Office of
Tax Simplification

Review of tax advantaged employee share schemes: Final report

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Foreword

The act of "ownership" can run from the mundane of buying a packet of crisps to the very significant, for example the purchase of a house. Rewarding people for the work they do can be as simple as paying them an hourly rate for the job or as complex as using a shareholder approved long term incentive plan, whose parameters reflect the trading performance of a company. For both employers and employees, share schemes offer the chance to combine these two concepts.

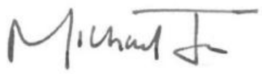
Over time, both Government and business have been passionate advocates about the benefits which they perceive arise from employees being able to acquire a financial stake in the enterprise for which they work. At their simplest, each of the UK's current approved share schemes provide employees with a tax advantaged way of building up and ultimately benefiting from a financial stake in the enterprise for which they work. They offer a simple proposition. If a company prospers through the collective efforts of its workforce and that is reflected in its share price then employees with a stake in the business can capture a part of this over and above their normal level of remuneration.

To achieve this objective we currently have four schemes. The most basic is Save As You Earn (SAYE). Here employees can use their own money to save up and ultimately decide if they then want to exercise options to acquire shares in their company at a discount. Share Incentive Plans (SIP) are more sophisticated, enabling a stake in an enterprise to be built through a combination of company share gifting and employee equity purchase. The other two plans are discretionary schemes with the Company Share Option Plan (CSOP) and Enterprise Management Incentives (EMI) targeted at the challenge of enabling employees to have access to the future growth in the value of the company, where issues of recruitment, motivation and long term reward are key factors. Ultimately, all these schemes come with tax advantages either to the employee or the company or both.

It's here that complexity kicks in. Because their operation represents a cost to the Exchequer and also affects the way that a type of income to scheme participants is to be taxed, complex rules to both approve and operate these schemes have been introduced. Our extensive series of roadshows and meetings of our Consultative Committee revealed a multiplicity of ways in which companies wanted to see the operation of these schemes simplified. They distilled out into three distinct lines of thought. Amend the approvals process, examine the need for all our current schemes and remove barriers to widening and increasing share ownership. As you will see from the structure of the report, that is what we have addressed.

We believe that the ideas we have put forward for further consideration will not only be of interest to the Chancellor, but also to other Ministers tasked with advancing the Government's enterprise agenda.

As currently constituted this is an area for the "expert". The Office of Tax Simplification (OTS) is very lucky to have had the advice and commitment of Sarah Anderson, Tony Page and Geraldine Pamphlett as secondees to the Office during the course of preparing this report, ably supported by Tunde Ojetola. Their wisdom and expertise has been invaluable in enabling us to properly understand both the issues and opportunities for reform that lie in this area.



Rt Hon Michael Jack
Chairman

Executive summary

In September 2011 the Office of Tax Simplification (OTS) began work on a review of the United Kingdom tax advantaged share schemes, with a specific remit to identify areas of the schemes that were causing complexity and disproportionate administrative burdens on employers, employees and advisers. The changes we are recommending in this report are a result of our analysis of the evidence gathered, feedback we received at roadshows, information provided by our Consultative Committee and firsthand experiences shared by individuals seconded to the OTS for the purposes of this review.

Although the OTS was not asked to examine the role of share schemes in today's workplace as part of its review on simplifying the schemes, as a starting point we wanted to understand why companies use share schemes and whether they felt share schemes were effective. Interestingly, despite the fact that increased productivity has been repeatedly used by previous governments as a rationale for using share schemes, none of the companies or advisers we spoke to told us that they used a share scheme primarily as a way to improve productivity, albeit some accepted that this could be a by-product of participation. Instead companies pointed towards the intangible benefits they have noticed as a result of adopting a share scheme. These included greater interest and commitment from employees as well as opening up share-ownership across employee levels.

However, while companies are positive about the benefits of share schemes and are prepared to invest considerable amounts and resources in providing them, they did feel that many aspects of the schemes were not working as well as they could be and that changes needed to be made. For example, we heard evidence from advisers and smaller companies who wanted to implement a SIP, but were put off from doing so because of its overly complex and restrictive nature.

After analysing all the evidence, the OTS has three main recommendations to put forward to the Chancellor of the Exchequer. These are supplemented by a number of other recommendations that we think are necessary to address administrative or legislative concerns as well as to make the schemes fit for purpose in today's business world.

Our first main recommendation is to dispense with the requirement to seek approval to adopt a SAYE, CSOP or SIP. Instead, companies should be able to use a self certification process similar to that used so successfully for EMI schemes. Out of all the areas we covered in this review, there was unanimous agreement regarding dissatisfaction with the approval process. In making this recommendation we are aware that a balance will need to be struck between companies having the reassurance that their schemes are compliant, and HM Revenue and Customs (HMRC) having the ability to deal with schemes that are seriously deficient. However, we are confident that this is possible. After all, the EMI scheme is far more generous than the other schemes and self certification has been in place and working for more than ten years.

Our second recommendation concerns CSOP. It is fair to say that we have struggled with the issue of whether CSOP is still relevant and did at one stage contemplate recommending its abolition. Our Consultative Committee was divided on this issue. Although the evidence points towards a decline in usage in this scheme, we were unable to get robust evidence as to the reason for this. In the time available during this review we were also unable to get reliable information on the characteristics of companies that are using CSOPs, as well as the reasons as to why they are using the scheme. Our recommendation is that more work should be undertaken on this issue, with a particular focus on the information provided to HMRC as part of this year's annual returns submission. The OTS would also welcome information from any companies that are using CSOPs.

Our third main recommendation – assuming that the evidence points to retaining CSOP - is to merge CSOP and EMI, which are the two discretionary schemes. Our reasoning behind this recommendation is largely driven by the fact that the schemes are broadly similar; the proposed merger would significantly reduce the amount of legislation. EU State aid rules would need to be taken into account with any changes.

Whether or not these three recommendations are accepted, there is a variety of improvements we think are needed to the individual schemes. These will deliver useful simplifications and make the schemes more attractive to users. The areas covered include

- harmonising definitions across the four plans,
- changing time limits to fit more with today's employment climate, and
- modifying various conditions.

We are conscious that our various recommendations may be seen as a general expansion of the schemes, with consequent increased cost to the Exchequer. We comment on likely cost implications in the report and are mindful of our mandate to be broadly cost neutral. However, we think our overriding mandate of aiming for simplification is more important and, if there is a tax cost to our proposals, we think the cost is likely to be commensurate with the overriding aim of encouraging wider share ownership among those working for the companies concerned.

One detail we think it is important to note is that the usage of many of the schemes has dropped markedly in recent years. This is not universal, nor does it mean they are little used: there are still a lot of employees that benefit from them, and a lot of companies keen to use them. We think that, if greater employee participation is seen to be a priority, then there is clear scope for something of a relaunch of the plans to encourage their use.

The recommendations in this report have been submitted to the Chancellor of the Exchequer in advance of Budget 2012.

1 Introduction

Background

1.1 In 2011, the Office of Tax Simplification (OTS) agreed with the Government to carry out a review of tax advantaged share plans[1] as these were perceived to be a highly complex area of the tax code. This complexity was seen as a frequent cause of error in tax returns and as a source of administrative burdens on employers, their advisers and employees.

1.2 Annex F sets out the full terms of reference for the project, but specifically the OTS was asked to

- evaluate the four schemes and identify where they create complexities and disproportionate administrative burdens for scheme users, and
- examine how the schemes could be simplified.

1.3 To assist the OTS on this project we were able to call on the expertise of individuals from the private sector. Between them they have experience in tax, law and management and operation of share schemes. In addition we were guided by a Consultative Committee drawn from representatives from industry (both large and small), administrators, reward consultants and the legal and tax profession[2].

Summary of share schemes

1.4 There are currently four tax advantaged share schemes:

Share Incentive Plan (SIP)

1.5 SIP is an all employee scheme which was introduced in 2000 as a vehicle to encourage employers to offer employees the opportunity to take a stake in their own organisation. The key features of SIP are that employees are able to purchase shares out of pre tax salary up to a specific limit ("Partnership Shares"). If they wish companies can match the amount of shares purchased by giving employees up to two "Matching Shares" for each Partnership Share purchased, and/or award "Free Shares", again up to a specific limit. Finally, employees may reinvest dividends into buying further shares ("Dividend Shares"). The SIP legislation is set out in Sections 488-515 and Schedule 2 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA)[3]. These provisions together with related provisions in other Acts including Part 1 Schedule 7D to TCGA 1992, Section 95 Finance Act 2001 (stamp duty provisions), ITTOIA 2005, Part 9 ITA 2007 and Part 11 CTA 2009 make up "the SIP Code".

[1] Our terms of reference covered the four tax-advantaged share plans: Share Incentive Plans (SIP), Save As You Earn share option plans (SAYE), Company Share Option Plans (CSOP) and Enterprise Management Incentives (EMI). In strictness only the first three of these arrangements are 'approved', as the EMI is self certified rather than formally approved by HMRC. It is more correct to refer to the four plans as the Government supported share plans, or the tax-advantaged share plans. We have tended to use the term 'approved' share plans to refer to all four plans as that is how they are usually referred to colloquially, though at times we have made it clear when we are referring to a subset of the four arrangements.
[2] See Annex K for members of the Consultative Committee.
[3] See Annex A for a glossary that includes the full names of the taxation Acts referred to.

Save As You Earn (SAYE)

1.6 SAYE was introduced in 1980 as a vehicle to encourage personal investment and direct personal involvement in stocks and shares of British industry. SAYE is an all employee scheme through which employees are able to enter into a regular savings contract putting money aside for a specified period. At the end of that period they can use their savings to exercise options over the shares in their company based on a discounted share price which was set at the start of the savings contract. Alternatively, the employee can take the money they have saved.

1.7 The SAYE legislation is set out in Sections 516-520 of ITEPA and in Schedule 3 to ITEPA. These provisions together with related provisions in Part 2 of Schedule 7D to TCGA 1992 make up "the SAYE Code".

Company Share Option Scheme (CSOP)

1.8 CSOP is a discretionary scheme which was introduced, in broadly its current form, in 1996. Under the scheme companies can grant options to selected employees up to a specified tax approved limit.

1.9 The CSOP legislation is set out in Sections 521 – 526 of ITEPA and in Schedule 4 to ITEPA. These provisions together with related provisions in Part 3 of Schedule 7D to TCGA 1992 make up "the CSOP Code".

Enterprise Management Incentives (EMI)

1.10 EMI was introduced in 2000 as a way to enable small companies to recruit and reward key personnel. The EMI is a discretionary scheme and allows qualifying companies to grant options to selected employees up to a specified tax approved limit.

1.11 The EMI legislation is set out in Sections 527-541 of ITEPA and in Schedule 5 to ITEPA. These provisions together with related provisions in Part 4 of Schedule 7D to TCGA 1992 make up "the EMI Code".

1.12 Any modification to EMI should be notified to the European Commission under State aid rules.

Structure of report

1.13 The report is structured as follows:

- Chapter 2 details the main recommendations arising from the review,
- Chapter 3 details the supplementary recommendations arising from the review,
- Chapter 4 sets out the next steps,
- Chapter 5 summarises the proposals we considered and rejected, and
- Chapter 6 covers those issues that were raised repeatedly during the review, but which do not relate to simplification.

1.14 The annexes provide the reader with supplementary information including details on the four schemes, evidence of the effect of share schemes on productivity and the terms of reference for this review.

2 Main recommendations

2.1 This chapter covers the three main recommendations arising from this review.

A new approval process

Recommendation

2.2 Our starting point is that the current approval process is involved, labour intensive and causes delays. It is not obvious how to simplify or streamline the process.

2.3 The OTS, taking into account the views of various stakeholders, and looking at the current position of the tax authorities in connection with self assessment in other areas of taxation, has concluded that a move towards self certification for SIP, SAYE and CSOP would be beneficial. We accept that the current approval process cannot be simply switched off without considering whether any measures are needed to protect employees, companies and the Exchequer.

2.4 The OTS therefore recommends that HMRC's Small Companies Enterprise Centre (SCEC) and interested stakeholders enter into discussions to design a self certification process. The target would be to introduce this reasonably quickly (we think a year would be practical) to replace the current approval process in place for SIP, SAYE and CSOP.

Summary of issue

2.5 Currently, companies must seek formal approval from HMRC before they can implement a SIP, SAYE or CSOP ("the approved schemes").

2.6 Before the formal approval stage, HMRC also offers an informal approval process, whereby companies can submit documentation for checking before seeking formal approval. Although this stage is not mandatory, companies are encouraged to submit draft documents and there is certainly the impression among some advisers and companies that this is effectively a mandatory step.

2.7 Once HMRC has confirmed that the draft documents meet the legislative requirements, companies may then adopt the approved scheme. Following adoption, companies must then submit the finalised documentation, as well as various additional documents including company resolutions, communication material and enrolment forms, for formal approval of the scheme. Only when formal approval has been received from HMRC can the company grant options, or award shares, under its approved scheme.

2.8 By contrast, EMI is not formally approved by HMRC. Rather, options are granted and then a notification of the option grant is made to SCEC within 92 days of the date of the grant of option. SCEC then has a 12 month window during which it can raise enquiries. Once that window has closed, the company and employees will have full confidence that the tax treatment relating to the options is secured.

The case for self certification

2.9 The approval process is perceived by many companies as lengthy and complex, causing delays in putting the scheme in place. Companies' share prices can fluctuate considerably while companies await HMRC approval and this is compounded by exchange rate fluctuations where global schemes are involved.

2.10 Admittedly, the first stage of the approval process is voluntary, but it would be extremely unusual for a company not to take advantage of HMRC's pre approval offering. In any event, even if the pre approval stage were not completed, HMRC would still need to check that schemes were compliant before giving approval, so it is unlikely that simply removing the pre approval stage would reduce the time taken. It may even add uncertainty – at the moment, once pre approval has been given, HMRC can usually turn around the final formal approval process in short time and will take all reasonable steps to comply with a company's timetable at that stage.

2.11 Advance approval does not fit with HMRC's introduction of self assessment and indeed the UK is the only country that we have identified (other than Ireland) where mandatory advance approval for a share scheme is required.

The case against self certification

2.12 Any simplification to the current approval process must be balanced with the need to ensure the correct use of the approved schemes. In particular, there may be a risk to the Exchequer if there were no upfront checks at the time a tax advantaged share scheme is established. It is crucial that a post implementation compliance framework is in place, including the ability for HMRC to enquire into companies, to revisit the schemes in order to challenge the self certified elements of the scheme, to withdraw approval, to unwind tax advantages, and to apply penalties if required.

2.13 Particular issues for consideration are set out below.

Protection for company and employer

2.14 Many companies (and, indeed, their advisers) welcome the "rubber stamp" available from HMRC when obtaining approval for a SIP, SAYE and CSOP. Self certification may prove a concern for those companies seeking certainty in relation to tax treatment of their share scheme and share option arrangements.

Protection for the Exchequer

2.15 If HMRC's ability to approve scheme rules in advance were removed, there would need to be a replacement with "downstream powers" in order to protect the Exchequer from tax losses arising out of potential misuse (or abuse) of the approved schemes (and, indeed, to ensure that employees are being fairly treated under the all employee schemes). HMRC already has a twelve month enquiry window for EMI schemes but this is applicable in relation to individual option grants. This is quite different from the approval process which does not look at individual option grants (or share awards) but at the wider concept of the rules of a scheme. The sheer numbers of participants in SIP and SAYE schemes would make it impractical for companies to notify HMRC of share awards or option grants under those schemes in order to open an enquiry window in the manner of EMI notification.

Recouping tax

2.16 An unusual feature of employee share schemes in terms of taxation is that one party (the employer) establishes and implements the arrangement, but it is a separate party (the employee) who obtains the key tax benefits. Companies do of course benefit from reduced employers' national insurance contributions (NICs) and a corporation tax deduction, but the primary mover behind the implementation of approved share schemes is the tax benefits for employees. Therefore, should the share scheme have to be wound up as a consequence of failure to comply with the rules of the scheme, it is the employee who would lose the benefits.

2.17 This raises the question of how HMRC would seek to recoup tax should a scheme be wound up – or, alternatively, how a company would seek to recoup any payments it had to make to HMRC because a scheme had "failed". If self certification is to be considered, there will be a real requirement to consider this point, taking into account a degree of protection for all the parties concerned.

The existing complexities of the approved schemes

2.18 Part of the reason EMI self certification is successful is because of the flexibility of the arrangement: there are comparatively few requirements for the company to meet, and the documentation is relatively simple. There is also the ability to seek clarification from HMRC on specific questions (e.g. relating to whether the company meets the trading activities requirement). It will be important that, following the successful introduction of self certification for the schemes, HMRC continues to provide share scheme advisers who can answer questions from companies and their advisers on HMRC's interpretation of the legislation.

2.19 The EMI legislation also sets out clearly the minimum terms that must be included in any option agreement. In comparison, the rules relating to SIP, SAYE and CSOP are more complex and there is more scope for companies to make errors, resulting in potential non compliance.

2.20 Were some of the other recommendations contained in this report to be accepted, this would reduce the difficulties inherent in self certification for the approved schemes.

Conclusion and way forward on self certification

2.21 Although the issues to be considered above may seem to be significant, we have set them out in detail for completeness. We do not think they are in any way insurmountable; in broad terms we think that the solutions are along the following lines

- protection for company and employer – model rules, with a list of required features (in the manner of EMI) should be published by HMRC,
- protection for the Exchequer – there needs to be power for HMRC to recover tax benefits for 'failed' plans, and
- recouping tax (and protecting employees) – the remedy should be payment by the company and not the employees unless it can be shown that they were knowingly involved in the default.

2.22 We hope, therefore, that this proposal, which has considerable potential to deliver practical simplification, will be taken forward promptly.

Further investigation into the relevance of CSOPs

Recommendation

2.23 We have seen considerable evidence through HMRC data that the use of CSOPs is declining significantly. At the same time, we have had strong representations from some users of CSOP's value. We are therefore unable to conclude definitively on the continuing relevance of CSOPs. The OTS therefore recommends that further work, either by the OTS or by HMRC, should be carried out to investigate whether the CSOP is still relevant for UK business.

2.24 The aim of the further work would be, among other things, to get a clearer picture of which companies currently use CSOPs and why. That might lead to a recommendation to amend the EMI rules to cover most CSOP users' needs.

Summary of issue

2.25 It has been difficult to identify clearly the types of companies using CSOP, because detailed information is of course protected because of confidentiality issues.

2.26 A piece of research for HMRC by Oxera, published in 2007[1], identified that larger companies were more likely to use approved share schemes (including CSOP) than smaller companies.

2.27 We also received anecdotal evidence from roadshows which suggests that CSOPs are used as follows

- by smaller companies which do not qualify for EMI (e.g. because of their trading activities) but wish to implement a discretionary option scheme,
- by companies which have grown beyond the limits placed by EMI but wish to implement a discretionary option scheme, and
- by larger companies who use CSOPs as a tax efficient part of their overall reward and remuneration strategy, typically for middle managers rather than senior executives. In the past, there have been examples of companies using a CSOP as a broader-based option scheme but we have not received any clear evidence of this during the course of writing this report.

2.28 It is worth noting that while, on the face of it, use of the CSOP is declining in popularity, there was very little appetite at the roadshows for its removal. Companies and advisers generally seem to welcome the availability of a tax efficient discretionary option arrangement beyond that offered under EMI. It was felt that CSOP formed part of a well understood and flexible suite of approved share scheme arrangements.

Merging CSOP and EMI

Recommendation

2.29 We propose the creation of one set of tax rules governing all tax advantaged discretionary option grants appropriate for use by companies, regardless of their size and trading activities.

2.30 Smaller, higher risk companies would continue to benefit from higher limits to ensure the continued incentives for growth as is currently the case under EMI.

Summary of issue

2.31 Companies and individuals can cease to qualify under EMI for a variety of reasons (e.g. the £30 million gross assets limit, number of full time equivalent employees exceeds 249 breaching qualifying trade rules, etc).

2.32 When that happens, if a company wishes to continue granting tax efficient options it must then introduce a CSOP, which requires additional administration, including introducing new rules and obtaining approval from HMRC and shareholders.

[1] http://www.hmrc.gov.uk/research/tax-advantaged-report.pdf

2.33 The disqualifying events under EMI can be difficult for companies to identify, and difficult for HMRC to police.

2.34 CSOP is much more restrictive than EMI – e.g. no ability to grant options at a discount, restrictions relating to the type of shares that can be used, rules relating to performance and conditions, options cannot normally be exercised with tax relief within three years of their grant date. Companies replacing their EMI with a CSOP will find that options which run alongside each other will be widely different, which is complicated and can be difficult to explain to employees.

