

# Share Incentive Plans

## *Guidance for Employers and Advisers*

This guidance has been produced to help companies that wish to set up and run a Share Incentive Plan (SIP). It replaces the guidance in booklet IR2005 which has now been withdrawn.

For a Share Incentive Plan to gain and keep the tax and National Insurance contributions (NICs) advantages available it must be approved by H M Revenue & Customs (HMRC). The plan must therefore comply with the provisions of Schedule 2 Income Tax (Earnings and Pensions) Act 2003. All applications for approval of a Share Incentive Plan must be made to the Employee Shares and Securities Unit.

Unless otherwise stated, the statutory references in this booklet are to Income Tax (Earnings and Pensions) Act 2003 and the abbreviations ITEPA 2003 and Sch. 2 have been used throughout. The Act can be found on the Internet at [www.legislation.hms.gov.uk](http://www.legislation.hms.gov.uk)

Companies may need to obtain professional advice or request the help of the Revenue & Customs Employee Shares and Securities Unit (ESSU) if they have any questions.

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## Background

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*What is a Share Incentive Plan?*

A Share Incentive Plan is a tax and NICs advantaged plan that helps employers to encourage employees to hold shares in the company or group they work for.

*What does the plan offer to smaller companies?*

The Share Incentive Plan legislation includes features intended to make the Plan attractive to smaller companies that may previously not have had an employee share plan.

The legislation includes provision for some special features to make a Share Incentive Plan attractive to unlisted companies, which may not have a ready market for their shares.

## **About this guidance**

This guidance is designed to address issues in the order companies are likely to come across them in putting together and running a Share Incentive Plan. It is set out in three sections.

### [Section 1 is about implementing a Share Incentive Plan and covers:](#)

- the requirements that have to be met for a plan to be approved
- how the plan will operate
- design options
- HMRC approval of a plan

### [Section 2 is about how to operate a plan and covers:](#)

- the award of shares and valuation
- the tax implications of a Share Incentive Plan (for employees, trusts and trustees, and employers)
- issues that might arise in operating a plan

### [Section 3 – Some terms explained](#)

## Summary of Share Incentive Plan legislation

### *What is a Revenue & Customs approved plan?*

A Share Incentive Plan is designed to be operated as a HM Revenue & Customs approved plan, which offers tax and National Insurance advantages. A company will have to send us details of its Share Incentive Plan for formal approval before it can start operating the plan. We will check that a plan complies with the Share Incentive Plan legislation before granting approved status (Para 81 Sch 2).

A Share Incentive Plan can operate without approval, but it will not benefit from the tax and NICs advantages that approved status can provide.

### *What are plan shares?*

The Share Incentive Plan legislation provides for three main types of plan shares to be used. They are:

- **free shares** - employers can give each employee free shares worth up to £3,000 each (Para 34 & 35 Sch 2)
- **partnership shares** - employees can use up to £1,500 per year out of pre-tax and pre-NICs pay to buy partnership shares (Para 43 & 46 Sch 2)
- **matching shares** - employers can give matching shares at a ratio of up to two matching shares for each partnership share bought by the employee (Para 58 & 60 Sch 2)

Various combinations of types of plan share can be used, for example, free shares only, or partnership with or without matching shares, or another combination to suit the business needs of the company (Para 3 Sch 2).

Companies can also allow an employee to use up to £1,500 of dividends from his or her plan shares each year to buy further shares in the company through the plan. These are called **dividend shares** (Para 62 & 64(1) Sch 2).

The term plan share refers to these four types of shares that are available under a Share Incentive Plan.

### *What optional features are there?*

As well as being able to choose between the four different kinds of plan shares to build a plan that suits its business needs, employers can also include other optional features, such as:

- performance-related awards - companies can link the award of free shares to performance measures
- forfeiture - companies can make employees give up some or all of their free or matching shares if they leave, for certain reasons, within three years of the award date
- holding periods - companies can require employees to hold free and matching shares in the Share Incentive Plan trust for up to five years. Dividend shares must normally be held for three years

These features are designed to make the Share Incentive Plan attractive and workable for as wide a range of businesses as possible.

### *What are the tax advantages for participants of a Share Incentive Plan?*

Employees who receive free or discounted shares in the company they work for normally have to pay Income Tax and NICs on those shares, because they are part of remuneration. But, employees who take part in a Share Incentive Plan will have the opportunity to pay less or no tax, or NICs, on the shares they acquire under the plan.

Whether an employee will have to pay any tax or National Insurance contributions on a particular acquisition of shares will depend on a number of factors, including:

- the type of plan shares
- how long the shares are held in the plan

The Share Incentive Plan legislation allows an employee to purchase partnership shares out of his or her salary before tax and NICs are deducted, which reduces the amount of salary on which he or she will have to pay tax and NICs.

There is no tax charge on certain dividends paid on plan shares used to buy further shares ('dividend shares') that remain in the plan for at least three years. As lower and basic rate taxpayers already pay no further tax on receipt of a dividend, it is only higher rate taxpayers, or those brought into higher rates because of the dividends, who will benefit from the tax free status.

*Are there any situations where social security benefits could be affected?*

Buying partnership shares under a plan may affect an employee's entitlement to certain social security benefits, statutory maternity pay and statutory sick pay. This is because an employee will not have paid NICs on the pay that he or she used to buy the partnership shares.

This will only affect a very small number of people, and our leaflet IR177 'Share Incentive Plans and your entitlement to benefits' explains this in more detail. The information should be made available to all employees.

*Are there benefits to an employer for providing a Share Incentive Plan?*

Provided the necessary conditions are met, an employer can claim relief against Corporation Tax (CT), and is not liable for employer's NICs on shares given to, or purchased by, employees through a Share Incentive Plan (Para 2 Sch 4AA ICTA 1988).

In addition, certain other expenses incurred by a company in relation to a Share Incentive Plan may be eligible for relief against CT (Para 7 & 8 Sch 4AA ICTA 1988).

*Is a trust necessary?*

Companies will have to set up a trust to hold the Share Incentive Plan shares. This trust has to satisfy certain requirements set out in the legislation (Para 71 Sch 2).

*What about extra administration?*

The amount of work involved in administering a Share Incentive Plan will depend on how simple or complex that plan is. For example, awards of plan shares will need to be recorded and monitored, so that the correct tax treatment is given when employees take their shares out of the Share Incentive Plan.

Companies can choose to outsource this administration work, or it could be done in-house.

Additional PAYE (Pay As You Earn) tax and NICs obligations may arise for companies as a result of operating a Share Incentive Plan.

## Section 1 - Implementing a Share Incentive Plan

There are three steps to implementing a Share Incentive Plan.

- [Step 1 - the requirements for Revenue & Customs approval](#)
- [Step 2 - decide how the plan will operate in practice](#)
- [Step 3 - apply for Revenue & Customs approval of a plan](#)

### Step 1 - check that the requirements for Revenue & Customs approval can be met

The first step in implementing a Share Incentive Plan is to establish whether the company will be able to operate it according to the rules set out in Schedule 2 ITEPA 2003. They set out the requirements that need to be met and the way that a Share Incentive Plan should operate if it is to secure Revenue & Customs approval.

The main requirements cover:

- the purpose of a Share Incentive Plan
- the **all employee** requirement
- employee eligibility
- qualifying periods
- types of shares

This section explains the requirements and the flowchart summarises them.

#### *What is the purpose of a Share Incentive Plan?*

The purpose of the plan is to provide share benefits to employees, which give them a continuing stake in the company (Para 7(1) Sch 2) The tax reliefs available for a Share Incentive Plan are conditional on that being the purpose of the plan. Therefore, the legislation does not allow a Share Incentive Plan to contain features that are neither essential nor reasonably incidental to achieving that aim (Para 7(2) Sch 2).

This means that we will not approve a Share Incentive Plan, which contains in its trust deed or rules and share agreements, or in the way that it operates, anything which is not essential to the aim of encouraging employee share ownership, or is not reasonably incidental to that purpose.

For example, a Share Incentive Plan that offers employees cash bonuses as an alternative to shares would not be approved. We will not approve a plan that uses a performance measure to calculate a bonus of £10,000, with employees having a choice of either taking £3,000 in shares and £7,000 in cash, or £10,000 in cash.

This does not, of course, affect the ordinary operation of companies' discretionary cash bonus schemes. A company can let its employees know that if they do not wish to participate in an award of shares under the plan, the company may consider a discretionary cash payment. But, if the cash award becomes established as an alternative to shares, so that employees expect cash rather than shares, then the operation of the plan may, in fact, contain a feature which is neither essential nor reasonably incidental to the purpose of the plan - the provision of share benefits to employees.

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*What is meant by the all-employee nature of the plan?*

The plan must be open to all employees who are:

- eligible under the Share Incentive Plan legislation (Para 8(1) Sch 2)
- liable to UK tax under on general earnings in respect of that employment, under Section 15 (Para 8(2) Sch 2)

Although companies **must** offer participation to **all** of these employees, the employees themselves may of course decide not to take part.

Part-time employees **must** be included in the offer and they must be treated in exactly the same way under the plan rules as full-timers. Awards of free shares can be tailored to the number of hours that employees work.

In addition, companies **may** offer participation to eligible employees who are not subject to tax under Section 15 in respect of their employment with the company (Para 8(5) Sch 2).

*Can a company set whatever rules it wishes?*

A company must not include any requirements for participation in a Share Incentive Plan other than those permitted by the legislation referred to in this guide (Para 11 Sch 2).

The Plan must not contain any features that might discourage any of the eligible employees from participating, for example, a requirement for participants to:

- live within a certain area
- take part in a company activity before shares could be awarded
- purchase shares outside of the Share Incentive Plan. (Para 8(3) Sch 2)

*What is meant by employees taking part on the same terms?*

All employees who take part in a Share Incentive Plan must do so on the same terms (Para 9(1) Sch 2). This does not prevent a company varying the number of free shares awarded to employees in the ways permitted by the legislation. The rules allow free shares to be awarded by reference to an employee's remuneration, length of service, or hours worked (Para 9(3) Sch 2).

The same terms requirement does not prevent a company imposing a performance condition on awards of free shares, as long as it complies with the Share Incentive Plan legislation (Para 9(5) Sch 2).

If a company decides to vary awards of shares by reference to level of remuneration, length of service, or hours worked, these factors must be treated separately and the separate entitlements added together to arrive at the total entitlement. (Para 9(4) Sch 2).

### **Example**

XYZ Limited decides to make an award based on level of pay and length of service.

A salary band of £5,000 is acceptable and gives rise to one unit for every £5,000 of pay, with each unit worth a given number of shares. Length of service entitles employees to one unit for every year of service.

Adam earns £30,000 and has seven years service.  
He is entitled to  $(£30,000/5,000) + 7 = 6 + 7 = 13$  units.

