CHAPTER 35

SAVINGS RELATED SHARE OPTION SCHEMES

35.1 Operation of the scheme

Savings related schemes are very simple to operate and administer and for this reason they are quite popular. The rules dealing with tax charges and PAYE deductions on Savings Related Share Option shares are contained at Sections 516 to 520 of ITEPA 2003. The approval procedures and the general rules regarding the operation and administration of the scheme are given in Schedule 3.

ITEPA 2003, s.516 -520 & Sch 3

In a savings related scheme, an employee will make regular monthly savings into a designated building society account. This account is also known as an SAYE – a Save As You Earn – account. The **employee will make monthly savings** throughout a designated contract period. At the **end of that contract period, the building society will add a terminal bonus to his savings.** The employee will therefore be left with a return of his savings plus a bonus.

The employee will then **use this cash** in the building society account **to purchase shares in his employer company** at a price which was fixed at the start of the contract. Typically the employer will offer these shares at a small discount.

Note that in this scheme, the employee is saving money on a regular basis and will use his savings to purchase shares from his employer. Unlike the Share Incentive Plan we have just looked at, there are **no free shares** awarded to the employees.

35.2 Conditions for approval

As is the case for most share schemes, the employer company must obtain HMRC approval before operating a savings related scheme. To obtain approval, the shares must be ordinary shares in the employer company. Although if the employee works for a subsidiary company, the shares awarded under the scheme can be in a parent or holding company. The company is usually a quoted company although the scheme can be operated by unlisted companies.

ITEPA 2003, Sch 3 Para 18 & 19

In this case, the company in which the shares are offered must not be controlled by another company. This generally means that the company will be a parent company. Alternatively, the company must be controlled by a listed company. These rules are rather complex and, in reality, most UK companies will qualify and will be able to introduce a savings related scheme.

All employees must be eligible to participate in the scheme although the employer can exclude employees with less than 5 years service. In practice most employers will invite all of their employees to join the scheme, irrespective of their length of service. **Persons with a material interest in the company are not allowed to participate** in the savings related scheme. An individual will have a **material interest** if he has more than **25% of the ordinary shares in the company** (or had 25% at any time in the 12 months prior to the grant of the option).

ITEPA 2003 Sch 3 Para 6

ITEPA 2003, Sch 3 Para 11 & 12

35.3 The share options

A savings related share option scheme operates in a relatively simple way. The employer company will grant an option to an employee. The **option gives the employee the right to purchase shares at a specified price.**

That price must be at least 80% of the market value of the shares at the date of grant of the option. This means that a savings related scheme can allow employees to purchase shares in their employer company at a small discount, but that **discount cannot be more than 20% of the value of the shares.**

ITEPA 2003 Sch 3 Para 28

For example, if the current market value of the shares in your employer company is £5, you cannot be given a right to buy them for anything less than £4. HMRC approval will be denied when the discount is more than 20%.

The employee will make regular contributions to a building society account. The employee will sign a contract with the building society whereby the account will run for either three years, five years or seven years. At the end of the contract, the cash saved plus the bonus added will be used to purchase shares.

The purchase price of the shares will be fixed at the date that the option is granted to the employee. Assuming the shares have risen in value over the three, five or seven year period, the employee will have the opportunity to purchase shares for less than they are worth.

Because the employee has to wait for between three and seven years to acquire the shares, this scheme is another way in which employers can try to retain their staff.

35.4 The SAYE account

A SAYE account is a contract between the employee and a building society. The **employee will agree to save for either a three year** period, a **five year** period or a **seven year period**. The length of the contract must be agreed at the start.

In the event of a **three year contract**, the employee will make monthly contributions for three years (36 months). At the end of the 36 month period, the building society will add a bonus on top of the cash saved. The amount of this bonus varies according to the date the contract was entered. Recent rates are as follows:

Date contract entered	*Bonus*
From 14 May 2010	No bonus
From 29 May 2009	0.3 months of contributions
17 February 2009 – 28 May 2009	0.6 months of contributions
27 December 2008 – 16 February 2009	1.5 months of contributions

The changes in bonuses coincide with falls and rises in interest rates.

If an employee takes out a **five year contract** he will save for five years (60 months). At the end of the 60 month period, a bonus will be added as follows:

Date contract entered	*Bonus*
From 14 May 2010	1.8 months of contributions
From 29 May 2009	2.2 months of contributions
17 February 2009 – 28 May 2009	2.6 months of contributions
27 December 2008 – 16 February 2009	4.8 months of contributions

If an employee takes out a **seven year contract**, he will only contribute to the building society account for the first five years. No contributions will be made in the last two years so, under a seven year contract, the employee will make 60 months contributions. At the end of the seven year period the bonus will be:

Date contract entered	*Bonus*
From 14 May 2010	4.9 months of contributions
From 29 May 2009	5.2 months of contributions
17 February 2009 – 28 May 2009	5.6 months of contributions
27 December 2008 – 16 February 2009	9.3 months of contributions

[Note: the bonus amounts are rarely required in an exam answer, so do not try to memorise these rates!]

The **bonus** added to a SAYE contract is **always tax free**. SAYE accounts used to be widely available but they can only now be taken out in conjunction with a savings related share option scheme.

The employee will save a regular amount on a monthly basis. The maximum contribution to a SAYE account is £250 per month. This £250 per month ceiling applies to all savings related schemes. Therefore, if an employee joins a savings related scheme in 2009 and contributes the full amount of £250 per month, he is therefore not eligible to join a scheme offered, say, in the year 2010 as he is already making maximum monthly contributions.

