CSOP share option schemes

An employer's guide

THE MILL CONSULTANCY
The Mill,
Christow,
Exeter,
EX6 7LX

PHONE
01392 432654

WEB
www.millconsultancy.co.uk

A share option gives someone the right to buy shares in the future, but at a price that is fixed now. Share options are very useful for companies who wish to incentivise and retain key employees and a CSOP (Company Share Option Plan) scheme can provide significant tax advantages to those employees.

A company can grant options over its shares to individuals, based on a specific plan for how and when they can exercise the options and buy the shares, i.e. an option holder is not automatically a shareholder of the company, but will become a shareholder when they eventually exercise their options.

Glossary – *grant* is when the options are awarded to someone. *Vest* is when those options can actually be *exercised* i.e. the options can be used to buy the shares.

A Company Share Option Plan (CSOP) enables a company to grant share options to selected executive directors and employees over shares at a market value agreed with HMRC at grant date. The acquisition of shares on the exercise of the option three or more years after the date of the grant will be free of income tax and National Insurance contributions (NICs), and only capital gains tax is payable on a sale of the shares.

When will a CSOP be appropriate?

A CSOP is a discretionary plan, which means that companies can select particular executive directors or employees to benefit, rather than an all-employee plan such as the approved share incentive plan (SIP) or Save As You Earn, where all eligible employees and directors must be invited to participate.

An individual can hold CSOP options over shares with a value of up to £60,000 as at the date of grant of the options. It's important to note that this amount is calculated using the HMRC-agreed market value, which for employees will typically be heavily discounted, such that the £60,000 limit can be worth several times that amount in real market value.

Which companies can use a CSOP?

To qualify to grant a tax-favoured option under a CSOP, a company must either be a listed company or, if unlisted, must be independent and not controlled by another company. The shares issued under that option must also fulfil certain conditions, including that they must:

- form part of the ordinary share capital of the company;
- be fully paid up and not redeemable.

Who can be granted an option?

Any employee is eligible, but only executive directors working at least 25 hours a week for the company are eligible – non-executive directors cannot participate. There is no working time requirement for employees who are not directors.

Individuals with a material interest – broadly a 30% shareholding – in a close company whose shares may be acquired under the CSOP are also unable to participate. A close company, for the purposes of UK tax law, is broadly speaking a small company with no more than five controlling parties.

How we can help

We are able to offer realistic fee rates that suit growing entrepreneurial companies. Typically, we can deal with the documentation by phone, post and email but if you would like a 'full service' basis, which would include face-to-face meetings (which can encompass presentations to staff for example) we are very happy to undertake this too.

We take care of all the scheme documents you need and your share valuation agreement with HMRC too: in other words, you get a turnkey service. Fees – a typical CSOP, all-inclusive, would cost a fixed fee of £3495 + VAT.

Requirements for the options themselves
Share options must be granted with an exercise price which is equal to or exceeds the market value of a share at the grant date. The options, therefore, provide a benefit to participants to the extent that the value of the shares increases between the date of the grant and the date the participant exercises that share option. That growth in value is delivered income tax free under a CSOP within the £60,000 maximum limit and assuming all other conditions are met.

When can an option be exercised?
In order to benefit from the favourable tax treatment offered by a CSOP, the option should not be exercised less than three years from the date of the grant except in certain circumstances set out below. Additionally, employees may only become eligible to exercise options subject to specified performance targets, which should be clearly laid out by the company at the date of the grant and communicated to optionholders. The share options would then become exercisable, if at all, to the extent that these performance targets were met.
Early exercise of a share option (ie within 3 years from the date of the grant) may benefit from the tax-favoured status in the following circumstances:

- "good leavers" – disability, injury, retirement or redundancy (if exercised within 6 months);
- death (if exercised within 12 months);
- certain "company events" - a cash takeover of the company, a court-sanctioned scheme of arrangement, or a shareholder approved reorganisation of a non-UK company's share capital or a minority squeeze out, provided certain conditions are met (if exercised within 6 months).