Ali earns £20,000 and has three years service.  
He is entitled to  $(£20,000/5,000) + 3 = 4 + 3 = 7$  units.

These units cannot be multiplied because the result would be disproportionate, example,  $(6 \times 7) = 42$  and  $(4 \times 3) = 12$  units.

*What is to stop preferential treatment being given to directors?*

We would not approve a plan containing features which benefit mainly directors or higher paid employees (Para 10(1) Sch 2).

For example, we would not approve a Share Incentive Plan that was designed to channel a disproportionate number of shares towards groups of directors or higher paid staff. However, this does not prevent a company from being able to vary awards of shares according to the employees' levels of remuneration (Para 10(4) Sch 2).

### *What about loan arrangements?*

A Share Incentive Plan must not be associated with loan arrangements under which employees borrow money from their employer in order to take part (Para 12 Sch 2).

### *What eligibility criteria do employees have to meet?*

For employees to be eligible to participate, the plan rules must ensure that participants are employees of the company which has established the plan, or, if it is a group plan, of a *constituent company*.

In the case of free shares, the employee must be eligible at the time of the award of free shares (Para 14(2) Sch 2).

In the case of partnership and matching shares, the employee must be eligible either:

- at the time the partnership share money is deducted from salary (pay day), where there is no accumulation period (Para 14(3) Sch 2)
- at the time of the **first** salary deduction (pay day), where there is an accumulation period (Para 14(4) Sch 2)

### *Can a qualifying period of service be specified?*

Yes. Companies can specify a qualifying period of service before employees can take part in a Share Incentive Plan. The qualifying times may vary, for example:

- for free shares - up to 18 months before the date of the share award (Para 16(2) Sch 2)
- for partnership and matching shares with no accumulation period (Para 50 Sch 2) - up to 18 months leading up to the deduction of the partnership share money for the share award (Para 16(3) & (5) Sch 2)
- for partnership and matching shares with an accumulation period (Para 52 Sch 2) - up to six months before the start of the accumulation period in question (Para 16(4) & (6) Sch 2)

If a qualifying period is set, then the participant must have been an employee of a qualifying company at all times during the qualifying period.

### *What is a qualifying company?*

A qualifying company is a company that:

- is a constituent company at the end of the qualifying period
- was a constituent company when the employee worked for it
- was, when the employee worked for it, an associate of a participating company or another qualifying company (Para 17(2) Sch 2).

Different qualifying periods can be set for different awards of shares, but within each award all employees must be subject to the same qualifying period.

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### *What rule prevents employees with a material interest from participating?*

The rule that prevents those employees who already have a substantial shareholding in the company from benefiting further from the plan is known as the material interest rule. All plans must contain this rule.

### *What does a material interest in a company mean?*

A material interest in a company means either of the following:

- the beneficial ownership of, or ability to directly or indirectly control, more than 25 per cent of the ordinary share capital of the company
- where the company is a close company, an entitlement to receive more than 25 per cent of the assets of the company if it was wound up (Para 20(3) Sch 2)

The rule also prevents anyone taking part in a plan who has, or has within the previous 12 months had, a material interest in:

- a close company whose shares may be awarded under a plan
- a company controlling such a company
- a company which is a member of a consortium owning such a company (Para 19(1) Sch 2)

The rule is wide ranging. An individual is treated as having a material interest in a company (Para 19(2) Sch 2) if:

- he or she alone has a material interest in the company
- he or she together with one or more associates has a material interest in the company
- any associate of his or hers, with or without any other associates, has a material interest in the company

### *Do share options count for material interest purposes?*

Options over shares are treated as a right to control them. The shares are taken into account for material interest purposes only if the company is under a contractual obligation to satisfy the option exercise with previously unissued shares (Para 21 Sch 2).

Shares that would be issued on the exercise of options held by anyone other than the option holder whose material interest is being calculated (or an associate) are not added to the shares in which the interest must not exceed 25 per cent.

Shares that are held by the trustees of an Approved Profit-Sharing Scheme or a Share Incentive Plan should be disregarded if they have not been appropriated or acquired on behalf of an individual (Para 21(6) Sch 2).

### **Example**

ABC Limited has four shareholders.

Ann holds 10,000 shares and has an option over a further 10,000 shares.

Ann's husband holds 4,000 shares.

Beryl holds 40,000 shares and has an option over a further 20,000 shares.

Charlie holds 36,000 shares and has an option over a further 20,000 shares.

The total issued share capital is 90,000 shares.

A Share Incentive Plan is to be introduced and it is proposed that Ann participates, but not Beryl or Charlie.

If Ann's option (if it was exercised) must be met by the issue of new shares, then her interest becomes 24,000 out of 100,000. This is less than 25 per cent so is not a material interest and Ann can participate in the Share Incentive Plan.

If, however, the exercise of Ann's option could be met by the transfer of existing shares, the interest would be 24,000 out of 90,000. This exceeds 25 per cent so would be a material interest, and she cannot participate in the Share Incentive Plan. In order to participate, Ann would have to sell shares held over 25 per cent and wait for a year.

Shares that would be issued on the exercise of options by Beryl and Charlie do not need to be added to the shares in which the interest must not exceed 25 per cent.

### *What is an associate?*

For the purposes of the material interest tests, associate means:

- the relative (husband, wife, parent or remoter forbear, child or remoter issue, brother or sister) or partner of an individual
- the trustees of any settlement in relation to which the individual or any relative is or was a settlor
- where the individual has an interest in any shares held in a settlement, the trustees of that settlement (Para 22 Sch 2)

Settlement here means a trust. Settlor means the person who provided funds for the trust.

### *Are trustees of an employee benefit trust counted as associates?*

The trustees of an employee benefit trust, as defined in Section 550 ITEPA 2003, are not regarded as associates unless:

- the individual
- the individual together with one or more of his or her associates
- any associate of the individual's, with or without any other such associates

has since 14 March 1989 been the beneficial owner of, or been directly or indirectly able to control, more than 25 per cent of the ordinary share capital of the company (Para 23(2) Sch 2).

If the individual is the object of a discretionary trust, and that trust holds shares in the company, those shares do not have to be counted in the material interest test if the individual disclaims that interest, or is excluded from it, provided both the following apply:

- no associate of his or hers has an interest immediately after
- he or she, or any associate, has not benefited under the trust for the previous 12 months (Para 24 Sch 2) .

### *Can employees participate in other share schemes?*

An employee cannot participate in an award of shares from two approved Share Incentive Plans, established by the company or a connected company **at the same time.** (Para 18(1) Sch 2)

However an employee may participate successively in one Share Incentive Plan in the same tax year in which he or she has already participated in one or more other approved Share Incentive Plans established by the company or a connected company. (Para 18A Sch 2)

In such cases the plan and the other plan or plans are regarded as a single plan for the purposes of the requirements governing:

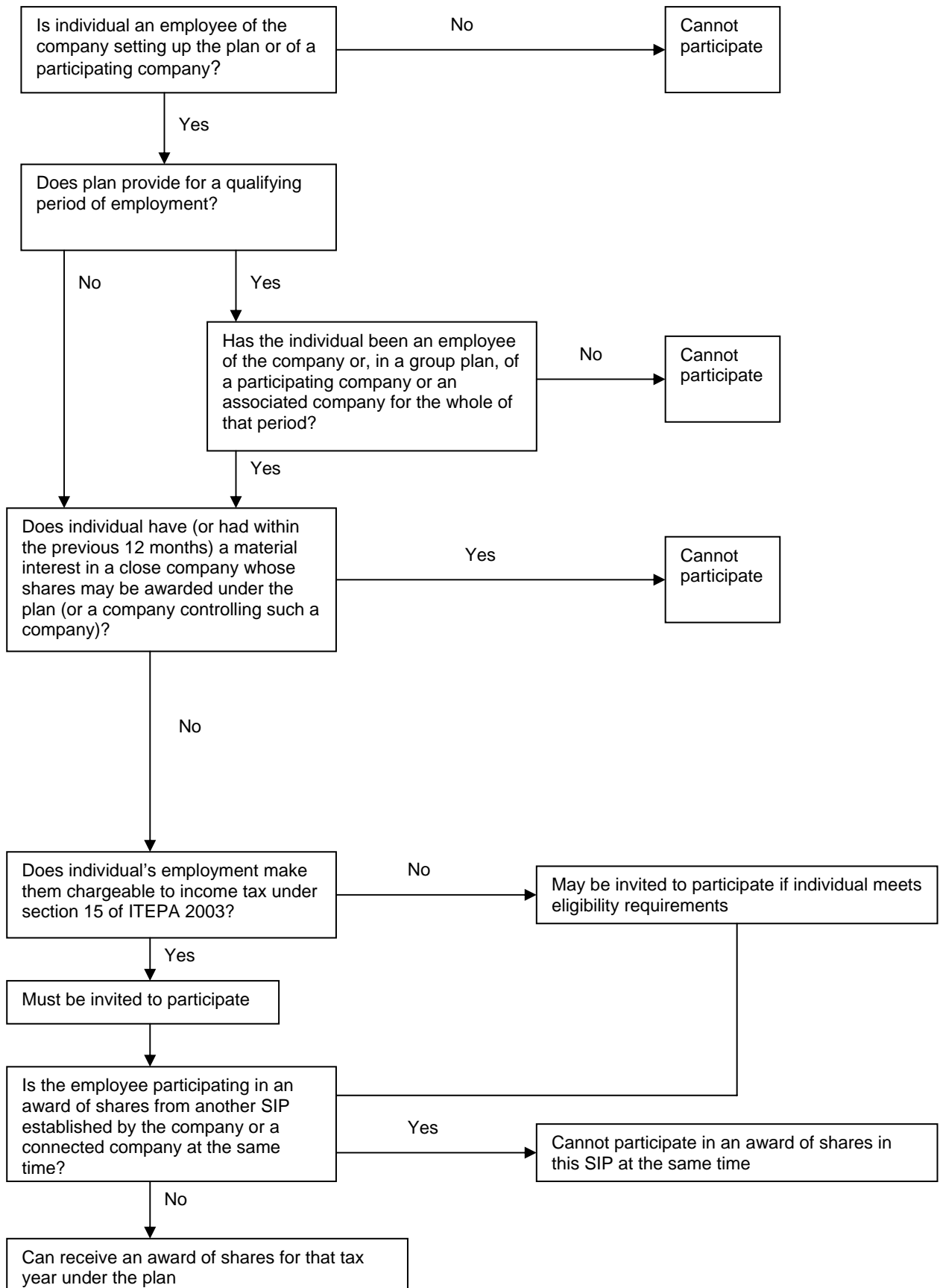
- the maximum annual award of free shares (Para 35 Sch 2)
- the maximum amount of partnership share money deduction (Para 46 Sch 2)
- the limits on the amount of cash dividends reinvested (Para 64 Sch 2)

For these purposes, a connected company is one that:

- controls or is controlled by the company
- is controlled by a company which also controls the company
- is a member of a consortium owning the company or is owned in part by the company as a member of a consortium (Para 18(3) Sch 2)

## Flow diagram on eligibility and types of share employees can acquire

*This diagram summarises the process of deciding whether employees can participate in a Share Incentive Plan (SIP), and if so, what types of shares they can receive.*



### *Which companies can set up a Share Incentive Plan?*

A company can set up a Share Incentive Plan solely for its own employees, or, if it controls other companies, extend the plan to employees of one or more of those companies. This is called a group plan (Para 4(2) Sch 2).

