CHAPTER 36

APPROVED COMPANY SHARE OPTION PLANS

36.1 Introduction

This chapter covers company share option plans (CSOPs). Under this type of arrangement, the employer company grants an option to an employee giving the employee the **right to buy shares in his company at a fixed price within a specified period of time.** The rules dealing with tax charges and PAYE deductions on CSOP shares are contained at Sections 521 to 526 of ITEPA 2003. The approval procedures and the general rules regarding the operation and administration of a CSOP are given in Schedule 4.

ITEPA 2003, s.521 -526 & Sch 4

The price at which the employee can purchase the shares must not be less than the market value of those shares at the time the option is granted. Unlike savings related schemes, **no discount is allowed** at the grant of the option.

ITEPA 2003, Sch 4 Para 22

At some point in the future, the employee will exercise his option. In doing so, he will buy shares at the price which was agreed when the option was granted. Given that shares generally increase in value over time, the employee will exercise his option at a time when the shares are worth more than he is paying for them. The employee can thereafter sell the shares and make a profit.

This arrangement is similar in certain ways to a savings related scheme. The main difference is that under a savings related scheme, the employee will save a certain amount each month and use that money to buy the shares. In a company share option plan, the employee will pay for the shares in one go when he exercises the option.

Unlike share incentive plans, under a company share option scheme the employee is **not being given free shares** in his employer company. The employee is simply taking up an offer to buy the shares at a specified price.

Latest figures indicate that there are approximately 2,150 scheme in existence.

36.2 Conditions for approval

Before a company share option plan can be operated, it must have advance approval from HMRC, and certain conditions must be met before approval is given.

The shares being acquired by the employee **must be ordinary shares** of his or her employer company. Like savings related schemes, if the employee works for a subsidiary company, he can be given an option to acquire shares in a parent or holding company.

ITEPA 2003 Sch 4 Para 16 & 17

The **shares** will **normally be quoted on the Stock Exchange**. However, an unlisted company can implement an approved company share option plan provided that company is not controlled by another company.

Prior to 24 March 2010 an unlisted company which was controlled by a quoted company could implement an approved company share option plan. This is no longer possible. In practice you will find these schemes are generally administered by quoted companies as smaller family-owned companies, are less likely to want to distribute shares to their employees.

One of the **main attractions** of a company share option plan, is that the **employer can invite selected full-time directors and full-time or part time employees to participate.** Part time directors working less than 25 hours a week cannot participate in such a scheme. Unlike SIPs and savings related schemes, this is not an "all employee" scheme. Instead it can be used to incentivise and remunerate key members of the workforce.

ITEPA 2003 Sch 4 Para 8

Individuals with a "material interest" in the company are **not allowed to participate** in a company share option plan. A material interest in this instance means holding **more than 25%** of the ordinary share capital.

ITEPA 2003 Sch 4 Para 9

A further condition to be satisfied before approval is given, is that the **maximum value of shares** over which an employee holds options, cannot exceed **£30,000.** This means that if a company wishes to grant options to an employee, and the market value of the shares at the time is £2.00, the employee can only be given a right to acquire 15,000 shares. Similarly, if the market value of the shares at the date of the option was £3.00, the employee could only be given a right to buy 10,000 shares. This maximum limit used to be as high as £100,000, but the Government tightened the share option rules in the mid-1990s.

ITEPA 2003 Sch 4 Para 6

36.3 Tax implications

There is no income tax / NIC charge when a CSOP option is granted.

There is no income tax or NICs when an option is exercised if the option is exercised **between 3 and 10 years from the date the option is granted**. This is irrespective of the market value of the shares at the date of the exercise.

ITEPA 2003 s.524(2)

Assume a company grants a share option to an employee in **May 2001**. If the employee exercises his option **in the period running from May 2004 to May 2011**, there will be **no charge to income tax or NICs on the exercise**.

There will be no charge to income tax or NICs if the option is exercised within three years from the date the option is granted, if the individual **ceases to be a full-time director or qualifying employee** due to **injury, disability, redundancy or retirement**. The option must be exercised **within 6 months** of such cessation.

ITEPA 2003, s.524(2A)

If the exercise takes place **earlier than three years after the grant** (other than due to injury etc) or **more than ten years after the grant**, a charge to income tax will arise. The rules applying to the exercise of **unapproved options** (covered in Chapter 37) will apply to calculate the amount of the income tax payable. Such income tax is collected under the **PAYE system** and the exercise is also subject to **NICs** if the shares are readily convertible assets.

Assuming the employee exercises the option without triggering an income tax charge, **the only tax to be charged will be capital gains tax when the employee decides to sell the shares.** To calculate the capital gain, we simply take the sale proceeds of the shares, and deduct the purchase cost.

Sale proceeds	X
Less: purchase cost	(X)
Capital Gain	X

Illustration 1

In May 2001, ABC plc grants options to Dennis, an employee. The options give Dennis the right to buy 20,000 shares at £1.00 each.

The market value of the ABC plc shares at this point, is also £1.00.

HMRC will give approval to this particular scheme. This is because the value of shares over which Dennis holds options is less than £30,000. Also the option has not been discounted – i.e. Dennis has a right to buy shares at a price equal to their market value.

Dennis exercises his option and buys the shares in October 2010 when they are worth £3.00 each. This is in the 7-year window between May 2004 and May 2011.

What Dennis is doing is paying £20,000 for shares which are actually worth £60,000. However, because the scheme has HMRC approval, there is no income tax (and no National Insurance) when the options are exercised. The only tax will be capital gains tax when Dennis eventually sells the shares.

Dennis sells the shares a couple of days later for £3.00 each. His sale proceeds will be £60,000. From this we deduct the purchase cost of the shares, being £20,000.

Dennis has made a cash profit on the sale of the shares of £40,000. This profit will not be charged to income tax but it will instead be charged to capital gains tax.

	£
Proceeds	60,000
Less: cost of shares	(20,000)
Capital gain	£40,000

The fact that there are no income tax or National Insurance charges is one reason why company share option plans are quite popular. As you will see when you study the capital gains tax part of the course, employees would rather have their profits charged to CGT because there are certain exemptions – such as the annual exemption – which do not apply for income tax purposes. In addition, capital gains tax is charged at the lower rate of 18% or (for gains realised on or after 23 June 2010) 28% where total taxable income and gains exceed the basic rate limit.

In general terms, an individual will pay less capital gains tax on his profits than he would do if the same profits were charged to income tax and National Insurance.

Example 1

Which of the following individuals are eligible to participate in the ABC plc company share option plan:

John Smith, Managing Director owns 32% of the shares
Jenny Bainbridge, Finance Director owns 5% of the shares
Tony Thompson, part-time security guard
Beryl James, part-time Director

Example 2

In July 2005, ABC plc granted Carol an option, under a CSOP, to buy 10,000 shares at £1 each. Carol has not yet exercised this option.

It is now March 2011 and ABC plc wishes to grant Carol some more options. The shares are currently worth £1.25.

How many approved options can be granted to Carol in March 2011?

Answer 1

	Eligible to participate?
John Smith, Managing Director	X (> 25% of shares)
Jenny Bainbridge, Finance Director	✓
Tony Thompson, part-time security guard	✓ (any employee)
Beryl James, part-time Director	X (< 25 hours per week)

Answer 2

	Value £
July 2005 options:	
10,000 @ £1 each	10,000
March 2011 options:	
Balance	20,000
	£30,000
Value March 2011 is £1.25 per share	
Maximum number of options granted $\frac{20000}{1.25}$	**16,000**