2.35 A company "on the edge" of EMI qualification – e.g. one with around 250 employees - can move in and out of EMI qualification status relatively easily and frequently. This means that companies can quite suddenly lose the ability to grant options to key staff and find themselves moving back into EMI qualification status just as suddenly.

2.36 The EMI option limit of £120,000 per individual must take into account any CSOP options that have also been granted to the individual.

Outline proposals for a new discretionary option scheme

2.37 The proposed scheme would effectively merge the current CSOP into the EMI making it available to all companies.

2.38 We recommend a phased introduction. The first phase is likely to be mainly administrative and to a degree follows some of the other recommendations in this report. The second phase may have more cost implications for the Exchequer. We therefore recommend that this phase is not implemented immediately, to allow full consideration of those details. Any changes to the EMI scheme would need to take EU State aid rules into account.

Box 2.A: Single discretionary share option scheme

Step One: Merge EMI and CSOP into one discretionary option scheme, based broadly on the EMI legislation. There would be limited changes to current EMI qualifying companies, but some limitations (taken from the CSOP legislation) would continue to apply to those companies which do not qualify for EMI.

Step Two: Extend and simplify the new scheme further to remove some of the limitations applicable to non EMI qualifying companies and allow further flexibility for all companies using the new scheme.

Step one: merging EMI and CSOP

2.39 **Limits on value**: The existing limits (£120,000 subsisting options for EMI qualifying companies, £30,000 subsisting options for non EMI qualifying companies) will continue. This will ensure that smaller, fast growing companies will continue to benefit from the more tax advantageous EMI arrangements.

2.40 **Purpose of granting the option**: as for EMI (i.e. commercial reasons, for retention or recruitment, and not for the avoidance of tax).

2.41 **Eligible employees**: any full time director (i.e. working 25 hours per week or, if less, 75% of their working time), or any other employee.

2.42 **Material interest**: as for EMI (i.e. 30% material interest).

2.43 **Shares**: as for EMI, ordinary share capital (either in the employing company or a company controlling that company or a consortium).

2.44 **Restrictions on shares**: as for EMI, restrictions would be permitted.

2.45 **Exercise price**: as for EMI, this would be flexible (i.e. may be at a discount or at nil cost). On exercise, there will be an income tax and NICs charge on any discount to the market value of the shares at the date of grant.

2.46 **Exercise period**: options may be exercised free of tax and NICs (except for any discount). For EMI qualifying companies, no exercise period will apply. For non EMI qualifying companies, the current CSOP three year exercise period required for income tax relief (except for good leaver provisions, see paragraph 3.27) will continue to apply.

2.47 **Leaver provisions**: no good leaver provisions will apply for EMI qualifying companies, as there will be no exercise period before income tax relief is available. For non EMI qualifying companies, a "bad leaver" provision (as set out in paragraph 3.29) will apply.

2.48 **Disqualifying events:** these rules could be simplified considerably for EMI qualifying companies. If a company ceases to meet the rules relating to numbers of employees, gross assets or qualifying trades, the subsisting options will continue to be treated as EMI qualifying options but no more such options may be granted (unless the company requalifies through reducing the number of employees or the value of gross assets, etc). The list of excluded activities should also be amended in line with the proposals set out in paragraph 3.139.

2.49 Otherwise – for example when an employee leaves or there is a takeover, sale or change of control as set out above – EMI qualifying options must be exercised within a period of six months to retain the beneficial tax treatment. The current 40 day exercise window is too short to be practical.

2.50 **Qualifying exchange of options**: as for EMI, in case options are not exercised on a takeover.

2.51 **Tax treatment (option holders):** there would be no income tax or NICs on grant. There would be no income tax or NICs on exercise for EMI qualifying options (except where there is a discount), provided exercise occurs within six months of cessation of employment or change of control, or within twelve months in the event of death of the option holder. There would be no income tax or NICs on exercise for non EMI qualifying options (except where there is a discount) if exercise occurs outside the three year exercise period, or in a good leaver position (the same time limits would apply).

2.52 **Tax treatment (companies)**: the corporation tax deduction would be allowable as currently.

2.53 **Notification of option grant**: the current requirement for companies to notify EMI option grants within 92 days of date of grant is an administrative burden for companies, particularly bearing in mind that they must also complete an annual return with the same details. Similarly the approval process for CSOP is administratively cumbersome and time consuming. We propose that option grants under the new scheme are notified only by way of an annual return. Note that this would be subject to any amendments made to the approval process (outlined earlier in this Chapter) and annual returns (paragraph 3.2).

2.54 **Ten year limit**: options must be exercised within 10 years of the date of grant, in order to qualify for income tax relief.

Step two: extend and simplify the new scheme

2.55 **Removal of three year exercise period for non EMI qualifying companies:** The removal of the three year period before which options can be exercised for non EMI qualifying companies will align the two parts of the scheme. It will also simplify the legislation and ensure that companies can match the exercise provisions of their discretionary scheme to tie in with their commercial requirements, including those of any overseas companies.

2.56 **Removal of leaver provisions for non EMI qualifying companies:** If this recommendation is accepted, there will no longer be any requirement for good leaver provisions. This will provide a significant simplification and will also permit companies to match leaver provisions to their own commercial needs, including the ability to apply discretion.

2.57 **Simplification of grants:** Many companies find it difficult to calculate the value of shares over which options may be granted because they have to take into account the value of subsisting options granted more than three years previously (currently under both EMI and CSOP). We propose that the limits are adjusted on a three year rolling basis as follows

- EMI qualifying companies: limit of £120,000 on a rolling three year basis, and
- non EMI qualifying companies: limit of £30,000 on a rolling three year basis.

In each case, there would be no requirement to take into account subsisting options from outside the three year period.

Box 2.B: Rolling three year option grants

Participant is granted EMI options over shares with a value of £120,000 on 1 April 2012.

On 1 April 2015, another grant of options over shares with a value of £120,000 may be granted, even though the previous options may not have been exercised, or may not have lapsed.

2.58 **Two separate limits:** For companies to take advantage of the higher limit under the new scheme, they must meet the following requirements

- must have only qualifying subsidiaries (as for EMI currently),
- must employ fewer than 250 employees (as for EMI currently),
- must have gross assets of less than £30 million (as for EMI currently), and
- must carry out only qualifying trades, i.e. conducted on a commercial basis and not consisting either wholly or as to a substantial part in the carrying on of excluded activities.

2.59 If a company does not meet the requirements above, it will only be able to grant options over shares with a maximum value of £30,000 for each option holder over a rolling three year period. No maximum company limit will apply (as is the current case under the CSOP rules).

How the proposals could lead to simplification

2.60 This proposal creates a single streamlined scheme, with the key difference being that higher limits would apply to smaller companies carrying out certain specified trades. It also offers the following advantages, as it

- allows companies to grow and change their trading profile yet continue to offer share based incentives without the cost of implementing new plans and seeking formal HMRC and shareholder approval,
- assists in alignment of plan design with companies' commercial objectives,
- enables companies to develop unified share plans compatible with global share plan design,
- removes complications associated with pre-emption rights and different classes of shares (common commercial requirements in many companies, particularly private companies),
- simplifies the rules relating to limits and removes the current necessity for companies to take into account subsisting options granted under two plans,
- removes the need for a pre approval process,
- reduces legislation to one schedule for all discretionary option grants,
- is easy for businesses to understand as it is based largely on the existing EMI and CSOP rules, and
- allows HMRC to focus their monitoring of share plans more efficiently.

2.61 The simplification of the rules for non EMI qualifying companies may encourage all employee option schemes for smaller companies that do not currently pass current EMI tests, for example because their trades do not qualify.

Protecting the Exchequer

2.62 We recognise that the merging of EMI and CSOP may lead to costs to the Exchequer. We set out below our consideration of those costs.

2.63 There will be no increase in the current applicable limits. The £120,000 limit would still apply to EMI qualifying companies with the larger non EMI qualifying companies still limited to £30,000.

2.64 There will be no use of subsidiary shares, avoiding possible value manipulation and tax avoidance.

2.65 Discounts on grants will be taxable, as for EMI currently.

2.66 The removal of the three year exercise period for non EMI qualifying companies will provide a major simplification. If options are exercised within three years of grant, it is likely that the option holders' gains will be lower, thus reducing the cost of the tax relief. In practical terms, most larger companies (particularly listed companies) use three year vesting periods in order to meet the requirements of institutional investors e.g. the Association of British Insurers (ABI) guidelines. Commercial demands often impose a three year limit on exercise; it is unnecessary for the tax legislation to impose the same limits.

2.67 There is no requirement to impose an effective three year holding period if tax relief is only going to be given for future increases in the value of the shares.

2.68 The removal of the three year exercise period may make the scheme more attractive which could have a potential cost that would need to be considered as part of developing the merged scheme.

3 Supplementary recommendations

3.1 This Chapter covers the supplementary recommendations arising from this review. We have divided the supplementary recommendations into two categories: those that we think can be implemented without a tax cost, and those which are likely to have a potential tax cost.

Recommendations common to all schemes – no cost

(A) Annual returns

Recommendation

3.2 Create a single annual return form on which all option grants and share awards pertinent to all tax advantaged schemes can be recorded and notified to HMRC. There should be an opportunity for companies and share schemes administrators to input into the design of the new forms to enable information to be downloaded from systems with minimal manual input thus reducing chances of incorrect information being recorded, whilst retaining key information for national statistics purposes.

Summary of issue

3.3 Currently, companies are required to notify HMRC of option grants and/or share awards under their annual returns. This is a duplication of effort and administration for EMI, where notification has already been made at the time of the grant of options.

3.4 There is a different annual return form for each of the approved schemes, as well as for EMI.

3.5 Under the proposed new self certification scheme, there would be no requirement for companies to notify HMRC of the grant of options/award of shares at the time of the grant/award. Instead, HMRC would be notified of the grant/award when the annual return is submitted.

(B) Online filing

Recommendation

3.6 Introduce online filing for share plan returns. This should apply both to annual returns and, should HMRC wish to make an enquiry into a tax advantaged scheme, the scheme documentation. As a starting point filing could be by submitting portable document formats (pdfs) of completed forms or ideally by the use of intelligent HMRC forms. In the long term, HMRC should consult with scheme administrators and adopt similar platforms whereby companies can download and upload scheme data onto a secure site.

3.7 In the long term, we would recommend that real time recording replaces the annual return. This would result in

- transparent relationships between HMRC and companies,
- alignment with PAYE remittances, and

- allow HMRC to keep track of option grants (so for example HMRC would easily be able to identify unusual or irregular activity in connection with option grants or share awards).

3.8 It would also take off the pressure from the system whereby HMRC would not be receiving thousands of forms at one point in time as happens with the current annual return process.

Summary of issue

3.9 All returns are paper based and have to be either completed by hand or companies have to print off reports from their own systems.

3.10 Some of the documents to be submitted to HMRC (whether for advance approval or self certification in the case of EMI) are also paper based.

3.11 Manually completing paper forms brings with it the risk of mistakes occurring when the information is being transposed from another document.

3.12 The ability to file online would reduce paperwork, result in swifter completion of forms, and minimise risks of errors.

(C) Prescriptive rules regarding operation of schemes

Recommendation

3.13 Give companies and trustees more flexibility on how schemes are operated. For example, they should be able to communicate with and provide information to employees in a way which suits them, within a broad framework laid down in legislation. This should include the ability to provide online communications. Another example would be to dispense with the common current practice for a full paper copy of a company's articles of association to be attached to an EMI option agreement (to set out restrictions relating to shares), or allowing participants to enrol online. In fact this is likely to reflect what companies are already doing in practice.

3.14 Remove the requirement for companies to submit employee communication material as part of the approval process.

3.15 Permit companies to make their own decisions on administrative aspects of schemes.

Summary of issue

3.16 Rules are prescriptive as to how participants receive scheme information, which increases the administrative burden of running schemes.

3.17 Employees no longer have an expectation of receiving information in hard copy. Many companies use different forms of social media to communicate with employees. Changes in working hours and shift patterns mean employees want to be able to access scheme information at times that suit them.

3.18 There is a significant amount of paperwork that must be submitted to HMRC as part of the approval process.

3.19 There are detailed requirements for administrative matters such as when to start, stop and restart deductions for SIP Partnership Shares. These include rules relating to withdrawal and repayment.

(D) Retirement age

Recommendation

3.20 Create one definition of retirement across all the schemes (excluding EMI). Age discrimination legislation precludes the inclusion of a standard retirement age, e.g. 55. Therefore this common rule should lay down principles and allow companies to have their own definition of retirement which reflects their wider operations.

3.21 Note that if the recommendation relating to "good leavers" (see paragraph 3.27) is accepted, this recommendation is likely to fall away.

3.22 There may be a tax cost or a yield here, depending on how the rules are changed.

Summary of issue

3.23 With the exception of EMI, each of the tax advantaged schemes allows options to be exercised or shares taken out of the scheme without a charge to income tax and NICs, before the usual exercise/acquisition date, for certain "good leaver" reasons. These include retirement. (No good leaver reasons are required under the EMI legislation, as options may be exercised free of income tax and NICs at any time following the date of grant.)

3.24 Retirement is defined differently in each of the approved schemes:

- SIP: shares may be taken out of the scheme by reason of the participant's retirement on or after reaching the retirement age specified in the scheme. The age must be the same for men and women and must not be less than 50.
- SAYE: retirement must be specified in the scheme rules and is defined as "on reaching the specified age, or any other age at which [the participant] is bound to retire in accordance with the terms of [the participant's] contract of employment". The specified age must be the same for men and women, not less than 60 and not more than 75.
- There is an additional complication under SAYE, which allows "two bites of the cherry", in that a participant may exercise early on reaching the specified age under the scheme, whether or not he or she is retiring, and may also exercise early on retirement, provided the participant retires on the date they are bound to retire on and not any other date.
- CSOP: retirement must be on or after the age specified in the scheme rules and set at an age which is the same for men and women and not less than 55.

3.25 The different retirement ages across the schemes cause confusion and inconsistency not only for companies operating more than one approved scheme, but also for those operating approved schemes alongside other unapproved arrangements, where companies can set their own definitions of retirement. Employees nearing retirement cannot easily assess their entitlements under the schemes and could mistakenly factor in a benefit on the assumption they would be treated as a retiree under all the schemes.

3.26 The specific ages set out above do not correspond with recent changes to the default retirement age for the purposes of receiving the state pension. Nor do they correspond with wider social changes whereby people may work beyond the age set out in the scheme, by reason of choice or necessity.

Recommendations common to all schemes – potential cost

(A) Good leavers

Recommendation

3.27 There are different consequences under the approved share schemes for employees who cease employment with a company, depending on the reason for their leaving. Generally speaking, a "good leaver" - someone who leaves, for example, because of redundancy, retirement or disability - will not lose their shares or options under the scheme because they have left. They will also retain the tax advantages under the relevant scheme, even if they have left before the usual exercise or holding period. Employees who leave for any other reason than those specified in the relevant legislation will be treated as a "bad leaver". They will lose the tax advantages under the relevant scheme and, in certain circumstances, may lose their shares or options altogether.

3.28 The "good leaver" rules vary across the schemes, which creates complexity. They are also restrictive, because they prevent companies putting in place leaver rules which meet companies' commercial and human resources requirements. They can cause confusion if they are mismatched with the leaver rules in a company's unapproved share plans. Finally, they can be unfair because employees may be treated as bad leavers in some circumstances when their employment has ended through no fault of their own. In fact, there are very few reasons why employees who cease employment involuntarily - i.e. other than voluntary resignation or dismissal for cause - should be classed as "bad leavers".

3.29 We recommend changing the approach to the legislation and setting a presumption that any leaver is 'good' except for those that fall into certain limited situations. Hence employees may exercise their options if they leave employment unless they are a "bad leaver". That term would mean voluntary resignation or dismissal with cause. Where the bad leaver rules do not apply, we recommend that options must be exercised within six months of the date of cessation of employment, or 12 months in the event of the participant's death in order to retain the "good leaver" tax treatment, as is the case currently.

3.30 Whilst we want to align the definitions, these must be read in the context of the individual schemes. Under the SIP, the bad leaver definition will apply to leavers within five years of share award since this is the current period shares have to remain in the plan before they can be withdrawn tax free. Likewise under SAYE/CSOP these rules will apply if employees leave within three years of grant.

3.31 In the case of CSOP, which is a discretionary scheme, companies would not be obliged to include "bad leaver" provisions. This would continue the current practice under CSOP, reflecting the discretionary nature of the scheme.

3.32 This recommendation would result in leaver provisions which are easy to understand, follow current common practice in unapproved schemes and are fair. It would also streamline the legislation.

Summary of issue

3.33 Good leaver provisions are when an employee leaves employment and is able to exercise his or her options, or take shares out of the SIP scheme, without negative tax consequences, even if the required period has not ended (e.g. three year exercise period in the case of a CSOP). Typical good leaver provisions include death or disability.

3.34 The legislation currently provides for good leaver provisions throughout the three approved schemes (SIP, SAYE and CSOP). Good leaver provisions do not apply to EMI, because there is no minimum period for which the option must be held.

3.35 However, there is some inconsistency relating to employees who cease employment with a company for certain reasons which are beyond their control.

3.36 Under SIP, the good leaver provisions apply to employees ceasing to be an employee of the company or group within five years of award of the relevant SIP shares, by reasons of injury or disability, on dismissal by reason of redundancy, by reason of a transfer under TUPE regulations, by reason of change of control of the employee's employer ending that company's status as an associated company under the scheme, by reason of retirement on or after a specified retirement age or on death. These are regarded as comprehensive and deal with all of the unexpected situations where an employee could leave employment outside of their immediate control that could give rise to a tax liability, were it not for these rules. These good leaver provisions also apply to forfeiture such that plan shares would not be forfeited in the case of a leaver falling within these provisions that would otherwise be subject to forfeiture.

3.37 Under SAYE, the good leaver provisions apply for employees leaving employment within three years of the grant of an SAYE option. These provisions are more restrictive than for SIP and do not specifically require that options can be exercised within three years and without income tax should an employment end by reason of TUPE transfer (although in many cases this equates to redundancy) or a change of control of the employee's employer ending that company's status as an associated company under the scheme. The major area of inconsistency is where the employee's employing company is sold outside the group, when the compulsory good leaver provisions do not apply. A similar commercial outcome for the company and, on the face of it, for the employee could be achieved by the sale of the business in which the employee is working to the same buyer. Under the current rules this would be considerably more beneficial for the employee whose original role would effectively be made redundant and his previous employer required to permit the early exercise of SAYE options without an income tax liability. As a further inconsistency, the scheme company can choose to permit early exercise in this circumstance when drawing up the rules but this does not confer equal tax treatment as afforded to an employee leaving for a compulsory good leaver reason.

3.38 Under CSOP the only good leaver reasons are redundancy, injury, disability, retirement or death. Unlike SAYE and SIP, the scheme does not have to include these good leaver provisions. However, HMRC's practice is to require companies' rules to spell out whether or not good leavers may exercise.

3.39 The good leaver provisions are complicated and inconsistent, resulting in different treatment of employees under different share and option schemes. This can be difficult to explain to participants.

3.40 It is also unfair for employees to be treated as bad leavers when the reason for leaving – e.g. the sale of a subsidiary or transfer of a business - is beyond their control. Events such as these will either cause employees to lose the tax advantages relating to the share schemes or, in some circumstances, result in their being unable to exercise their options or acquire their shares at all.

(B) Cash takeovers

Recommendation

3.41 Allow tax free early exercise for cash takeovers in order to protect employees should an option exchange not be feasible.

3.42 This issue is of particular importance to companies operating SIPs because of the clawback relating to employers' NICs (see paragraphs 3.107 to 3.110).

Summary of issue

3.43 Different consequences flow from different mechanisms on corporate events such as takeover and reconstruction. Options become exercisable at different times depending on the arrangements. In some cases options do not become exercisable at all.

3.44 Options in the existing company can sometimes be exchanged for "new options" in the acquiring company where there is a reconstruction or takeover. Where there is a share for share exchange, the beneficial tax treatment is continued with the acquiring company.

3.45 In some cases, however, this is not possible, for example, where there is a cash offer. In this situation, the participating employees are obliged to exercise their options (or, in the case of SIP, take their shares out of the scheme) and be paid out in cash. Employees are then effectively treated as bad leavers – i.e. they will lose the tax advantages associated with the scheme – even though they are remaining with their employing company. The corporate event has a negative effect on their scheme participation, even though it is beyond their control.