Both listed and unlisted companies - UK and non-UK - can establish a Share Incentive Plan.

### *What shares can be used in a plan?*

A Share Incentive Plan must only use shares that meet the requirements set out in this section (plan shares) (Para 25 Sch 2).

The plan shares must be ordinary shares in one of the following:

- the company setting up the plan
- a company which controls that company
- a company which is, or controls a company which is, a member of a consortium that owns or controls the company setting up the plan (Para 26 Sch 2)

Plan shares must be one of the following:

- shares listed on a recognised stock exchange
- shares in a company which is not under the control of another company
- shares in a company which is under the control of another company whose shares are listed on a recognised stock exchange (unless that other company is, or would be, a close company if resident in the UK) (Para 27 Sch 2)

Plan shares must also be:

- fully paid up
- not redeemable (Para 28(1) Sch 2)

The exception is for redeemable shares in co-operatives that are registered as industrial and provident societies under the Provident Societies Act 1965 or the Industrial and Provident Societies Act (Northern Ireland) 1969 (Para 28(4) Sch 2).

### *Can a company impose restrictions on its plan shares?*

The purpose of the Share Incentive Plan is to enable employees to become shareholders with a stake in the business in the same way as other shareholders.

Generally, there is a requirement that the shares used do not have restrictions that do not also apply to other shareholders. However, rules set out in the Stock Exchange Model Code are not counted as restrictions for the purposes of the Share Incentive Plan (Para 30(3) Sch 2).

Certain limited restrictions can be attached to the plan shares to enable more private companies to implement a Share Incentive Plan. These companies often have restrictions attached to shares that can be acquired by employees and directors.

The restrictions that the Share Incentive Plan legislation permits are:

- restrictions affecting all ordinary shares in the company (Para 30(1)(a) Sch 2)
- holding periods for the shares (Para 30(1)(c) Sch 2)
- no, or limited, voting rights that are different from the voting rights of shares held by other shareholders (Para 31 Sch 2)
- certain forfeiture provisions (Para 32 Sch 2) . Employees can be required to give up some or all of their free or matching shares if they leave employment or withdraw partnership shares from the plan during a set period
- pre-emption provisions (Para 33 Sch 2)

### *What are pre-emption provisions?*

These are provisions attaching to shares that require shareholders to sell them if specified circumstances arise. Pre-emption provisions are allowed if they require employees and permitted transferees to offer their plan shares for sale if they leave employment. The provision must:

- be contained in the company's Articles of Association
- apply to all the company's employees
- require the shares to be offered for sale at a specified and pre-determined price.

In addition, the Articles must say that anyone selling shares of the same class, in any capacity, must not be able to sell them on better terms than anyone else (Para 33 Sch 2)

## Step 2 - decide how the plan will operate in practice

### *Types of shares*

There are four types of shares that may be used in an approved Share Incentive Plan:

- free shares
- partnership shares
- matching shares
- dividend shares

Different rules apply to each.

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### *Free shares*

The company can award up to £3,000 of free shares to each qualifying employee each tax year. The value of the shares is taken at the date the award is made. Shares subject to restrictions or a risk of forfeiture are valued as if there was no such restriction or risk (Para 35 Sch 2).

### *Can a company link performance to an award of free shares?*

Yes. The company may link the award of free shares to the meeting of performance measures. The measures can be linked to either the number or the value of free shares awarded, and can apply to the performance of:

- the whole company
- sections, departments or units
- individual employees

The *same terms* rule does not apply to awards of shares linked to performance, provided the performance measures meet the requirements of the legislation. Performance measures must be based on business results or other objective tests (Para 39(3) Sch 2).

### *What sorts of performance measures are allowed?*

The legislation sets out two ways in which a performance measure may work: Method 1 and Method 2. The company can choose between these two.

Under **Method 1**, the company can structure its plan so that:

- at least 20 per cent of the shares are awarded without reference to performance but on a same terms basis
- the remaining shares are awarded by reference to performance

The highest number of shares awarded to an individual by reference to performance must not be more than four times the highest number awarded

to an individual without reference to performance (Para 41 Sch 2) The case study illustrates this.

Under **Method 2**, the company can award some or all the shares according to performance.

In this case, all the employees within each separate performance unit must take part on the same terms. A performance unit is a group of one or more employees.

*Can there be different performance tests for each unit?*

Yes. The performance criteria can vary between business units. This enables companies to design performance conditions that meet their business needs, and that are directly relevant to groups of individuals (Para 42 Sch 2).

If, under Method 2, different conditions are set for different performance units, those targets must be comparable (Para 42(6) Sch 2). If they cannot reasonably be viewed as being comparable at the time that they are set in accordance with the plan, this is a disqualifying event and we may withdraw our approval of the plan (Para 84(1) Sch 2).

Remember that all performance conditions under Method 1 or Method 2 have to satisfy both the following requirements:

- based on business results or other objective criteria
- fair, objective measures of the performance of the groups of employees to which they apply

It is not possible to base awards of free shares on subjective measures, for example, annual performance appraisal ratings may contain subjective elements.

*Communicating the criteria to employees*

The company must notify all qualifying employees, in general terms, of the performance measures to be used as soon as reasonably practicable. The only exception is if the provision of the information would prejudice commercial confidentiality.

In addition, all employees participating in an award must be told of the performance measures to be used in their individual case. Companies cannot withhold this information on grounds of commercial sensitivity.

Employees cannot receive a performance award from more than one performance unit at the same time. So, for each award of shares they can only be part of one performance unit (Para 39(4) Sch 2).

## **Case study**

### **Background**

ABC Limited is an unlisted UK company, which manufactures clothes and shoes and supplies these to high street retailers. There are 240 employees; 200 work on the factory production lines and 40 are administrative staff and management. A third of the employees work part-time.

The business has four workshops in the UK, spread across four regions - north, south, east and west. Each region contains one workshop, which generally supplies goods to retailers in that region.

Currently, sales growth in the south and east regions is slow (2 per cent and 3 per cent growth respectively over the last year), whilst the north and west regions are enjoying fast-growing sales figures (8 per cent and 10 per cent respectively). The difference exists mainly because ABC Limited has more competitors in the south and east regions.

ABC Limited only used to manufacture clothes, but three years ago it started to make shoes as well. This is currently about 10 per cent of the company's business.

There is a larger profit margin on shoes and it's easier to secure bulk orders. So, one of the company's strategic objectives is to double shoe sales by the end of the next financial year.

ABC Limited is finding it difficult to meet shoe orders because it does not have enough trained employees. The board of ABC Limited recognise that re-training is needed so that more employees can manufacture shoes. However, no-one has shown any enthusiasm to re-train.

The shares in ABC Limited are owned by the directors and some external investors. There are 1,000,000 ordinary shares with a nominal value of £1 each presently in issue. The market value is about £2 per share.

ABC Limited does not have an employee share scheme, so shareholders have agreed to issue up to 100,000 new shares in a Share Incentive Plan. However, they have stipulated that employees should only be awarded these if a significant growth in sales is achieved over the next financial year.

The shareholders have decided to only use free shares in the plan. They have stipulated that a performance condition is attached to the award of shares. The shares will be awarded at the end of the next financial year, which begins next month.

The directors think that the performance condition should relate to that financial year, so have asked the finance director to propose two different performance conditions to take into account the factors set out above. Having considered these factors and the Share Incentive Plan legislation, the finance director makes the following proposals.

### **Proposal One - Method 1 performance condition**

From the 100,000 shares, 30 per cent (30,000, with a market value of £60,000) will be awarded after the end of the financial year on the basis of salary. Employees will receive 10 shares for each £1,000 earned, up to a maximum of 150. So, an employee earning £8,000 will receive 80 shares and an employee earning £15,000 or more will receive 150 shares. Shares will be rounded up to the nearest 1,000, so an employee earning £10,600 will receive 110 shares.

***This satisfies the requirements for the same terms element of Method 1.***

The remaining 70 per cent of available shares (70,000, with a market value of £140,000) will be awarded after the end of the financial year using the regions as performance units. Awards will only be made to employees if shoe sales in that region are doubled compared to the previous financial year. If this target is met, those employees will receive awards of shares according to sales growth (both clothes and shoes) in that region.

Each employee will be awarded:

150 shares if the sales growth is less than or equal to the figure for the previous financial year (2 per cent, 3 per cent, 8 per cent and 10 per cent in south, east, north and west regions respectively), and up to a maximum of a further 100 shares if the sales growth exceeds 10 per cent more than that region's figure for the previous year (12 per cent, 13 per cent, 18 per cent and 20 per cent in south, east, north and west regions respectively).

The maximum shares that can be awarded under the performance-related element are 250.

This satisfies the requirements for the performance-related element of Method 1.

The maximum performance-related award that can be made under the legislation in this situation is 600 shares (that is, four times the number of shares awarded on the same terms), so the proposed award is within the limit.

## **Proposal Two - Method 2 performance condition**

Employees in each region will only receive an award if the sales growth exceeds that of the previous financial year (2 per cent, 3 per cent, 8 per cent and 10 per cent in south, east, north and west regions respectively). If this target is met, 25,000 shares will be awarded to employees in that region. The level of award to employees in each region where the target is met will be determined on the basis of salary.

This means that there will be different targets for each region, but the directors of ABC Limited consider that the likelihood that each region will reach its target is comparable.

This satisfies the Method 2 requirement for different measures for different performance units (in this case the regions) to be broadly comparable, and for awards within performance units to be on the same terms.

### **Which proposal to adopt?**

The directors of ABC Limited decide to implement Proposal One because

- all employees will receive an award of some shares, no matter what the performance of the company is. It was considered important that the plan resulted in some shares being awarded, even if performance targets were not met
- the number of shares awarded is closely related to the rate of sales growth in each region
- it will be more effective at aligning the employees' interests with the company's corporate objective of doubling shoe sales over the next financial year

### *Does a Share Incentive Plan have to include a holding period?*

The company must set a holding period for each award of free shares, during which the plan shares must be held in the plan trust. In normal circumstances, the holding period must be three years, but the company can extend this to any period between three and five years from the date of award of the shares (Para 36(2) Sch 2).