Tax treatment
For individuals exercising CSOP options in approved circumstances, the big advantage of the scheme is that any increase in the value of the shares between the grant and the exercise of the share option is delivered free of income tax and NICs. If and when the shares are sold by the employee, normal capital gains tax (CGT) rules will apply if there has been an increase in the market value of the shares between the time the share option was exercised and when the shares were disposed of, so tax will be payable at the 10% or 20% rate for CGT and the annual allowance will be available as well.
Where share options are exercised within 3 years of the date of grant other than in the specified circumstances above, income tax will be due on any increase in value between the market value of the shares at the date they are acquired and the exercise price. This may be collected under Pay As You Earn (PAYE) arrangements if the shares are "readily convertible assets" at the time, in which case NICs (including employer NICs) will also be due.
The company itself is likely to qualify for a corporation tax deduction when the option is exercised by its employees. Tax relief is given as a deduction from company profits of an amount equivalent to the benefit received by the option holder.

Summary
A CSOP is an efficient way to deliver an additional financial benefit to selected individuals within an organisation.

How is the CSOP operated?
A separate signed agreement will be required in respect of options granted to each employee. This enables the company to tailor each grant of an option to the particular employee. It's fine to have different vesting periods and option numbers for different employees.

Does HMRC supervise the operation of the CSOP?
There is no need for prior approval of CSOP schemes from HMRC - the company must simply notify HMRC after an option has been granted. A valuation of shares will need to be agreed with HMRC. This is important – it means that the market value of the shares is agreed by HMRC as at the date of the granting of the options and avoids any arguments later on when the employee eventually sells the shares.

Companies who grant CSOP options will need to make an annual return to HMRC by the 6 July after each tax year. We can provide this service if required.

What are the tax advantages of CSOP options?
No income tax or national insurance contributions (NICs) are payable when options are granted.

If the option's exercise price is set at the same or a higher price than the HMRC-agreed market value of shares on the date that the option is granted, then no income tax or NICs are payable when the option is exercised.

When shares obtained on exercise are eventually sold the employee will be liable for capital gains tax (CGT), currently at the rate of 10% (or 20% for higher rate tax payers). The employee can also use their annual CGT exemption.

After exercise, the net market value of the options exercised by employees may be an allowable expense, similar to expensing normal employee remuneration.

Sometimes it will make sense for a company to have new **Articles of Association** drafted, for two main reasons - first, the company may require that it can buy back shares from an employee who has bought shares under their option agreement but who later leaves employment, so 'buy back' provisions will be needed, and second, a number of companies require that option shares are a different class e.g. non-voting, so the Articles will need to cover different class rights for A shares, B shares etc. If new Articles are required, we can draft them for you.

To discuss your requirements please call or email Jerry Davison: 01392-432654 or jerry@millconsultancy.co.uk

'Jerry set up our EMI scheme and I can't recommend him highly enough, Jerry provided us with all the advice, documentation and dealt with HMRC to get us heavily discounted options.' – Paul Thomas, Cupris Software

‘We chose the Mill Consultancy to create our share scheme based on the all-inclusive package (i.e. including the company valuation and having no hidden extras) and the price which was extremely competitive. We were very happy with our decision. Jerry at Mill Consultancy was fast and effective whilst always maintaining great communication and being happy to help with any questions we had. What to a small company had seemed a daunting task turned out to be a very smooth procedure indeed and all thanks to Jerry for that. It is very easy to recommend the Mill Consultancy to you for your EMI share scheme.’ - Rodney Higgins - CEO - VSR2 Limited

Pricing matrix – fixed fees

Full CSOP option scheme service – £3495

- Option Agreement providing for the grant of CSOP options exercisable either based on time vesting, performance measures or on an exit/sale of the company and incorporating standard leaver provisions.
- Review of your Articles to assess conformance with the scheme
- HMRC Share Valuation Application consisting of the letter to HMRC requesting agreement to the proposed share valuation, compiling supporting documentation and then any dialogue or negotiation with HMRC if required.
- Help sheets and discussions to guide you through every step of the process.
- A briefing document for employees showing the key terms of the option agreement including the tax implications.
- Board minutes approving the terms of the Option Agreement and the grant of options.
- Formal notice of the grant of the options to HMRC.

Add-ons if required

Amendments to Articles – if you need to change your Articles of Association e.g. to create a separate class of shares, or provide for share buy back from leavers, you will need board minutes, shareholder resolutions and new Articles (or just an addendum) - £295

All fees are plus VAT