3.46 Aside from the inherent unfairness, this can lead to additional complications, because the exercise of the options, or sale of the shares, constitutes a taxable event. Both the company and the individual are required to complete a return, which would not be required were the event non-taxable, and PAYE must be operated on the taxable value in the case of SIP.

3.47 In addition, there is evidence that companies will sometimes seek to implement complex arrangements to get around this issue. For example, the target company and buyer may look to put in place a specific loan note alternative to stand in the shoes of the target company shares and remain in the SIP until the expiry of the five year holding period in order that the income tax and NICs free status of the shares can be maintained.

(C) Features not reasonably incidental

Recommendation

3.48 Remove the broad prohibition for SIP, SAYE and CSOP and replace with a specific targeted clause setting out the key areas which HMRC considers should be prohibited, e.g. the operation of the scheme in conjunction with salary sacrifice.

Summary of issue

3.49 These rules prohibit the inclusion in approved schemes of "features not reasonably incidental to the provision of shares".

3.50 SIP requires that the purpose of the scheme must be to provide benefits to employees in the nature of shares in the company which give them a continuing stake in that company. The scheme must not contain, and the operation of the scheme must not involve, features which are neither essential nor reasonably incidental to that purpose.

3.51 Both SAYE and CSOP require that the scheme must not contain features which are neither essential nor reasonably incidental to the purpose of providing benefits for employees and directors in the nature of share options.

3.52 HMRC's guidance[1] states that there is no statutory definition of these features so it is not possible to provide a definitive list of unnecessary features, although some examples are given.

3.53 While the overriding purposes of the schemes may be to provide benefits to employees in the nature of shares or options, the commercial purposes behind the implementation of schemes may be much wider, e.g. to increase productivity or to cement a certain company culture.

3.54 The requirements set out in the legislation are confusing and do not necessarily sit with companies' own commercial objectives behind implementing schemes.

3.55 Removal of the prohibition is another area which could assist in a move away from the formal approval process and enable self certification.

(D) Material interest

Recommendation

3.56 We propose that the material interest provisions are removed altogether for SIP and SAYE. We consider that the complexity of the legislation is wholly disproportionate to any tax avoidance that may be undertaken as a consequence of the removal and their design as all employee schemes provides some protection against abuse.

3.57 We recognise however the potential for abuse under the discretionary schemes, i.e. EMI and CSOP. We would therefore recommend retaining the principle of the material interest test for these schemes, but aligning the percentages, so that a material interest for CSOP would be defined as 30% as for EMI (any amendment to the EMI percentage would require notification to the European Commission so it would be easier to standardise on the EMI percentage).

Summary of issue

3.58 The material interest rules apply to all the schemes and make up a large part of the legislation in each of the relevant Schedules. They exist to prevent individuals who already own significant percentages of a company's share capital from benefiting further under tax approved arrangements, particularly when those individuals have enough control to influence the grant of share options or the making of share awards under approved schemes.

3.59 An individual's ownership is calculated not only by their direct shareholding but also by the shareholdings of their associates. "Associate" is widely defined, including spouses/civil partners, parents, children and relatives in the direct line. It also includes trustees of settlements in which the individual (or his or her associates) has an interest, or of which he or she was a settlor.

3.60 For the all employee schemes in particular (SIP and SAYE), the complexity and detail of the material interest provisions seems disproportionate to the value likely to be obtained by any individual seeking a tax advantage by way of abusing the material interest test. This is because the limits on those schemes are much smaller by comparison to those allowed under the two discretionary option arrangements.

3.61 The material interest test differs across the schemes, being set at 25% for the three approved schemes, and at 30% for EMI.

[1] http://www.hmrc.gov.uk/manuals/essum/index.htm

(E) Restrictions on shares

Recommendation

3.62 We recommend that the requirements under SIP, SAYE and CSOP for shares only to have permitted restrictions are removed entirely.

3.63 Where shares are subject to restrictions, there would be a requirement that any option agreement, rules or associated documentation contain details of the restrictions, as is the case for EMI.

3.64 The legislation should provide that if an option is granted over restricted shares then they are to be valued as if they were not restricted. This would provide a safeguard against abuse of the individual limits using highly restricted shares.

Summary of issue

3.65 Shares with restrictions cannot be used in tax advantaged schemes (other than EMI), with some limited exceptions. This makes participation in approved share schemes particularly difficult for private companies, where restrictions on shares are common and often put in place for sound commercial reasons.

3.66 The legislation itself is not particularly lengthy, but the HMRC guidance runs to many pages, demonstrating the number and different types of restrictions used by companies which prove a barrier to the implementation of approved share schemes.

3.67 The legislation relating to permitted restrictions is inconsistent across the different Schedules of ITEPA, meaning that companies using more than one type of approved scheme will have to follow different sets of rules for each scheme. The use of shares under unapproved schemes is also severely restricted if companies wish to run an approved scheme alongside their unapproved arrangements.

3.68 SIP: the types of restrictions permitted are set out in legislation[2]. Permitted restrictions include

- shares may carry no or limited voting rights,
- there may be provision for forfeiture of the shares in connection with Free or Matching Shares, but not for Partnership Shares; nor may the restrictions apply to a participant leaving for certain "good leaver" reasons, or in any way linked to performance,
- pre-emption conditions may attach to the shares, provided that they apply, broadly, to all employees, all cessations of employment and all shares originally awarded under the scheme, and
- pre-emption rights may be imposed not only by the company's articles of association, but may include any other written agreement between the shareholders of the company.

3.69 SAYE and CSOP: the types of restrictions permitted are also set out in legislation[3]. Permitted restrictions are as follows

[2] ITEPA 2003 paragraphs 30 – 33 of Schedule 2
[3] ITEPA 2003 paragraphs 21 of Schedule 3 (SAYE) and paragraphs 19 of Schedule 4 (CSOP)

- restrictions must attach to all shares of the same class or must be certain permitted restrictions,
- permitted restrictions include certain "employee pre-emption" provisions. Shares held by employees may be subject to compulsory transfer provisions when an employee ceases employment, but the transfer must broadly take place on the same terms as for any other shareholder, and
- there will also be a restriction under any other contract or arrangement in place (e.g. shareholders' agreement). In the case of CSOP only, this does not apply to any terms of a loan which makes provision as to how it will be repaid.

3.70 This is a common area of confusion and difficulty which arises during the approval process. Removal of the rules relating to restrictions would be a very important step towards simplifying the approval process, or enabling it to be removed altogether and replaced with the self certification route.

3.71 Companies wishing to implement share schemes for their employees and directors in some cases will need to make changes to their articles of association (and in some cases to existing shareholders' agreements) in order to comply with the legislation. This adds to the cost of the schemes, as well as resulting in changes to the company's constitutional documents which may not be in their commercial interest.

3.72 EMI provides tax advantages for companies whose shares are restricted (and also allows different classes of shares to be used – see "requirements as to other shareholdings" below). This is managed by notifying employees of the restrictions placed upon the shares and the effect on the shares' value of those restrictions.

(F) Requirements as to other shareholdings

Recommendation

3.73 Permit companies with more than one class of shares to operate SAYE and CSOP, without requiring compliance with conditions that do not apply to a company with only one class of ordinary share.

Summary of issue

3.74 The legislation requires that, if companies have more than one class of share, employees are granted options over shares which are worth having. This is achieved by requiring the majority of the issued shares of the same class as the eligible shares to be either employee-control shares or open market shares[4].

3.75 For many private companies, and a number of listed companies, it is a commercial reality to have more than one class of share. It is also usual, especially for private companies, to have restrictions attaching to the shares in connection with transfer rights.

3.76 For companies wishing to differentiate between classes of shares, it is very difficult to make use of a tax advantaged share scheme (with the exception of EMI, which is not open to all companies).

[4] ITEPA 2003 paragraph 22 of Schedule 3 (SAYE) and paragraph 20 of Schedule 4 (CSOP)

(G) Group schemes and associated companies

Recommendation

3.77 Permit associated companies to participate in approved schemes provided they are subsidiaries of the company whose shares are being acquired.

Summary of issue

Box 3.A: Definition of associated company[5]

One company is an "associated company" of another at any given time if at that time one has control of the other or both are under the control of the same person or persons.

3.78 Currently, employees within a group of companies may only participate in an approved scheme if they are employed by the parent company or a subsidiary. Employees of associated companies may not participate. This can lead to complications in setting up the schemes initially, and also in dealing with reorganisations within an international group.

3.79 For international groups of companies there can be set up problems when there is a foreign parent company but no common UK holding company. It may not be practical for the foreign parent to be the sponsor of a scheme which is only applicable to UK employees; furthermore, there may be complex overseas regulations and timing issues to be taken into account in order for the foreign parent to establish the scheme. In this situation it is necessary for each UK holding company to establish a separate approved scheme for its own subsidiaries – although the schemes may be identical in all but name, and use the same parent company shares. Were associated companies able to participate in group schemes, this complexity could be avoided.

3.80 Reorganisations within the group can also cause difficulties, and inconsistencies. For example, if an employee employed by a subsidiary participating in a SIP is transferred to an associated company (still within the group), they must cease contributing to the SIP – but must keep their existing shares within the trust in order to benefit from the tax relief. This is a particularly confusing outcome for employees.

3.81 The associated companies rules create a confusing "halfway house" scenario which is very difficult to explain to participants and results in unfair treatment. This is particularly the case for international groups which may undertake restructuring for commercial purposes, only to discover that a section of their workforce has effectively left the "SIP group" – but remained within the group as a whole.

3.82 It is worth noting that the exclusion of associated companies under the tax legislation does not correspond with the wider definition of "employees' share scheme" under company law as the following box shows.

[5] CTA 2010, section 449

Box 3.B: Definition of employees' share scheme (Section 1166 Companies Act 2006)

A scheme for encouraging or facilitating the holding of shares in or debentures of a company by or for the benefit of

(a) the bona fide employees or former employees of

i. the company,

ii. any subsidiary of the company, or

iii. the company's holding company or any subsidiary of the company's holding company...

Recommendations specific to SIP – no cost

(A) Redundant legislation

3.83 Delete paragraph 78 of Schedule 2 ITEPA 2003 relating to acquisition of shares from QUESTs[6] as this is now redundant.

(B) Partnership shares – accumulation period

Recommendation

3.84 Permit companies to specify that the number of shares to be awarded can be determined by reference to the share price on the award date (following the end of the accumulation period) or at the share price at the start of the accumulation period or the lower of the price at the start and the end of the accumulation period. Whichever is chosen must be specified in the partnership agreement.

Summary of issue

3.85 There is a cost to the company in relation to the current arrangement that they cannot hedge, so there is uncertainty.

3.86 Where a company has an accumulation period for Partnership Shares, the number of shares awarded to employees is based on the lower of the share value at the start and end of the accumulation period. Any movement in the share price may have cost implications for the company depending on whether the share price rises or falls and at what point the company buys the shares. In example one below, the number of shares is determined with reference to the lower share price at the start of the accumulation period. Because the share price rises, shares purchased by the company at the award date will cost more than the amount saved by the employee. However, if the price falls, as shown in example two, there would be cost implications if the company buys the shares at the start of the accumulation period. If the company buys the shares at the award date there would be no cost implications.

6 QUEST - Qualifying employee share ownership trust

Box 3.C: Examples

Example 1: An employee saves £100 per month for six months. Total savings are £600. The share price has risen from £5 per share to £6 per share over that period. Under current rules, the employee buys 120 shares at £5 per share.

The company has to buy shares at £6 per share and so incurs an extra cost of £120.

Example 2: As in example 1, but the share price falls from £6 to £5 per share over the period. Under current rules, the employee buys 120 shares at £5 per share.

The company has bought 100 shares at the start of the period at £6 per share (so that the total cost was the £600 the employee expected to save). At the end of the period, the company has to buy an extra 20 shares costing it £100.

3.87 This is a particular issue for smaller companies (whether or not quoted) which cannot easily and cost effectively operate a SIP without an accumulation period because of the lack of a ready market.

(C) Operation of PAYE

Recommendation

3.88 A change should be made to the PAYE penalty regime such that penalties will not be chargeable on the late payment of PAYE if the taxable event is related to shares leaving the SIP and the PAYE is paid within 90 days of the due date. This would be fairer and more practical for employers.

3.89 Since April 2010, penalties apply if PAYE is not paid by the 19th of the following month. This is frequently impractical as far as share schemes are concerned and it may mean that companies incurring penalties due to share schemes regularly claim reasonable excuse grounds to escape the penalty. It does not seem possible for HMRC to give a blanket reasonable excuse for share schemes since there will be occasions when share plans are genuinely in default.

3.90 We do not propose any changes to the date at which the taxable value is calculated. This will still be calculated with reference to the date the employee ceases employment.

Summary of issue

3.91 If a SIP participant's employment ends there will only be a tax exemption if he or she leaves for a good reason, such as retirement or redundancy. There will be no such tax exemption if an employee leaves for another reason, e.g. resignation. When this is the case, the shares are deemed to leave the SIP on the date of leaving and an income tax charge arises on that date. The deadline for making PAYE payments is the 19th of the following month.

3.92 This is a particular issue for SIP because of the complex legal structure where the shares are held by the trustees on behalf of the employee. It is the employer who in practice usually operates PAYE though technically in certain circumstances the obligation can fall to the trustees. In a leaver situation, the employer must deduct PAYE on the taxable value of the SIP shares valued on the date of leaving. However, the employer has no right to receive funds from the sale of shares unless those funds have been provided by the SIP trustee – so in effect the employer has no funds from which to deduct the PAYE. The source of the PAYE is from the sale of the shares, which must be sold by the trust before the trust can remit the PAYE to the company (or to HMRC, if the trust pays this directly).

3.93 The trustee is usually reluctant to sell some or all of the shares to fund the tax liability even though it may be able to do so under the trust deed because of its duty to act in the best interest of the employee who is the beneficiary. Therefore, the trustee will usually contact the employee as soon as it knows that an employee has left employment and that income tax and NICs will be due and ask for the employee's instructions. The trustee will usually specify that sufficient shares will be sold to fund the PAYE liability if the employee does not respond within a reasonable time period. The trustee also may have limited opportunities each month to actually sell the shares for administrative and legal reasons e.g. close periods. The result is that the shares are typically sold and the proceeds passed to the company and the PAYE remitted within two to three months of the date that the employee leaves. As such the employer is liable to a late payment of PAYE penalty, even though the employer is unable to remit PAYE earlier. These circumstances may not be apparent to HMRC at present but will be under Real Time Information (RTI).

3.94 This has only been an issue since 6 April 2010, when the PAYE late payment regime was introduced. Previously, employers paid the PAYE on the taxable value of SIP shares late but there was no penalty regime in place so there was no PAYE or penalty issue, provided the PAYE was made good by the employee within 90 days of the relevant date.

3.95 The amount of penalty will depend on the amount paid late and how many times the payments are late in a tax year. The table below shows how the penalties are calculated:

Table 3.A:

No of times payments	Penalty percentage	Amount to which penalty percentages apply
1	No penalty (as long as the payment is less than six months late)	Total amount that is late in the tax year (ignoring the first late payment in that tax year)
2-4	1%	
5-7	2%	
8-10	3%	
11 or more	4%	
Source: http://www.hmrc.gov.uk/paye/problems-inspections/late-payments.htm		

Box 3.D: Current position on PAYE

The operation of PAYE in relation to share based payments made after cessation of employment is currently taxed at the basic rate. All other payments after leaving are taxed using a progressive 0T code.

This presents an issue to companies processing share based payments and other payments after leaving in the same pay period, as two different tax codes must be used for one period. This is proving impossible to comply with for many employers, and is resulting in some companies being exposed to penalties for PAYE failure in the 2011/12 tax year. As stated above, it is common for companies to operate PAYE on share related payments through the monthly payroll, and as such this creates complexity.

We note that HMRC is consulting on changes to the tax code operated on share based payments made after cessation of employment. See www.hmrc.gov.uk/drafts/share-pay-qanda.pdf

Recommendations specific to SIP – potential cost

(A) Tax free holding period

Recommendation

3.96 Reduce the tax free holding period for all shares under the SIP to a standard three years, instead of the current varying periods. As well as having the effect of considerably simplifying the scheme, we believe that this would make the SIP considerably more attractive. The cost impact of this would be twofold. First, the income tax and NICs receipts otherwise received in relation to shares leaving the scheme between three and five years would be lost to the Exchequer. Secondly, an increase in take up would increase the cost of income tax and NICs relief associated with the scheme.

Summary of issue

3.97 The SIP has a number of different holding periods which cause confusion and lead to a disconnect in some cases between the holding period and when full tax relief can be realised. The box below demonstrates the different holding periods. It would be much simpler if all the periods could be aligned at three years.

Box 3.E: SIP Design

- three year period during which Partnership, Matching and Free Shares will be taxed at full market value if they are withdrawn from the scheme,
- five year period during which Partnership, Matching and Free Shares will have some tax to pay if they are withdrawn from the scheme,
- holding period of between three and five years for Matching and Free Shares (this is the period shares must remain in the trust other than if the employee leaves the company),
- holding period of three years for Dividend Shares, and
- possible forfeiture of zero to three years for Free and Matching Shares.

3.98 A wide perception of stakeholders is that the five year holding period before which the full tax advantages of SIP can be realised is too long and causes considerable confusion.

3.99 The five year holding period causes confusion because of the inconsistency between the minimum holding period and required holding period for tax. Although the minimum holding period for Free and Matching Shares is three years, tax relief is not available until shares have been held for five years. This makes the SIP difficult to communicate to employees on launch and maturity, and it taints the positive elements of the scheme.

3.100 There are also different rules for calculation of the tax liability where shares are held for less than three years from those shares held for between three and five years from award. Where a tax liability arises, it is difficult for employees to understand the calculation of the taxable value associated with leaving the scheme where some shares have been held for less than three years and others between three and five years.

3.101 The five year holding period is inconsistent with current remuneration practices. The holding period for SIP is longer than a typical holding period of three years in CSOP and unapproved schemes, including executive schemes. SAYE also allows participants to exercise after three years. Feedback suggests that five years is generally considered too long to maintain a realistic retentive effect and offer a line of sight for employees.

3.102 International companies prefer to use one scheme design globally with typically a two or three year holding period. The longer holding period in relation to the SIP makes it difficult to incorporate this in to a global scheme; with the result many companies use an unapproved share scheme instead, although they may be using approved schemes in other countries. A survey of US companies with international employees in 2008 found that 95% of those companies had employees in the UK and 62% had an all employee share scheme in the UK; however only 3% of companies used a SIP[7].

3.103 The different holding periods for SIP and SAYE can add to the complexity in a takeover situation where the company has both SIP and SAYE schemes.

(B) Uncapped PAYE and NICs liability on cash takeovers

Recommendation

3.104 The recommendation set out in paragraph 3.41 (cash takeovers) would solve this issue.

3.105 If this issue is not resolved by a new income tax and NICs exemption in circumstances where shares leave the scheme early as a result of a cash takeover, we recommend that the basis for calculation of the taxable value be changed in these circumstances such that income tax and NICs are charged on the lower of the initial market value of the shares awarded and the value when the shares leave the scheme. This would have the effect of reducing the income tax and NICs liability in the event of a cash takeover within zero and three years of the award of shares and would address the clawback issue in relation to Partnership Shares.

3.106 This approach is more clearly targeted to specific circumstances than the cash takeovers recommendation. It would make SIP more attractive, and might increase costs as a result of increased takeup of the scheme, but to a lesser degree than the recommendation on cash takeovers.

[7] 2008 International Stock Plan Design and Administration Survey by the National Association of Stock Plan Professionals and Deloitte LLP

Summary of issue

3.107 If SIP shares leave the scheme within three years of award, there is an income tax and NICs liability (including employers' NICs) on the market value of the shares at the time the shares leave the scheme. This liability is not known at the time of the share award and the employers' NICs liability is not transferable to the employee (as it is for CSOP, EMI and unapproved share schemes).

3.108 This makes the SIP unattractive for those companies who fear they may be subject to a takeover within three years of awarding shares. This has been raised by private companies and a number of advisers as a significant barrier preventing these companies from offering the SIP to their employees. We understand that the removal of this area of uncertainty would significantly increase the take up of the SIP amongst these companies, which are more likely to be smaller companies which the Government of the time wanted to encourage to provide shares to employees.

3.109 This is not an issue for the SAYE scheme because the difference between the market value and the exercise price is liable to income tax but is not subject to NICs.