The period must be the same for all shares in the same award. Different holding periods can be set for different awards of free shares, but the holding period cannot be increased once the award is made (Para 36(3) Sch 2).

Participants who have received free shares normally have to hold their shares in the plan for the whole of the holding period. But, the holding period automatically comes to an end if the employee leaves the company, because he or she can take the shares with them. (Para 36(5) Sch 2).

However, the company's plan rules can provide for the shares to be forfeited if an employee leaves employment.

*Does there have to be a forfeiture period?*

Employees can be required to give up some or all of their free or matching shares if they leave employment or withdraw partnership shares from the plan during a period of time set by the company. This period can be up to three years from the date of award.

Forfeiture cannot be linked to the performance of employees in any way, (Para 32(3) Sch 2) and the same forfeiture conditions must apply to all shares in the same award in the plan (Para 32(4) Sch 2).

The company may provide for forfeiture in specific cases, but the same provisions must apply to all participants in each award.

The company cannot require any shares to be forfeited if an employee leaves employment due to:

- injury or disability
- redundancy
- a transfer of employment to which the Transfer of Undertakings Regulations (TUPE) apply
- a company reorganisation under which the company loses its associated status
- on or after reaching retirement age (as specified in the plan)
- death (Para 32(2) Sch 2)

It is possible for the proportion of shares that are subject to forfeiture to vary according to a pre-determined scale.

### **Example 1**

A company sets up a Share Incentive Plan providing free shares to its employees. It wishes to encourage employees to remain with the company, so imposes a restriction on the shares awarded. This restriction is that if employees leave:

- within one year of the award, they forfeit all of their shares
- within 1-2 years, they forfeit 50 per cent of their shares
- within 2-3 years, they forfeit 20 per cent of their shares.

This is acceptable under the Share Incentive Plan.

### **Example 2**

A company sets up a Share Incentive Plan providing partnership and matching shares to its employees. It wishes to encourage employees to retain their partnership shares and therefore imposes a restriction on the shares awarded. Under this restriction, if employees withdraw partnership shares

- within one year, they forfeit all of the matching shares awarded in respect of those partnership shares withdrawn
- within 1-2 years, they forfeit 50 per cent of those matching shares
- within 2-3 years, they forfeit 20 per cent of those matching shares

This is also acceptable under the Share Incentive Plan.

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### *Partnership shares*

#### *What are partnership share agreements?*

If the company wishes to use partnership shares in its plan, it must arrange for the qualifying employees to enter into partnership agreements under which the company deducts money from those employees' salaries or wages, and arranges for shares to be purchased with the proceeds (Para 46 Sch 2).

The agreement must specify the amount of the deductions from wages or salary, which might be done on a weekly or monthly basis, or over some other interval.

There is a model partnership agreement and other model documents available on our website.

#### *What are accumulation periods?*

A plan with partnership shares can be operated with or without accumulation periods. These are periods over which deductions from salary are made.

The partnership share money deducted must be used to buy partnership shares within 30 days of the end of the accumulation period. Companies can decide how long accumulation periods will be, subject to a maximum of 12 months (Para 51 Sch 2).

If there is no accumulation period, the partnership share money must be used to buy shares within 30 days of the last time money was deducted from an employee in that month (or other pay period) (Para 50 Sch 2).

Employees starting employment during an accumulation period cannot participate - they must be eligible at the time of the first deduction of partnership money relating to the award.

The partnership share agreement may specify that an accumulation period must come to an end if a specified event occurs (Para 52(8) Sch 2). For example, it is possible for the partnership share agreement to stipulate that it

ends after 12 months or on a takeover, or reorganisation of the company, whichever is earlier.

A decision by the directors to terminate the period does not qualify as a specified event.

*Is there a maximum deduction?*

Yes. The deductions from salary must not exceed:

- £1,500 in any tax year
- 10 per cent of the employee's total salary for the tax year

The plan may specify lower limits.

The plan can also specify whether all or only part of an employee's salary is to be used when calculating the maximum percentage of salary to be spent on partnership shares. For example it is acceptable to exclude a particular description of earnings, such as overtime or bonus payments. This allows for the use of a specified amount of salary only for the purpose of the 10 per cent limit. If a particular description of salary is to be excluded it must apply to all participants in the plan. (Para 46(4A) Sch 2).

*Is there a minimum deduction?*

The company can set a minimum monthly amount to be deducted from pay. This must not be more than £10 on any occasion. (Para 47(1) Sch 2)

For the purposes of calculating how much salary an employee can use to buy partnership shares, salary means earnings subject to PAYE, after deduction of expenses and benefits in kind (Para 43(4) Sch 2).

*How does a company set the contribution limits?*

The maximum contribution must be set before the start of the purchase period, whether or not there is an accumulation period. The plan can specify lower limits for deductions than those set by the legislation, and limits can differ for different awards (Para 46(3) Sch 2). But, a company must not unilaterally vary the limit during an accumulation period.

*What happens to money held by trustees?*

Partnership money deducted from employees' salary must be paid to the trustees of the plan trust as soon as practicable, and must be held by them until they use it to buy shares for each participant. (Para 49(1) Sch 2)

Any excess or surplus amounts, or amount left over after the employee has left employment must be repaid to him or her, subject to PAYE and NICs. In most cases the trustee will route the repayment through the employer's payroll.

### *What happens to any interest on money held?*

The trustees must hold partnership money in a bank or building society account, which may or may not be interest-bearing (Para 49(3) Sch 2)

If the account is interest-bearing, that interest will belong to the employee, and he or she will be subject to tax, which will be deducted at source by the bank or building society. Higher rate taxpayers account for all their tax on this interest through their Self Assessment tax return.

It is not possible for interest to be added to partnership money in order to buy additional shares.

### *Can interest be used to meet plan administration costs?*

Yes. A company and employees can agree that any interest earned on partnership money is used to meet the administration costs of the plan. But, the interest will remain part of the taxable income of each employee, even though they do not receive it. This means that the employees will be taxed on amounts of interest that they never receive.

Employers are not able to ask employees to help them meet the administrative costs of the plan in any other way. Corporation Tax (CT) deductions help with these costs.

### *What about over-deductions?*

If amounts are deducted from salary over and above the limits set for that award, the excess must be repaid to the employee as soon as practicable (Para 46(5) Sch 2). This depends on the circumstances of the company. It may be either the next pay day, or the one after that, if the payroll input deadline is missed. If this is as soon as practicable for a particular company, it will meet the requirements of the legislation.

If a subsequent deduction is being made from salary the following month, the previous over-deduction can be taken into account by deducting less on this deduction.

Repayments made to employees must be subject to PAYE and NICs deductions. (S503)

### *What if the employee leaves the company during the year?*

The annual deduction for partnership shares is the lower of:

- £1,500
- or 10 per cent of salary for the tax year

from employment with the company operating the SIP.

If an employee leaves the company, and his or her deductions are in excess of 10 per cent of salary from the start of the tax year to date of leaving, then any excess must be subject to PAYE and NICs.

### **Example**

An employee on a salary of £15,000 per annum leaves 8 months into the tax year, having earned £10,000 up until date of departure. The maximum amount of deduction permitted is £1,000 ( $10\% \times £15,000 \times 8/12$ ).

The employee had already paid £1,500 out of his salary to purchase partnership shares. The amount in excess of the maximum limit, £500 (£1,500 - £1,000), is now regarded as gross employment income. PAYE must be operated and NICs accounted for by the employer.

The plan may contain provisions allowing the company to meet their PAYE and NICs obligation arising when shares cease to be subject to the plan by:

- the trustees selling some of the shares that the employee has in the plan
- accepting cash paid to them by the employee

#### *How are partnership shares bought?*

The annual limit of £1,500 or 10 per cent of salary for the tax year (whichever is the lower) refers to the level of deduction from salary, not to the value of shares purchased.

The market value of the shares will determine how many are awarded to each participant, so on occasion there might not be enough money to buy a whole number of shares. In such cases any surplus partnership money can be either:

- carried forward and added to the amount of the next deduction, with the employee's agreement
- paid over to the employee as soon as practicable, subject to PAYE and NICs

If there is no accumulation period then the number of shares awarded to each employee will be determined in accordance with the market value of the shares on the date they are awarded by the trustees. (This cannot be more than 30 days after the date the partnership share money is deducted from salary.)

## Example 1

The Keyboard software company introduces a Share Incentive Plan, with no accumulation period.

Employee K has £50 deducted from his monthly salary. The market value of the shares at the date they are awarded is £4, so he will be awarded 12 partnership shares.

The surplus deduction of £2 may be either:

- carried forward and added to the amount of the next deduction, with the employee's agreement
- paid over to the employee as soon as practicable, subject to PAYE and NICs (Para 50(5), S503(2))

If there is an accumulation period, the number of shares awarded to each employee will be determined as the lower of:

- the market value of the shares at the beginning of the accumulation period
- the market value of the shares on the date they are awarded to employees by the trustees (this cannot be later than 30 days after the end of the accumulation period) (Para 52(3) Sch 2)

## Example 2

The Mouse software company introduces a Share Incentive Plan. It provides the opportunity for employees to buy partnership shares and decides to use an accumulation period of 12 months.

Employee M has £100 deducted from his salary over this accumulation period.

At the start of this accumulation period, the company's share price is £5. During the 12 months, there is a sharp upturn in technology shares, and by the end of the accumulation period, the company's share price has reached £10.

Employee M's salary deductions (totalling £100) are used to buy shares at the market value of the shares at the beginning of the accumulation period (£5), so the employee will be awarded 20 shares. There is no income tax or NICs charge to the employee in respect of this 'discount'.

The company may have to make a payment to the trustees of the Share Incentive Plan to cover this shortfall when partnership shares are awarded at a 'discount'. Any such payment is allowable to the company in computing their taxable profits for Corporation Tax (Para 3 Sch 4AA ICTA 1988).

## Example 3

The Disk software company introduces a Share Incentive Plan providing partnership shares and also decides to use an accumulation period of 12 months.

Employee D has £100 deducted from their salary over the accumulation period.

At the start of the accumulation period, this company's share price is also £5. However, over the course of 12 months the business fails to grow as expected, and by the end of the accumulation period when it is time to acquire the shares, the company's share price has fallen to £3.50.

The employee's accumulated salary deductions (£100) are used to buy shares at the market value on the date they are awarded to the employee by the trustees (£3.50), so the employee is awarded 28 shares.

The surplus share money remaining after the acquisition (£2) must be either:

- carried forward and added to the next accumulation period, with the employee's agreement
- paid over to the employee as soon as practicable, subject to PAYE and NICs (Para 52(6), S503(2))

*Can a company restrict the number of shares awarded?*

The company may decide to specify the maximum number of shares that may be included in an award of partnership shares. All employees must be notified that the plan includes such a restriction:

- before the deduction of the partnership money, if there is no accumulation period
- before the beginning of the accumulation period, where there is one (Para 53 Sch 2)

*How does an employee stop deductions?*

The plan must allow employees to give notice, at any time, in writing to the company to stop making deductions from their pay (Para 54 Sch 2).

