CHAPTER 37

UNAPPROVED SHARE OPTION SCHEMES

ITEPA 2003, s.471 -484

37.1 Introduction

An unapproved share option scheme is one that does not have HMRC approval. The main implication of HMRC refusing approval for a share option scheme, is that the tax advantages available for approved schemes will be denied.

There are essentially **two main reasons why a share option scheme may not obtain HMRC approval**.

First, in considering whether to give approval to a scheme, HMRC will compare the option price with the market value of the shares at the date of grant. If the employee is given a **right to purchase shares for less than their market value** at that time, HMRC will not give approval to the scheme. Therefore, if options are discounted, the scheme will be unapproved.

Secondly, if the value of shares over which an **employee holds options exceeds £30,000** at the date of grant, the options will be unapproved. For example, if an employee is given the right to buy 50,000 shares for £1.00 each, only the first 30,000 of those are approved - the excess will be dealt with under the rules for unapproved share option schemes.

37.2 Tax implications

HMRC will not give tax reliefs to unapproved schemes. If an employee **exercises options under an unapproved scheme, there will always be an income tax charge on the exercise of the option.** There is no exception to this rule.

Income tax on exercise of option:

Value of shares at exercise	X
Less: cost of shares	(X)
Less: charge at grant (if any)	(X)
Amount treated as employment income	X

As we saw in Chapter 33, if the shares are readily convertible assets, for example listed on the Stock Exchange, income tax and NIC will need to be accounted for under the PAYE system.

In certain instances there is also an income tax charge when the option is originally granted. However, tax will **only be charged on the grant** of an option, if;

(a) the option was granted **before 1 September 2003**; **and**

(b) the option was then **capable of being exercised more than 10 years from the date of the grant**.

Therefore there will **never** be an income tax charge on the **grant** of an unapproved option **on or after 1 September 2003**.

ITEPA 2003, s.475

For pre-September 2003 options, if an unapproved option is only exercisable within the first 10 years, there will be a charge at the date of exercise but there will not be a charge at the date of grant.

If a pre-September 2003 option can be exercised more than 10 years from grant, the tax charge on the grant of the option was calculated as follows:

Value of shares at grant	X
Less: option price	(X)
Charge at grant	X

Therefore the **discounted element** was charged to tax. This means that if an employee was given a right to buy shares **before September 2003**, and the option price is the same as the market value – i.e. there was **no discount** – the income tax charge at the grant of the option would have been zero.

In the event of a tax charge at the date of grant, PAYE and NIC was applied if the shares were readily convertible assets.

Any amount charged to tax on the grant of an option can be deducted from the amount charged when the option is eventually exercised. This prevents there from being a double charge to tax.

Illustration 1

A quoted company, ABC plc, grants an option to a director (who has a salary of £300,000) in July 1998. Under the terms of the option, the director has the right to buy 50,000 shares for £1.00 each at any time in the next 15 years. The market value of the shares at the date that the option is granted is £1.50.

These are unapproved options. HMRC will not give approval to the scheme for a number of reasons. First the value of the shares over which the director has options exceeds £30,000.

Secondly, the option was granted at a discount – the director has the right to buy shares for £1.00 when the shares are actually worth £1.50 at that time. Note that either of these points would result in the share option scheme being unapproved. It is not necessary for the scheme to fail on both grounds.

The director exercises these options in 2010, when the shares are worth £4.00 each. Because the options were granted before September 2003 and are exercisable more than 10 years after grant, there will be a charge on the grant of the option.

Tax at grant:	£
Value of shares at grant (50,000 x £1.50)	75,000
Less: Option price (50,000 x £1)	(50,000)
Amount charged to tax (1998/99)	£25,000
Tax @ 40%	£10,000

Tax at exercise:	£
Value of shares at exercise (50,000 x £4)	200,000
Less: price paid for shares (50,000 x £1)	(50,000)
Less: amount charged to income tax at grant	(25,000)
Employment income charge	£125,000
Tax @ 50%	**£62,500**

In summary, the director bought shares for £50,000 and sold them for £200,000 making a profit of £150,000. He is taxed on this total profit but in two stages.

