EMPLOYEE SHARE INCENTIVE ARRANGEMENTS - March 2007

This bulletin is for companies operating share-based employee incentive arrangements.

- The Employment Equality (Age) Regulations 2006 (the **"Age Regulations"**), which came into effect on 1 October 2006, make it unlawful for an employer to discriminate against employees on the grounds of age. One of the less obvious ways in which these Regulations have an impact on companies is in relation to their share incentive arrangements. We set out the issues that all companies operating share schemes need to consider now that HM Revenue and Customs ("HMRC") have agreed a policy on how they will treat the necessary changes.

- We provide a progress report on the proposed **changes to the accounting rules for share based payment** (contained within FRS20).

- Travers Smith acted for an employer in its successful High Court claim for the **recovery of PAYE from an option holder**. We summarise the implications of this important case.

- Companies operating HMRC approved **Share Incentive Plans**, will need to amend their standard Partnership Share Agreements to reflect changes that will be introduced by the Civil Partnership (Employee Share Ownership Plans) Order 2007.

- The Chancellor's **Pre-Budget Report** in December 2006 did not contain any changes that will have an impact on share incentives but HMRC have published guidance on income tax charges arising in respect of **Post Acquisition Benefits From Securities** and have issued draft legislation relating to **Managed Service Companies**.

- HMRC have published the **2007 annual returns** for approved Share Incentive Plans (Form 39), Save As You Earn plans (Form 34), Company Share Option Plans (Form 35), Enterprise Management Incentives (EMI 40) and the annual return and guidance for unapproved arrangements (Form 42).

1. THE AGE REGULATIONS

Companies must take great care to ensure that they are not discriminating against employees on grounds of age in either the structure or operation of their share plans. Note that the Age Regulations do not only protect older employees - they apply equally to discrimination on account of someone's youth. The Regulations apply to all subsisting awards under share plans, including those granted before 1 October 2006. It is therefore very important for companies to "health check" their share plans to limit their exposure to an age discrimination claim.

The principal areas where age discrimination could take place in the context of share plans are as follows:-

- *Who participates in the share plan?* If awards are made to only senior executives (who tend to be older) this discriminates against younger employees. Where eligibility is dependent on the employee having completed a minimum period of service then this will discriminate against those, usually younger, employees who have not met this. Fortunately the Age Regulations include an exemption for minimum periods of service of five years or less. At the other end of the scale, excluding employees who are approaching retirement from participation in a share plan will be discriminating against older employees.

Issues covered in this bulletin:

- **Age Regulations**
- **Accounting Rules**
- **Recovery of PAYE**
- **Partnership Share Agreements**
- **Post-Acquisition Benefits from Securities**
- **Managed Service Companies**
- **Annual Returns**

- *What happens when a participant retires?* Plans often have "good leaver" provisions which enable retirees to exercise their options or receive awards early. Some HMRC approved plans require retirees to be treated as good leavers as a condition of the plan's approval. Treating those who retire differently from other participants could be discriminatory. If the company operates an HMRC approved Share Incentive Plan or "SIP" then a provision under which retirees forfeit their free or matching shares may be discriminatory.

Fortunately the Age Regulations provide a possible defence to allegations of discrimination. If the discriminatory practice in question can be "objectively justified" (that is, it can be said to be a proportionate means of achieving a legitimate aim) then it will not be in breach of the Regulations. As this term is not defined in the Regulations it remains to be seen how it is developed by case law.

What Should You Do Now?

Every company should undertake a thorough review of their plan rules and grant policies to see if they fall foul of the Age Regulations and make amendments where necessary. In many cases the amendments will require prior shareholder approval and changes to approved plans will need advance HMRC consent. We set out below the changes that companies might choose to make.

New Plans/New Awards under Existing Plans

- *Eligibility* - In the case of discretionary share plans, Boards need to ensure that they can objectively justify the basis upon which they select participants. Any provisions within plan rules that exclude individuals approaching retirement should be removed. Service conditions must be within the five years permitted under the Regulations.