*How does an employee re-start deductions?*

Plans with an accumulation period, must allow participants to re-start the deductions, though missed deductions cannot be made up. A plan can prevent a participant from re-starting more than once during a particular accumulation period.

For plans with no accumulation period, companies cannot limit the number of re-starts of deductions (Para 54(3) Sch 2).

If an employee sends in a notice:

- to stop deductions, the company must act on it within 30 days of receipt unless a later date is specified in the notice
- to re-start, deductions must be included in the first deduction date following 30 days from receipt of the notice unless a later date is specified in the notice

#### *How does an employee withdraw from a plan?*

Employees must be able to withdraw from their partnership agreement at any time, provided they give notice in writing to the company. Unless the employee specifies a later date in his or her notice, the withdrawal takes effect 30 days after the notice has been received (Para 55 Sch 2)

Any unused partnership money must then be repaid to the employee as soon as practicable, subject to PAYE and NICs.

We would not approve a plan if it required employees to meet the administrative costs of withdrawing shares.

#### *When does partnership money get repaid?*

Partnership money might not be used up in buying shares for the participant if:

- the employee leaves during an accumulation period (Para 52(7) Sch 2)
- the employee gives notice to withdraw from the partnership share agreement (Para 55(3) Sch 2)
- the plan approval is withdrawn (Para 56(1) Sch 2)
- a termination notice is issued (Para 56(3) Sch 2)

In such circumstances the money must be repaid to the employee, subject to PAYE and NICs, as soon as practicable. (S503(2)) In most cases the trustees will route the repayment through the employer's payroll.

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#### *Matching shares*

Matching shares are free shares awarded by the company to match the partnership shares bought by the employee out of his or her salary. They may be awarded using any ratio, subject to a maximum of two matching shares for each partnership share (Para 60(2) Sch 2).

A company can provide for a match up to a fixed level of partnership shares bought, with the balance of partnership shares not attracting a match.

#### **Example**

Earle Limited structures its matching share award policy as follows.

The first 5 partnership shares bought by employees are matched using a ratio of 2:1. So, an employee buying 5 partnership shares receives 10 matching shares.

The next 5 partnership shares are bought using the ratio of 1:1. So, an employee buying 10 partnership shares receives 15 matching shares (10 + 5).

The next 10 partnership shares are bought using a ratio of 1:2. So an employee buying 20 partnership shares receives 20 matching shares (10 + 5 + 5).

If more than 20 partnership shares are acquired, no matching award is made.

*What are the main rules about matching shares?*

The matching shares must be:

- shares of the same class and carrying the same rights as the partnership shares they match
- awarded on the same day as the partnership shares they match
- awarded to all those who take part in the award on exactly the same basis (Para 59(1) Sch 2)

*Is there a holding period?*

Yes. As with free shares, the plan must specify a holding period for matching shares. The same rules that apply to free shares also apply to matching shares: the holding period must be a minimum of three years and a maximum of five years (Para 61 Sch 2).

*Can there be a forfeiture period?*

Yes. As with free shares, the plan can provide for forfeiture of matching shares (Para 59(2) Sch 2) and the company can set a forfeiture period of up to three years. Forfeiture periods can be changed, introduced or removed between awards, but not for awards already made.

If changes are made, all participants must be informed before matching share awards take place. In addition, the matching shares may be forfeit if the corresponding partnership shares are withdrawn from the plan during a forfeiture period.

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*Dividend shares*

The plan can, if the company wishes, provide for dividends paid on plan shares to be reinvested in further shares. These are called dividend shares.

*Is there a limit to the reinvestment?*

The limit is £1,500 per year for each participant (Para 64(1) Sch 2). It applies to the total cash dividends used by the trustees to buy dividend shares, whether under the present Share Incentive Plan or any of the company's other Share Incentive Plans - or plans of associated companies - to which the employee may belong (Para 64 Sch 2).

Any cash dividends exceeding the £1,500 limit, or which the employee has asked not to be reinvested, must be paid to him or her as soon as practicable (Para 64(3) Sch 2)

*How are dividends to trustees paid?*

When a company pays a dividend to the trustees, it must issue a dividend voucher in the usual way regardless of whether or not all or some of the dividend is reinvested.

*How does a company include dividend shares in a plan?*

The company can arrange for the plan to:

- provide for all the cash dividends on free, partnership and matching shares held in the plan to be reinvested in more shares on the employees' behalf, (Para 62(1) Sch 2)
- offer participants the choice of whether they wish their dividends to be reinvested in this way, or to receive the cash dividend directly (Para 62(14) Sch 2)

The company may end the dividend reinvestment arrangement at any time.

If an amount of the dividend (up to the limit of £1,500 per tax year) is reinvested in shares under a plan, the trustees must not issue a voucher for it. There is no tax credit in respect of that amount. (S496)

*What happens to dividends that are not reinvested?*

All dividends or parts of dividends that are not reinvested must be paid to the employees as soon as practicable. (Para 69 Sch 2) The trustees must issue a voucher for dividends paid, in a plan to each of those employees, which must show the amount of the dividend passed on and the associated tax credit in the normal way.

The requirement to pay the participant dividends that are not reinvested under the plan will be satisfied where the money is reinvested in further shares outside the plan in accordance with his or her instructions.

*Is there a holding period for dividend shares?*

There is a holding period for the dividend shares, but unlike free and matching shares the holding period must be three years (Para 67 Sch 2).

### *What happens to dividend shares that cease to be subject to the plan?*

If the dividend shares cease to be subject to the plan within three years of being acquired, for example, because the employee leaves, the trustees must issue a voucher for:

- the amount chargeable to tax
- the date of exit from the plan
- the amount of tax credit in force on that date

The amount chargeable to tax will normally be the amount of dividend used to buy those shares plus the tax credit. There are special circumstances where exit from the plan before three years does not bring about a tax charge.

The employee or former employee will need to declare the information provided on the voucher in his or her tax return. Lower or basic rate taxpayers will have no more tax to pay, unless the amount chargeable to tax takes them into the higher rate band.

### *What happens to uninvested amounts?*

There may be amounts of cash dividends that are not reinvested straight away because the cash is insufficient to pay for a whole number of shares, or because amounts are left over after the acquisition.

The trustees can carry the amounts forward to the next reinvestment. However, each sum must be clearly identifiable in the trust records, because this money must be paid to the employee if:

- it is not reinvested within three years
- he or she leaves
- the plan is terminated (Para 68 Sch 2)

If any of these events happens, the trustees must issue a voucher showing the amount paid, the date on which it was paid, and the amount of the tax credit applicable to that amount on that date.

### *What rights must dividend shares carry?*

The dividend shares must be of the same class and carry the same rights as the shares on which the dividends were paid. Dividend shares must not be forfeitable (Para 65 Sch 2)

### *How are dividend shares bought?*

In acquiring dividend shares, the plan trustees must treat participants fairly and equally. They must also use the cash dividends to buy extra shares within 30 days of receipt of those dividends, if the amount of money is sufficient.

The number of shares to be acquired for each participant must be determined on the basis of the market value of those shares on the date they are acquired on behalf of employees: the acquisition date (Para 66 Sch 2).

The market value of the dividend shares on the acquisition date may not necessarily be the price paid for those shares by the trustees because shares may come from a variety of sources, including:

- having been held for varying periods of time in the trust itself
- being new issue shares
- being purchased at a variety of prices over the 30 day period

## *Design options*

### *Designing your plan*

There are a number of areas where the legislation enables a company to decide how its specific Share Incentive Plan will operate. This means that a tailor-made plan can be put together by each company, taking into account its corporate strategy and needs, its resources and also the interests of its employees.

A company has scope to make its own design decisions.

The purpose of this section is to help highlight what design decisions a company can make, and some of the considerations to take into account when making those decisions.

### *What are the different types of share award?*

The three main types of share award are described earlier in this guidance in the section called Summary of share plan legislation. It is not necessary for all three types of share to be used by a company operating a Share Incentive Plan. A company can offer:

- free shares only
- partnership shares only
- partnership and matching shares
- free and partnership shares
- free, partnership and matching shares

A company cannot offer matching shares under a Share Incentive Plan unless it also offers partnership shares.

In addition, dividend shares can be used in a plan. So in total, a plan can use four different types of share award.

**Things to remember** when deciding what types of share award to use in a Share Incentive Plan.

- If partnership and matching shares are being used, the maximum ratio of matching shares to partnership shares is 2:1. In other words, the company may award up to two matching shares for every partnership share bought by an employee.
- It is possible to make different types of award at different times. For example, a company may only make awards of free shares in the first year of operation of its Share Incentive Plan. In the second year, it may decide to offer employees the opportunity to buy partnership shares as well. However, it is important that the rules of the company's plan are flexible enough to allow this.

- If plan rules allow for all four types of award, this does not mean that all of them need to be made each time the company operates the plan. But, including the possibility for all four provides this flexibility. Companies can include provisions for all four types of award when the plan is adopted, even if it is not planned to use them all immediately.

Our [model rules](#) cater for all these types of share award and are available on our website.

#### *What about an accumulation period?*

If a company uses partnership shares in its Share Incentive Plan, it does not have to operate accumulation periods.

**Things to consider** when deciding whether to include accumulation periods in a Share Incentive Plan.

- Administration issues - the use of an accumulation period of up to 12 months will enable companies to administer the acquisition of shares in blocks at the end of each accumulation period, rather than having to arrange for share acquisitions following each salary deduction (probably monthly).
- Taxation implications - tax and NIC savings may be made by employees as a result of the use of accumulation periods, depending on the share price movement of the underlying shares.
- Design issues - US companies may operate employee share purchase plans under which salary deductions are made and shares purchased at the end of a three or six month period using the accumulated salary deductions. The use of accumulation periods for partnership shares can help achieve a similar (but not identical) structure for UK employees.

Another design aspect is that the company may wish to consider whether to pay interest on cash held during the accumulation period (although there is no requirement to do this).

#### *How about reinvesting dividends?*

A company may, if it wishes, include dividend shares in its Share Incentive Plan, but there is no obligation to do so. If they are included, the legislation allows companies to include provisions in their plan rules for dividend reinvestment to be either compulsory, or the choice of each employee (Para 62 Sch 2)

**Things to consider** when deciding whether to include dividend shares in a Share Incentive Plan.

- Administration issues - if dividend reinvestment is included in a plan, record-keeping systems have to be capable of tracking this extra element. Amounts of dividend carried forward also need to be tracked.
- Taxation issues - dividend reinvestment gives employees an extra opportunity to enjoy tax benefits, because dividend shares held in a Share Incentive Plan will be free of tax for the employee, subject to the limit of £1,500 per year.
- Design issues - companies should consider how likely it is that dividends will be paid on shares to be held in the plan over the next few years, and whether it is worth including this feature in their plan. It involves extra administration, but will enable employees to benefit from an extra tax advantage.

