The Legal 500 Country Comparative Guides

United Kingdom: Employee Incentives

This country-specific Q&A provides an overview to employee incentives laws and regulations that may occur in United Kingdom.

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1. **What kinds of incentive plan are most commonly offered and to whom?**

Two main types of incentive plan are commonly offered to UK employees and directors: share option plans and share acquisition plans.

Under share option plans participants are awarded a right to acquire shares in the future at a price fixed now. Participants will have no interest in the shares until they exercise their options.

Under share acquisition plans participants acquire shares from the outset and have the same rights as other shareholders of that class.

2. **What kinds of share option plan can be offered?**

Share option plans can either be (i) all-employee or discretionary; and (ii) tax-favoured or non tax-favoured.

All-employee plans must be offered to all qualifying employees, whereas a discretionary plan can be offered to selected individuals or groups of employees.

Tax-favoured plans operate within a special tax regime, under which (provided strict criteria are adhered to) participants will not pay any income tax on exercise of their option and will pay capital gains tax on the sale of their shares. Under non tax-favoured plans, income tax and (usually) social security contributions (called national insurance) will be payable on the exercise of the option.

The most common types of share option plans are as follows:

Company Share Option Plan (**"CSOP"**)

A CSOP is the traditional method of giving employees a personal interest in the future success of a company. Under such plans, employees can be awarded options to acquire shares in the issuer company at a future date (usually no sooner than three years from the date of grant) at their current market value. A CSOP is a discretionary share option plan therefore participation does not have to be extended to everyone; it can be offered simply to selected individuals (usually chosen to participate by the board of directors or remuneration committee). It is usual for a CSOP to be designed in two parts. The first part is structured as a tax-favoured plan under which it is possible to grant options that benefit from favourable tax treatment. There is a limit on the value of shares that an individual can hold under such tax-favoured options at any time. Options above this limit are granted under the second part of the plan which is drafted on broadly the same terms as the first but without the restrictions attaching to tax-favoured plans.

SAYE Option Scheme (**"Sharesave Plan"**)

A Sharesave Plan is a tax-favoured plan with similar objectives and benefits to a CSOP. Unlike a CSOP, a Sharesave Plan must be open to all qualifying employees and therefore favours wider share ownership. Sharesave options are exercisable after three or five years and their exercise is financed by the proceeds of special tax-efficient savings accumulated through the deductions from the participant's salary which are required to be made over the life of the option.

Enterprise Management Incentives (**"EMI"**)

Under an EMI plan an issuer company can grant tax-favoured share options to selected employees. The rules governing the terms of EMI options are very flexible which means they can be tailored to deliver the desired incentive and reward. The exercise price of an EMI option can be at, above or below the market value of the shares at the time the option is granted. Unlike other forms of tax-favoured share incentive, an EMI option does not have to be held for a set period of time to receive favourable tax treatment on exercise.

Performance Share Plan (**"PSP"**)

A PSP is the term often used by companies to refer to arrangements that give executive directors and senior employees an opportunity to acquire free shares at a future date dependent on the satisfaction of performance criteria. Other names given to these arrangements include 'Long-Term Incentive Plans', 'Deferred Share Plans' and 'Restricted Share Plans'.

It is usual to structure such arrangements as a non tax-favoured option plan but with the exercise price set at a nominal amount or even nil. PSPs usually permit awards to be granted in a variety of other ways such as awards that vest automatically without the award holder having to formally exercise them. The plan may also allow awards to be satisfied in cash. This gives the issuer company the flexibility sometimes needed when using the plan in different jurisdictions where a particular type of award structure may be preferred for tax or other reasons.

3. **What kinds of share acquisition/share purchase plan can be offered?**

Like share option plans, share acquisition plans can be either (i) all-employee or discretionary; and (ii) tax-favoured or non tax-favoured.

Share Incentive Plan (**"SIP"**)

A SIP is a tax-favoured share ownership plan. Although (unlike a share option plan)

participants own their shares from the outset, they have to be held within a specially formed SIP trust. SIP, like Sharesave, is an all-employee scheme. As a result, participation under a SIP must be offered to all eligible employees on the same terms.

