Legal Business Solutions Academy

Employee Share Plans

June 2024

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Employee Share Plans

Employee share plans are an important way for many companies, from startups to listed multinationals, to incentivise, attract and retain their employees. This session will explore the main types of share plan that listed and private companies put in place, and look at some of the main issues in-house lawyers and company secretaries frequently encounter on the operation of share plans.

PwC Employee Share Plans Legal Team

Daniel Hepburn
Director
daniel.c.hepburn@pwc.com

Andrew Nealey
Senior Manager
Private Business Incentives - Lead
andrew.nealey@pwc.com

Naomi Joslin-Tan
Senior Manager
naomi.joslin-tan@pwc.com

Caroline Geater
Senior Manager
caroline.geater@pwc.com

Adessa Ascroft
Senior Manager
adessa.ascroft@pwc.com

Saehaan Memon
Senior Associate
saehaan.a.memon@pwc.com

Agenda

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Why companies use employee share plans

Why companies use employee share plans

To incentivise employees, and align their interests to shareholders.

Financial regulatory and corporate governance requirements.

To attract new employees.

Some types of plan carry tax benefits.

To retain employees.

Potential cash cost savings for the company.

Identification of employees with their company.

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Overview of employee share plans

Types of employee share plan

- Plans intended for selected employees e.g. directors and executives
- Plans operating on an all–employee basis
- Plans using options or other rights to receive shares
- Plans under which employees receive value above a hurdle
- HMRC tax advantaged share plans
- Plans delivering shares free to employees
- Plans under which employees buy shares
- Phantom or cash based plans where payments are based on share value
- Plans operating with employee trusts

Case study

ListCo plc is a UK listed company which has decided to set up two types of employee share plan.

- A long term incentive plan (**LTIP**) under which executive directors and senior executives will be awarded nil cost options to acquire shares subject to remaining in employment and meeting prescribed performance conditions.

- A tax advantaged all-employee savings related share option plan (**SAYE Plan**) under which options are granted to employees alongside a savings contract over a 3 or 5 year period, with an exercise price set at up to 20% discount to the market value of the shares.

Legal/tax benefits of having an employee share plan

There are a number of benefits for employee share plans under the Companies Act 2006, the Financial Services and Markets Act 2000 and the UK Prospectus Regulation.

Companies Act 2006

- An **employees' share scheme (ESS)** is: "*a scheme for encouraging or facilitating the holding of shares in or debentures of a company by or for the benefit of: 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, or the spouses, civil partners, surviving spouses, surviving civil partners, or minor children or step-children of such employees or former employees." (section 1166 Companies Act 2006).
- ESS exemptions from Companies Act 2006 requirements for shareholder approval to grant options and/or allot shares and statutory pre-emption rights

  - But always check a company's articles of association and any investment/shareholders' agreement for any additional restrictions and/or consents (e.g. class consent to change share rights) and any other regulatory requirements.
- Financial assistance - exception from prohibition where financial assistance provided for the purposes of an ESS if certain conditions are met.

Financial Services and Markets Act 2000

- Certain exemptions from prohibitions on carrying out regulated activities and communicating financial promotions apply to employee share plans.
- Application of the exemptions will depend on the circumstances and there is no exemption from prohibition on providing investment advice.

UK Prospectus Regulation

- Exemption from requirement to publish a prospectus for offer or allotment of securities to existing or former directors or employees by their employer or an affiliated undertaking.
- Exemption applies if a document is made available containing information on the number and nature of the securities and the reasons for and details of the offer or allotment.
- Similar exemption applies for admission to listing of securities.
- Other exemptions may apply e.g. offers to under 150 persons in the UK.

Other reasons

- Plan rules are needed for some HMRC tax advantaged plans.
- Administration and supporting a uniform approach.