#### *What about forfeiture for free and matching shares?*

A company can include provisions in a Share Incentive Plan that free and matching shares will be forfeited if the employee ceases to be employed, or takes the shares out of the plan, within the period of forfeiture. In addition, matching shares may be subject to forfeiture if the corresponding partnership shares are withdrawn from the plan. The forfeiture period may be up to three years from the date of award of those shares.

Again, this feature does not have to be included and the company can decide whether to include such provisions in the plan rules of its Share Incentive Plan.

**Things to consider** when deciding whether to include forfeiture provisions in the plan.

- Taxation issues - if shares are forfeited by an employee because he or she leaves employment or due to one of the other events that triggers forfeiture, no tax charge arises on the employee.
- Design issues - a forfeiture period may be a useful tool for companies wishing to retain employees because it requires them to remain employees if they wish to receive the benefit of the shares awarded to them under the plan. But, forfeiture cannot be linked to individual or company performance.

Remember that the same provision for forfeiture must apply in relation to all free or matching shares included in the same award under the plan. It is not possible to include forfeiture provisions in relation to employees who cease employment as involuntary leavers (due to injury, disability, redundancy, TUPE transfer, change in control of the subsidiary employing company, retirement or death).

However, a company can have different forfeiture provisions for different types of other leavers. For example, employees who resign could be treated differently from those who are dismissed for misconduct.

*What are the holding periods for free and matching shares?*

If free or matching shares are included in a Share Incentive Plan, a holding period of at least three years must be included. During this period, employees are contractually bound to keep shares in the plan, and must not sell or give away their interest in these shares.

A company can provide for a longer holding period - up to five years from the date of award of the shares. This holding period must be the same for all participants in any given award of shares, and may not be increased once the shares have been awarded. No matter how long the holding period, employees cannot leave their shares in the plan if they leave employment during that time.

**Things to consider** when deciding whether to include a holding period of more than three years.

- Taxation issues - employees will be subject to income tax when the shares are taken out of the plan, if they are taken out by employees between three and five years after award.
- Design issues - the use of a holding period of more than three years will encourage employees to hold their shares for a longer period of time, taking a longer-term stake in the company.

Dividend shares must also be made subject to a holding period of three years.

*Summing up*

A company may wish to include all or none of these design features in their plan. A company can also decide to include:

- an award policy - how often to make awards of shares
- a matching share to partnership share ratio

This should enable the company to design a unique Share Incentive Plan, which operates in a way that supports its strategy and objectives.

Companies should consider making their plan rules as flexible as possible when they first implement a Share Incentive Plan, including the possibility of using features that are not immediately going to be used. This will help them to change and develop the way that their Share Incentive Plan works over time, without having to change their plan rules and get the changes approved by us.

## *Share Incentive Plan trusts*

When a Share Incentive Plan is set up, it is necessary to set up a trust to hold the shares. The legislation details various requirements for this trust, and the duties and responsibilities of its trustees. This section explains some of them.

The trust needs to be:

- constituted by a trust deed that complies with the Share Incentive Plan legislation (Para 71(3) Sch 2)
- subject to local UK law
- administered by trustees who are resident for tax purposes in the UK (Para 71 Sch 2)

The trust deed must not contain any features that are neither essential nor reasonably incidental to the purpose of complying with the Share Incentive Plan legislation (Para 71(4) Sch 2). (This means, for example, that it must not enable employees to receive cash rather than shares out of the plan.)

Our [model trust deed](#) contains all the features that are required by the legislation and is available on our website.

Two other model trust deeds with rules for employee representation will be available shortly if that is your preferred option. One model is for larger companies that would like to do this and the other for smaller companies.

### *Who should the trustees be?*

The trustees must be a body that is separate from the company setting up the trust and can be either a collection of individuals, or a specially created trust company.

Trustees can be employees or directors of the company or of a constituent company in the case of a group plan.

As trustees they must act:

- in accordance with the trust deed and the Share Incentive Plan legislation
- in the best interests of the beneficiaries of the trust, that is, the employees of the company

### *What are the duties of trustees?*

The trustees are required by the trust deed to:

- acquire shares and appropriate (that is, designate or allocate) them to employees as free or matching shares

- apply partnership share money in buying partnership shares for employees
- apply cash dividends in acquiring dividend shares (Para 71(2) Sch 2 )

A plan does not need to operate all four types of share awards, but the trustees cannot use money they receive for other purposes, such as, paying cash bonuses to employees.

The trustees have a range of duties that are set out in Part 9 Schedule 2 ITEPA 2003.

*What are the trustees' duties to give notice?*

The trustees must give various notices to participants as soon as practicable:

- after awards of free or matching shares, specifying the number and description of those shares, their market value on award date, and the holding period applicable to them (Para 75(2) Sch 2)
- after awards of partnership shares, specifying the number and description of those shares, the amount of partnership share money used to buy those shares, and their market value on the day they were bought by the trustees (Para 75(3) Sch 2)
- after awards of dividend shares, specifying the number and description of those shares, their market value on the day the shares were bought, the holding period applicable to them, and details of any amounts carried forward (Para 75(4) Sch 2)

Where any foreign cash dividends are received on shares held on behalf of employees in the trust, the trustees must provide details of any foreign tax deducted from the dividend before it was paid to the employee (Para 75(5) Sch 2)

*What are the trustees' general duties?*

Trustees must only dispose of participants' shares, or deal with any rights arising from those shares, on the direction of participants (Para 72(1) Sch 2).

The trustees must not sell free, matching or dividend shares during the applicable holding period unless a participant has ceased employment (Para 73(2) Sch 2) subject to the terms of the following parts of the legislation:

- general offers under Para 37 Sch 2
- raising funds for subscription for rights issues under Para 77 Sch 2
- meeting PAYE obligations under Para 79 Sch 2
- termination of plan under Para 90 Sch 2

*Can the trustees raise funds to subscribe for rights issues?*

Yes. Subject to the duty to act in accordance with a participant's directions under Para 72(1) Sch 2, the trustees may dispose of some of the rights arising under a rights issue in order to obtain sufficient funds to exercise the rest of the rights (Para 77(1) Sch 2).

*What about PAYE and NICs obligations?*

The plan rules must enable the trustees to operate PAYE when shares are taken out of the plan in circumstances where a PAYE obligation arises (S510 & S511). This happens where, for example, an employee takes the shares out of the plan before the end of the holding period and the shares are readily convertible assets.

The rules should allow the trustee to meet their PAYE obligation by:

- selling some of the shares being taken out of the plan
- selling some of the other shares that the employee has in the plan
- accepting cash paid to them by the employee - this must be agreed in a share agreement. There are [model share agreements](#) on our website

Trustees must maintain necessary records for their PAYE obligations and those of the participants' employer, which relate to the plan (Para 80 Sch 2). Trustees must also maintain records of participants who have participated in one or more other plans established by the company or a connected company (Para 71A Sch 2).

*Do the trustees have any other duties?*

In addition to the matters set out above, the Share Incentive Plan legislation allows employees to authorise trustees to accept certain offers for free, matching and dividend shares (Paras 37, 61 and 67 Sch 2) The authorisation can be incorporated into the partnership or free share agreement.

*What duties are connected with partnership shares?*

Trustees must hold partnership share money on behalf of employees until they apply it in acquiring partnership shares (Para 49(1)(b) Sch 2).

The plan must provide for the trustees to keep any money required to be held by them under Para 49 Sch 2 in an account with a bank, a building society or other authorised institution (Para 49(3) Sch 2).

If partnership money is held for employees in these circumstances in an interest-bearing account, the plan must provide for trustees to account to employees for the interest (Para 49(4) Sch 2).

If there is no accumulation period, the plan must provide for partnership share money to be applied by the trustees in acquiring partnership shares on behalf of the employee within 30 days after the last date for the deduction (Para 50(4) Sch 2)

Any surplus money left over after the acquisition of partnership shares must be either:

- carried forward with the participant's consent
- repaid to the employee as soon as practicable (Para 50(5) Sch 2)

Where there is an accumulation period, the plan must provide for the partnership share money to be applied by trustees in acquiring partnership shares on behalf of employees within 30 days of the end of the accumulation period.

Any surplus must be either:

- carried forward to the next accumulation period
- repaid to the participants (Para 52(6) Sch 2)

Where an employee withdraws from a partnership agreement, any partnership money held on his or her behalf by the trustee should be repaid to the participant (Para 55(3) Sch 2).

Where the approval of a plan is withdrawn or the plan is terminated, any partnership money held on behalf of participants must be paid over to those participants (Para 56 Sch 2).

*What about dividend shares?*

In exercising their powers in relation to the acquisition of dividend shares, the trustees must treat participants fairly and equally (Para 66 Sch 2).

If the plan provides for reinvestment of dividends, any excess over the £1,500 limit must be paid to participants as soon as practicable (Para 64(3) Sch 2).

The plan must also allow trustees to apply cash dividends in acquiring shares on behalf of participants within 30 days of receipt of the dividend (Para 66(2) Sch 2).

*What about any surplus dividend money?*

Any surplus money left after acquiring dividend shares can be carried forward by the trustees, but must be held by them so that it can be separately identifiable (Para 68(3) Sch 2). This money must be paid to the relevant participant within three years of the dividend being paid if:

- it is not reinvested
- he or she ceases employment
- a termination notice is issued in relation to the plan

In these circumstances, the money must be paid as soon as practicable (Para 68(4) Sch 2).

The trust must issue vouchers showing the amount paid and the appropriate tax credit for the date of that payment where the surplus is paid to the relevant participants (S515).

If a participant leaves the plan within three years (apart from the good leaver exceptions on cessation of employment), the trust must issue him or her with a voucher showing:

- the amount of dividend applied to purchase the shares
- the appropriate amount of tax credit for the date of exit from the plan

### Step 3 - apply to Revenue & Customs approval of a plan

Once a Share Incentive Plan has been put together by a company, and the necessary documents prepared, the company is ready to apply to HM Revenue and Customs for approval of the plan.

The address is:

**Employee Shares and Securities Unit  
Room G52  
100 Parliament Street  
London  
SW1A 2BQ**

**E-mail:** [shareschemes@hmrc.gsi.gov.uk](mailto:shareschemes@hmrc.gsi.gov.uk)

**Tel:** 020 7147 2843 or 2853

**Fax:** 020 7147 2747

Our Share Schemes service statement sets out the level of service that companies and their advisers can expect to receive in relation to plan approvals.

In helping companies set up a plan, we will look at draft documentation and point out any potential problems at an early stage. If we are made aware of the company's timetable early enough, we will do our best to fit in with it.