Share Offer

Share Offers are a discretionary and non tax-favoured form of share acquisition plan. Under a Share Offer a company will usually offer shares to a wide range (but not necessarily all) employees. The shares will typically be purchased by participants at market value and held under nominee arrangements for a set amount of time.

Joint Share Ownership Plans (**"JSOP"**)

A JSOP allows participants to acquire an interest in a share as opposed to the entire share. This interest entitles the participant to benefit from some of the growth in value of the share above a pre-determined threshold. The return realised by the participant should be taxed as capital gain rather than income.

4. **What other forms of long-term incentives (including cash plans) can be offered?**

Phantom options/share appreciation rights

Phantom options are rights to receive cash payments that relate to the value of real shares. Typically participants will receive cash bonuses where the amount payable is based on growth in value of a notional parcel of shares. Phantom options are a discretionary form of employee incentive which some companies prefer to use rather than real shares because issuing new shares would dilute the interests of existing shareholders.

Deferred bonus plan

A deferred bonus plan is a discretionary form of employee incentive plan, under which part of a participant's bonus will be paid in shares which must be retained for a period of time (usually three years). The issuer company may provide a matching element subject to the participant remaining in employment and certain performance conditions being met. Deferred bonus plans will usually involve non tax-favoured share options.

5. **Are there any limits on who can participate in an incentive plan and the extent to which they can participate?**

Non-tax advantaged plans do not usually have a limit on the extent to which individuals can participate. Tax-advantaged plans however do have strict conditions and limits. These include:

SIP

Under a SIP a company can (in any tax year) only offer each participant a maximum of £3,600 of free shares, £1,800 of partnership shares (being shares bought with gross pay) and up to two matching shares for every partnership share purchased. (Note, however, that if the relevant SIP rules allow this, the participant may be able to buy more shares using the dividends received from free, partnership or matching shares).

SAYE

An individual can participate in SAYE with deductions from net salary of between £5 and £500 per month.

CSOP

Under the tax-favoured part of a CSOP there is a limit on the value of shares that an individual can hold under options. This is currently £30,000 and is measured by reference to the market value of shares at the time the relevant option is granted.

EMI

An individual can only hold EMI options over shares with a market value of £250,000. EMI plans can only be operated by companies with fewer than 250 employees and gross assets not exceeding £30 million.

6. **Can awards be made subject to performance criteria, vesting schedules and forfeiture?**

It is common for some of the share option plans outlined at question 2 above (especially CSOP and PSPs) to specify that awards are subject to performance criteria, vesting schedules and forfeiture. Such terms are required under many corporate governance rules and institutional investor committee guidelines. Some plans include provisions under which awards (or shares acquired pursuant to awards) can be “clawed back” in the event of certain circumstances including misconduct or material misstatement of financial information.

SAYE and (usually) SIP are not granted subject to performance conditions however awards/shares can be forfeited in certain circumstances.

7. **Can awards be made subject to post-vesting and/or post-employment holding periods. If so, how prevalent are these provisions both generally and by reference to specific sectors?**

Awards granted to executive directors of companies with shares admitted to the Official List and traded on the London Stock Exchange are expected to have a combined vesting and holding period of at least 5 years. Such individuals are also required to build-up a significant level of shareholding in their company (usually a multiple of their base salary) to be maintained for at least 2 years after they leave. Companies with shares traded on other

markets (such as AIM) are encouraged to put in place similar arrangements.

8. **How prevalent malus and clawback provisions are and both generally and by reference to specific sectors?**

Companies with shares admitted to the Official List and traded on the London Stock Exchange are expected to attach malus and clawback provisions to awards granted to their executive directors. The remuneration schemes for such companies are also expected to include provisions that give the company the discretion to override formulaic outcomes. Companies with shares traded on other markets (such as AIM) are encouraged to put in place similar arrangements. Historically, the circumstances in which malus and clawback are applied have been instances of gross misconduct or serious misstatement of results. Current good practice is for companies to create a more specific and wider list of circumstances in which such malus and clawback provisions will be applied.