3.110 It is also not an issue for CSOP, EMI and unapproved schemes because companies and employees may enter into an agreement to pass the employer NICs charge to the employees who benefit from the increase in share price.

(C) Dividend reinvestment

Recommendation

3.111 Remove the dividend cap and permit all dividends earned on SIP shares which are held in the scheme to be reinvested in the scheme.

3.112 We considered whether it would be sufficient to increase the cap amount, but decided against this as the same amount of work would still be required to assess whether individual participants were affected by the new cap, and this would not result in any simplification.

3.113 Remove the three year limit on the carry forward of cash dividends to be used in dividend re-investment.

Summary of issue

3.114 The current limit for dividends relating to SIP shares to be reinvested in Dividend Shares is £1,500 per year. There is also a three year limit on dividend reinvestment, which can prevent employees from acquiring Dividend Shares where the company share price is high in comparison to the level of dividends paid. We noted that this issue would be mitigated if companies made awards over fractions of shares, which is permissible under the scheme. UK companies can only issue whole shares and as such the SIP trust would have to hold whole shares but allocate fractional awards to participants. We do not consider this would be a simplification.

3.115 The SIP was designed to encourage employees to leave their shares in trust on a long term basis, rather than take them out at the end of the holding period. Increasing numbers of employees now have more than 10 years' worth of shares and the level of dividends may exceed the reinvestment limit of £1,500. This means that only part of the dividend can be re-invested and the balance must be paid out to the employee in cash. This creates additional administration for the share scheme administrators and companies as analysis must be carried out immediately before the payment of each dividend (some companies pay quarterly) to identify those participants who will be over the limit and arrangements must be set up to pay across the additional funds (in some cases these can amount to very small sums). The individuals who could be affected will not be the same for each payment as it will be dependent on the dividend rate applicable at that time and the number of shares held by the employee. Allowing full reinvestment of dividends would seem to be commensurate with the overall aims of the SIP scheme.

Recommendations specific to SAYE – no cost

(A) Different savings periods

Recommendation

3.116 Remove the SAYE seven year savings period.

Summary of issue

3.117 Confusion may arise from the fact that a variety of savings periods can be offered if the company wishes.

3.118 Employees could have multiple schemes vesting in the same year e.g. a three year and a five year exercise period with different option prices, bonus rates etc. This can lead to errors in capital gains tax (CGT) calculations.

3.119 Although three year savings contracts are most popular, a recent survey suggested that around 30% of contracts are for five years, even though only 50% of companies give employees this option[8]. This suggests that the five year saving period is reasonably popular with participants. Accordingly, although a single period (which, if it were pursued, would be our recommended three year period) would be an obvious simplification, we accept the case for continuation of the five year period.

3.120 However, the seven year savings period is rarely used. Removing the seven year alternative would reduce some complexity of legislation without any significant negative effects to companies or participants.

(B) Prescriptive rules on non PAYE contributions

Recommendations

3.121 The circumstances in which savings can be made otherwise than from salary should be expanded, with the circumstances to be agreed by the establishing company.

Summary of issue

3.122 Currently, savings for SAYE must be made by way of salary deductions. When a female employee is no longer salaried because she is on maternity leave, HMRC will permit contributions to be continued and made directly into the savings contract. However, this flexibility is not available for other participants who may not be paid a salary for a certain period, even though they will be returning to work at the end of that period e.g. those on secondments or on sabbatical. The cessation of contributions in these circumstances could result in the savings contract ending and options lapsing. It would seem appropriate to allow companies to set rules around regular contributions to fit in with their wider human resources policies. These would presumably need to be within HMRC guidelines and not go so far as allowing totally variable contributions, but increased flexibility is needed to keep in line with changing ways of working.

[8] Ifs ProShare SAYE and SIP Survey 2010, covering 445 companies with live schemes, around 75% of the number of companies with live SAYE schemes in 2009/10.

(C) Approved savings carrier

Recommendation

3.123 We recommend that the issue of approved SAYE savings carriers is taken into account by the Department for Business, Innovation and Skills (BIS) in their longer term review into the wider application of employee ownership among smaller private companies.

Summary of issue

3.124 Very few smaller private companies offer SAYE share options to their staff. Part of the reason for this is that there is a limited number of approved savings carriers in the market, and it is not always cost effective for those carriers to provide services to smaller numbers of SAYE participants. As a consequence, while a large plc may be able to arrange a savings contract without any charges arising, a smaller company may have to pay a charge per participant. The requirement to set up separate savings arrangements with an approved carrier is one reason why smaller companies are put off establishing SAYE schemes at all.

3.125 The OTS team considered whether a separate approved savings arrangement is really necessary for the successful operation of an SAYE option scheme. The team considered whether it would be possible for smaller companies to self administer the scheme, using a separate bank account with a regulated bank. For example, it is already the case that weekly paid employees need a feeder account where weekly contributions are held before they can be transferred into the SAYE account.

Recommendations specific to EMI – no cost

(A) Disqualifying events

Recommendation

3.126 Extend the 40 day exercise period to six months.

Summary of issue

3.127 There is a loss of the EMI tax advantages if a disqualifying event occurs unless the option is exercised within 40 days of the disqualifying event.

3.128 Disqualifying events include

- the company losing its independent status,
- the company ceasing to meet the trading activities requirement,
- the employee ceasing to qualify as a result of ceasing to be employed or ceasing to meet the working time requirement,
- certain changes to the company's share capital, and
- the grant of a CSOP option if, immediately after the grant of the CSOP option, the employee holds unexercised options over shares with a value of more than £120,000.

3.129 In certain circumstances, the 40 day exercise period is impractical (for example, when an individual is leaving and a compromise agreement must be agreed, or the company ceases to meet the trading activities requirement).

3.130 The 40 day limit does not correspond to the exercise period for other approved schemes, which is a more practical six months.

Recommendations specific to EMI – potential cost

(A) Working time requirement

Recommendation

3.131 Amend the working time requirement so that it applies only to directors (as is the case for CSOP). This would enable key employees with flexible working arrangements and more than one employment contract to participate in EMI.

3.132 The risk of a disqualifying event occurring without the company's or individual's knowledge would be reduced as the requirement would now only extend to directors.

3.133 This would also simplify the notification of grant to HMRC as directors could self certify their working time to the company at the time of grant, without any need to include this on the notification of grant.

3.134 We understand from HMRC that there may be a cost to the Exchequer but we have been unable to explore this in more detail.

Summary of issue

3.135 For an individual to qualify under EMI he or she must commit at least 25 hours a week, or, if less, 75% of his or her working time, to working on the business of the relevant company or group.

3.136 Working time includes any time spent on remunerative work as an employee, or as a self employed person, when income or profits from that work are taxed as general earnings, or chargeable to tax as the profits of a trade, profession or vocation carried out in the UK, or would be so chargeable to tax if the employee were resident or ordinarily resident in the UK.

3.137 The working time requirement can create difficulties in a marketplace where working arrangements are increasingly flexible, with individuals working for more than one organisation or working part time for one or more organisations alongside a position of self employment.

3.138 In particular, a failure to meet the working time requirement is a disqualifying event. Many companies that use EMIs do not have dedicated staff working on managing the scheme as all their time is committed to growing the business. It is not uncommon therefore for option holders and the company to be unaware of the implications that a change in working arrangements will have on the option.

(B) Qualifying trades and excluded activities

Recommendation

3.139 Reduce the list of excluded activities by removing the following

- ... other financial activities,
- providing legal or accountancy services,
- shipbuilding,
- producing coal,
- producing steel,
- operating or managing hotels or comparable establishments (but <u>not</u> "managing property used as a hotel or comparable establishment"), and
- operating or managing nursing homes or residential care homes (but <u>not</u> "managing property used as a nursing home or residential care home").

Summary of issue

3.140 The parts of the legislation relating to qualifying trades and excluded activities are complex and confusing for companies who are understandably not knowledgeable about the precise rules. In particular, failing to meet these tests can result in a disqualifying event. For example, a company can be carrying out an excluded activity (such as leasing) as a small proportion of its trade; but if the leasing business grows – even temporarily – existing EMI options may become disqualified.

3.141 Tracking the levels of qualifying trades in this way is impractical for small businesses and difficult for HMRC to police.

3.142 In addition, companies carrying out certain excluded activities are precluded from benefiting under EMI, even though some of those activities may be legitimately carried out by smaller, high risk companies. For example, companies carrying out "other financial activities", providing legal or accountancy services and operating or managing nursing homes or residential care homes may all welcome the opportunity of recruiting and retaining key individuals by way of a share option arrangement. The policy objective behind EMI is to target "high risk" businesses, but none of these activities are particularly low risk – particularly if those businesses fall within the other EMI requirements relating to size, number of employees and gross assets. In fact some – e.g. providing accountancy services – are knowledge based businesses that would seem to lend themselves very much to the concept of share options. The reason these activities are listed in the EMI legislation is because of EU State aid regulations, rather than any direct link to commercial risk.

3.143 There are certain excluded activities set out in detail in the legislation which would appear unlikely to meet the independent and gross assets test and so the exclusion of those activities seems to be largely redundant.

3.144 It is recognised that some of these points are governed by State aid rules, which may make changes difficult. But this part of the legislation could be reduced considerably.

4 Next steps

4.1 We anticipate that the Chancellor will respond to this report at Budget 2012. However, it is unlikely that any legislation will be implemented in response to this report this year, given the Government's policy to publish draft tax legislation three months in advance of the Finance Bill. Any recommendations are likely to be considered for the Finance Bill 2013 at the earliest.

If the Chancellor is minded to take forward any of our proposals, we would expect a full consultation to be undertaken in connection with any major changes to legislation arising out of our recommendations. There will therefore be plenty of opportunity for interested parties to comment on the proposals during the consultation period, but the OTS would also welcome comments now on any or all of the proposals in this report. Please email these to:

ots-ess@ots.gsi.gov.uk

4.2 The OTS also invites any comments in connection with the second phase of our report on employee share schemes. This phase will incorporate a review of the legislation governing non tax advantaged arrangements, commonly referred to as unapproved share schemes. We are discussing terms of reference for this phase of our review with HMRC and HM Treasury and expect to publish details shortly on our website (http://www.hm-treasury.gov.uk/ots.htm).

5 Proposals considered and rejected

5.1 The purpose of this report is to make recommendations on areas in tax advantaged share schemes legislation that could be simplified, making life easier for all stakeholders. In many cases this can happen immediately by shortening and removing redundant legislation. The long term benefits from simplification should be clear and certain, otherwise the proposals will inevitably fail.

5.2 The OTS has previously observed that frequency of change is a major contributor to complexity. A complex system can become simple (or at least simpler) if it is left in place for many years so taxpayers can become comfortable with the requirements over time. Any change to the tax system can in itself create complexity associated with the transition from the old to the new regime.

5.3 In the course of this review, we have considered and rejected a number of proposals to reduce complexity where on balance the potential long term benefits from simplification were outweighed by the potential transition costs or other considerations. We have detailed these proposals and have summarised our reasoning below.

The abolition of approved share schemes

5.4 We considered the possibility of abolishing all tax advantaged share schemes. This would clearly reduce the length and complexity of the legislation by removing it altogether; it would also allow companies to implement share ownership arrangements tailored exactly to their requirements, without the need to follow the restrictive rules in place to obtain tax advantages.

5.5 However, we needed to take into account whether the length of legislation is in itself a complexity. We also needed to consider the effect on broader policy objectives of the removal of all the tax advantaged schemes.

5.6 The schemes currently cover 115 pages of income tax primary legislation, all of which could be removed in the future if the schemes would be abolished. During the review companies did not raise the length of the legislation as being an issue. However steps to align definitions and some housekeeping to remove redundant legislation could go some way to reduce the volume of legislation. These proposals are considered elsewhere in this report.

5.7 The OTS has previously commented that we do not think the volume of legislation necessarily leads to complexity.

5.8 The promotion of employee share ownership and the associated benefits was one of the policy objectives for the introduction of tax advantaged schemes. EMI has an additional policy objective of targeted help for small businesses to recruit key staff. Evidence contained elsewhere in this report shows that tax advantaged share schemes widen employee share ownership and it is clear that there would be fewer opportunities for employees to participate in shareholding if no tax relief was offered.

5.9 Annex E summarises the evidence on the effect of share schemes on productivity. The report also records observations and evidence on staff retention, motivation and loyalty.

5.10 Leaving aside productivity, companies do perceive there to be benefits to them in providing share schemes to employees. This is demonstrated by the investment of considerable time and money in implementing new share ownership arrangements of all types.

5.11 The abolition of tax advantaged share schemes would not stop companies using shares to reward employees; they would continue to do so under unapproved arrangements. However, we suspect that such arrangements would be concentrated on a small proportion of employees. Accordingly, any such schemes put in place would be unlikely to match the objective of opening share ownership to a broader base of employees, or – in the case of EMI – encouraging the growth of smaller companies by recruiting and incentivising key staff. In addition, there would be a requirement for companies to put in place transitional arrangements while winding down their existing tax advantaged schemes.

5.12 Our conclusion is that the removal of tax advantaged share schemes would not be a significant simplification in itself.

The merger of SAYE and SIP

5.13 There are currently two all employee tax advantaged schemes available to companies. SAYE is a savings related option scheme and SIP is a share award scheme. However, there are common features that make it possible to combine the two schemes with minimal changes to the key features of either scheme.

5.14 The key features of each scheme are explained in detail in Annex G and Annex H.

5.15 The OTS did consider whether one merged scheme with one set of legislation, scheme rules and documentation would over time reduce the complexity of all employee share schemes. However, we rejected the idea for the following reasons

- it was felt that a combined scheme would have most of the complications of the existing schemes,
- there would be additional cost for companies, e.g. new rules, adviser fees, employee communication and complexities around transition between the old and new products, and
- there would be significant systems and complexity issues for administrators and companies as a result of the change.

5.16 In conclusion, SAYE is a popular scheme that is easy to communicate and widely understood. Our Consultative Committee recommended that the best approach would be to fine tune it to improve its day to day operation rather than combine it into SIP, which itself is a more complex scheme.

Breaking the SAYE link to share options

5.17 There is a separate issue around SAYE schemes that we considered. That is whether the link of the savings scheme to share options should be maintained. We heard regularly that many employees use the scheme solely as a savings arrangement and do not exercise the options they are entitled to, or simply exercise and immediately sell their new shares. That might argue for the scheme to be recast as a version of a corporate sponsored ISA.

5.18 However, against this, we heard equally regularly that there is an important psychological link of the savings scheme to the company via the share option. It also has to be noted that the whole SAYE scheme is well established and understood.

5.19 Accordingly we do not recommend breaking the SAYE link to share options. In any event, we suspect that such a move would be regarded as a policy matter and outside our remit.

Multiple types of share award

5.20 The SIP has four different types of awards: Partnership Shares, Free Shares, (free) Matching Shares and Dividend Shares. Each has a different tax free limit and different conditions. This can be a source of complexity.

5.21 One way to reduce complexity could be to reduce the number of different types of share award or to consider whether separate limits were needed.

5.22 We examined whether there was a coherent reason for each type of award which supported the overall policy objective. This is set out below:

- Partnership Shares – the purchase of shares using employees' own money makes the employees' stake in the company more explicit. When combined with other forms of active employee participation, this is more likely to motivate employees and help in the success of their company.
- (Free) Matching Shares – the use of Matching Shares enables companies to provide additional free shares only to those employees already committed to buying Partnership Shares. This further encourages employees to take a stake in the company – but with a slightly reduced financial risk.
- Free Shares – many companies that use SIPs like to offer Free Shares to all employees - for example, as part of an annual profit share - without a requirement for an employee contribution. This promotes share ownership to the widest group of employees including lower earners who otherwise might not participate in employee share ownership e.g. to all staff working in store in the retail sector. Free Shares are the simplest to administer and may be preferred by smaller companies.
- Dividend Shares – this component is consistent with promoting employee share ownership by reinvesting dividends on SIP shares into the scheme. It can also reduce the administrative burden associated with the payment of cash dividends.
- Flexibility - during the process of consultation associated with the introduction of the scheme, an important feature that emerged was that of flexibility for companies to choose different share awards to tailor a scheme to best suit the needs of its employees and shareholders over time.

5.23 We concluded that any simplification benefits associated with reducing the number of types of share awards would be outweighed by the reduced flexibility and attractiveness of the scheme. This could be detrimental to wider employee share ownership and the associated benefits thereof.

5.24 In the course of the review, the OTS has found no compelling evidence to support that the introduction of one limit across all reward types would lead to simplification.

Trust requirement for SIP

5.25 A reason why many smaller companies do not consider operating a SIP is that in order to do so it is necessary to set up a trust. We considered whether it would be possible to operate a SIP in a different form without the need for a trust, and whether this would be a simplification.

5.26 The SIP (unlike SAYE and CSOP) involves the ownership and holding of shares, which may be subject to forfeiture and a PAYE charge when the employee leaves the company. The employer must therefore be able to exercise the right of forfeiture and/or be able to sell some of the shares to cover the PAYE liability on exit which is the company's responsibility.

5.27 The possibility of using an alternative to a trust was considered in the extensive consultation process when the scheme was introduced. This found that most companies were familiar with trusts and already operated some kind of trust arrangement. As such the trust requirement would not considerably increase the complexity of the scheme.

5.28 HMRC consulted on alternative arrangements but understood that these could themselves involve complexity.

5.29 In the course of this review, the OTS has found no compelling reasons to indicate both that the removal of the trust requirement and the introduction of an alternative structure to hold shares would lead to simplification.

SAYE bonus rates

5.30 One of the frequent comments from our roadshows was that the bonus rates (interest equivalent) offered under SAYE contracts were out of line with other fixed interest rates offered by banks and other financial institutions. It was felt that this was making SAYE less attractive to employees who could get a better rate elsewhere. The main concern was that the current rate was now 0% for a three year savings scheme and that a 0% savings scheme had nothing to commend it. It was felt that a 0% rate was symbolic and this in itself was the issue. In the past there have been very low rates (not significantly different from zero) but these, whilst not popular, have been tolerated.

5.31 A key consideration was whether it would be possible to introduce any changes to the current mechanism that would improve SAYE bonus rates for employees without further reducing the number of financial institutions offering approved SAYE contracts. Currently interest rates are disproportionately low and as such this is more of a timing issue that will be resolved once interest rates return to more normal levels.

5.32 In the course of this review, the OTS has not identified any alternative to the current formula used to set bonus rates that would lead to simplification. More information is available here: http://www.hmrc.gov.uk/shareschemes/model-saye-bonus-mechanism.pdf.

Inflexibility in SAYE savings amount

5.33 Another issue raised with SAYE schemes, in contrast to the SIP, is that employees are committed to saving the same amount each month for a period of three or five years. They can miss up to six contributions but cannot change the amount of their monthly savings. Should an employee miss more than six contributions the savings contract comes to an end and no further savings can be made; however the savings can remain in the savings contract. We considered if the six month period should be increased and if employees should be able to change their savings level.

5.34 The six month savings holiday is linked to the six month period after the normal bonus date in which options can be exercised. This enables employees to catch up on any missed contributions and have sufficient savings to exercise all of their SAYE options before the final exercise date. This currently works well and should the savings holiday be increased the exercise period should also be extended.

5.35 The inflexible savings arrangement together with the ability to make up six months of missed contributions ensures that the savings should always equal the total exercise price of the option, other than in exceptional circumstances where the SAYE options can be exercised before the end of the savings contract. This is simple for employees because usually the number of shares that can be acquired on exercise of the SAYE options is consistent with their option certificate.

5.36 This does mean that in most cases employees who miss more than six contributions as a result of a change in their circumstances can lose out since generally options will lapse when the savings contract ends and they are unable to do a partial exercise of the options with their savings. We note the lapse of option in these circumstances is not compulsory and as such if companies wish they can permit employees to partially exercise their options if the savings remain in the savings contract until the bonus date.

5.37 We concluded that SAYE would be more complex were it not for these rules and changing this would not lead to simplification.

5.38 On a related point, we received comments that the commitment to a regular savings amount is not easy for a low paid member of staff who cannot be sure they will be able to spare the amount saved. We understand the issue and sympathise, but changing the SAYE scheme to permit ad hoc contributions from individuals as they have money available would fundamentally alter the concept of the scheme, even if it might increase participation. We therefore cannot recommend changing the scheme to allow complete flexibility on contributions; we do note that a savings scheme can always be started and simply terminated without penalty.