If there are specific issues which we think might be better resolved by having a meeting than by correspondence, we are happy to meet with companies to take these forward.

#### *How to apply for approval of a plan*

There are two stages in applying for approval. The first of these is informal approval, when we will check the documentation that you send us and tell you if it is capable of approval. If it is not, we will work with you to make it suitable for approval.

#### *Checklist*

We have produced a [checklist](#) that enables companies or their advisers to check that the trust deed and rules of a plan contain all of the features that are required by the legislation.

Please complete the checklist and send it to us with the other documents for informal approval, to help us process your application more quickly.

### *Informal approval*

In order to consider a plan for informal approval, we will need to see:

- draft rules and trust deed of the plan
- the Memorandum and Articles of Association of the company (or equivalent)
- the completed checklist
- copies of ancillary documents for the plan, such as, partnership and matching share agreements and employee communications documents

### *Formal approval*

When we have confirmed that the plan rules and trust deed are capable of approval, the plan can be adopted by the company (for example, at the annual general meeting) and the trust deed stamped if necessary. Details on the stamp duty implications of a Share Incentive Plan can be found in the frequently asked questions on stamp duty.

When we have sent this confirmation, you can apply for formal approval and submit the relevant documents.

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### *What are the relevant documents required for formal approval?*

One copy of:

- A statement giving the name and registered office of the company setting up the plan. It should also show the names of the Tax Offices and the reference numbers under which the company makes its corporation tax (CT) and PAYE returns. In the case of a group plan this information is required in respect of all companies to which the scheme is expressed to extend.
- A statement either:
  - confirming that the plan extends to all companies in the group of which the establishing company is a member
  - explaining the grounds on which it is considered that the requirements of Para 10(3) Sch 2 are satisfied
- The Memorandum and Articles of Association with any amendments for any company whose shares will be used in the plan.
- A declaration that the shares to be used in the plan satisfy the conditions in Para 25 to 33 Sch 2. This should include the directors' undertaking to us that any power of the directors under the Articles of Association to veto the transfer of shares acquired under the plan will not be used in such a way as to discriminate against participants in the plan. It should also state

that all qualifying employees will be notified of the undertaking (Para 30(4) Sch 2). A statement on company headed notepaper signed by the company secretary is acceptable.

- The resolution adopting the plan. This should be an original signed resolution or a certified copy of it and should state the date of adoption of the plan by the company.
- An Approvals Stencil completed as far as possible, if not previously submitted.

In addition, you will need to send two copies of:

- The plan rules.
- The executed trust instrument.
- Any other documents which will be issued to those taking part (or invited to take part) in the plan or to shareholders. These should include the free and partnership share agreements and employee communications documents.

*Does a company have to get approval for any changes made to the plan?*

If a plan is amended after it has received formal approval, it does not necessarily need to be approved again, unless the amendments are to key features of the plan (Para 84 Sch 2).

Key features are those that are necessary to meet the requirements of the Share Incentive Plan legislation in Schedule 2 ITEPA 2003.

Changes to parts of the plan that are not key features do not require our approval. For example, if the rules are changed to reflect a change in the name of the company, prior approval is not required.

However, if a change to a key feature is made without our prior approval, it will be a disqualifying event. This means that we can withdraw the approval of the whole plan from the time that the disqualifying event happened (Para 84(1)(b) Sch 2).

*What happens if amendments to plan rules are made?*

If amendments to the rules are going to be made, and they are amendments to key features of the plan, there are two stages for applying for approval to the amendments. They are:

- **Informal approval** - we will need to see the deed or rules with the proposed changes highlighted, and will tell you if it is capable of approval. If it is not, we will tell you why.
- **Formal approval** - when we have confirmed that the amendment is capable of approval, the company should adopt the amendment and if the

amendment is to the trust deed, execute a deed of amendment. A copy of the following documents should then be submitted for formal approval:

- the resolution adopting the amendment the rules or deed as amended
- the deed of amendment (if applicable).

If amendments are made that do not involve a key feature, you will need to supply a copy of the amendment to us after it has been made.

*Does the Revenue & Customs have to approve takeover and merger documents?*

The terms of any exchanges of shares held in a plan, for example, as a result of a takeover, do not need to be agreed in advance with us.

*When will the Revenue & Customs withdraw its approval of a plan?*

We will withdraw our approval of a plan if a disqualifying event happens (Para 84 Sch 2) for example, if

- the plan is operated contrary to its rules and trust deed or the legislation
- there is an alteration of a key feature without our prior approval
- non-comparable Method 2 performance targets are set
- there is an alteration to the share capital of the company or to the rights of shares used in the plan that materially affect the value of the shares in the plan
- there is different treatment of the shares used in the plan compared with other shares of the same class
- the company fails to make returns of information about the plan (see below)

We will notify the company of our withdrawal of approval (Para 83 Sch 2). At the same time, we will specify the date on which the withdrawal takes effect. Generally, this will be the date on which the disqualifying event itself occurred, but we have discretion to specify a later date. The tax benefits that employees enjoy under the plan will not be available from that date. This does not affect the treatment of shares in the plan up to that date (Para 83(3) Sch 2).

*Can a company appeal against withdrawal of approval or refusal to approve a plan?*

Yes. A company may appeal against our decision to withdraw approval or refuse to approve a plan. To do this, it must give us notice within 30 days of the relevant notice being given to the company (Para 85(3) Sch 2).

Appeals will be heard by the Special Commissioners (Para 85(2) Sch 2). The Special Commissioners are independent, full-time members of a tribunal. Their hearings are generally public, although you may ask to have your hearing in private if you wish.

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*The Share Incentive Plan tax return (Form 39)*

Companies are required to submit annual returns after the end of each tax year. The returns must include details of awards of shares that have been made to employees during that tax year.

At the end of the tax year we will send returns to companies with approved plans. These must be completed and returned to us within three months of the date on which the return was issued. (Para 93 Sch 2) There are penalties for failure to submit a completed return. If you have not received a return you can get one on our website at [www.hmrc.gov.uk/shareschemes/ann-app-schemes.htm](http://www.hmrc.gov.uk/shareschemes/ann-app-schemes.htm)

This return is in addition to the Self Assessment trust return.

*Self Assessment trust return*

The trustees are also required to provide a Self Assessment (SA) trust return for each tax year, which should be submitted to the relevant trust office shown in the table below.

We will tell the trust office about the plan trust, and they will arrange for the trustees to receive SA trust returns. For further information contact [Revenue & Customs Trust](#).

## Section 2 - Operating a Plan

### *Award of shares and valuation*

This section explains the process for making awards of shares to employees once the plan has been approved.

#### *What happens when shares are awarded?*

When shares of any type have been awarded to an employee, those shares are held by the trust for the benefit of that employee, subject to the terms of the trust deed and plan rules.

The trustees have certain responsibilities to employees who have interests in the shares in the trust and must give notice to each participant of free, matching, partnership and dividend shares awarded to them (Para 75 Sch 2).

#### *What control do employees have over their shares?*

When shares have been awarded, trustees may dispose of an employee's share only if he or she instructs this.

An employee may direct the trustees to dispose of his or her partnership shares at any time, though there may be tax implications.

Generally, the trustees may not dispose of any employee's free, matching, or dividend shares within the holding period unless the employee leaves the company. The only other situations in which trustees may dispose of shares during the holding period is if a plan terminates (Para 89(2) Sch 2) or if a participant directs them to:

- accept a general offer for his or her shares (Para 327 Sch 2)
- raise funds for rights issues (Para 77 Sch 2)

### *Trustees' PAYE obligations*

A plan must provide for trustees to be able to discharge any PAYE obligation where shares cease to be subject to the plan early, either by:

- arranging for relevant participants to pay a sum equal to the PAYE obligation
- selling participants' plan shares to meet that obligation (Para 79 Sch 2)

#### *What happens to money received by trustees?*

If the trustees receive money or money's worth as a result of holding the shares that have been appropriated to employees, this must be paid to the relevant employees as soon as practicable (Para 74 Sch 2).

### *How are shares valued?*

Under a Share Incentive Plan, the market value of the shares must be determined at various times so that tax and NICs can be correctly calculated. A company will need to establish the value of the shares being used in a Share Incentive Plan if there is:

- an award of free and matching shares
- a purchase of partnership shares with no accumulation period
- a purchase of partnership shares with an accumulation period - you will need to establish the value of the shares at the beginning of the accumulation period and at the acquisition date
- dividend reinvestment - the market value will need to be established on the date that dividend shares are acquired with the cash dividend
- a participant who ceases employment in the first five years of an award of free, partnership or matching shares
- a withdrawal of free, partnership or matching shares from the plan within five years of acquisition
- acquisition of shares by trustees in order to quantify the corporation tax deduction to be claimed

### *What is meant by market value?*

The market value of any shares is the price they might reasonably be expected to fetch on the open market. If the shares are quoted in the London Stock Exchange Daily Official List the market value is:

- the lower of the two prices in the List on the relevant date plus one-quarter of the difference between those two figures
- if less, halfway between the highest and lowest prices recorded in the shares for the relevant date

Prices recorded in the Financial Times are usually halfway (or mid-market) prices.

For other companies, it is necessary to agree the market value of the shares with our Shares Valuation Office.

## Tax and NICs implications of a Share Incentive Plan

Participation in a plan by employees can affect their tax and NICs as well as that of their employing company and the tax of the trustees of the plan trust. When income tax arises, PAYE and NICs liabilities may also arise.

### *Income Tax & NICs implications for participants*

The tax and NICs treatment explained here applies to participants in the plan if they are subject to income tax on their general earnings from employment, under s15, at the time of the award.

Partnership share money is taken from participants' pay before tax and NICs are deducted. It does not reduce remuneration or relevant earnings when working out an individual's salary for pensions and annuity purposes.

Tax and NICs are not charged when a participant is awarded shares under a plan, or when dividend shares are acquired on his or her behalf.

### *What is the tax treatment of shares ceasing to be subject to the plan?*

When shares are withdrawn they cease to be subject to the plan if:

- they are transferred to the participant (or another person) on the direction of the participant
- the participant transfers his or her interest in shares held in the plan
- they are sold by the trustees on the direction of the participant (Para 96 Sch 2)

Shares cease to be subject to the plan when participants stop working for the company operating the plan (or group operating the plan, if it is a group plan). The tax implications when the shares cease to be subject to the plan depend on the circumstances of their withdrawal. (S497)

The general rule is that there is no income tax or NICs to pay when the shares cease to be subject to the plan, provided they have been held in the plan for the full five years required by the legislation. Different amounts may be taxed if the shares have been held for a shorter period (S505 to S507)

There is generally no liability to income tax or NICs on shares withdrawn from a plan when a participant ceases employment with the company as an involuntary leaver, due to:

- injury
- disability
- redundancy
- TUPE transfer

- change in control of the subsidiary employing company
- retirement on or after the age specified in the plan
- death (S498)

### *Identifying which shares come out of the plan*

If an employee only takes some shares out of a plan, it is important to know which shares have been taken out in order to determine the tax treatment. Shares that went in first must come out first, providing that they are not still within a holding period.