9. **What are the tax and social security consequences for participants in an incentive plan?**

    1. on grant;
       No tax or social security (national insurance contributions) is payable by an individual on the grant of options under either a tax-favoured or non tax-favoured share option plan.
    2. on vesting;
       Where vesting means shares are delivered to participants, income tax and (usually) national insurance contributions will be payable on vesting. Where vesting simply means that an award (such as an option) is capable of being exercised then no liability to income tax or national insurance contributions will arise until exercise.
    3. on exercise;
       No tax is payable by an individual on the exercise of an option under a tax-favoured share option plan provided the specific conditions of each plan (including, if applicable, holding periods) are met. If an individual exercises an option under either a tax-favoured plan in non-qualifying circumstances or a non tax-favoured share plan then income tax and (usually) national insurance contributions will be due on the difference between the market value of the shares on exercise and the aggregate exercise price paid for them.
    4. on the acquisition, holding and/or disposal of any underlying shares of securities; and
       Other than when a non-tax-favoured option is exercised, no income tax or national insurance contributions should normally arise through the acquisition and holding of shares acquired pursuant to a share option plan. The acquisition of shares under a non-tax advantaged share ownership plan will give rise to income tax and (usually) national insurance contributions if the participant pays less than market value for them.

       Although there are anti-avoidance provisions that can trigger charges to income tax and national insurance contributions in respect of shares held by employees, it is usually possible to manage these through the making of special elections.

       Any gain made by an individual on the disposal of shares should be subject to capital

gains (depending on the availability of allowances and reliefs).

5. in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

   It is quite common for a company to make loans available to its employees in order to enable them to participate in share offers.

   The loans can be made available to employees on an interest-free basis. However, if the loan to an individual employee exceeds £10,000, that employee will be charged to tax on the difference between the interest paid (i.e. zero) and interest calculated by reference to an official rate prescribed by HMRC (the UK's tax authority).

   As regards repayment of the loan, this could be by employees paying monthly instalments or using the sale proceeds of the shares acquired. Alternatively, the loan terms could provide for waiver of all or part of the loan in prescribed circumstances, for example by reference to the achievement of performance conditions. Any waiver of the obligation to repay the loan would give rise to an income tax charge and national insurance contributions.

   Due to anti-avoidance legislation, is it now uncommon for third parties to make loans to employees as these can trigger automatic charges to income tax and national insurance contributions at the time the loan is advanced.

10. **What are the tax and social security consequences for companies operating an incentive plan?**

    1. on grant;
       No tax is payable by the company on the grant of options under either a tax-favoured or non tax-favoured share option plan.
    2. on vesting;
       If an income tax charge arises for the participant on vesting (see 7 above) then this will be payable by the employer under the Pay-As-You-Earn ("**PAYE**") collection system if the shares are "readily convertible assets". Broadly this is where the shares are either capable of being sold or are deemed to be readily convertible assets because the company cannot secure a corporation tax deduction in respect of them. If the shares are readily convertible assets then a charge to national insurance contributions will also arise both for the employee and the employer. Whereas an employer can seek an indemnity in respect of the income tax and employee's national insurance contributions that it is required to pay under PAYE, it is not generally possible to recover the employer's national insurance contributions that become due (but see (iii) below). Note that if the shares are not "readily convertible assets" then any income tax is payable by

the individual under self-assessment (and not via PAYE) and there is no national insurance contributions charge (either employee or employer).

3. on exercise;
   If an income tax charge arises for the participant on the exercise of an option and the shares are readily convertible assets, the employer will have to account for this tax (and any associated employee's and employer's national insurance contributions) under the PAYE collection system. In these circumstances, it is also possible for the employer and participant to agree that the participant will bear all or a proportion of the employer's liability to national insurance contributions that becomes due.

   Provided certain conditions are met, a company may be able to claim a corporation tax deduction from its profits in relation to the option plan.

4. on the acquisition, holding and/or disposal of any underlying shares or securities;

   If the shares are readily convertible assets then the employer will be liable to account for any tax and national insurance contributions arising on the acquisition of the shares under the PAYE collection system.

   Provided certain conditions are met, a company may be able to claim a corporation tax deduction from its profits on the issue of shares under a share ownership plan.

5. in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

   If an individual has an income tax charge because they pay less than the official rate of interest on their loan then this will give rise to a corresponding liability to national insurance contributions on the employer. In this case, however, there is no national insurance liability for the employee. If the loan is waived then the income tax charge that arises is not payable through PAYE but by the individual under self-assessment. However, an employee's and employer's charge to national insurance contributions will arise and will be payable by the employer under PAYE.