6 Issues beyond simplification

6.1 The purpose of this report is to identify areas in approved share schemes legislation that could be simplified. However, as part of our evidence gathering at roadshows, certain important issues were brought up so often that, although these do not relate to simplification, we feel obliged to note them within this report.

EMI and entrepreneurs' relief

6.2 In 2008 taper relief was abolished and entrepreneurs' relief introduced. This had a significant impact on the tax treatment of EMI option holders. For gains arising before 6 April 2008, taper relief could reduce the amount of a gain chargeable to CGT; in the case of a "business asset" held for two years or longer, this resulted in an effective CGT charge of only 10% for a higher rate taxpayer. A business asset included shares held by employees in their companies. In addition, for EMI options, the taper relief was calculated from the date of the grant of option, rather than the date of the acquisition of shares on exercise of the option. For many EMI option holders, assuming a two year period between the date of grant and the eventual sale of their shares, this resulted in an effective tax rate of only 10% on any gains made as a result of the exercise of options and the sale of the shares.

6.3 The introduction of entrepreneurs' relief has effectively removed the attractive CGT treatment for the majority of EMI participants, as entrepreneurs' relief only applies to individuals who have held a minimum of 5% of the ordinary share capital and 5% of the voting rights in their company for at least one year before the disposal. The 5% limit in particular prevents many EMI participants from benefiting under entrepreneurs' relief.

6.4 This is not an issue of simplification in itself but it has been regularly cited to us as a driver for companies looking for alternative routes to obtain the effective 10% CGT rate originally available for EMI option holders. This has led to the adoption of arrangements that are more complex than EMI (e.g. Joint Share Ownership Plans, Deferred Share Purchase Schemes) and which are put in place to obtain CGT treatment rather than income tax treatment.

6.5 In addition, EMI has the particular benefit for companies in that direct shareholding need not always be used; the incentive is provided purely through the use of options, which can lapse in certain circumstances (e.g. if option holders leave before an exercise event). Issuing shares is in itself more complex than granting options, and thus requires more complex, and potentially costly, advice.

6.6 We think that the position of EMI shares in relation to the CGT tax rate needs to be considered in the light of the eligibility criteria for entrepreneurs' relief. This is an overall policy matter and so is probably outside our remit. But we note that the change away from taper relief has made EMI schemes much less attractive.

6.7 We have received the following comments and suggestions which we note for the purposes of this report. These should not be taken as recommendations by the OTS:

- make provision in TCGA 1992 Chapter 3 (Entrepreneurs' Relief) to allow the sale of shares acquired under EMI to be treated as a qualifying business disposal without the need to hold at least 5% of the share capital for 12 months before disposal, and with the shareholding treated as though it were held from the date of grant of option rather than acquisition of the shares,

- the reintroduction of a beneficial CGT rate for EMI option holders will make EMI more attractive, and reduce the numbers of companies seeking alternative and more complex arrangements to obtain a lower rate for key employees,
- in particular, where EMI options only become exercisable upon an exit event, there will be no requirement for private companies to issue shares to employees, which in itself can be a complex procedure,
- this would effectively put EMI option holders in the same position as they were before the introduction of entrepreneurs' relief, and

reintroducing the effect of taper relief for EMI may help reduce alternative routes sought by companies which currently challenge the tax authorities and can be costly and complex for companies to implement.

6.8 It would be difficult to quantify the cost of such changes as the Government's records have not in the past differentiated between the cost of taper relief for "ordinary shareholders" and EMI option holders.

Scheme limits

6.9 The limits for SAYE have remained unchanged for some 20 years and for CSOP since its introduction (broadly in its current form) in 1996. Even SIP has retained the monetary limits set out at its introduction in 2000. EMI is the only scheme where limits have been amended.

6.10 Feedback from participants suggests that limits are now out of date and no longer meet their requirements. This is particularly the case for CSOP and SAYE.

6.11 This is more of a policy matter than a simplification and we suspect the erosion of plan limits is hampering the original objectives being achieved. Accordingly, we do not seek to recommend any changes in connection with scheme limits. Furthermore, the current economic climate and our requirement to seek cost neutrality under this report would make any such suggestion inappropriate.

6.12 Nonetheless, we note the issue for future consideration. We feel the limits need to be kept under review. This will clearly fall within the category of policy rationale: essentially, if employee share schemes are to be encouraged because they are deemed to result in positive outcomes, it seems appropriate for the limits to be reviewed on a reasonably regular basis.

Eligible organisations

6.13 Rules in the approved share schemes legislation preclude certain types of company and organisation from participating in tax advantaged share schemes. One example is private companies backed by venture capitalists, where the company does not meet the independence test in EMI, or is a subsidiary company for the purposes of CSOP.

6.14 Another is mutual societies, whose share capital is not eligible for a number of reasons. Mutuals' share capital does not fall into the definition of "ordinary share capital", the shares are non redeemable, and are unlikely to be employee controlled. There is an existing exemption for cooperative shares, which are non redeemable, under the SIP legislation but this does not extend to the other tax advantaged schemes, and does not include any other mutual organisations other than cooperatives.

6.15 For mutuals in particular, the FSA Remuneration Code includes a principle requiring that the remuneration packages of certain senior employees of financial institutions include some form of long term incentive with a part deferral into shares or alternative capital instruments. The use of tax advantaged share schemes may be a way of meeting this requirement.

6.16 We note this issue for future consideration. Again, this falls within the category of policy rationale: if employee share schemes are to be encouraged because they are deemed to result in positive outcomes, they should be made widely available to organisations of different types and structures.

Accounting treatment of SAYE options

6.17 The cancellation of a SAYE contract by an employee is not treated as failure of a vesting condition and therefore the employer must continue to reflect the fair value of the option as a charge to the profit and loss account. The charge is actually accelerated to the current accounting period as a result of cancellation of the contract. If an employee is granted a new SAYE option to replace the one cancelled the employer has to make an accounting charge for the new option as well. This is making companies reluctant to offer SAYE schemes, so employees lose out.

6.18 We note this issue for future consideration, though it evidently falls outside the scope of this report.

A Glossary

BIS	Department for Business, Innovation and Skills
CA 2006	Companies Act 2006
CGT	Capital gains tax
CSOP	Company Share Option Plan
CTA 2009	Corporation Taxes Act 2009
EMI	Enterprise Management Incentives
ESSUM	Employee Share Schemes Unit Manual
EU	European Union
FA	Finance Act
HMRC	Her Majesty's Revenue and Customs
ISA	Individual Savings Account
ITA 2007	Income Tax Act 2007
ITEPA	Income Tax (Earnings and Pensions) Act 2003
ITTOIA	Income Tax (Trading and Other Income) Act 2005
NICs	National Insurance Contributions
PAYE	Pay As You Earn
SAYE	Save As You Earn
SCEC	Small Company Enterprise Centre
SIP	Share Incentive Plan
TCGA 1992	Taxation of Capital Gains Act 1992
TUPE	Transfer of Undertakings (Protection of Employment) Regulations 2006

B Methodology

B.1 In this review's terms of reference, complexity in share schemes was cited as a frequent cause of error in tax returns and a source of administrative burden on employers, employees and advisers. The purpose of this section is to explain how the team sought to get evidence and examples of the complexity and burden, and how we assessed whether the examples did indeed cause complexity and warranted simplification.

B.2 The team also gathered evidence on the effectiveness of employee share schemes, including the reasons why companies implement tax advantaged share schemes. More information is set out at Annex E.

Gathering and assessing evidence

B.3 As there are different perspectives on complexity, it was important to take account of the views of different stakeholders: advisers (both legal and tax), employers, scheme administrators, and employees. The stakeholders also included government departments such as HMRC, HM Treasury and BIS. We also took pains to publicise the review project and this attracted a number of submissions by way of papers and comments from interested parties. The OTS is very grateful to all the organisations and individuals who contributed and would particularly wish to thank HMRC's share schemes experts for their extensive and constructive technical input.

B.4 The OTS organised roadshows with various stakeholders. The company representatives who attended were generally involved in managing their share schemes and were able to give us first hand evidence of operating the schemes including their employees' perspectives and experiences. A questionnaire was prepared for use at the roadshows to gather views on a range of different topics. The purpose of this was twofold: to gather evidence on the type of schemes being used; and to identify the areas that are working well and those areas that are not working as well as they could.

Box B.1: Topics covered at roadshows

- types of schemes used and rationale for using those schemes,
- perceived effects and benefits of using the schemes,
- best and worst parts of the schemes,
- examples of areas that are:
  - unnecessarily complex,
  - difficult for employees to understand,
  - a burden to operate,
  - inappropriate in today's business world, and
  - ready for improvement or simplification.

B.5 In addition to the roadshows, members of the Consultative Committee[1] forwarded findings of research they had independently undertaken. These included employee and company surveys, feedback from companies and proposals made by individuals or parties.

B.6 All the evidence gathered was collated with a note of the stakeholder who had made the recommendation and categorised under each of the four schemes. We also made a separate list of those items which applied to more than one scheme (e.g. the approval process). A summary of the main points gathered from the roadshows is set out at Annex C.

B.7 Meetings were also held with HMRC and HM Treasury to gain their perspective on operating the schemes and potential changes (including costs) as well as to gain an understanding of the historical contexts of certain aspects of the schemes.

B.8 We found that companies are more concerned with the operational and design aspects of the schemes and they raised very few comments regarding the legislation. Advisers, on the other hand, are more involved with the legislation and their comments and proposals reflected this. Notwithstanding this, there were some areas where comments overlapped. In carrying out this review our intention is not to put the requirements of one stakeholder over another. We have prioritised our recommendations based on analysis of evidence gathered over the course of the review using the following criteria:

- Is there evidence of complexity, compliance costs and/or administrative burden?
- Have changes in the business environment made elements of the share scheme no longer fit for purpose?
- Who would benefit from simplification?

Applying methodology

B.9 The purpose of this section is to demonstrate our methodology against a sample of proposals:

A: Approval process for SIP, SAYE and CSOP

B.10 Before implementing and operating any of these schemes, companies must seek formal approval from HMRC. In addition, approval must be obtained before certain changes can be made to the schemes.

Is there evidence of complexity, compliance costs and/or administrative burden?

B.11 All scheme documentation (including employee communications) must be submitted to HMRC in hard copy. There is a two stage process involved as set out in paragraphs 2.5 – 2.8. Companies are unable to control the timing of when the scheme will be implemented as they are dependent on HMRC's turnaround time in reviewing the schemes before approval is granted. For multinational companies this is important as they often want to launch share schemes across all the countries at the same time so as not to favour one group of employees over another, in particular with regard to purchasing shares. This is a contrast to unapproved schemes, where a company can control and schedule the implementation, e.g. after shareholder approval has been granted in general meeting.

B.12 HMRC must check all the documentation in fine detail to ensure compliance with the legislation. This includes cross checking legislative references and ensuring definitions are

[1] Please see Annex K for a list of the committee members.

correct. The present system places the onus on HMRC to ensure everything is correct and to notify companies of errors.

B.13 Companies are also required to notify HMRC of options granted and/or shares awarded under their annual returns for each scheme.

Have changes in the business environment made the approval process no longer fit for purpose?

B.14 HMRC's current approach of self assessment and self certification in other areas of tax is contrary to requiring advance approval for three of the four government sponsored schemes. EMI alone works on a self certification basis, whereby companies notify HMRC of the grant of options within ninety two days of date of grant. Apart from Ireland, the UK is the only country identified as requiring companies to seek advance approval.

Who would benefit from simplification?

B.15 Both companies and HMRC. Streamlining or removing the advance approval requirement would give companies the ability to better manage the launch and operation of their share schemes.

B: Late payment penalties

B.16 HMRC applies late payment penalties if companies do not meet monthly deadlines for the payment of PAYE. In some circumstances it is impossible for companies to remit monies by the deadline.

Is there evidence of complexity, compliance costs and/or administrative burden?

B.17 Particular events under the share schemes legislation trigger a taxable event, e.g. leaving before the end of the SIP five year holding period. In these circumstances, a company must withhold the tax and forward the monies within a specified timeframe after the taxable event. Payrolls and administrators have genuine difficulties in meeting the monthly deadline despite their best efforts. For example, in many companies the operation of the share scheme is outsourced to an external administrator. The administrator is dependent on human resources managers to advise them of leavers. However, these managers could be unaware the employee was a participant in a share scheme and notification is not made. It could be many months before the administrator is aware the individual has left and tax can be withheld.

Who would benefit from simplification?

B.18 Companies would benefit if they were no longer penalised provided they could demonstrate that all reasonable efforts had been made to pay within relevant period.

C: Retirement age

B.19 There is no consistent definition of retirement age.

Box B.2: Different retirement ages depending on scheme

SIP: The age must be the same for men and women and must not be less than 50.

SAYE: The age must be the same for men and women, not less than 60 and not more than 75.

CSOP: The age must be the same for men and women and not less than 55.

Is there evidence of complexity, compliance costs and/or administrative burden?

B.20 It is not uncommon for a company to have more than one share scheme, both approved and unapproved, and it is confusing for employees participating in more than one share scheme to take account of different retirement ages. An individual nearing their retirement would want to assess their financial position, and they could mistakenly factor in a benefit on the assumption that they would be treated as a retiree under all their share schemes. Not only is it difficult for them to assess what their entitlements are under the scheme, it is not easy for them to determine if they should join the scheme if they likely to reach retirement age during the holding period.

Have changes in the business environment made the definitions of retirement age no longer fit for purpose?

B.21 Age discrimination legislation has led to many companies moving away from using specified ages in their definitions of retirement in rules for unapproved share schemes. In addition, employees often work beyond the ages defined in the schemes.

Who would benefit from simplification?

B.22 Employees, as having one definition would provide clarity. Companies, as clarification would reduce the level of explanation required to participants.

C Summary of feedback

Summary of roadshows

C.1 The OTS sought feedback from a variety of stakeholders to identify areas of complexity in share schemes legislation. These included professional advisers, lawyers, accountants, large, medium and small companies, share scheme administrators and representative bodies.

C.2 In addition to the companies contributing directly to the roadshows, much of the feedback obtained from the various advisers or administrators was linked strongly to feedback they had received from their clients. For example, one share schemes administrator surveyed 40 of its clients which operated a SIP or SAYE and reported back to us. At some roadshows, accountants and advisers were accompanied by some of their clients, but the feedback was recorded as part of one meeting. Some companies shared with us the results of their own surveys to give us access to some employees' views.

C.3 The results of the feedback have not been broken down by individuals' feedback but by organisation. This may result in some skewing of the results – for example, a private company's view of difficulties will be given the same weighting in this summary as the view of a large accountancy firm which is representing the opinions of a large number of clients.

C.4 Furthermore, not all of the respondents had views on all of the schemes. For example, a large plc would not have given any feedback on EMI, as the scheme would not be available to them; similarly, advisers specialising with smaller private companies or family owned businesses would be unlikely to have any strong views on the technical details of SAYE. It would therefore be unlikely that any issue relating to one particular scheme would result in feedback from all of the respondents.

C.5 Finally, the tables below do not include all the comments and suggestions made at the roadshows but merely provides a summary of the key points raised more often by the respondents. The points below are set out in order of the frequency they were raised (i.e. the points raised most frequently are at the top of the table).

Table C.1: Issues identified: all schemes

- Restrictions on shares: makes it difficult or impossible for many private companies to establish schemes (particularly CSOP)
- Scheme limits have remained unchanged over the years
- Retirement ages inconsistent
- Approval process is lengthy and causes delays
- Material interest: inconsistent and disproportionate in connection with likely tax avoidance
- Paper based returns and notifications lead to administrative burdens
- Involuntary leavers (e.g. as a result of takeover) are treated unfairly when compared to other involuntary (or "good") leavers
- Allow adjustment of options where demerger etc without seeking approval from HMRC
- Corporation tax relief can be lost on takeover, when shares become shares in a subsidiary (timing issue)
- Features neither necessary or incidental – confusing and unnecessary
- Formal approval "rubber stamp" is welcomed

Table C.2: Issues identified: SIP

- Dividend reinvesting limit too low
- Forfeiture rules are complex e.g. holding period is three years but full tax relief is not available until shares have been held for five years
- Five year period is too long for genuine motivation/retention
- Leavers: 30 day reporting limit almost impossible to meet
- Savings: prescriptive rules for stopping and starting
- Four limits are complex – combine limits to one overall maximum amount
- Using special SIP trust is complex and expensive
- Participation on same terms are complex
- Participation on same terms difficult to operate
- Performance targets for free shares are complex

Table C.3: Issues identified: SAYE

- Accounting treatment is complex and costly
- Prescriptive rules for stopping and starting savings
- Bonus rates currently nonexistent
- Seven year period rarely used and could be removed
- Time to exercise options is too prescriptive

Table C.4: Issues identified: CSOP

- Inability to exercise tax efficiently within three years of date of grant
- Inability to grant at discount is misaligned with other schemes and doesn't correspond with current practice for unapproved schemes
- Discretion re leavers

Table C.5: Issues identified: EMI

- Independence test – venture capital backed companies should be able to participate
- Qualifying trades – seems to unfairly exclude certain sectors e.g. financial activities
- Replacement of taper relief with entrepreneurs' relief has removed key advantage for EMI companies
- Limits too low
- Annual returns are duplication of information given under notice of grant
- Disqualifying events complex and easily missed
- Notice of grant within 92 days causes difficulties
- Working time requirement no longer fits current working patterns
- 40 day exercise period post disqualifying event is too short
- Number of employees requirement is too low or causes difficulties when companies "outgrow" EMI
- 10 year exercise period causes difficulty for long term planning and exits (family owned companies)

D Statistics relating to schemes

D.1 Table 1[1]

Companies with tax-advantaged Employee Share Schemes (1)

Number of companies operating tax-advantaged Employee Share Schemes by year scheme is in operation

Numbers: Companies

Year	All-Employee Schemes			Discretionary Schemes			Any Tax-Advantaged Employee Share Scheme (4)
	SAYE Share Option Schemes	Share Incentive Plans	Any All-Employee Share Scheme (2)	Company / Discretionary Share Option Plans	Enterprise Management Incentives	Any Discretionary Share Option Scheme (3)	
2000-01	1,110	90	1,180	4,270	870	4,960	5,180
2001-02	1,090	310	1,320	3,930	2,390	6,000	6,360
2002-03	920	490	1,300	3,660	3,540	6,800	7,250
2003-04	860	570	1,320	2,960	4,500	7,090	7,580
2004-05	820	750	1,360	2,710	5,660	8,000	8,570
2005-06	760	870	1,450	2,440	6,790	8,930	9,600
2006-07	780	940	1,530	2,450	8,020	10,150	10,840
2007-08	700	860	1,380	1,880	9,110	10,700	11,330
2008-09	670	870	1,370	1,710	10,500	11,500	12,140
2009-10	600	840	1,270	1,490	10,610	11,880	12,500

Source: HMRC administrative database

Table updated June 2011

(1) These figures show the numbers of companies operating a tax advantaged share scheme. A company may have more than one live scheme of any type. The numbers of live schemes at the end of each tax year are displayed in the tables for each type of scheme.
(2) Companies with either a SAYE Share option scheme or Share Incentive Plan or both.
(3) Companies with either a Company Share Option Plan or Enterprise Management Incentive or both.
(4) Companies with one or more tax-advantaged employee share scheme.