Typical provisions in an employee share plan

An employee share plan may include some or all of the following provisions:

- Eligibility
- Individual limits
- Limits on total number of shares/dilution
- Price payable (if any) for the shares
- Times when awards can be made
- Performance conditions or other conditions for vesting/delivery of shares
- Service period requirement
- Vesting date(s)
- Consequences if cease employment, including any “good leaver” treatment
- Lock up or holding periods
- Source of shares
- Tax withholding provision
- Lapse provisions
- Treatment on change of control and other corporate events
- Adjustments on variation of share capital
- Relationship with employment contract
- Administration responsibilities
- Discretions (e.g. treatment on cessation of employment and change of control)
- Interpretation and amendment provisions

Share plan documentation and some key action points

The features of an employee share plan are usually documented in plan rules and employee award documentation, which can take many forms.

- Check you have access to all relevant plan documentation - may be contained in several documents.
- Check that the plan rules, employee award documentation and any employee communications are consistent.
- Check what is needed for the plan to be established by the company (e.g. shareholder and/or Board approval).
- Confirm who makes decisions under the plan (e.g. Board, remuneration committee).
- Check role of external plan administrators and trustees on plan operation.
- Register any employee share plan with HMRC and comply with HMRC reporting requirements.
- Check that arrangements are in place to account to HMRC for any tax which needs to be withheld through PAYE.
- Consider local tax and local legislation (e.g. securities law requirements) for internationally mobile employees and international plans.

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Listed companies

Examples of types of plan in listed companies

Long Term Incentive Plan (**LTIP**)

Typically award a right to receive shares at nil (or nominal cost) cost.

Vesting typically subject to meeting performance conditions and service over a vesting period (e.g. three years).

Deferred Bonus Plan (**DBP**)

Typically award a right to receive a portion of a bonus in shares, rather than cash, at nil (or nominal) cost.

Vesting typically subject to service vesting period (e.g. three years).

Restricted Share Plan (**RSP**)

Typically similar to an LTIP but award vesting typically subject to service but over a vesting period but not subject to meeting performance conditions.

Share Incentive Plan (**SIP**)

Tax advantaged all–employee share plan for awarding free shares, partnership shares, matching shares and dividend shares.

Save As You Earn (**SAYE or Sharesave**)

Tax advantaged all–employee share plan under which options granted alongside a savings contract over a 3 or 5 year period, with an exercise price set at up to 20% discount to the market value of the shares.

Company Share Option Plan (**CSOP**)

Tax advantaged share plan under which options are granted with an exercise price based on the company's share price at grant.

Design influenced by:

- The UK Corporate Governance Code.
- Institutional investor guidelines e.g. the Investment Association Principles of Remuneration.
- Market practice.

Listed companies - practical issues (1 of 2)

Shareholder approval under Listing Rules (LR 9.4 and 13.8)

- UK premium listed companies must obtain shareholder approval through an ordinary resolution for:
  - An 'employees' share scheme' which may use new issue or treasury shares.
  - A 'long term incentive scheme' (**LTIS**) in which directors of the listed company may participate (two potential exceptions - LTIS operated on an all-employee basis and for certain one off–arrangements for directors).
- Where shareholder approval required, the company must publish a circular:
  - Including the text of the plan or a description of the plan's main terms.
  - Stating that certain provisions (e.g. individual and plan limits) cannot be altered to participants' advantage except for certain minor amendments (e.g. to take account of tax).
  - Stating that the plan will be posted on the National Storage Mechanism.
- *If shareholder approval required for amendments, or discounted options to subscribe shares are to be granted, separate requirements apply.*
- *Important to note that there may be other rules for companies who have their shares trading on other exchanges.*

Directors' Remuneration Policy (DRP) and Directors' Remuneration Report (DRR)

- Where a company is required to have a DRP under the Companies Act 2006, directors' remuneration payments and loss of office payments must be consistent with the DRP.
- Important to check consistency between plan rules and award documentation with the DRP.
- The annual DRR has various reporting requirements relevant to employee share plans e.g. disclosure of grants and vestings of LTIP awards.

Corporate governance aspects

- UK Corporate Governance Code and institutional investor considerations including:
  - Malus and clawback.
  - Power to override formulaic vesting.
  - Vesting and holding periods.
- Performance conditions for vesting.
- Role of remuneration committee.

