# Unapproved Share Options

Share plans are important tools for growing businesses. They can help companies to recruit, retain, and incentivise employees. Where companies need flexibility or where they cannot operate HM Revenue & Customs (HMRC) approved plans for any reason, unapproved share option plans can form an important element of the remuneration package of employees.

**Outline**

Unapproved share options can be granted by companies to their employees or employees of their subsidiaries.

A share option constitutes the right to acquire shares at a specified date in the future for a price normally set at the date of grant. Optionholders have no dividend rights or voting rights until options are exercised and the optionholder becomes a shareholder. For companies listed in the UK, it is typical for exercise to be conditional on meeting long-term (three years or more) company-related performance targets. For non-listed companies, it is common for exercise to be conditional on an exit event happening.

For the optionholder, an option has the advantage in that he or she can potentially benefit from the increase in value of a growing company but without any actual financial risk. Options may be regarded as a 'one way bet' on the company's share price. This right is not itself subject to tax until exercise.

Share option plans fall into two types: those that are regulated and approved by HMRC and those that are free from such regulation and so are unapproved. Unapproved plans do not offer the tax advantages of approved plans but are attractive to companies who either cannot make use of approved plans or need more flexibility than is offered by approved plans such as the Company Share Option Plan and/or Enterprise Management Incentives. Unapproved share option plans can either stand alone or 'top up' benefits afforded to employees under parallel approved arrangements.

With unapproved arrangements, there are no statutory restrictions and the company is free to operate them as it sees fit. The freedom is usually, however, still restricted by investor or market requirements to limit the level of dilution resulting from the grant of options and to restrict the quantum of individual reward.

**Employee tax position**

Income tax is normally charged on the exercise of the unapproved option on the difference between the:

- market value of the shares at the date of exercise; and
- amount paid for the shares under the option.

Employees wishing to retain their shares rather than sell them immediately following exercise need to ensure that they have the cash funds to pay the option price and any tax liabilities. If the underlying shares are readily convertible assets (i.e. in general terms, there is a market for the shares), the income tax and national insurance contributions (NICs) will need to be accounted to HMRC by the Company through the PAYE system. If not, there may be no NICs and the income tax may only need to be paid by the employee by way of self-assessment.

It is possible for the option to be granted subject to the condition that the employee agrees to bear any employer's NIC liability. The employee's gain for income tax would then be reduced by the amount of the employer's NIC liability so transferred.

**Example**

An option is granted in 2008 over 15,000 shares at an exercise price of £2 per share. The option is exercised three years later in 2011 when the market value of a share is £5. After a further two years the shares are sold in 2013 for £8 per share. Assuming that the shares are readily convertible, the employee's marginal tax rate is 40 per cent, the employee has not agreed to bear any employer's NIC liability, the capital gains tax (CGT) annual exemption remains £9,600 and is available to set against any gain on the disposal of the shares and entrepreneurs' relief is not available, the employee's tax position is as follows.

*On grant:* No tax is payable.

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|---|---|
| *On exercise:* | *£* |
| Market value on exercise | 75,000 |
| Less: Exercise price | (30,000) |
| Gross gain | 45,000 |
| Income tax @ 40% | (18,000) |
| Employee's NIC @ 1% | (450) |
| Net gain | 26,550 |
| Employer's NIC @ 12.8% | 5,760 |

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| *On disposal:* | |
| Sale proceeds | 120,000 |
| Less: Exercise price | (30,000) |
| Amount subject to income tax on exercise | (45,000) |
| | 45,000 |
| Less: Annual exemption | (9,600) |
| Chargeable gain | 35,400 |
| CGT @ 18% | 6,372 |

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| *Net benefit for participant:* | |
| Sale proceeds | 120,000 |
| Less: Exercise price | (30,000) |
| Income tax | (18,000) |
| Employee's NIC | (450) |
| CGT | (6,372) |
| Net benefit after tax | 65,178 |

A further point to note is that the CGT exemption cannot be set against the income tax liability incurred.

**Employer issues**

Provided that the conditions to obtain statutory relief are met, a corporation tax deduction should be available to the employing company in the period in which the employee realises a gain. The amount on which a deduction can be claimed is the amount on which the employee is subject to income tax.

Options granted under unapproved share option plans need to be measured at 'fair value' and recorded as an expense in the accounts of the employing company. 'Fair value' will generally be determined according to an option pricing model, such as Black-Scholes or a binomial model. The fair value needs to be measured at the date of grant and charged against profits over the vesting period.

**How can we help?**

We can help with all aspects of the design and implementation of your unapproved share options including participation policy, performance measures, communication and ongoing compliance requirements.

If you would like more information about unapproved share options or if you have any other issues in relation to employee incentive arrangements please contact Bryan Rickman on 07939 583386 or br@dermotscully.com.

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