- *Retirees* - Companies need to consider how the plan rules deal with retirees. In particular, the exercise provisions of option plans should be reviewed if they permit retirees to exercise early. In the case of those HMRC approved plans for which the rules on retirement are prescribed by statute (such as Save As You Earn ("SAYE" or "Sharesave") plans and SIPs), companies must take care to ensure that any change (such as lowering the retirement age within the plan rules) will not prejudice the approved status of the plan. In the case of plans where the rules governing retirement are more flexible (such as HMRC approved company share option plans ("CSOPs") and unapproved arrangements) it might be appropriate to amend the definition of retirement or remove it as a good leaver event altogether. Some plan rules give the Board a general discretion under which they can allow leavers to keep their options and companies operating such plans might wish to deal with retirement under this heading. SAYE plan rules have to allow the exercise of options when an individual retires on reaching the "specified age" or any other age at which he is "bound to retire" under the terms of his employment contract. The Age Regulations give employees the right to request to work beyond normal retirement age, therefore, there is arguably no longer an age at which employees are "bound" to retire. HMRC have said that approved SAYE plans can include a definition of "bound to retire". An individual can then exercise his options in tax approved circumstances where he retires, having chosen to work beyond retirement age.

Existing Awards

Companies may amend existing awards to deal with age discrimination issues by, for example, changing the retirement age applicable to those awards. Any such changes will need to be made in accordance with the amendment provisions of the particular plan. Most rules provide that any change to the disadvantage of an award holder requires his prior consent. Changes to option holders' advantage usually needs the approval of shareholders.

We would be happy to "health check" your share incentive arrangements from the point of view of the Age Regulations and to advise you on what changes you should make to them. Please call your usual contact within the Travers Smith Employee Incentives Group if you would like us to do this.

2. PROPOSED CHANGES TO ACCOUNTING RULES

In our April 2006 Bulletin we reported on a proposed change to the accounting rules under which companies must expense share based payments through their profit and loss account. These are set out in FRS 20 (for those companies subject to UK accounting standards) and IFRS 2 (for companies reporting by reference to international accounting standards).

As we explained last year, in March 2006 the Accounting Standards Board published proposed amendments to FRS 20 (in line with amendments to be made to IFRS 2) that will have particular impact on companies operating SAYE plans and SIPs. The proposed amendments will require a company to recognise an accelerated charge to its profit and loss account where options are cancelled by employees (as well as by the company). The exception to this is where the cancellation is due to the failure of "vesting conditions" (broadly "performance conditions" or the option holder ceasing employment). One case in which the change would have an important impact is where a participant in an SAYE plan is unable to continue his monthly savings contract and allows his options to lapse. This would be treated as a cancellation due to the failure of a non-vesting condition. The employer would, in these circumstances, have to recognise an accelerated charge to its profit and loss account.

A period of consultation has now passed and it is understood that the International Accounting Standards Board ("IASB") has received a number of responses expressing concern over the proposed changes. The IASB stated that, in light of the comments it has received, it will alter the wording of the proposed amendment to IFRS 2 (which will no doubt be followed by an amendment to FRS20) to clarify a number of issues. The proposed areas of clarification include the definition of "performance conditions" and the treatment of all non-vesting conditions. In addition a flow chart is to be included in the implementation guidance to help identify service conditions, performance conditions and non-vesting conditions. A final decision on this may not be reached until the end of the year and the amendment will now apply to accounting periods beginning on or after 1 January 2008.

3. RECOVERY OF PAYE FROM OPTION HOLDERS

Travers Smith employee incentives partner, Mahesh Varia, acted for the employer in the case of *McCarthy v McCarthy and Stone plc [2006]* EWHC 1851 in which the company successfully recovered PAYE and employee National Insurance contributions ("NICs") from an option holder.

The case concerned a former employee who had exercised share options following the end of his employment. Income tax and employee's NICs were due on the option gain. After the options were exercised the company made a payment to HMRC of the PAYE liabilities due. The option holder refused to reimburse the company on the basis that he had no obligation to do so, whether contractual or otherwise (note that the terms of the options did not provide for the recovery of PAYE). The Company successfully argued that the company had a "quasi contractual" right to recover the PAYE from the option holder. The judge in the case came to this decision because the following three conditions were satisfied: (i) the company was compelled by law to make the payment on the option holder's behalf (ii) the company did not unnecessarily expose itself to the liability and (iii) the payment made by the company discharged a liability of the option holder.