11. **What are the reporting/notification/filing requirements applicable to an incentive plan?**

Every employee share plan has to be registered with HMRC through the PAYE Online Service. For tax-favoured plans the registration process includes an additional requirement that the company must self-certify the plan as meeting the relevant statutory conditions.

Once a plan is registered, the company must submit an annual online return by 6 July following the end of each tax year. This is the case even if there has been no activity in relation to the plan during the year.

12. **Do participants in incentive plans have a right to compensation for loss of their awards when their employment terminates? Does the reason for the termination matter?**

The majority of incentive plans will be governed by leaver provisions either in the plans themselves or in the articles of association of the company. These provisions will set out the conditions under which an individual will be a good leaver or a bad leaver, and what will happen to their options/shares or what they will receive for their shares upon termination of their employment. Good leavers (commonly those that leave by reason of death, injury, disability, redundancy, retirement or the transfer of the company or business for which they work outside the issuer's group) are generally entitled to retain their awards whereas other leavers typically lose them. Some plans may permit the board to have a discretion to determine whether or not a participant's awards will lapse.

If a participant's options lapse on the termination of their employment then the rules of the plan will generally provide that they are not entitled to any compensation for the loss of their options even if this is as a result of the breach of their employment contract. However, in some circumstances, it is not possible to exclude liability under a statutory claim the participant may have (for example by reason of unfair dismissal or redundancy).

13. **Do any data protection requirements apply to the operation of an incentive plan?**

The operation of incentive plans involves the processing of personal data, therefore they must be compliant with data protection legislation. Among other things, operators of incentive plans will need to ensure that their plan documentation provides a signpost to the company's data privacy notice which in turn should describe the purposes for which personal data will be used in the operation of the incentive plan and the legal basis for doing so. Where the plan involves the appointment of trustees and/or administrators, the company needs to ensure that appropriate safeguards are put in place when transferring personal data to them.

14. **Are there any corporate governance guidelines that apply to the operation of incentive plans?**

In the UK, the corporate governance regime is a mix of statutory rules, codes and investor guidelines and the extent to which it applies will depend on the size of the issuer company, where it is incorporated and whether or not it is listed.

Companies with shares admitted to the Official List are subject to the UK Corporate Governance Code which sets out principles of good corporate governance in relation to remuneration. Companies with securities traded on other markets have other corporate

governance codes and a special code is also being developed for larger private companies. Institutional investor protection committees (such as the Investment Association: https://www.theinvestmentassociation.org/) also publish guidelines on good corporate governance.

15. **Are there any prospectus or securities law requirements that apply to the operation of incentive plans?**

All companies offering shares to employees resident in the EU need to consider the application of the Prospectus Rules which require any offer of shares to the public to be made pursuant to an approved prospectus. The definition of 'offer' is broad and although it does not include the grant of share options it does extend to the offer of shares under employee incentive arrangements such as share offers, SIP and JSOPs.

Fortunately, there are exemptions which mean that an issuer company should not have to go to the effort and expense of producing a full prospectus when operating its share plans. These currently include (i) an exemption for offers where the aggregate amount paid by participants when aggregated with all other offers made in the previous 12 months throughout the EEA is less than EUR8 million (a useful exemption for offers of shares where no consideration is being paid such as free shares awarded under a SIP), (ii) offers made to fewer than 150 people in each EEA state and (iii) an exemption for employee offers. Any company wishing to rely on the employee offer exemption has to publish an employee information document containing prescribed information about the offer and the issuer. This requirement is far less onerous than the need to publish a full prospectus.

16. **Do any specialist regulatory regimes apply to incentive plans?**

Companies operating incentive plans need to take a number of issues into account ensuring compliance with (i) financial services laws in respect of regulated activities and financial promotions; (ii) company law, listing rules and market abuse legislation, (iv) employment and discrimination legislation and (v) consumer rights and consumer credit laws. Also, companies operating within the financial services sector have additional regulatory regimes that need to be complied with.

17. **Are there any exchange control restrictions that affect the operation of incentive plans?**

While there are no general currency restrictions in force in the UK, dealing with certain countries is restricted. When dealing with a country that has problematic relations with the international community, it is important to check that no restrictions apply.

