59 & 60 ITEPA 2003, Sch 2 Para 3

As with free shares, the plan must specify a holding period for matching shares, during which period the shares cannot be withdrawn from the plan, of between three to five years. Again, the holding period comes to an end if the employee leaves the employment. ITEPA 2003, Sch 2 Para 61

There is never a charge when matching shares are initially awarded to the employee. **When the shares are withdrawn from the plan, the income tax and NIC implications are the same as they are for the free shares**. This means that there will be a tax charge if the shares are withdrawn either within the first three years or between three and five years, but full exemption is given if the shares remain within the plan for a minimum period of five years. ITEPA 2003, s.505

34.8 Dividend shares

If an employee receives dividends on his shares whilst they remain within the plan, the employee can use the cash from the dividends in order to purchase more shares. The employee can re-invest **up to £1,500 per annum** of dividends in acquiring new shares. ITEPA 2003, Sch 2 Para 64

If dividend shares are acquired in this way, the dividends used to purchase shares are **completely free of tax**. This means that these dividends can be omitted from the income tax computation in the year in which they are received. ITTOIA 2005, s. 770

If the employee wishes to keep the dividends, and not use the cash to purchase more shares, the dividends not reinvested are taxable in the normal way.

The holding period for dividend shares is three years.

The tax position on a withdrawal of dividend shares from the plan is slightly different to the tax rules with regard to free, partnership or matching shares.

If **dividend shares** are **withdrawn within three years**, (due to the employer leaving) the **dividends originally used to purchase the shares become taxable** in the **year** in which the shares are **withdrawn**. If dividend shares are **withdrawn more than three years** after they were acquired, there is **no income tax or NIC** on their withdrawal.

ITTOIA 2005, s. 407

34.9 Other points

The driving force behind a company implementing a share incentive scheme, is typically the retention of staff. As such, on the **termination** of an employee's employment, **any shares awarded must be removed from the plan**.

As we have seen, any income tax and NIC charges depend on the length of time the shares have been held within the plan.

These rules only apply for employees whose employment is terminated voluntarily by the employee. If an employment is terminated due to **injury, retirement, redundancy or death**, there is **no charge on a withdrawal** of shares from the plan.

ITTOIA 2003, s. 498(2)

If the necessary provision is contained in the plan, free or matching shares may be subject for forfeiture. If an employee resigns his employment within the forfeiture period (which cannot be more than three years), the employer can clawback any free or matching shares awarded to the employee. The employer will do this by effectively cancelling the shares held by the trustees as at the date the employee leaves the company. There could therefore be a considerable incentive for the employee to wait for three years to elapse before resigning. Again, if the employment comes to an end due to injury, redundancy, retirement or death the shares will not be subject to forfeiture.

ITTOIA 2003, Sch 2 Para 32

Any income tax or NIC charges – i.e. on shares withdrawn either within three years or between three and five years – will normally be subject to deduction at source under PAYE. Remember that tax must be withheld at source under PAYE if an employee receives a readily convertible asset.

If the shares are **not readily convertible**, there is **no requirement** for the employer to withhold tax at source under PAYE. This will typically be the case if the shares are **not listed** on the Stock Exchange – i.e. the shares are in an unquoted company. If tax and NIC is deductible under PAYE, the PAYE scheme will generally be operated by the employer company and not by the trust.

34.10 Capital Gains Tax implications

Capital gains tax is charged on the growth in value of the shares between acquisition and sale.

The amount charged to capital gains tax is the difference between the value of the shares at the date they are withdrawn from the plan and their value at the date of sale. This means that if an employee withdraws shares from the plan, holds them for a period, and sells them later on, **any increase in value in that period will be charged to capital gains tax.**

However, remember that once the minimum holding period has elapsed (or at any point in respect of partnership shares), the employee can call for the shares at any time. The trustees are only holding the shares on the employee's behalf. Therefore, the only reason for the employee to withdraw the shares from the plan, is in order to sell them and release the cash proceeds.

For this reason, any **capital gains tax can be avoided by the employee withdrawing the shares from the plan immediately prior to the date of sale.** Presumably if an employee withdraws the shares from the plan on the Monday and sells the shares on the Tuesday, there will not be a capital gains tax liability as the shares are unlikely to have increased significantly in value within that 24 hour period.

Example 1

ABC plc introduce a Share Incentive Plan. The employees of ABC plc include:

Mr Huntingdon-Smythe	Managing Director
Mrs Mopp	Part time cleaner who works 15 hours per week
Miss Abacus	Finance Director with overall responsibility for the scheme
Mr Loud	Sales Manager who joined the company 6 months ago

How many of these employees can ABC plc invite to participate in the scheme?

a) One
b) Two
c) Three
d) Four

Example 2

ABC plc allocate 2,000 free shares to Mrs Mopp on 1 September 2006. The shares were worth £1.00 each at that date.

Mrs Mopp left the company in March 2011. The share price was £3.00 per share at that date.

Calculate the amount which counts as employment income for Mrs Mopp in 2010/11.

Answer 1

The answer is **D**

All 4 employees can be invited to participate.

All full time and part time employees must be invited to join. ABC plc may exclude Mr Loud as he has worked for the company for less than 18 months but this is discretionary. In many instances the company will invite every employee to participate.

Answer 2

Withdrawal between three and five years so charge on lower of

- Initial value: September 2006 = £2,000
- Value at removal: March 2011 = £6,000

i.e. £2,000.