Listed companies - practical issues (2 of 2)

New joiners and buy-out awards

- Check eligibility criteria for new joiners to join the company's plans and if any special terms required.
- Buy–out awards to compensate executives for awards forfeited at their previous employer.
- If existing plan rules do not allow the relevant awards, special arrangements may need to be put in place.

Leavers

- Many companies' plans have 'good' and 'bad' leaver provisions, with discretions to treat employees as good leavers, and power to decide the timing and level of vesting for leavers.
- Need to consider application in light of investor expectations.
- If there is a settlement agreement, check alignment with plan rules and, where relevant, DRP.

Sourcing shares

- Shares can be sourced from new issue shares, treasury shares or shares bought on the market.
- Dilution limits for new issue and treasury shares – e.g. Investor Association 10% and 5% in 10 year limits.
- Corporate finance considerations.
- Using an EBT to buy shares in the market
  - methods e.g. gift or loan.
  - financial assistance considerations.
  - disguised remuneration tax treatment must be reviewed where an EBT is used.

Share dealings

- Dealings under employee share plans need to comply with relevant requirements of the UK Market Abuse Regulation (**MAR**), the Criminal Justice Act 1993 and any company share dealing code.
- Relevant dealings may include grants, vestings, option exercises and sales of shares.
- Dealing restrictions in MAR closed periods and periods where inside information in place need careful review.
- Notification requirements for persons discharging managerial responsibility (**PDMRs**).

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Private companies

Private companies

Key considerations/benefits when implementing a new plan

- Align management/employees with shareholders typically towards an exit.
- Tie in with investor expectations – skin in the game.
- Recruitment, retention and incentivisation of key employees.
- Seek tax efficiency (CGT vs income treatment).
- Tax efficiency - corporation tax deduction on awards.
- Limit cash cost to company.
- Consider accounting impact.

New scheme - key commercial and legal terms (1 of 2)

The table below sets out a summary of the key commercial and legal considerations that will need to be determined before any new scheme is implemented.

Terms	Narrative
Overview structure of the incentive scheme	• The company will need to determine which type of scheme it will implement e.g. EMI, CSOP, growth shares, or a combination. • Usually, this will depend on which scheme/s the company is eligible to use.
Which Company will issue the shares?	• The company will need to consider in respect of which company's shares the awards are made. • Usually, this will be the holding company of the group.
What shares will be used for the purposes of the scheme?	• The company will need to consider whether awards will be over an existing share class or a new special employee class of shares.
What percentage of the share capital will be used for the scheme?	• The company will need to consider what percentage of the share capital will be used for the scheme (including upfront awards and future awards.
Who will participate in the scheme?	• The company will need to consider whether awards are limited to key management or are distributed more widely to employees.

New scheme - key commercial and legal terms (2 of 2)

The table below sets out a summary of the key commercial and legal considerations that will need to be determined before any new scheme is implemented.

Terms	Narrative
What happens if an employee leaves employment?	● Awards will often lapse upon cessation of employment of the participant unless the Board determines otherwise. ● However, some companies will have pre determined good/bad leaver provisions.
Will any performance conditions apply to awards?	● The company will need to consider whether any company or personal performance conditions can apply to awards.
What will be the impact of a change of control?	● Usually awards will vest and become realisable in full. ● However, in certain circumstances awards may continue following a transaction.

Enterprise Management Incentives (EMI)