37.3 National insurance contributions

Where a quoted company grants unapproved share options to the employee, as the shares are **readily convertible assets**, PAYE and NIC will need to be accounted for when the options are exercised. The exercise of the options by the employee will therefore leave the employer with a charge to Class 1 secondary NICs at 12.8%.

As this is a liability over which the employer will have no control, it is often written into the share option agreement that liability for the employer's NICs will pass to the employee on exercise. Therefore when the employee exercises his options, he will be liable to income tax under PAYE, Class 1 employee's contributions (at either 11% or more often, 1%) and also to the employer's NICs at 12.8%.

Sch 1 SSCBA 1992 Paras 3A & 3B

If the employee is made liable for the employers NICs, this is treated as a cost to the employee of acquiring the shares and will therefore **reduce the amount which will be treated as employment income.** SSCBA 1992, s.481

Illustration 2

In January 2005, Glassworks plc granted unapproved options to Graham, a senior employee. The options give Graham the right to buy 100,000 shares at 10p per share. The share price at the time of grant was £1.25.

Graham exercised the options in June 2010 when the share price was £1.80. Under the terms of the option, Graham is liable for any employer's NICs on exercise. Graham is a higher rate taxpayer.

Graham's employment income charge is calculated as follows;

	£
Value of shares at exercise (100,000 x £1.80)	180,000
Less: price paid for shares (100,000 x 10p)	(10,000)
Chargeable to NICs	£170,000
Employee's NIC @ 1%	£1,700
Employer's NIC @ 12.8%	£21,760

Income tax at exercise:	£
Value of shares at exercise (100,000 x £1.80)	180,000
Less: price paid for shares (100,000 x 10p)	(10,000)
Less: secondary NIC liability	(21,760)
Employment income charge 2010/11	**£148,240**

37.4 Capital Gains Tax

Where shares acquired through unapproved options are sold, the capital gain is calculated as below:

	£	£
Sale proceeds		X
Less: CGT base cost		
Amount paid for shares	X	
Add: Amount charged to income tax at exercise	X	
		(X)
Gain/(loss)		X

Note that for the purposes of this calculation, the amount charged to income tax at exercise is calculated before any relief is given for employer's NIC paid by the employee or for any amount charged to income tax at grant.

So in actual fact the total **CGT base cost is actually the market value of the shares at exercise**. Therefore you can use the market value as a "short cut". Consequently if the employee sells the shares shortly after exercising the options, there will be no charge to CGT since the sale proceeds will usually equal the market value at exercise.

Illustration 3

Graham (from Illustration 2) sells his shares in December 2010 for £2.20 per share.

Graham's capital gain is calculated as follows:

	£	£
Sale proceeds (100,000 x £2.20)		220,000
Less: CGT base cost		
Amount paid for shares	10,000	
Amount charged to income tax on exercise (ignoring relief re employer's NIC paid)	170,000	
		(180,000)
Gain		£40,000

Alternatively	£
Sale proceeds	220,000
Less: MV at exercise (100,000 x £1.80)	(180,000)
Gain	£40,000

Example 1

In March 2001, Harvey was granted options to buy 25,000 shares at £3. The shares were worth £4 at the time. Harvey could exercise his options until March 2011.

In January 2011, Harvey exercised 15,000 options. He sold the shares on the same day for £95,000.

Calculate the amount charged to income tax on grant and exercise.

Example 2

Madeline was granted options to buy 10,000 shares at £7.50 each in May 2001. She could exercise her options at any time between 2001 and 2011. The scheme does not have HMRC approval.

Madeline exercised 6,000 options in February 2009 when the shares were worth £10 each.

Madeline sold these shares in July 2010 for £11.50 each.

Calculate the capital gain/loss on the sale.

Answer 1

	£
Charge on grant	
Only exercisable within 10 years	Nil
Charge on exercise	
MV at exercise	95,000
Less: Price paid	
(15,000 x £3)	(45,000)
Income tax charge	**£50,000**

Answer 2

Income tax on exercise:	£	£
Market value 6,000 x £10		60,000
Less: cost of shares 6,000 x £7.50		(45,000)
Charged on exercise		£15,000
Capital gain on sale:		
Sale proceeds 6,000 x £11.50		69,000
Less: CGT base cost:		
Amount paid for shares	45,000	
Add:		
Charged to income tax	15,000	
		(60,000)
Gain		£9,000