[1] http://www.hmrc.gov.uk/stats/emp_share_schemes/companies.pdf

D.2 Table 2[2]

Share Incentive Plan

Share Incentive Plans approved under Schedule 2 Income Tax (Earnings and Pensions) Act 2003

Type of shares	Number of live plans at the end of the tax year (1)	Grants: Number of plans that appropriated shares (2)	Grants: Number of employees awarded / purchased shares ('000) (3)	Grants: Initial value of shares (£ million)	Grants: Average value of shares per employee (£) (3)	Exercises: Estimated cost of income tax relief (£ million) (4)	Exercises: Estimated cost of NIC relief (£ million) (4)
2000-01 (5)							
Free	..	30	70	20	290	..	..
Partnership	..	20	60	5	80	..	..
Matching	..	20	60	5	80	..	..
Dividend	..	-	-	-	-	..	..
Total	**90**	**50**	**..**	**30**	**..**	**10**	**-**
2001-02							
Free	..	100	140	60	450	..	..
Partnership	..	140	830	80	100	..	..
Matching	..	90	570	50	80	..	..
Dividend	..	20	80	-	10	..	..
Total	**310**	**210**	**..**	**190**	**..**	**40**	**30**
2002-03							
Free	..	140	335	180	520	..	..
Partnership	..	270	2,060	260	130	..	..
Matching	..	160	1,210	130	100	..	..
Dividend	..	80	185	-	20	..	..
Total	**500**	**340**	**..**	**570**	**..**	**150**	**100**
2003-04							
Free	..	180	670	305	450	..	..
Partnership	..	330	2,930	250	90	..	..
Matching	..	200	1,790	170	100	..	..
Dividend	..	120	375	15	30	..	..
Total	**580**	**430**	**..**	**730**	**..**	**180**	**120**
2004-05							
Free	..	210	660	350	530	..	..
Partnership	..	380	3,090	250	80	..	..
Matching	..	250	2,090	160	75	..	..
Dividend	..	150	630	20	35	..	..
Total	**760**	**490**	**..**	**780**	**..**	**170**	**120**
2005-06							
Free	..	200	760	350	460	..	..
Partnership	..	380	3,600	270	80	..	..
Matching	..	240	2,140	150	70	..	..
Dividend	..	160	530	30	60	..	..
Unknown	..	20	330	55	165	..	..
Total	**880**	**520**	**..**	**850**	**..**	**170**	**110**

[2] http://www.hmrc.gov.uk/stats/emp_share_schemes/sip.pdf

2006-07							
Free	..	200	740	430	580	..	..
Partnership	..	400	3,880	370	100	..	..
Matching	..	250	2,280	150	70	..	..
Dividend	..	180	890	50	50	..	..
Unknown	..	20	290	50	180	..	..
Total	**960**	**530**	**..**	**1,000**	**..**	**200**	**140**
2007-08							
Free	..	200	730	430	590	..	..
Partnership	..	380	3,030	240	80	..	..
Matching	..	240	1,690	120	70	..	..
Dividend	..	170	710	50	80	..	..
Total	**870**	**500**	**..**	**850**	**..**	**130**	**90**
2008-09							
Free	..	180	590	340	570	..	..
Partnership	..	420	4,250	350	80	..	..
Matching	..	270	2,810	210	70	..	..
Dividend	..	210	950	80	90	..	..
Total	**890**	**530**	**..**	**980**	**..**	**190**	**130**
2009-10							
Free	..	178	170	120	690	..	..
Partnership	..	403	3,380	300	90	..	..
Matching	..	257	2,570	180	70	..	..
Dividend	..	197	510	60	110	..	..
Total	**860**	**520**	**..**	**650**	**..**	**130**	**90**

Source: Annual returns (Form 39) Table updated June 2011

(1) The number of live schemes at the end of each year is higher than the number of companies operating tax-advantaged share schemes as some companies operate more than one scheme of the same type.

(2) The sum of the components will not match the total because a plan can appropriate more than one type of share.

(3) An employee is counted in these statistics each time he or she participates in an award. This means that an employee participating in an award more than once a year will be counted several times. Employees may also participate in more than one award type at the same time.

(4) The annual cost of income tax and NICs relief relates to shares appropriated to employees and coming out of the plan in the year.

(5) Share Incentive Plans were introduced in July 2000. Therefore, the first year's figures are for the period from 28 July 2000 to 5 April 2001 only.

- Negligible

.. Not available

D.3 Table 3[3]

6.3 Save As You Earn Share Option Schemes

Save As You Earn Option Schemes approved under Schedule 3 Income Tax (Earnings and Pensions) Act 2003

		Grants			Exercises		
Year	Number of live schemes at the end of the financial year (1)	Number of employees to whom options granted during year ('000) (3)	Initial value of shares over which options granted during year (£ million)	Average value of shares over which options granted per employee (£)(3)	Number of employees who exercised options during year ('000) (2,3)	Estimated cost of income tax relief (£ million) (4)	Estimated cost of NIC relief (£ million) (4)
1980-81	20	10	20	1,600	..	-	..
1981-82	140	90	150	1,700	..	-	..
1982-83	220	95	175	1,800	..	-	..
1983-84	290	105	185	1,800	..	-	..
1984-85	400	225	560	2,500	..	5	..
1985-86	520	200	460	2,300	..	15	..
1986-87	620	290	520	1,800	..	50	..
1987-88	710	440	970	2,200	..	30	..
1988-89	810	370	740	2,000	70	40	..
1989-90	900	460	1,020	2,200	275	60	..
1990-91	980	550	1,430	2,600	160	110	..
1991-92	1,060	480	1,400	2,900	165	60	..
1992-93	1,150	590	1,880	3,200	185	100	..
1993-94	1,260	480	1,290	2,700	235	135	..
1994-95	1,400	550	1,590	2,900	225	135	..
1995-96	1,120	610	1,730	2,800	320	290	..
1996-97	1,270	800	2,170	2,700	310	310	..
1997-98	1,310	1,170	2,970	2,500	395	500	..
1998-99	1,400	990	2,930	3,000	320	390	..
1999-00	1,350	1,000	2,830	2,800	465	445	..
2000-01	1,320	1,030	3,460	3,400	325	365	..
2001-02	1,300	1,300	2,785	2,100	530	295	..
2002-03	1,060	865	2,945	3,400	330	145	100
2003-04	1,010	600	1,890	3,100	300	100	60
2004-05	920	570	1,880	3,300	320	100	70
2005-06	960	560	2,120	3,800	390	250	170
2006-07	940	570	2,100	3,700	400	310	210
2007-08(5)	830	520	..	..	300	130	90
2008-09(5)	800	640	..	..	240	100	70
2009-10	720	760	3,060	4,100	170	110	70

Source: Annual returns (Form 34)

Table updated June 2011

(1) The number of live schemes at the end of each year is higher than the number of companies operating tax-advantaged share schemes as some companies operate more than one scheme of the same type.
(2) The number of employees who exercised options during the year is not available for years prior to 1988-89.
(3) An employee is counted in these statistics each time he or she receives/exercises a grant option.
This means that an employee receiving or exercising a grant option more than once in a year will be counted several times.
(4) The lump sum resulting from the SAYE contract can be used to buy the shares if the employee chooses to exercise their options after a minimum of 3 years.
The annual cost of income tax and NIC relief relates to the exercise of options granted 3, 5 or 7 years earlier.
(5) For 2007-08 and 2008-09 the initial value of shares over which options granted and average value of shares over which options granted during the year are not available due to changes made to form 34.
- Negligible
.. Not available

[3] http://www.hmrc.gov.uk/stats/emp_share_schemes/saye.pdf

D.4 Table 4[4]

Enterprise Management Incentives (1)

Enterprise Management Incentives notified under Schedule 5 Income Tax (Earnings and Pensions) Act 2003

Year	Grants				Exercises		
	Number of companies that granted options	Number of employees to whom options were granted	Initial value of shares over which options were granted during year (£ million)	Average value of shares over which options granted per employee (£)	Number of employees who exercised options	Estimated cost of income tax relief (£ million)	Estimated cost of NIC relief (£ million)
2000-01 (2)	870	4,700	130	26,400	0	-	-
2001-02	1,910	20,600	220	10,600	300	-	-
2002-03	1,960	23,100	200	8,800	1,200	20	10
2003-04	2,050	22,600	200	8,900	2,100	40	20
2004-05	2,410	26,500	260	9,900	4,500	80	40
2005-06	2,630	27,500	290	10,700	6,900	120	50
2006-07	2,820	27,000	300	11,200	7,500	210	90
2007-08	2,850	26,500	310	11,600	8,900	170	70
2008-09	2,560	22,100	210	9,400	5,100	90	40
2009-10	2,190	16,900	160	9,200	5,200	90	40

Source: Annual returns (Form 40) and notifications of EMI option grants — Table updated June 2011

(1) This table contains some revisions to historical data: please refer to the section on Publication and Revision Strategy in the accompanying report Employee Share Scheme Statistics for 2009-10

(2) Options could be granted under Enterprise Management Incentives from July 2000.
Therefore, the first year's figures are for the period from 28 July 2000 to 5 April 2001 only.

- Negligible

[4] http://www.hmrc.gov.uk/stats/emp_share_schemes/emi.pdf

D.5 Table 5[5]

Company Share Option Plans & Discretionary Share Option Schemes [(1)]

Company Share Option Plans approved under Schedule 4 Income Tax (Earnings and Pensions) Act 2003 and Discretionary Share Option Schemes approved under the Finance Act 1984

Year	Number of live schemes at the end of the tax year (2)	Grants: Number of employees to whom options granted during year ('000) (3)	Grants: Initial value of shares over which options granted during year (£ million)	Grants: Average value of shares over which options granted per employee (£) (3)	Exercises: Number of employees who exercised options during year ('000) (3,4)	Exercises: Estimated cost of income tax relief (£ million) (5)	Exercises: Estimated cost of NIC relief (£ million) (5)
1984-85	210	50	800	16,000	..	-	..
1985-86	1,480	50	870	17,000	..	-	..
1986-87	2,240	55	1,150	21,000	..	-	..
1987-88	2,980	90	1,800	20,000	..	55	..
1988-89	3,850	90	1,660	18,000	..	30	..
1989-90	4,400	105	1,900	18,000	..	110	..
1990-91	4,790	65	1,450	22,000	..	125	..
1991-92	5,090	80	1,350	17,000	20	140	..
1992-93	5,340	80	1,600	20,000	25	155	..
1993-94	5,680	70	1,760	25,000	35	220	..
1994-95	6,170	90	2,200	24,000	25	190	..
1995-96	4,060	125	1,970	16,000	35	280	..
1996-97	4,400	140	800	5,700	30	280	..
1997-98	4,480	330	1,070	3,300	30	315	..
1998-99	4,590	280	1,500	5,400	45	315	..
1999-00	4,660	240	1,310	5,000	80	250	..
2000-01	5,170	415	2,200	5,000	25	80	..
2001-02	4,730	280	1,860	7,000	80	155	..
2002-03	4,420	185	1,410	8,000	80	95	..
2003-04	3,570	220	980	4,500	120	95	25
2004-05	2,950	130	600	4,600	135	145	40
2005-06	3,030	120	590	4,900	120	150	40
2006-07	3,000	130	460	3,500	135	150	40
2007-08 (6)	2,330	65	380	5,900	..	..	..
2008-09 (6)	2,150	40	240	6,200	..	..	..
2009-10	1,910	40	280	7,300	30	70	30

Source: Annual returns (Form 35) Table updated June 2011

(1) Discretionary Share Option schemes were replaced by Company Share Options Plans in 1996.
(2) The number of live schemes at the end of each year is higher than the number of companies operating tax-advantaged share schemes as some companies operate more than one scheme of the same type.
3) An employee is counted in these statistics each time he or she receives/exercises a grant option.
This means that an employee receiving or exercising a grant option more than once in a year will be counted several times.
(4) The number of employees who exercised options during the year is not available for years prior to 1991-92.
(5) The annual cost of income tax and NIC relief relates to the exercise of options granted between 3 and 10 years earlier.
(6) Due to changes to Form 35, the number of employees exercising options during the year, and the estimated cost of income tax and National Insurance Contributions reliefs cannot be calculated for 2007-08 and 2008-09.
- Negligible
.. Not available

[5] http://www.hmrc.gov.uk/stats/emp_share_schemes/csop.pdf

E Evidence of effect of share schemes on productivity

E.1 As part of our review, the OTS wanted to challenge the overall validity of tax advantaged share schemes. It goes beyond the remit of this report to demonstrate the efficacy of employee share schemes, whether in terms of productivity, economic growth or any other way. However, the OTS team believes that the question is fundamental to our work, as it links to the policy objectives of the reliefs inherent in the share schemes. We have therefore reviewed previous research and reports investigating the question of whether employee share schemes work. The team has also spoken with some leading academic researchers into this issue.

E.2 The question is too complex for a clear solution to be identified within this report. What can be done, however, is to:

- identify key pieces of research carried out to date
- provide a brief summary of the research
- draw a conclusion as to next steps

Key research to date

E.3 Over the years a huge amount of research has been carried out into the effects of employee share ownership. Largely this has been carried out by independent researchers; some has been carried out on behalf of organisations lobbying on behalf of employee share ownership. There have also been reports produced for companies seeking to identify the practical effects of their employee share schemes, as well as reports carried out for HMRC.

E.4 Because this report has focused on the simplification of tax advantaged share schemes, it would clearly have fallen outside the OTS' terms of reference to review the hundreds of reports produced on the subject. The following research reports and reviews of research have however been reviewed

- "Employee share ownership and human capital development: complementarity in theory and practice", by A Pendleton & A Robinson, 2011. (**Pendleton and Robinson 2011**),
- "Employee Stock Ownership, Involvement and Productivity: An Interaction-Based Approach" by A Pendleton and A Robinson, 2010. (**Pendleton & Robinson 2010**),
- "The Oxford Handbook of Participators", Chapter 14 "Financial Participation" by Ian Kessler, Oxford University Press, edited by A Wilkinson, P Gollan, R Marchington & D Lewin 2010 (**Kessler**),
- Company Share Plans – Gift or Incentive? Evidence from a Multinational Corporation, prepared for an anonymous company by Alex Bryson and Richard Freeman 2011 (**Gift or Incentive Report**),
- "Employee Share Ownership Plans: a Review", produced by Eric Kaarsemaker and Andrew Pendleton of The York Management School, University of York and Erik Poutsma of Nijmegen School of Management, Radboud University in February 2009 (**the 2009 Pendleton Review**),

- "Evaluation of Tax advantaged All employee Share Schemes" prepared by Jane Kerr and Clare Tait for HMRC in September 2008 (**the 2008 All Employee Share Schemes Report**),
- "Enterprise Management Incentives (EMI) Evaluation Survey: Use of EMI and its perceived impact" prepared for HMRC by Ipsos MORI in February 2008 (**the EMI Ipsos Mori Survey**),
- "Tax advantaged employee share schemes: analysis of productivity effects" prepared for HMRC by Oxera in August 2007 (**the Oxera Report**),
- "Shared Company: How employee ownership works" produced by Job Ownership Limited, 2005 (**the JOL Report**), and
- The Inland Revenue Enterprise Management Incentives Company Survey 2003, prepared by FDS International for the (then) Inland Revenue in April 2004 (**the FDS Report**).

E.5 Each of these reports has established both positive and negative findings in connection with the effect of tax advantaged share schemes on productivity. For example:

- The Oxera Report states that "on average, across the whole sample, the effect of tax advantaged share schemes is significant and increases productivity by 2.5% in the long run", but "tax advantaged schemes on their own do not appear to be sufficient to improve performance".
- Pendleton and Robinson (2010) finds that all-employee share ownership has positive effects on productivity irrespective of other forms of participation, and that the effects are larger the more employees participate in the plan.
- Pendleton and Robinson (2011) finds that the use of an all-employee share plan significantly increases the probability of the firm offering training programmes. Once again, the more employees participate, the more likely training is to be offered.
- The 2009 Pendleton Report states that "employee share ownership has positive effects on performance (especially productivity) but those outcomes are often small or statistically insignificant".
- The 2008 All Employee Share Schemes Report states that "Overall, employers reported that the SAYE had a positive effect on the organisation as a whole" but "productivity was the one area asked about during the interview where respondents reported a mixed effect, with 51% of respondents reporting a positive effect and 45% of respondents reporting no effect".
- The IPSOS Mori Report states that "the majority of employers said that EMI had helped them retain key workers, improve staff motivation and improve company performance" but "since the research did not include a control group … it is not possible to conclude with any certainty the extent to which EMI has helped … improve company performance".

E.6 In short, the main conclusion we can draw from the research and reports produced is that on balance the evidence suggests positive effects, but methodological and data limitations mean that the evidence cannot be regarded as definitive.

Employee ownership and productivity

E.7 A number of key reports have focused specifically on productivity. The 2009 Pendleton Review states that since the 1970s there have been more than 70 reports produced on this area alone. Among those reports is the 2007 Oxera report produced for HMRC.

E.8 The 2009 Pendleton Review sets out three key conclusions in connection with those reports. These are reproduced here because they reflect our conversations with academics as well as what may be described as "a broad understanding in the marketplace" – by which we mean the many advisers and lobbyists for employee ownership from whom we have sought evidence while producing this report:

Box E.1:

The consensus from this literature can be stated as follows. Employee share ownership has positive effects on performance (especially productivity) but those outcomes are often small or statistically insignificant. Positive effects tend to be larger and stronger amongst firms with majority employee share ownership than amongst firms with "mainstream" employee share schemes ... though there is some evidence to the contrary. Finally, the effects of employee ownership are greater, or are only achieved ... when there is also participation in decision making.

E.9 Having drawn this broad conclusion, the 2009 Pendleton Review also goes on to point out that there are a number of difficulties relating to research on this topic. Because of these the final conclusion relating to the productivity studies is:

Box E.2:

There is evidence to suggest that employee share ownership has favourable effects on performance but there are methodological and data problems that limit how confident we can be about this finding.

Beyond productivity: other evidence

E.10 The 2009 Pendleton Review is of particular interest because it reviews "the main strands of research on employee share ownership over the last forty years ... highlighting the main findings that have emerged ... to date".

E.11 The report references no fewer than 98 separate pieces of research on the topic, evidencing the depth and breadth of investigation carried out over the years. Referenced authors include M Blair, D Kruse and J Blasi ; A Bryson and R Freeman; Will Hutton, Corey Rosen; and J Pierce, D Kostova and K Dirks. Also referenced are reports by the US based National Center for Employee Ownership and the Oxera Report.

E.12 The specific subjects studied within these reports are not limited to productivity or economic growth but do focus strongly on those areas – or alternatively, on issues which may be linked closely with them. Examples of specific areas of study include

- employee ownership: an unstable form or a stabilizing force?
- are diversification and employee ownership incompatible?
- does fair share capitalism improve workplace performance?

- employee share option schemes: why workers are attracted to them,
- monitoring colleagues at work and free rider problem: profit sharing, employee ownership, broad based stock options and workplace performance in the United States,
- financial participation in Europe: determinants and outcomes,
- the determinants of stock option compensation: the evidence from Finland,
- unions and the incidence of performance-linked pay schemes in Britain,
- employee stock ownership schemes and productivity in Japanese manufacturing firms,
- employee ownership, employee attitudes and firm performance: a review of the evidence,
- employee share ownership schemes in Australia: a survey of key issues and themes, and
- the perception and effects of share ownership: empirical evidence from employee buyouts.

E.13 This list is not exhaustive, but helps demonstrate the wide ranging nature of research that has been carried out. Reports have looked at companies from the US to Australia; at stock options for executives and employee owned companies; at empirical evidence and employees' viewpoints; at productivity in specific sectors and at less measurable concepts such as colleague monitoring and opportunities to "free ride" once a share scheme is in place.

E.14 Despite difficulties and limitations of the evidence, there is nevertheless substantial evidence of attitudinal and behavioural impacts in certain circumstances and there is also enough evidence to suggest that share ownership has favourable effects on company and workplace performance. This is particularly the case where there is substantial employee ownership.

E.15 We also refer to the 2005 JOL Report. This is a group that may be lobbying on behalf of employee ownership and any conclusions should bear this in mind. Nonetheless, the report references 23 other papers and reports, some overlapping with the references above in the 2009 Pendleton Review.

E.16 The JOL Report is useful in that it clearly identifies areas in addition to productivity on which employee ownership is likely to have a positive effect, in particular

- greater innovation,
- higher levels of customer loyalty,
- lower staff turnover, and
- increases in shareholder value.

E.17 The JOL report also notes other advantages of wider employee ownership which are less often highlighted – in particular, "micro effects" at an individual company level. For example, the report argues that extensive employee shareholding "tends to foster a sense of individual enterprise that directly fuels productivity". Furthermore, employee controlled companies tend to achieve high standards of accountability and corporate social responsibility.

The companies' view

E.18 In the UK, companies spend thousands of pounds on the design and implementation of employee share schemes in the UK alone. Employee share ownership, in whatever shape, now forms a major part of the reward and remuneration strategy of the UK's corporate giants. There is barely a company in the FTSE 100 that does not operate a share scheme of some type.

E.19 Yet companies do not seem to establish share schemes with the direct aim of improving productivity. Productivity may be a by-product, but it is not the sole reason behind the implementation of schemes.

E.20 Companies to whom OTS spoke talked of "the buzz" that comes about as a result of a successful SAYE scheme. The various research reports above identify many areas where employee share schemes can have an effect, including recruitment, retention, motivation, engendering a feel of ownership, reduction of absenteeism, longer hours working, more positive relationship between companies and employees, enabling employees to participate in ownership of the organisation, enhancing flexibility of remuneration and creating an emotional attachment to an organisation which encourages positive behaviours. Many of these aspects could be summarised as making employees "think like owners".