Summary – qualifying requirements

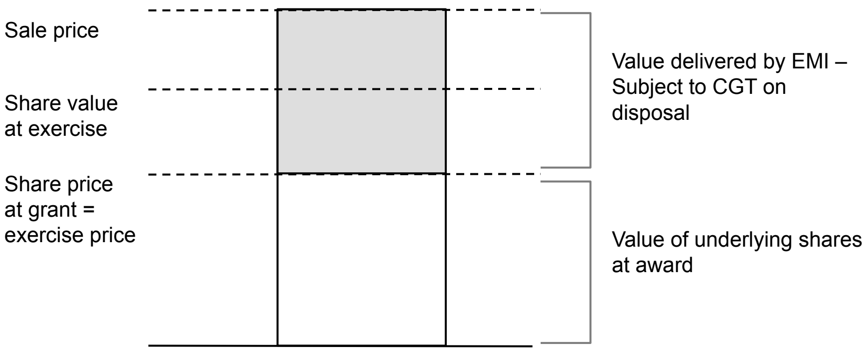
- Certain criteria must be met in order for the Company to qualify to grant EMI options. In summary, these include that:
  - The company granting the EMI options can't be under the control of another company.
  - The company and its subsidiaries can't have more than 250 employees.
  - The company and its subsidiaries can't have gross assets in excess of £30 million.
  - The company and its subsidiaries can't engage to a significant extent in certain 'excluded activities'.
- The maximum value of shares under EMI options allowed to be held by an individual is £250,000 (calculated at the date of grant).
- The maximum value of shares granted under EMI options that can be granted in total is £3 million (calculated at the date of grant).

Summary – tax advantages

- There will be no income tax and NICs on the exercise of the EMI options provided that the exercise price is set at an amount equal to the market value of the shares under option on the date of grant.
- Capital gains tax will arise on the difference between the sale proceeds and exercise price (assuming there is no charge to income tax).
- Provided the option and/or shares are held for at least two years this will be at the 10% Business Asset Disposal Relief (BADR) rate (up to the £1 million lifetime limit)
- The employer is entitled to a corporation tax deduction for the employees' option gains at the time of exercise.

This arrangement enables UK participants to be free of income tax and NICS on exercise of qualifying options and capital gains on sale of shares

Diagram



Strengths

- Capital gains for participants on any growth (potentially at BADR rate).
- Flexible and easy to establish.
- Share valuation can be agreed in advance with HMRC.
- Corporate tax relief on employee gains at exercise.
- Very well understood arrangement.
- No or minimal changes to the articles.
- Ease of administration in dealing with leavers.

Weaknesses

- Maximum value of shares under EMI options per person is £250,000 at any one time.
- Qualifying criteria must continue to be met.
- A purchaser is needed for the shares post–vesting.

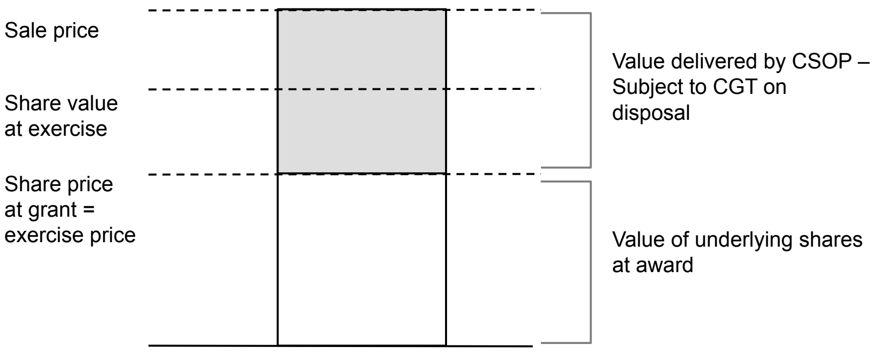
Company Share Option Plan (CSOP)

Summary

- A CSOP is a tax advantaged share option scheme.
- Certain criteria must be met in order for the company to qualify to grant CSOP options (in particular, the company granting the options can't be under the control of another company).
- The maximum value of shares under CSOP options allowed to be held by an individual is £60,000 (calculated at the date of grant).
- The exercise price of the options needs to equal (or exceed) the market value of the shares at the date of grant (which is agreed in advance by HMRC).
- Tax treatment:
  - There is no income tax and NICs if the employee exercises the option after the third anniversary of the grant date, if the employee has retired or left employment due to certain 'good leaver' reasons, or in order to accept certain kinds of take–over offer.
  - Capital gains tax is charged on the difference between the sale proceeds and exercise price (assuming there is no charge to income tax).
- The employer is entitled to a corporate tax deduction for the employees' option gains at the time of exercise.