ITEPA 2003, Sch 3 Para 25

The minimum monthly contribution is £5.

Latest statistics show there are approximately 700 SAYE schemes in existence. The number of schemes has declined each year since 2000/01 and there has been a fall in the number of people participating in the schemes. At the end of 2009, 1.36 million had SAYE accounts, which had fallen from 1.64 million in 2008.

Illustration 1

A quoted company, ABC Plc, grants an option to an employee in February 2011. Under the option, the employee is able to buy shares in ABC Plc for £2.50 per share.

The market value of the shares at the date that the option is granted is £3.00.

Here you will see that there is a 50p per share discount. However, because this is less than 20% of the market value of the shares, this discount is permitted and the scheme will obtain HMRC approval.

The employee takes out a Save As You Earn contract with the building society under which the employee agrees to save £200 per month for the next five years. Our requirement here is to calculate the number of shares the employee will be able to purchase in five years time.

The employee will contribute £200 per month to the building society for the next 60 months. Therefore, at the end of the contract, the employee will have saved £12,000. At the end of the contract, the building society will add a bonus. Because the scheme was entered into after 14 May 2010, the bonus will be equal to 1.8 of monthly contributions. Here the bonus will be £360.

Therefore, in February 2016 – i.e. in five years time – the employee will have cash of £12,360 at his disposal. The employee has an option whereby he has the right to use this cash to purchase shares for £2.50 each. As he has £12,360 of cash and the option price is £2.50 per share, in three years time he will be able to purchase 4,944 shares.

		£
Monthly contributions:	200 x 60 months	12,000
End of contract bonus:	1.8 x £200	360
Cash available		12,360
Option price of shares is £2.50		
Amount of shares purchased: 12,360/2.50		**4,944**

Remember that the option gives the employee the right to buy shares if he or she wants to. Presumably the employee will only take up that right – i.e. the employee will only exercise the option and buy the shares – if the shares are worth more than £2.50 in five years time.

35.5 Tax implications

The tax implications of an employee acquiring shares from a savings related scheme are very straightforward. There is never any tax or National Insurance when the initial option is granted to the employee. As we have already mentioned, the bonus at the end of the contract is also free of tax. ITEPA 2003 s.475

When the employee exercises the option and purchases the shares with the cash in his building society account, there is no tax at this point. This is irrespective of the value of the shares at that date. ITEPA 2003, s.519

The **only tax to consider in an approved savings related scheme will be capital gains tax when the employee eventually sells the shares.**

Illustration 2

Assume in the previous illustration that the employee sold the shares for £4.00 each.

The employee had the right to purchase 4,944 shares. If all of these are sold, the sale proceeds will be £19,776.

The capital gain is the difference between the sale proceeds and the cost of the shares to the employee. The purchase price of the shares was £12,360. This is equal to the money saved plus the terminal bonus.

	£
Proceeds	19,776
Purchase price	(12,360)
Gain	**£7,416**

On the sale of the shares, the employee is making a profit – i.e. a capital gain – of £7,416. This amount will be charged to capital gains tax.

An individual has an annual exemption for CGT which is currently £10,100. Therefore, if this is the employee's only capital gain for the year, the profit will be covered by the annual exemption and no CGT will be payable.

35.6 Employees leaving

The final thing to look at in this session is what happens if the employee leaves the employment before the end of his SAYE contract. If the employment terminates due to the death of the employee, the option can be exercised within 12 months of death by the employee's personal representatives. ITEPA 2003, Sch 3 Para 32

If the employment terminates due to the injury, disability, redundancy or retirement of the employee, the option can be exercised, but this time only within 6 months of the termination of the employment. ITEPA 2003, Sch 3 Para 34

Otherwise **the employee needs to be in employment at the end of the contract period if he or she is to be able to exercise the options**. Therefore if an employee resigns and leaves the employment before the end of the contract period, he or she will forfeit the right to purchase the shares. In respect of options which have been held for more than three years, some schemes may allow the option to be exercised within 6 months. This fits with the general philosophy of share option schemes which only offer rewards to employees if they remain with the company for a minimum period of three years.

If an employee leaves the company before the end of the SAYE contract, that employee can continue making monthly contributions into the SAYE scheme until the contract date. At the end of the contract, the building society will pay the bonus as agreed. However, the former employee is not then able to use the money to buy shares in the company.

There is no requirement for the former employee to continue making monthly contributions. If he wishes to do so, he can draw the cash out of the account. The building society will add interest up to the date of withdrawal and will thereafter close the account. Any interest credited to a designated SAYE account is tax-free and is not brought into the taxpayer's income tax computation.

Example 1

Ron joins the savings related share option scheme offered by his employer in January 2010.

He takes out a 7-year SAYE contract paying £100 per month into the account.

Calculate the amount of cash available to him at the end of the contract.

Example 2

Continuing the previous example, Ron spends all the cash from the scheme in acquiring shares in his employer company at the option price of £2 per share.

He sold the shares the next day for £5 each.

Calculate Ron's capital gain.

Answer 1

7 year contract	£
= 5 years contributions	
£100 x 60 months	6,000
Add end of contract bonus	
5.2 x £100	520
Total cash available	**£6,520**

Answer 2

Cash available	£6,520
Option price is £2.00 per share	
Number of shares acquired 6,520/£2.00	3,260
Capital gain:	£
Proceeds (3,260 x £5)	16,300
Less: purchase cost	(6,520)
Gain	**£9,780**