E.21 In fact, the reasons companies put in place share schemes vary enormously. For one company it may be to recruit highly skilled programming staff; for another it may be to engender excellent customer service at the tills. The variety of approved share schemes available to companies in the UK means that they can fit their share based reward schemes according to their needs.

Summary of conclusions

E.22 Research into the evidence of the efficacy of employee share schemes is widely available.

E.23 However, the approaches taken are so varied, and the bases of research so many, that it is difficult to draw any firm conclusions from the existing research.

E.24 The probable conclusions that we infer from the reports are:

- There is some evidence that using employee share schemes may improve productivity. Where this evidence exists, however, it is small or insignificant and the causal link between employee ownership and increased productivity is uncertain, both in terms of direction and in terms of how employee share ownership brings about productivity.
- There are many other areas where employee share ownership, in one form or another, can be viewed as having positive effects (e.g. increased innovation, increased employee loyalty and retention) and some of these areas may result, indirectly, in increased productivity. However the causal link has not been established in the research.
- Despite this lack of hard evidence, however, there remains a widely held perception that employee ownership does encourage a variety of behaviours in employees which can help employee performance. Certainly, this belief seems to be held by the various companies of all sizes and sectors, in the UK and worldwide, which go to some trouble and cost to design, implement and administer employee share schemes, sometimes on a global scale.

Next steps

E.25 There has been so much research carried out into the links between approved share schemes (and broader employee share ownership) and productivity that it seems that carrying out further research is unlikely to produce any more definitive evidence. It is evidently extremely difficult to demonstrate without any doubt that there is any causal link between the two.

E.26 We would not therefore recommend that money is spent by Government on producing further reports which are likely to be inconclusive.

E.27 It may be that the view that productivity is the focus behind employee share schemes is misdirected. Perhaps further consultation could focus on the reasons behind use of the schemes in the commercial sector – e.g. why companies implement schemes and why employees participate. This may demonstrate, one way or the other, the efficacy of tax approved share schemes beyond the narrow focus of productivity, for example by making employees feel more involved or making them more likely to stay with the firm.

E.28 Any such decision is clearly a policy one and beyond the scope of our report.

F Terms of reference

The OTS consultations with business have found that employee share schemes are perceived to be a highly complex area of the tax code. This complexity is seen as a frequent cause of error in tax returns and as a source of administrative burdens on employers, their advisers and employees.

Reflecting this, the Government is asking the OTS to carry out a two stage project,

- first looking at the four tax advantaged, or government approved, share schemes, and
- second looking at complexity around non tax advantaged or unapproved share schemes.

The initial work on approved share schemes will

- evaluate the four schemes and identify where they create complexities and disproportionate administrative burdens for scheme users,
- examine how the schemes could be simplified, and
- cover all four government approved schemes: Save As You Earn (SAYE), Company Share Option Plans (CSOP), Share Incentive Plans (SIP), and Enterprise Management Incentives (EMI).

The review should have regard to:

- the impact on companies and their employees and on HMRC, including the impact on employers with international workforces,
- the Government's corporate tax reform agenda including the need for fairness and simplicity,
- the wider economic and policy implications of any proposals – including the original purpose of the schemes and overall tax receipts,
- the takeup of the schemes by companies and employees,
- the availability of non tax advantaged share schemes,
- accounting treatment of share schemes,
- the risk of non compliance and avoidance opportunities, and
- the Spending Review resource constraints on HMRC.

G Share Incentive Plan - further information

Background and changes to date

G.1 The SIP was introduced by the Finance Act 2000 after an extensive period of consultation between November 1998 and March 2000. The new plan was intended to encourage employers to give to all employees the opportunity to take a stake in their own organisation by providing income tax and NICs benefits related to share ownership. The Government at that time believed that employee share ownership had positive effects on employee productivity and could play an important role in closing the productivity gap with other countries.

G.2 The key features of the new scheme which distinguished it from existing schemes were flexibility for employers to give free shares to those employees who buy shares themselves or to award free shares on varying terms to reward performance. Also this scheme enabled employees, for the first time, to buy shares in their company out of their pre tax and NICs salary.

G.3 Paragraph 105 – 114 of Schedule 8 Finance Act 2000 provides for a statutory corporation tax deduction in relation to the award of SIP shares (based on the market value at the time of award). This relief can now be found in Chapter 1 of Part 11 CTA 2009.

G.4 Finance Act 2003 introduced corporation tax relief for other costs of setting up and running a SIP now found in Chapter 1 of Part 11 CTA 2009. This includes a corporation tax deduction at the time a contribution is made to the SIP trust to be used to acquire more than 10% of the share capital of a company from a founder, provided all of the SIP shares are awarded within 10 years. There was evidence that this provision was being used to obtain a tax deduction with no intention to award SIP shares. Finance Act 2010 introduced legislation which denied a tax deduction if there was a tax avoidance motive behind the contribution.

G.5 A change was made in 2002 to permit an employee representative to be appointed as trustees of the SIP trust.

G.6 Some further improvements were introduced in Schedule 21, Finance Act 2003. Firstly, a more flexible definition of salary was provided for the purposes of the 10% limit applying to Partnership Shares which permitted companies to exclude a particular description of earnings, such as overtime or bonus, for the purpose of this limit and to apply a lower percentage. Secondly, participation by employees in more than one SIP in any tax year was permitted but only in one SIP at any one time. However, if an employee participated in more than one SIP operated by connected companies in the same tax year the individual participation limits applied to all connected schemes.

Key features of SIP

General

G.7 SIP is an all employee share scheme which provides income tax, NICs and CGT advantages in connection with shares acquired by employees and gives employees a continuing stake in the company.

G.8 Every SIP must provide for the establishment of a trust to hold the scheme shares on behalf of employees. The trustees have certain obligations which are set out in the legislation.

G.9 The scheme must be approved in advance by HMRC. Once approved the company and employees have certainty that they will benefit from the tax and NICs advantages until such time as a disqualifying event occurs.

All employee nature of the scheme

G.10 All employees of the company who otherwise meet the eligibility requirements must be invited to join a SIP. A company controlling other companies can set up a group scheme and extend the SIP to any of these companies, and if it does so, all employees of participating companies (defined as a "constituent company") otherwise eligible must be invited to join the scheme.

G.11 Employees who join the scheme must do so on the same terms. No feature of the scheme may result in a preferential treatment to directors or employees receiving the highest pay.

Types of share awards

G.12 Employers can chose to incorporate all or some of the following share awards

- Free Shares worth up to £3,000 each year,
- Partnership Shares worth up £1,500 each year, which employees may buy out of their pre tax (gross) salary subject to the cap of 10% of salary,
- (Free) Matching Shares worth up to £3,000 each year – the company may award these shares free to employees at a ratio of up to two Matching Shares for every Partnership Share purchased, and
- Dividend Shares – dividends from the other SIP shares up to a value of £1,500 each year can be reinvested in further Dividend Shares.

G.13 Free Shares can be awarded based on performance.

G.14 Free and Matching Shares must be held within the SIP trust for a minimum of three years and a maximum of five years (although they may be taken out of the trust early in certain "good leaver" situations).

G.15 Dividend Shares must be held in the trust for three years.

G.16 There is no minimum holding period for Partnership Shares, but removing them from the SIP trust may have tax consequences.

G.17 If a participant leaves employment with the company (or an associated company) for any reason, his/her scheme shares immediately cease to be subject to the scheme. Free and/or Matching Shares may be forfeit if an employee leaves employment within a period of three years after the award (except if there is a "good leaver" situation). In the case of Matching Shares, these may also be forfeit if the participant sells or otherwise withdraws the corresponding Partnership Shares from the scheme.

G.18 The value of Partnership Shares cannot exceed 10% of an employee's total salary for the year.

Tax treatment

G.19 Employees do not pay income tax or NICs on the value of the shares at the time they are awarded or on withdrawal from the scheme provided they are kept in the scheme for five years from award. However, charges to income tax and NICs will arise if the shares leave the scheme early other than in circumstances when employees leave the employment for a "good" reason. Income tax and NICs (where applicable) are collected via PAYE.

G.20 If Free, Matching or Partnership Shares cease to be subject to the scheme within three years of the date of award, there will be an income tax and NICs charge based on the market value of the shares at the date the shares cease to be subject to the scheme. There may also be an income tax charge on Dividend Shares being withdrawn from the plan within three years of the acquisition date. This is through self assessment but basic rate taxpayers are likely to have any liability covered by the dividend tax credit.

G.21 If Free, Matching or Partnership Shares cease to be subject to the scheme between three and five years of the date of the award, there will be an income tax and NICs charge based on the market value of the shares either at the time of the award or the date of withdrawal if that value is lower.

G.22 A tax charge does not arise on shares ceasing to be subject to the scheme within five years of award if the employee leaves the employment for a "good" reason. These are injury, disability, redundancy, TUPE transfer, a change of control or other circumstance ending the associated company status of the employing company, retirement at age not less than 50 years and death.

G.23 No CGT is payable on the increase in value while shares are held within the scheme.

G.24 It is also possible, subject to the taxpayer's other investments, to transfer SIP shares worth up to £11,280 at the time of transfer into a stocks and shares ISA without CGT (as of 6 April 2012).

G.25 There is a statutory corporation tax deduction in relation to the set up cost, running costs and the SIP shares based on the market value at the time of award.

The shares to be used

G.26 Shares must be fully paid up and not redeemable, and form part of the ordinary share capital of certain specified companies. The shares must either be listed on a recognised stock exchange, or shares in a company not controlled by another company (i.e. not shares in a subsidiary) or shares in a subsidiary of a listed company.

G.27 The scheme shares must not be subject to restrictions other than those affecting all ordinary shares of the company and those restrictions permitted by the legislation. Unlike SAYE and CSOP, the legislation permits restrictions to voting rights and for forfeiture of shares.

G.28 SIP legislation permits certain employee pre-emption conditions set out in the articles of association to apply to the shares. This includes compulsory transfer provisions on cessation of employment, provided the transfer takes place on the same terms as for any other shareholder.

Employees who may participate

G.29 To participate in a SIP, an individual must be an employee in the company which established the scheme (or in the case of a group scheme an employee of a constituent company). The scheme may provide for a qualifying period of employment of up to 18 months before an employee can join.

G.30 To be eligible to participate, individuals must not have an interest in the company of 25% or more.

G.31 There are restrictions on participating in more than one SIP in any one year.

Miscellaneous

G.32 On a company reorganisation (e.g. general offer, compromise or arrangement), there may be an exchange of shares in the target company for "new" shares in the acquiring company.

Current usage

G.33 An extract from national statistics on the use of SIP is included in Annex D. The key trends are as follows:

Participation in all employee share schemes

G.34 There has been a decline in the number of live SIPs (860 in 2009-10) and the number of companies operating them (840) from the peak of 960 schemes operated by 940 companies in 2006-07.

G.35 A similar number of companies now operate a SIP as the 859 companies that operated an Approved Profit Sharing Scheme (APS) in November 1998 as reported in the Consultation on Employee Share Ownership (1998). This was the scheme replaced by SIP that was little used by smaller private companies and one of the policy objectives of introducing the SIP was to considerably increase the number of smaller company users by making the new scheme more attractive to these companies. The evidence shows that the growth in the number of companies operating an all employee share scheme has been relatively flat between 2000-01 and 2009-10 and the growth in SIP offset by the fall in the number of companies using SAYE.

G.36 There was a fall in the number of awards in 2009-10 and as a consequence the initial market value of the shares awarded fell by one third from £980 million to £650 million. The value of SIP awards over a three year period ending in 2009-10 is below the value of shares for which options had been granted under SAYE (£3 billion in 2009-10).

G.37 The annual cost of income tax and NICs relief is based on the initial value of shares appropriated in the year as adjusted to take in to account shares leaving the scheme without tax relief. The fall in the value of SIP shares in 2009-10 from £980 million to £650 million resulted in a corresponding reduction in the cost of the income tax and NICs relief by £100 million to £220 million.

Participation by small private companies

G.38 We have not found any evidence that the SIP is more attractive to smaller private companies as was intended when SIP was introduced. A survey of SIP administrators that administered over 50% of schemes showed that only 7% of the companies were private companies[1]. It may be that smaller companies tend to operate self administered SIPs and therefore this is unrepresentative.

G.39 There is further evidence in the 2008 All Employee Share Schemes Report (see Annex E) that identified that a private company is ten times less likely to have provided a SIP or SAYE scheme to its staff than a public limited company[2]. Furthermore, they found that 74% of small companies with 49 employees or fewer had never provided an all employee share scheme.

[1] Ifs ProShare SAYE and SIP survey 2010

[2] http://www.hmrc.gov.uk/research/report59-main.pdf

Participation by foreign controlled companies

G.40 National statistics[3] show that a quarter of companies with a ceased SIP or SAYE scheme were foreign controlled companies who closed down a SIP or SAYE scheme after taking over the UK company. Few companies of this type that were surveyed had an active SIP, SAYE or both.

G.41 There is some evidence that larger US companies may use an unapproved global scheme to offer free or matching shares on an all employee basis, rather than to use an SAYE or SIP[4]. Notwithstanding this the introduction of the SIP has seen more foreign companies offer shares to their employees in the UK than using a SAYE.

Type of share awards

G.42 The most widely offered shares were Partnership Shares either alone or combined with Matching Shares. The initial value of Partnership Shares and the number of employee awards fell by 14% and 20% respectively in 2009-10[5].

G.43 National statistics[6] on share schemes showed there was a 70% decline in the number of employees receiving Free Share awards in 2009-10. There has been a corresponding reduction in the initial value of awards. Ifs ProShare reports show that the number of companies offering Free Shares has now fallen to an all time low of 14%. Whilst the trend for Free Shares has fallen over the long term the trend is more gradual than the 70% fall seen in 2009-10.

G.44 There is evidence that the objective of employees keeping a long term stake in their employer has been achieved with the SIP. The 2008 All Employee Share Schemes Report reports that just under 60% of employees surveyed expected to hold SIP shares for three years or more (or until they leave the company).

G.45 The 2008 All Employee Share Schemes Report finds evidence that companies and employees found SIP a more complex scheme compared with SAYE.

G.46 A key aspect of complexity in SIP related to leavers

- while only 22% of companies operating SIPs found this scheme difficult to explain to staff, 61% of those companies named the issue of leavers as the main or one of the main issues that caused difficulty, and
- 44% of SIP administrators reported instances of misunderstanding of the rules by employees; again a significant proportion related to employees leaving employment.

G.47 The perceived complexity of SIP produces a 'double whammy' in terms of takeup of the scheme, with companies reluctant to implement the scheme, and eligible employees reluctant to join an existing scheme. Some 63% of companies who had never had a SIP stated complexity as the main reason or one of the main reasons for not doing so; 29% of employees who were eligible to join but chose not to stated complexity as a reason. A similar number of companies also noted the administration burden associated with this scheme.

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3 http://www.hmrc.gov.uk/research/report59-main.pdf

4 2008 International Stock Plan Design and Administration Survey by the National Association of Stock Plan Professionals and Deloitte Tax LLP

5 See Annex D

6 See Annex D

H Save As You Earn - further information

Background and changes to date

H.1 In 1980 a tax advantaged all employee share option scheme was introduced under which share options were linked to five year Save As You Earn (SAYE) savings contracts for employees. The other key features of the original scheme were the possibility of offering share options with an option price at a discount of up to 20% on the share price at the time of grant (initially 10% before Finance Act 1989), payment of a tax free bonus at the end of the savings contract and the ability to defer exercising the option for a further two years.

H.2 In 1996, the Government amended the terms of the scheme to permit three year savings contracts (coupled with three year option agreements).

H.3 A SAYE scheme is intended to be a company or group wide scheme, with all employees of the company or of those companies controlled by the scheme organiser being eligible to participate. The scheme is run in conjunction with an approved savings contract, allowing employees either to take their savings as cash at the end of the savings period, or use the money to exercise their options and acquire shares in the company. The ability to take the savings as cash means that SAYE is viewed very much as a "no risk" scheme for employees.

Key features of SAYE

General

H.4 SAYE is an all employee share option scheme, under which options are granted giving the participants the opportunity to exercise the option to purchase the company's shares in the future at the option price set at the time of invitation.

H.5 Options may be granted at a discount of up to 20% to market value at the time of grant.

H.6 Before an option can be granted under an SAYE scheme, the scheme must have been approved by HMRC.

All employee nature of the scheme

H.7 All employees of the company who otherwise meet the eligibility requirements must be invited to join a SAYE. A company controlling other companies can set up a group scheme and extend the SAYE to any of these companies and, if it does so, all employees of participating companies otherwise eligible must be invited to join the scheme.

H.8 Employees who join the scheme must do so on the same terms. No feature of the scheme may result in a preferential treatment to directors or employees receiving the highest pay.

H.9 The scheme may provide for a qualifying period of employment of up to five years before an employee can join.

H.10 To be eligible to participate, individuals must not have an interest in the company of 25% or more.

The shares to be used

H.11 Shares must be fully paid up and not redeemable, and form part of the ordinary share capital of certain specified companies. The shares must either be listed on a recognised stock exchange, or shares in a company not controlled by another company (i.e. not shares in a subsidiary) or shares in a subsidiary of a listed company.

H.12 The scheme shares must not be subject to restrictions other than those affecting all ordinary shares of the company and those limited restrictions permitted by the legislation.

Approved savings contract

H.13 The options are linked to an approved SAYE savings contract which can run for three, five or seven years. The savings contract requires a bonus to be paid at the end of the savings period in accordance with HMRC rates. Employees may save between £5 and £250 per month over the savings period. The number of shares under option need not take the bonus in to account, though it normally does in practice. At the end of the savings period, employees may either exercise their options or take the cash.

Exercise of options

H.14 The timing of exercise is linked to the bonus date which is at least three years from grant. Options may only be exercised by an employee of the scheme organiser, a company under the control of this company or (if permitted by the scheme rules) an associated company. If the employee is not in employment with such a company at this time, the option will lapse though with no damage to the savings contract.

H.15 Exercise is allowed within three years of the date of grant if the employee leaves or reaches the age specified in the rules and has the right under the rules to exercise early, or six months after the bonus date, or within 12 months of the date of death.

H.16 The scheme rules must allow early exercise within six months of end of employment when employment ends by reason of injury, disability, redundancy or retirement (good leaver provisions) and within six months of reaching a specified age without retiring.

H.17 If an option is held for less than three years, it will usually lapse on cessation of employment with a participating company, except if good leaver provisions apply, or if the company provides in the scheme rules for the early exercise to be permitted in the circumstances specified below

- transfer of an employing company outside the scheme organiser's group, or
- transfer of the business to another company not in the scheme organiser's group.

H.18 Companies can include a right to early exercise of option on change of control. They can also include a right to exchange option in the old company for the option in the new company on change of control.

Tax treatment

H.19 There is no charge to income tax on grant of options.

H.20 There is no charge to income tax on exercise provided one of the following conditions is met

- the option is exercised on or after the third anniversary of grant, or
- the option is exercised before the third anniversary of grant as a result of employment ceasing due to injury, disability, redundancy, retirement either on the

specified age or on the date the employee is bound to retire in accordance with the terms of their contract of employment, or on the employee's reaching the specified age (without necessarily retiring), or death.

H.21 Where tax is chargeable PAYE is not due under the readily convertible asset provisions nor is there NICs. The income tax is collected via self assessment.

H.22 CGT is due on the eventual sale of shares, calculated on sales proceeds less the actual exercise price for income tax relieved exercise (subject to the annual CGT allowance). The limits applicable under SAYE mean that gains will often fall within the CGT annual exemption and thus there is not a significant tax yield for the Exchequer.

H.23 It is also possible, subject to the taxpayer's other investments, to transfer SAYE shares worth up to £11,280 at time of transfer into Stocks and Shares ISA without CGT (as of 6 April 2012). There is also the facility for transferring shares acquired through SAYE directly into a registered pension plan. There is no CGT exemption if this is done.

Current usage

H.24 An extract from national statistics on the use of SAYE is included in Annex D. The key trends are as follows:

Participation in SAYE grants

H.25 There has been a 45% reduction in the number of SAYE schemes to 720 (operated by 600 companies) in 2009-10 from 1,320 schemes (operated by 1,110 companies) in 2000-01.

H.26 Despite the fall in the number of schemes, the number of employee awards rose by 19% between 2008-09 and 2009-10 to 760,000. The initial value of shares placed under option has increased to £3 billion in 2009-10, however not all of these options will be exercised at the end of the savings contract. This is only a decline of around 10% from the value of shares for which options have been granted in 2000-01. The average value per employee of £4,100 is the highest since the scheme was introduced. This seems to indicate that the rate of take up in companies offering SAYE has increased along with the level of employee savings.