18. **What is the formal process for granting awards under an incentive plan?**

The formal process for granting awards depends on the nature of the incentive plan. Some

plans (such as SAYE, SIP and share offers) involve the issue of invitations where participants are asked whether they want to participate and to what extent. In the case of discretionary share option plans, it is usual for options to be granted unilaterally by the board (or remuneration committee) of the issuer company. In both cases, participants are usually issued with certificates that evidence their awards and which are subject to the terms of a set of plan rules. An exception to this is EMI options which are granted by way of an agreement between the issuer company and the participant although these are usually subject to a more detailed set of rules. A further communication will be made when the award "matures" in which case participants will be given the documentation necessary to exercise their options/deal with their shares as appropriate.

19. **Can an overseas corporation operate an incentive plan?**

An overseas company can operate an incentive plan in the UK including most tax-favoured plans. Where an overseas company already has its own share incentive plan, it may be able to operate this without any amendment in the UK. It will need to ensure that the operation of the plan complies with UK securities laws and regulatory rules. However, it is usually preferable (and necessary if the issuer company wants to operate a tax-favoured plan) for it to adopt a schedule to its plan that will operate as a separate arrangement in the UK.

20. **Can an overseas employee participate in an incentive plan?**

An overseas employee can participate in an incentive plan but it will be important for the company operating the plan to obtain local law advice on the tax and legal implications of the plan in each applicable jurisdiction. An overseas employee can participate in a tax-favoured plan but will not generally be able to benefit from the associated tax relief as they are unlikely to be subject to UK tax.

21. **How are share options or awards held by an internationally mobile employee taxed?**

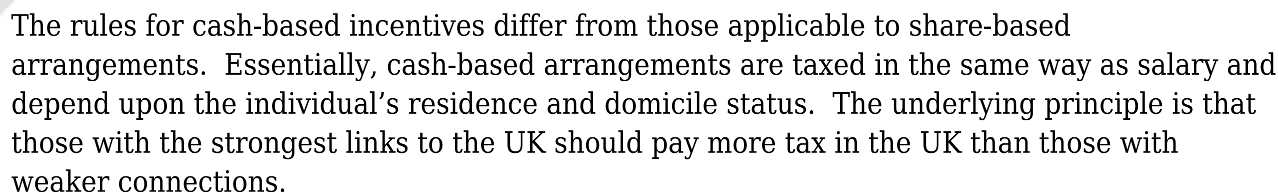
The UK tax treatment of share options or awards held by an internationally mobile employee is not straightforward. A tax charge in relation to the option or award is not triggered upon leaving the UK, but upon vesting or exercise of that award.

Broadly speaking, any option gain or growth in the value of shares during the vesting period that relates to UK duties of employment will be taxable in the UK.

In addition, there are specific provisions that protect internationally mobile employees against double taxation, and they may also be able to claim relief under double tax treaties.

The rules for national insurance contributions are similar.

22. **How are cash-based incentives held by an internationally mobile employee taxed?**



The rules for cash-based incentives differ from those applicable to share-based arrangements. Essentially, cash-based arrangements are taxed in the same way as salary and depend upon the individual's residence and domicile status. The underlying principle is that those with the strongest links to the UK should pay more tax in the UK than those with weaker connections.

23. **What trends in incentive plan design have you observed over the last 12 months?**

The emphasis on the need for good corporate governance has continued to rise and, particularly in the public company arena, there is a growing trend for shareholders to demand that incentive arrangements do not provide for excessive pay-outs or rewards for failure. As well as requiring malus and clawback provisions it is becoming common for companies to have a discretion to adjust awards to avoid formulaic outcomes. Executives are also expected to maintain a shareholding in the company for a period of time after their employment with it has ended.

24. **What are the current developments and proposals for reform that will affect the operation of incentive plans over the next 12 months?**

Brexit – The terms of the UK's exit from the EU remain unclear. The key areas that may have an impact on incentive plans include: (i) securities laws in relation to the publication of prospectuses; (ii) data protection in relation to share plans that operate across the EU; (iii) share dealing governed by the EU market abuse regulation and (iv) cross border social security arrangements.