This arrangement enables UK participants to be free of income tax and NICS on exercise of qualifying options and capital gains on sale of shares

Diagram



Strengths

- Capital gains for participants on any growth.
- Share valuation can be agreed in advance with HMRC.
- Corporate tax relief on employee gains at exercise.
- Very well understood arrangement.
- No or minimal changes to the articles.
- Ease of administration in dealing with leavers.

Weaknesses

- Maximum value of shares under CSOP options per person is £60,000 at any one time.
- May lose income tax relief if exit within 3 years.
- Qualifying criteria must continue to be met.
- A purchaser is needed for the shares post–vesting.

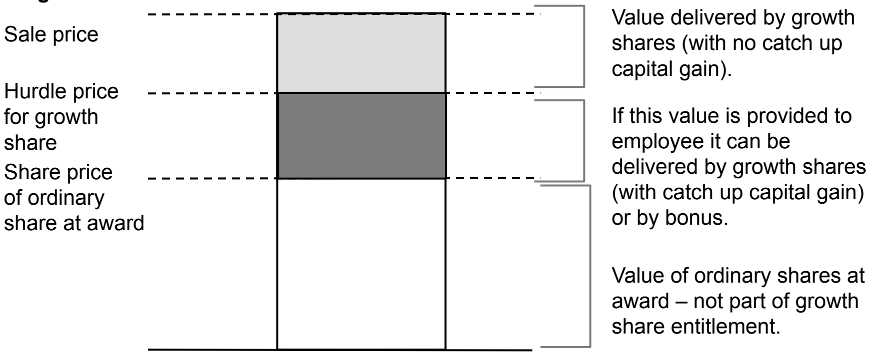
Growth Shares

Summary

- Growth shares involve creating a special type of share class in a company, which only participate in the capital value above a target threshold ‘hurdle’.
- By setting the thresholds on the growth shares at a level which is at or above the company's current value, these shares could have low initial value.
- Because the employee becomes a shareholder, the initial acquisition is a taxable event such that there is income tax and potentially NICs on the difference, if any, between the market value and the price paid (which is likely to be small, subject to valuations).
- Any future gain should be subject to CGT (current standard rate 20%).
- To enable a low initial value to be agreed, the hurdle may be set above the initial market value of an ordinary share. For later awards where values increase, multiple classes of shares may be required.
- If the company wants employees to benefit from the value between the market value at grant and the hurdle this can be done by a bonus in cash or shares for the difference at disposal.

This arrangement enables participants to acquire their award for a lower initial value with the potential for the growth above current value to be treated as a capital gain

Diagram



Strengths

- Lower upfront cost and tax liability. Opportunity for growth above today’s market value to be mainly within capital gains treatment.
- Can be used in conjunction with a nominee arrangement to assist ease of administration (i.e dealing with leavers and forfeited shares).

Weaknesses

- Requires changes to the company’s Articles of Association.
- Some initial cost (purchase price or tax cost) will be incurred by employee – company can assist with funding this.
- Would need additional classes of shares for future awards if values increase.
- May be seen as complex for participants.
- A purchaser for the shares needs to be available post–vesting.
- Unlikely that the gearing in the shares could survive an IPO as value would convert into ordinary shares at IPO (may not be important).

Tax treatment - Shares or cash award

The tables below show a simple comparison between the tax treatment in respect of EMI shares, CSOP shares, growth shares and a cash bonus. It assumes that: (a) for shares, that they pay the unrestricted market value and make a gain of £1 million in aggregate; and (b) cash bonuses of £1 million are paid in aggregate.