H.27 This is also illustrated by the ifs ProShare SAYE and SIP survey for 2010, which showed an increased average monthly savings from £86 in 2008 to £107 in 2009, before falling back slightly to £101 in 2010. The equivalent monthly savings for the SIP were £78 and £73 respectively for 2009 and 2010.

H.28 This understates the cumulative savings as employees may be saving towards more than one grant at any one time up to the maximum monthly savings limit of £250. In 2009, 23% of employees saved the maximum across all grants. This fell to 15% in 2010.

H.29 In summary, whilst the total value and average value of share options granted per employee are higher under SAYE, the total number of SIP schemes and employees participating in SIPs is higher. This is likely to be for a variety of reasons, including

- perceptions of the complexity of SIP (see Annex G),
- larger quoted companies tend to use SAYE due to economies of scale. The number of these companies limits the number of schemes,
- the higher savings limit under SAYE compared to the Partnership Shares limit, and
- SAYE is a "no-risk" option scheme, while SIP (where Partnership Shares are used) requires direct investment from participants.

Exercise of options and cost of relief

H.30 There has been a downward trend in the number of employees who have exercised SAYE options in 2006-07 and 2009-10. This may partly reflect that the stock market values in 2009-10 were on average around 15% lower than 2006-07, when many of the options to be exercised in 2009-10 were granted, and so the option price (even with the discount) may have exceeded the market price at the exercise date. This also reflects the fluctuations in the number of options granted in earlier years.

H.31 The cost of the income tax and NICs relief is calculated based on the estimated gain on exercise at the average marginal income tax and NICs rates. The fall in the number of options exercised in the period 2006-07 to 2009-10 has resulted in a corresponding reduction in the estimated cost of the income tax and NICs relief from £520 million (2006-07) to £180 million (2009-10).

Analysis of companies by type and size

H.32 A survey of SAYE administrators[1] administering two thirds of all SAYE schemes showed that companies offering SAYE were typically large companies with over two thirds being FTSE listed companies and the remainder being AIM listed and companies listed overseas. Only 6% of the companies included in the survey were private companies.

H.33 Further evidence on the type of companies with SAYE schemes can be found in the 2008 All Employee Share Schemes Report. One of the findings of this report was that more than 50% of companies with an SAYE scheme had more than 1,000 employees. This reflects the higher set up and operating costs associated with this scheme which is more suited to larger companies.

Type of awards

H.34 88% of organisations that featured in the 2008 All Employee Share Schemes Report[2] offered a three year contract compared to 57% of organisations offering five year contracts (43% only offered three year contracts). The numbers offering seven year contracts are small.

H.35 78% of employees entering into an SAYE contract joined a three year scheme compared to 21% joining a five year scheme. Less than 1% joined a seven year scheme[3].

H.36 One of the criticisms of SAYE schemes is that they do not result in employee share ownership since employees either do not exercise the option or do so and then sell the shares immediately. There is contrasting evidence: one source of data indicated that less than 40% of option holders actually sold some or all shares immediately on exercise. Another survey reported that on average only 25% of employees intended to retain some or all of the shares.

H.37 This will vary considerably by organisation and will be much higher in some organisations that foster long term share ownership and who make special arrangements to encourage employees to use savings to buy shares even when the SAYE option is underwater. In one particular company, special arrangements were made to facilitate the purchase of 880,000 shares by 1,700 employees over the past three years; in this particular case a large proportion of employees did not see SAYE as just a savings scheme but as a means of share ownership.

[1] Ifs ProShare SAYE and SIP Survey 2010
[2] http://www.hmrc.gov.uk/research/report59-main.pdf
[3] Ifs ProShare SAYE and SIP Survey 2010

Enterprise Management Incentives - further information

Background and changes to date

I.1 Following consultation, Enterprise Management Incentives (EMI) were introduced by the Finance Act 2000 Schedule 14 with some further amendments made in the following year.

I.2 At its introduction, according to a Technical Note produced by HMRC on 30 April 1999[1], "the Government recognise[d] that one of the key constraints on growth for a small ambitious company is the quality of its management, and that it can be difficult to get high calibre managers to move from mature companies into growing businesses. … targeted tax advantaged share incentive schemes might encourage more high calibre managers to join and stay with smaller companies thereby enhancing the growth prospects of those companies". So the EMI option arrangement was aimed at "small, higher risk trading companies".

I.3 Specifically, and as set out in the legislation, EMI options should be granted "for commercial reasons in order to recruit or retain an employee in a company".

I.4 The EMI legislation is set out in Sections 527 – 541 of ITEPA and in Schedule 5 to ITEPA.

I.5 Since its introduction, EMI has been amended on a number of occasions, including the following changes

- limit on 15 participants: removed entirely,
- limit of gross assets increased from £15 million to £30 million,
- £100,000 limit per participant increased to £120,000,
- limit of 250 employees per company introduced, and
- replacement of taper relief with entrepreneurs' relief (see Chapter 6 "Issues beyond simplification").

Key features of EMI

General requirements:

I.6 The option must be granted for specific purposes and not for the avoidance of tax.

I.7 No individual participant may hold unexercised options over shares with a total value of more than £120,000. This limit includes unexercised CSOP options.

I.8 Employees may not be granted further EMI options within a three year period of an initial grant of £120,000. However the wording of this part of the legislation permits a further grant of options with a value of less than £120,000. Companies may therefore grant options over, say, £119,000 of shares, and make a further grant within the three year restriction period of a further £119,000 (subject to the total limit of £120,000 of unexercised options).

[1] http://www.hmrc.gov.uk/consult/tnemi.pdf

I.9 There is a whole company limit on the value of unexercised qualifying options of £3 million.

Company tests

I.10 The company must be independent and only have "qualifying subsidiaries" – i.e. it must control 75% of the subsidiary, or 90% if the subsidiary whose business consists wholly or mainly of holding or managing land or property.

I.11 The value of its gross assets (including, if necessary, the gross assets of its subsidiaries) must not exceed £30 million.

I.12 It (together with its subsidiaries) must have fewer than 250 employees, or the full time equivalent.

I.13 If it is a single company, it must exist wholly for the purpose of carrying out one or more qualifying trades, i.e. its business must be conducted on a commercial basis with a view to making a profit and the trade must not consist wholly or substantially of carrying out excluded activities.

I.14 If it is a parent company, at least one group company must exist wholly for the purpose of carrying out one or more qualifying trades and the business of the group as a whole must not consist wholly or substantially of the carrying out of non qualifying activities. Non qualifying activities means excluded activities and activities carried on otherwise than in the course of a trade.

I.15 There are a number of excluded activities.

Employee tests

I.16 To participate, an individual must be an employee of the company or one of its qualifying subsidiaries.

I.17 He or she must meet the working time commitment. The employee must be required to commit an average amount of time per week working for the company which must equal or exceed either 25 hours per week or, if less, 75% of his or her working time. Working time is defined as time spent on remunerative work whether as an employee elsewhere, or on a self employed basis, including time which would be chargeable to tax in the UK were the employee resident and ordinarily resident in the UK.

I.18 The employee must not have an interest in the company (or any member of the group) of 30% or more.

Requirements relating to options

I.19 The shares over which options are granted must form part of the ordinary share capital of the relevant company, must be fully paid up and must not be redeemable. However, there are no other restrictions that apply so it is possible for companies to create a different class of shares for use under EMI (for example, non voting shares or shares that do not pay a dividend) without falling foul of the legislation.

I.20 The option must be capable of exercise within 10 years to obtain the beneficial tax treatment.

I.21 The terms of the option must take the form of a written agreement. This allows individual options to be granted by way of an agreement between the grantor and the option holder without any reference to rules. In practice, many companies do in fact establish a set of rules with associated option agreements where grants are to be made to a number of individuals. The legislation sets out a list of the details which must be included in the agreement. This includes the requirements for any restrictions attaching to the shares to be included in the agreement.

I.22 Options are non transferable, but if options are permitted to be exercised on death, they must be exercised within 12 months of the date of death of the participant.

Tax treatment

I.23 No income tax or NICs on the grant of the option.

I.24 No income tax or NICs on the exercise of the option (unless the option is granted at a discount, when the discount will be subject to income tax and, if relevant, NICs).

I.25 CGT is due on the eventual sale of shares, calculated on sales proceeds less the actual exercise price for income tax relieved exercise (subject to the annual CGT exemption). If the EMI option is granted at a discount, the CGT charge will be the sale proceeds less the market value of the shares at the date of grant, which will be higher than the exercise price.

I.26 EMI participants are able to enter into a joint NICs election with their employer to transfer the secondary NICs liability to them (should it arise).

European Commission requirements

I.27 The reason why only certain types of companies can benefit under EMI is because of the rules relating to State aid. State aid applies if a specific measure transfers state resources to certain types of undertaking which gives them an advantage over other types of undertaking and has the potential to distort competition. In the case of EMI, the state resources are the tax benefits, and the types of undertaking are the limited types of companies which can benefit. State aid is more often focused on small and medium enterprises (SMEs), as a way of acknowledging how important they are to growth, and the tests set for the types of company that can use EMI are largely created to ensure that only SMEs, as recognised by the European Commission, can in fact benefit under the arrangements. Any changes to State aid measures – for example, measures that might result in non-SMEs being able to use EMI – must be notified to the European Commission.

I.28 For example, any changes made to the rules relating to excluded activities are likely to require clearance from the Commission. If amendments are made resulting in tax breaks for non SMEs, any aid perceived by the Commission to have been given out incorrectly may be subject to a clawback.

Key advantages of EMI

I.29 For smaller, privately held companies, EMI is a flexible option arrangement which offers a number of advantages over the approved schemes, i.e. SIP, SAYE and CSOP. The key advantages are as follows:

I.30 **Restricted shares**: options may be granted over shares with restrictions, including shares subject to pre emption rights commonly contained within private companies' articles of association.

I.31 **Self certification**: a simple agreement may be drawn up between option holder and grantor without seeking prior approval from HMRC. Once the option is granted, a notification must be made to SCEC within 92 days of the date of grant. If no enquiry is raised within 12 months, the company can rely on the tax advantages pertaining to an EMI option.

I.32 **Valuation**: there is no specific requirement to seek a valuation of the shares before the grant of an option, although in practice this is advised and many companies do take advantage of the ability to seek a valuation for the purposes of grant of an EMI option.

I.33 **Ability to grant options at a discount** to market value of the shares and with **performance conditions**: in fact, EMI options can be granted at nil cost if this suits the company's commercial objectives, although the discount will be subject to income tax and NICs upon exercise. Another advantage of EMI is the ability to grant options with performance conditions which may not meet the objectivity rules that apply to CSOP.

I.34 **No time limits/no good leaver provisions**: unlike the approved schemes, there is no minimum time requirement for options to be held prior to exercise. In theory, EMI options can be exercised immediately after they are granted, without any negative tax consequences. As a result, there is no requirement for the legislation to impose good leaver regulations as for the approved schemes. This enables companies to draft their own good leaver provisions and incorporate an element of discretion in relation to leavers to match the commercial requirements of the company. For example, a company could ensure that options were only exercisable if a desired exit event were achieved, ensuring that employees who left the company before that goal were reached did not benefit at all from the EMI option arrangement.

Current usage

I.35 Until the introduction of EMI in 2000, CSOP was the only discretionary tax advantaged scheme available in the UK. As detailed above, EMI provides significantly more tax advantages and flexibility for companies wishing to grant options on a discretionary basis. Since EMI's introduction, the numbers of companies using CSOPs has decreased (see Annex J) while the number of companies using EMI has increased over the years.

I.36 According to national statistics, in 2001-02, the first complete year after EMI was introduced in 2000, 1,810 companies granted EMI options; this number peaked at 2,850 in 2007-08 and has decreased slightly in recent years, with 2,190 granting EMI options in 2009-10.

I.37 Of the 11,880 companies operating a tax advantaged discretionary scheme (i.e. CSOP or EMI) in 2009-10, 10,610 were EMI arrangements. Around 200 of these companies also had CSOP.

I.38 EMI options were granted to 20,600 employees in 2001-02; in 2009-10 this had fallen to 16,900 (having peaked at 27,500 in 2005-06). The numbers of employees to whom EMI options were granted in 2009-10 is still considerably less than those to whom CSOP options were granted (40,000 employees in the same year). This is because the companies using EMI are smaller than those using CSOP and therefore grant options to fewer employees. The average number of employees granted EMI options in any one company (or group of companies) is 7.7.

J Company Share Option Plan - further information

Background and changes to date

J.1 A tax advantaged discretionary share option scheme was introduced under Schedule 10 of the Finance Act 1984. At the time, it was used mainly for executive directors, allowing a grant of options over shares with a value of up to £100,000 or four x salary, whichever was the greater. Income tax relief was available on exercise and the capital gains tax payable on the sale of the shares provided an incentive because of the considerable difference between income tax and capital gains tax rates at the time.

J.2 In 1995, the Greenbury Report on Directors' Remuneration was published. The Report arose partly out of a concern about large gains for directors from the exercise of share options, in particular in relation to the recently privatised utility industries. The Report criticised share options for providing "windfall gains" reflecting general market movements rather than the efforts of directors, and for failing to encourage directors to become long term shareholders in their companies.

J.3 Amongst other recommendations, the Report suggested that option gains under discretionary share option schemes should be taxed as income rather than capital gains, that no discounts should be available for option grants to executives and that a minimum exercise period of three years should be introduced.

J.4 Following the Greenbury Report, the scheme was effectively restyled as the Company Share Option Plan (CSOP) in 1996, and the individual limit reduced to £30,000. This immediately had the effect of making the scheme considerably less attractive as a method of incentivising and motivating higher earning employees.

J.5 Since the introduction of CSOP in 1996, the most significant change has been the introduction of EMI which, together with the reduction of the individual limit, has made CSOP attractive only to those companies which do not qualify for the considerably greater tax benefits available under the EMI legislation.

J.6 Other legislative changes, in particular those aimed at reducing tax avoidance, have been implemented in the intervening years. These include

- the material interest test was increased from 10% to 25%,
- a requirement was introduced to obtain approval from HMRC if amendments were made to a key feature of scheme,
- where CSOP options are exercised early and do not qualify for tax relief, the resulting gain is subject to income tax and NICs for listed shares acquired after 8 April 2004. Companies have had to update CSOP rules and put in place processes to discharge the PAYE liability, e.g. by selling sufficient shares and allotting the balance of the shares to the option holder. CSOP participants are also able to enter into a joint NICs election with their employer to transfer the secondary NICs liability to them, and

- amendments made to the eligible shares which can be used under CSOP (subsidiary shares).

J.7 The CSOP legislation is set out in sections 521–536 ITEPA and in Schedule 4 to ITEPA.

Key features of CSOP

General

J.8 The scheme is discretionary, allowing selected individuals to be granted options over shares with a maximum value of £30,000 at the date of grant. This is not an annual limit but applies to all subsisting options. There is no company limit.

J.9 Options may not be granted at a discount.

J.10 Before options can be granted under a CSOP, the rules of the scheme and certain associated documents must be given formal approval by HMRC.

Eligible employees

J.11 The scheme is open to full time directors and employees of the company granting the options or, if the case of a group, a constituent company.

J.12 To be eligible to participate, individuals must not hold an interest in the company of 25% or more.

Types of shares

J.13 Shares over which options may be granted must be fully paid up and not redeemable, and form part of the ordinary share capital of certain specified companies. The shares must either be listed on a recognised stock exchange, or shares in a company not controlled by another company (i.e. not shares in a subsidiary).

J.14 The shares under option may only be subject to very limited restrictions (described as "authorised restrictions" in ESSUM). In particular, any restrictions on the shares must apply to all shares of the same class; or there may be a restriction allowing certain restrictions contained in the company's articles of association. These are referred to in ESSUM 43490 as "employee pre emption provisions". Broadly, shares held by employees may be subject to compulsory transfer provisions when an employee ceases employment, but the transfer must take place on the same terms as for any other shareholder.

J.15 CSOP may be used by companies that have more than one class of share but only if the majority of the shares of the class used under the scheme meet certain requirements, being either employee control shares or open market shares.

Tax treatment

J.16 There is no charge to income tax and NICs on grant of the options.

J.17 Options may be exercised free of income tax and NICs between three years and ten years following the date of grant.

J.18 Options may also be exercised free of income tax and NICs within three years of the date of grant if the employee leaves for reasons of injury, disability, redundancy, retirement or death. When this is the case, the options must be exercised within six months of the date of cessation of employment, except in the case of death, when a 12 month period is allowed.

J.19 Options may be exercised before the third anniversary but no income tax or NICs relief will apply.

J.20 Retirement must be specified in the scheme rules and set at an age not less than 55.

J.21 CGT is due on the eventual sale of shares, calculated on sales proceeds less the actual exercise price for income tax relieved exercise (subject to the annual CGT exemption).

J.22 CSOP participants are able to enter into a joint NICs election with their employer to transfer the secondary NICs liability to them (should it arise).

Miscellaneous

J.23 The scheme must not contain features which are neither essential nor reasonably incidental to the purposes of providing benefits for employees/directors under the scheme.

J.24 On a company reorganisation (e.g. general offer, compromise or arrangement), there may be an exchange of "old" options in the target company for "new" options in the acquiring company. Such an exchange must occur within six months of the change of control (the period varies according to the type of reorganisation occurring).

Current usage

J.25 Until the introduction of EMI in 2000, CSOP was the only discretionary tax advantaged scheme available in the UK. EMI provides significantly more tax advantages and flexibility for companies wishing to grant options on a discretionary basis. As a consequence, only companies which cannot grant options under EMI, because they fail to meet any one of the EMI requirements or because it is commercially impractical for them to do so, would grant options under CSOP.

J.26 The use of CSOP has dropped considerably in the last 10 years and national statistics prepared in June 2011 (Employee Share Scheme Statistics for 2009-10) demonstrate a long term decline in the numbers of companies using the scheme.

J.27 An extract from national statistics on the use of CSOPs is included in Annex D. Key statistics include the following

- in 2000-01 5,170 live CSOP schemes; in 2009-10, the numbers had dropped to 1,910,
- of the 11,880 companies operating an approved discretionary scheme in 2009-10, 10,610 companies were using EMI, and only 1,490 were using CSOP. Some 200 companies had both an EMI and a CSOP,
- in 2000-01, CSOP options were granted to 415,000 employees; in 2009-10, only 40,000 employees were granted CSOP options, and
- in 2000-01, the total initial value of shares over which options were granted was £2,200 million. In 2009-10, that value was £280 million.

J.28 Although CSOP's popularity is clearly in decline, more employees were granted options under CSOP in 2009-10 than under EMI (40,000 in comparison to 22,000). This suggests that CSOP remains a useful method of granting tax advantaged, discretionary options for companies unable to make use of the EMI arrangements, which are limited to smaller companies.

J.29 It has been difficult to identify clearly the types of companies using CSOP, because detailed information is of course protected because of confidentiality issues. We have therefore had to rely to a degree on anecdotal evidence from roadshows which suggests that CSOP is used as follows

- by companies which do not qualify for EMI but wish to implement a discretionary option scheme,

- by companies which have grown beyond the limits placed by EMI but wish to implement a discretionary option scheme, and
- by larger companies (included quoted companies) who use CSOP as a tax efficient part of their overall reward and remuneration strategy, typically for middle managers rather than senior executives.

J.30 It is worth noting that while, on the face of it, CSOP is declining in popularity, there was very little appetite at the roadshows for its removal. Companies generally seem to welcome the availability of a tax efficient discretionary option arrangement beyond that offered under EMI. It was felt that CSOP formed part of a well understood and flexible suite of approved share scheme arrangements.

Unclear policy rationale

J.31 There is one final point to consider when reviewing CSOP, which is the policy rationale behind the scheme.

J.32 The CSOP limit of £30,000 has remained unchanged since its introduction in 1996. If CSOP is aimed at executives, the limit is too low; if aimed at all employees, it is too high. This is the conclusion of feedback we have received throughout the roadshows, evidenced by the fact that, as far as it is possible to identify, CSOP is increasingly used for middle managers rather than senior executives.

J.33 Is CSOP's current purpose to provide an alternative discretionary option scheme for non EMI companies? If that is the case, then the additional limitations set out above are so much more burdensome than those set out in EMI that the administrative burden is disproportionate to the value that can be obtained under the scheme.

J.34 A key advantage of having CSOPs is to allow companies which cannot meet the extremely detailed requirements of the SIP and SAYE legislation to offer an approved share plan to their employees.

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