This decision is very useful because the circumstances in which employers can recover tax and NICs from employees are very limited. Employers now have a recognised non-statutory right to recover amounts paid under the PAYE system from employees. However the right can only be exercised where the three conditions referred to above are satisfied. Whilst the decision in the McCarthy case is good news for employers, it does not take away the need to ensure that share incentive arrangements include appropriate contractual provisions for the recovery of PAYE from participants.

4. SIPS - PARTNERSHIP SHARE AGREEMENTS

If you operate a SIP then you will need to amend your standard form of partnership share agreement. Partnership share agreements must contain a notice containing information prescribed by regulations (the "Prescribed Notice") as to the possible effect of deductions to acquire partnership shares on an employee's entitlement to social security benefits, statutory sick pay and statutory maternity pay. Under the Civil Partnership (Employee Share Ownership Plans) Order 2007 the reference in the Prescribed Notice to "wife or husband" was replaced with "spouse or civil partner" from 13 February 2007. We have received confirmation from HMRC that partnership share agreements entered into prior to that date will not need to be amended. New agreements will need to contain the revised wording, however, it is not necessary to obtain prior HMRC approval when amending your standard agreement to incorporate the change.

5. POST ACQUISITION BENEFITS FROM SECURITIES

HMRC have issued new guidance on post acquisition benefits from securities. The guidance relates to tax charges that can arise where individuals receive benefits after they have acquired securities (usually shares) in connection with such securities. The term "benefits" is very wide and can include anything (HMRC give the examples of bonus shares, accommodation, the provision of travel). Generally a benefit only comes within this charge if it is not otherwise chargeable to income tax. This exclusion does not apply where something has been done for tax avoidance purposes.

6. MANAGED SERVICE COMPANIES

Some commentators consider that the new guidance described in 5 above indicates HMRC's willingness to scrutinise owner/managed companies where some income may be paid out in the form of salary and some as dividends. If HMRC consider that there is a tax avoidance motive then they could seek to tax dividends as employment income even though they have already been taxed as dividends.

HMRC do say that where owner/managed companies run as a genuine businesses pay dividends out of company profits and there is no contrived scheme to avoid tax or NICs on remuneration or to avoid the IR35 rules, they will not seek to argue that a post acquisition benefit has been received. Nevertheless, those with owner/managed companies will need to ensure that they pay an appropriate level of remuneration and can justify their dividend policy to avoid challenge.

The 2006 Pre-Budget Report did not contain any proposals that will have a direct impact on share incentives however a consultation paper on "Managed Service Companies" ("MSCs") was published at the time of the report. The Government is seeking to attack arrangements under which individuals provide services to clients using companies that are promoted by scheme providers. It is concerned that these arrangements are being used to avoid income tax and NICs and that new powers are needed to tackle them effectively. Draft legislation was published with the consultation paper and the Government recently issued draft regulations setting out who might be liable for an MSC's PAYE "debts". These regulations are very wide and could result in liability for end clients and agencies. The new legislation is to take affect from 6 April 2007 however HMRC have indicated that, in the meantime, they will use the powers described in 5 above to deal with the most aggressive schemes. If you wish to discuss this at all then please call your usual Travers Smith Employee Incentives Group contact.

7. ANNUAL RETURNS FOR YEAR ENDING 5 APRIL 2007

HMRC have published annual returns for the current tax year. As ever, it is important to consider your reporting requirements and the relevant deadlines at the earliest opportunity to avoid penalty charges. The following table sets out the forms that you will need to consider and the associated filing deadline:

Plan Type	Return	Filing Deadline
SIP	Form 39	6 July 2007 (see note below)
CSOP	Form 35	6 July 2007 (see note below)
SAYE	Form 34	6 July 2007 (see note below)
EMI	EMI 40	6 July 2007
Unapproved Share Incentive Arrangements	Form 42	6 July 2007 (unless the form was sent to you on or after 8 June 2007 in which case you have until 30 days from the date of issue)

Note: In the case of the SIP, CSOP and SAYE returns, if the form was sent to you on or after 7 April the filing deadline is three months from the date of issue.

If you have any queries in relation to your reporting obligations or any other matter referred to in this bulletin, then please call a member of the Travers Smith employee incentives team.

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