# Consider the options

JOHN COLVILLE explains the fundamental principles of share option schemes.

Share option schemes are an important topic in the Association of Taxation Technicians' exams. They are regularly examined in both Paper 1 and Paper 3. Questions often require an understanding of non-tax advantaged schemes and the three types of tax advantaged schemes. Examiners often report that candidates confuse the schemes or apply a particular one in the wrong circumstances. So the aim of this article is to clarify the key features and application of each of the tax advantaged schemes. I am not going to delve into every detail of the schemes – instead, I want to focus on the overall picture.

## Motivation and mechanics

Share options have long been an important mechanism to help employers motivate and retain staff. In this regard, employees can benefit from the growth in the value of the employing company's shares, but with only a limited downside should their value fall. Successive governments have recognised the importance of encouraging wider share ownership and employee involvement. Consequently, various tax advantaged schemes have been introduced and, at the last count, there were more than 10,000 such schemes in existence, of which more than 85% were enterprise management incentives (EMI).

We need to start by identifying how an employee share option works. The employee is granted an option which is a contract that enables them to buy a specified number of shares, at a specified price, at a specified time in the future. On the day specified, the employee can exercise the option, pay the specified price and acquire the shares. As the term 'option' suggests, the exercise of it and the purchase of the shares is not compulsory and the employee is within their rights not to go ahead. Consequently, the downside for the employee is limited. If the share value falls below the option price they will decline the option and suffer no loss.

### KEY POINTS

- Do not confuse the various schemes.
- Employee share schemes can help to motivate staff.
- Generally, no income tax arises on exercising the option under an approved scheme.
- Income tax arises on the exercise of an unapproved share option; if the shares are readily convertible assets the tax is collected under PAYE, otherwise under self assessment.

© iStock.com/fotosipsak

## The tax consequences

To appreciate the tax consequences of tax advantaged schemes we must start with the effects of non-tax advantaged schemes. There are no tax consequences on the grant of an option. However, when the option is exercised a charge will arise on the difference between the value of the shares acquired and the price paid, being the specified option price. Thus the tax charge is based on the benefit the employee receives by being able to buy the shares at less than the current market value.

If a tax charge arises, we need to consider the way it is paid. If the shares represent readily convertible assets (usually quoted shares) the tax is collected through the PAYE system. Further, the taxable amount will be subject to class 1 National Insurance. If the shares are not readily convertible assets the income tax is collected through the self-assessment system and no National Insurance is payable.

Subsequently, when the shares are sold a capital gain will arise. In most cases this will be calculated as the difference between the proceeds of sale and the market value of the shares at the date of acquisition. This gain is then subject to capital gains tax, after deduction of the annual exemption.

## The three schemes

There are three tax advantaged share option schemes.

- Company share option plan (CSOP).
- Enterprise management incentives (EMI).
- Savings-related share option scheme, known as save as you earn (SAYE).

Although the mechanics of the schemes may differ, the tax advantage is the same in each case, namely there is generally no income tax charge on the exercise of the option. There are circumstances in which taxable income will arise, but that is beyond the scope of this article. That is the good news. However, there is also bad news, which is that the capital gain is now calculated as the difference between the sale proceeds and the original price paid for the shares. ***John's Share Option*** shows the calculation of the taxable amounts both for a tax advantaged and a non-tax advantaged option. One effect, therefore, is to convert taxable income to capital gain. Generally, capital gains will be preferred to income for several reasons.

- Every individual has an annual exemption.
- Capital gains tax rates are lower than the corresponding income tax rates.
- Disposals can be staggered over a number of years, using various annual exemptions.
- Gains can be shared with your spouse (or civil partner).

## JOHN'S SHARE OPTION

John has been granted an option by his employing company. This allows him to acquire 1,000 shares at a price of £2 each. The current market value of the shares is £2. On the specified date, John exercises his option and acquires the 1,000 shares. By this time the share price has risen to £6 each. He subsequently sells the shares for £7 each.

The tax consequences will be as follows.

*Non-tax advantaged scheme*

| | |
|---|---|
| Taxable as income on exercise 1,000 x (£6 – £2) | £4,000 |
| Taxable as gain on sale 1,000 x (£7 – £6) | £1,000 |

*Tax advantaged scheme*

| | |
|---|---|
| Taxable as income on exercise £nil | |
| Taxable as gain on sale 1,000 x (£7 – £2) | £5,000 |

*Note*. If the shares are readily convertible assets any amounts subject to income tax would also be subject to National Insurance.

## The basic workings

The CSOP and EMI work in much the same way. The share option is granted – this is merely a piece of paper handed to the employee. At the appropriate time the employee, if they wish, exercises the option and acquires the shares. Generally, at that time there is no tax liability; this will arise only when the shares are sold. Neither of these schemes involves a funding element. It will be up to the employee to decide how to fund the exercise. In some cases, this will involve them selling some of the shares immediately to fund the purchase.

These are both discretionary schemes whereby the employer can decide who is to benefit and by how much. The main distinction is the amount and focus of the two schemes.

A CSOP allows options of a value up to £30,000 to be granted to selected employees. There are very few restrictions on the type of companies that can participate or on the employees. These schemes tend to be favoured by large, often quoted, companies to motivate significant numbers of employees.

The EMI scheme allows up to £250,000 of options to be granted to eligible employees, with a company-wide limit of £3m. So, if 12 employees were granted the maximum allowed the company-wide limit would be used up. There are significant restrictions on the types of company that can offer EMI options, of which the most important reflect the size of the business. The gross assets cannot exceed £30m and the number of employees must be fewer than 250.

As can be seen, the CSOP scheme allows the company to reward a large number of employees to a limited extent. Conversely, an EMI scheme allows the company to reward a restricted number of employees to a significant extent.

A further benefit of an EMI scheme is that, in most cases, any gain on the sale of EMI shares will be eligible for entrepreneurs' relief which would give a 10% tax rate on any chargeable gain.

## Save as you earn

The SAYE scheme is different in focus. Again, there are few restrictions on participating companies or employees. Here, the employee decides whether they want to join. It is sometimes described as an 'all-employee scheme' because it cannot be restricted to specific individuals.

The company will announce that it is to offer SAYE options. The individual employee then decides whether they wish to take part and how much they wish to save.

The company will specify the exercise price, which can be discounted by up to 20% of the current market value. The employee commits to save a specified amount of not more than £500 a month, for either three or five years. The employee is then granted an option over the number of shares their savings will buy at the end of the specified savings period. At the end of that time, the employee can exercise the option and acquire their shares. There will be no income tax consequences on the exercise of the option. However, as before, there will be capital gains to consider when the shares are sold. There is one further possibility in this case. The employee may transfer the shares into an ISA, as long as they are within the account's limits. In that case there would be no capital gain to consider when the shares are sold.

As with all share option schemes, the SAYE scheme is relatively risk-free for the employee. If the employee does not want to exercise the option, perhaps because the share price has fallen, they merely take out the cash they have saved. There are few restrictions about the types of company that may offer SAYE schemes and they are popular with large quoted companies because they help to motivate and retain as many staff as possible by involving them with an interest in the organisation's share capital.

## Summary

Tax students should now be able to identify the key features of the various share option schemes. In the exam it is important to understand the mechanics and application of the schemes. This can then be supplemented with knowledge of the detailed rules that apply for each scheme. Understanding and knowledge will bring success in questions involving share option schemes.

**John Colville FCA, CTA, TEP** is a senior tutor for Tolley Exam Training. He can be contacted on 020 3364 4500 or examtraining@lexisnexis.co.uk. Visit: www.tolley.co.uk/products-and-services/exam-training.