	EMI shares
Gain on EMI shares made by management	£1,000,000
Tax paid CGT paid on £1,000,000 (@10%)*	£100,000**
Net amount received by management	£900,000
Company NIC / Social Security	Nil

	CSOP shares
Gain on CSOP shares made by management	£1,000,000
Tax paid CGT paid on £1,000,000 (@20%)	£200,000**
Net amount received by management	£800,000
Company NIC / Social Security	Nil

	Growth shares
Gain on growth shares made by management	£1,000,000
Tax paid CGT paid on £1,000,000 (@20%)	£200,000**
Net amount received by management	£800,000
Company NIC / Social Security	Nil

	Cash award
Cash bonus to management	£1,000,000
Employee tax paid (Income Tax (45%), Employee NI (2%))	£470,000
Employer NI charge (13.8%)	£138,000
Net amount received by management	£530,000
*Company NIC / Social Security****	£138,000

* Assumes BADR is available
**Assumes CGT annual allowance is already utilised
*** Assumes there is no corporate tax deduction available due to exit based incentive

Private companies

Key considerations on a transaction

- **Due diligence -** Consider whether the necessary qualifying conditions have been met in relation to the tax advantaged plans
- **Due diligence -** Consider what tax liabilities may arise in relation to target's share schemes.
- **Due diligence -** Consider what will be the impact of the transaction on existing awards.
- **Vesting/exercise and sale process** – buyer will want certainty they will acquire 100% of share capital so all options are exercised pre–transaction and shares sold.
- **Vesting/exercise documentation** - Typically notices of exercise and powers of attorney will be required.
- **Sale documentation** - The treatment of share awards will need to be covered in the SPA, with warranties and indemnities in respect of the schemes and their tax treatment.
- **Sale documentation** - often participants will sign a "minority SPA" with a more limited set of warranties and indemnities than the main SPA.

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Questions and feedback

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Appendix

Save As You Earn Plans (SAYE or Sharesave)

Summary

- Tax–advantaged all employee plan.
- Provides for the grant of share options to all eligible employees of the company/group alongside a savings contract with a third party savings provider.
- Employees can save up to £500 per month for 3 or 5 years.
- Option exercise price can be set at up to 20% discount to the market value of the shares.
- At the end of the savings period, the employees either use the money saved to exercise their option and buy company shares, or withdraw their savings.

Tax advantages

- No income tax and NICs on the exercise of the SAYE options if the employee exercises the option:
  - On or after the 3rd anniversary of the grant date.
  - Before the 3rd anniversary if the employee has left employment due to certain ‘good leaver’ reasons.
- CGT applicable on sale.
- The employer is entitled to a corporation tax deduction for the employees’ option gains at the time of exercise.

Key conditions

- The shares used must either:
  1. Be shares in a company not under the control of another company;
  2. Be shares listed on a recognised stock exchange;
  3. Be shares in a company under the control of a company listed on a recognised stock exchange; or
  4. Be shares in a company that is subject to an Employee Ownership Trust.
- Participation must be available to all eligible employees.
- The grant of the option is conditional on the employee taking out a linked savings arrangement.
- The option exercise price must not be less than 80% of the market value of the shares.

Share Incentive Plan (SIP)

Summary

- Tax–advantaged all employee plan.
- Awards can be made to eligible employees of the company/group in one or more of the following forms:
  - Shares awarded free to employees (free shares) – up to £3,600 per tax year.
  - Shares bought by employees through salary deductions (partnership shares) – up to £1,800 per tax year.
  - Free shares awarded by reference to number of partnership shares (matching shares) – up to 2:1.
  - Dividend shares.

Tax advantages

- Money deducted from salary to buy partnership shares is free from income tax and NICs. This type of tax relief is unique to SIPs.
- SIP shares benefit from full income tax and NICs relief if held in the SIP trust for at least five years, with partial relief if held in the SIP trust between 3 to 5 years.
- Income tax and NICs relief is also available for leavers provided they cease employment due to certain ‘good leaver’ reasons.
- On sale, SIP shares are exempt from CGT as long as shares remain in the SIP trust until then (i.e. sold directly from the SIP).
- Corporation tax deductions are available to the employer in connection with the SIP.

Key conditions

- The shares used must either:
  - i. Be shares in a company not under the control of another company;
  - ii. Be shares listed on a recognised stock exchange;
  - iii. Be shares in a company under the control of a company listed on a recognised stock exchange; or
  - iv. Be shares in a company that is subject to an Employee Ownership Trust.
- Participation must be available to all eligible employees.
- The SIP must be operated by a UK resident trustee.

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