### **Examples**

Carmel has 100 free shares, which are subject to a three year holding period, and 100 partnership shares. She takes out 100 shares.

If:

- the free shares were awarded four years ago and the partnership shares were awarded two years ago, the free shares will come out of the plan
- the free shares were awarded two years ago and the partnership shares were awarded four years ago, the partnership shares will come out of the plan
- the free shares were awarded two years ago and the partnership shares were awarded one year ago, the partnership shares will come out of the plan as the free shares are still subject to the holding period
- the free and partnership shares were awarded at the same time four years ago, the shares that give rise to the lower income tax charge will come out of the plan

If the free and partnership shares were awarded four years ago but the free shares are subject to a five year holding period, the partnership shares will come out of the plan.

### *How are free and matching shares taxed?*

Any income tax charge depends on how long the shares have been held in the plan. For example, if the shares are held for

- less than three years, income tax is based on the market value of the shares on ceasing to be subject to the plan
- at least three but less than five years, income tax is based on the lesser of the market value at the date of award and on ceasing to be subject to the plan
- five years or more, no income tax is charged

### *What about PAYE and NICs?*

Income tax, through PAYE, will have to be withheld if the shares are readily convertible assets at the time the tax charge arises. In addition, a Class 1 NICs liability will also arise on the same amount that is subject to tax through PAYE.

When considering the NICs position employers should bear in mind that there is a weekly primary and secondary threshold before Class 1 NICs are payable. Further information about this and other NICs issues is contained in booklet [CWG2 'Employer's Further Guide to PAYE and NICs'](#).

### *How are partnership shares taxed?*

The amount of income tax payable when partnership shares are withdrawn from the plan depends on the length of time the shares have been held in the plan. For example, if shares are held for:

- less than three years, income tax is based on the market value of the shares on ceasing to be subject to the plan
- more than three years but less than five years, income tax is based on lesser of the partnership money used to buy the shares, and the market value of the shares at date they cease to be subject to the plan
- five years or more, no income tax is charged

The same PAYE and NICs rules apply to partnership shares as for free and matching shares (see above).

Partnership share money may be repaid to the participant in certain circumstances. If so, it will be subject to PAYE and NICs if there is

- a refund of deductions in excess of the permitted maximum
- surplus money after shares have been acquired
- a refund on the employee leaving the company
- a refund on termination of the accumulation period
- a refund after the employee withdraws from the partnership agreement
- a refund on Revenue & Customs withdrawal of plan approval
- a refund on termination of the plan

### *How are dividend shares taxed?*

If cash dividends are paid on shares held in the plan and reinvested in dividend shares, they are not liable to income tax in the hands of the participant, nor is the participant entitled to any tax credits on them.

Dividends are not subject to NICs so NICs will not arise on dividends that are reinvested in dividend shares.

If dividend shares cease to be subject to the plan before three years after their acquisition on a participant's behalf, he or she will be liable to income tax on the cash dividend used to acquire those shares. The participant will also be entitled to the appropriate tax credits. In this situation, the trustees must supply the participant with a statement that includes details of the amount of the dividend and the tax credit.

### Example

Ian wants to reinvest £1,500 worth of dividends from plan shares into dividend shares. The share price of £1 ordinary shares is £4.80 per share.

Dividends reinvested ( $312 \times £4.80$ ) = £1,497.60

Amount carried forward within plan for reinvestment ( $£1,500 - £1,497.60$ ) = £2.40

After 30 months Ian leaves the company.

Market value of shares is £5.50 per share

= £1,716

Tax credit rate on the date of exit\*

= 10% of gross amount

(net amount grossed up by one ninth)

Chapter 3 Part 4 ITTOIA 2005 liability =  $£1,500^{**} + (£1,500/9 = £166) = £1,666$

\* The tax credit is that which applies for the date of exit from the plan.

\*\* The value of the relevant dividend brought into charge is the amount of the dividend reinvested plus the return of any amount carried forward and not reinvested.

If dividend shares cease to be subject to the plan three or more years after acquisition, the participant will not be subject to income tax on the dividends or the dividend shares.

### *What about cash dividends?*

Where a cash dividend is paid to the participant without being used to buy dividend shares, he or she is liable for income tax and is entitled to tax credits in the normal way.

The trustees must provide the participant with a statement showing details of the cash dividend and the tax credit.

### *Are there any exceptions?*

In certain situations, there are exceptions to the rules set out above (Sec 498) For example, a participant will not be subject to income tax if the shares are taken out of the plan early because he or she has ceased employment due to:

- injury or disability
- redundancy
- a transfer of employment to which the Transfer of Undertakings Regulations (TUPE) apply
- a company reorganisation under which the company loses its associated status
- retirement on or after reaching retirement age (as specified in the plan)
- death

If the plan provides for the forfeiture of shares when a participant leaves employment, it must be made clear that the forfeiture will not apply in these situations. (Para 32 Sch 2)

### *What about capital receipts?*

Participants are subject to income tax if they receive capital receipts in relation to shares that are held for them in a plan trust (Sec 501)

Capital receipts are liable to income tax if the shares in question are:

- free, matching or partnership shares awarded less than five years before the capital receipt
- dividend shares acquired less than three years before the receipt

All money or money's worth received as a result of holding the shares is regarded as a capital receipt (S502) unless it:

- is otherwise counted as taxable income in the hands of the recipient
- consists of the proceeds of disposal of the shares
- comprises new shares or securities following a company reconstruction
- arises out of a direction to raise money in connection with a rights issue in the same company
- is received after the participant's death (S501(6))

PAYE and NICs will apply if the capital receipt is in the form of cash or readily convertible assets.

## **PAYE and NICs implications for employee**

When operating a Share Incentive Plan, some events may give rise to an income tax charge on the employee. Where there is such a charge there may be a PAYE and NICs obligation.

### *When do obligations arise?*

There will always be PAYE and NICs obligations in connection with cash payments to employees. There may also be PAYE and NICs obligations in connection with shares, if the shares are readily convertible assets. Shares are readily convertible assets if they can easily be turned into cash. (S702)

### *What about cash payments?*

The most common situation arises where there is a repayment of money to a participant, which has been put aside to purchase partnership shares. There is an income tax charge and a PAYE and NICs obligation on the payer.

Either the trustees or the employer can repay partnership share money, depending on the arrangements that they make.

It is for the trustees and employer to decide who will pay the employee when there is a repayment of partnership share money. In most cases it is likely that the employer will make the repayment through the payroll and deduct any PAYE and NICs in the normal way.

However, the trustees must assume responsibility for operating PAYE and NICs if:

- there is no employer to operate PAYE
- the Revenue & Customs decides that it is not practicable for the employer to operate PAYE (S511)

In either of these situations, the trustees must operate PAYE and NICs as if the participant is an ex-employee of the company. Consequently, PAYE should be deducted at the basic rate and the individual is responsible for paying any balance of income tax due under Self Assessment.

The booklet [CWG2 'Employer's further guide to PAYE and NICs'](#) gives guidance on how to operate NICs after an employee has left.

### *Other situations where PAYE and NICs may apply*

Exceptionally, there may be some cash taxable on the employee as a capital receipt where both cash and shares are received in connection with a

company reorganisation, a takeover or an amalgamation. It is likely that the trustees will pass the cash to the employer so that it can be paid to the employee through the payroll with PAYE and NICs operated.

The most common time that a repayment of partnership share money arises, is when an employee leaves employment, or an employee withdraws from the plan, before accumulated partnership share money has been used to buy shares.

Repayment of excess deductions from salary relating to partnership shares, or surpluses after buying shares, also create an income tax charge and a PAYE and NICs obligation.

The employee will have to pay tax and possibly NICs on the money that he or she receives. If money is refunded when he or she has no earnings, for example, during unpaid leave there may not be any tax or NICs due, subject to their earnings and the earnings threshold in the pay period concerned.

The purchase of partnership shares from pre-tax and pre-NICs pay can affect benefit entitlement. The repayment of partnership money and the NICs paid in relation to it can also affect benefit entitlement.

#### *How is the PAYE obligation discharged in practice?*

Where the PAYE and NICs obligation arises, it is the employer who has to operate PAYE and NICs. Exceptionally, the obligation may fall on the trustees.

The Share Incentive Plan arrangements can provide for either:

- the participant to fund the employer to pay the tax, for example, out of other salary or a payment directly to the employer
- for the trustees to fund the employer

Where the trustees fund the employer, they have the power to dispose of a participant's plan shares to release sufficient funds to cover the tax and NICs liability. The employee then gets the balance of the payment in remaining shares and cash.

#### *What about the PAYE liabilities of leavers?*

The most common situation where an income tax charge arises (and PAYE and NICs will be relevant if the shares are readily convertible assets), is when an employee leaves the company and:

- is not an involuntary leaver
- the shares have not been held for 5 years (3 years in the case of dividend shares)

The tax (and if applicable NICs) charge arises at the date of cessation of employment, although the PAYE and NICs will be deducted at a later date - when the administration has been completed.

If the employee takes his or her shares out of the plan and a tax charge arises, the date on which the charge arises is the date on which the trustees receive the request to transfer the shares. Again, although the tax charge arises on receipt of the transfer notice, the PAYE and NICs will be deducted at a later date - when the administration has been completed.

The NICs regulations relating to Share Incentive Plans are in the Social Security (Contributions) Regulations 2001, (Regulations 1,22,25 and Paragraphs 6 and 7 of Part X, to Schedule 3).

The Northern Ireland legislation is in the corresponding Social Security (Contributions) (Northern Ireland) Regulations 2001.

### **Capital gains tax (CGT) for participants**

*How is CGT charged on shares held in a plan?*

Participants are treated for CGT purposes as absolutely entitled to the plan shares once they are awarded to them. A participant who keeps his or her shares in the plan until he or she sells them will not have to pay any CGT on any gains they make, however large (Para 3 Sch 7D TCGA 1992)

*What about shares ceasing to be subject to the plan?*

There is no CGT liability for participants on shares ceasing to be subject to the plan, or on shares which are forfeited under the plan rules (Para 5 & 7 Sch 7D TCGA 1992) An allowable loss does not arise for CGT.

*What about shares sold after ceasing to be subject to the plan?*

If a participant takes his or her shares out of the plan and sells them later, he or she may have to pay CGT on any increase in value after the shares come out of the plan. From 6 April 2008, taper relief is no longer available to reduce the amount of the chargeable gain. Instead the chargeable gain will be liable to tax at the rate of 18 per cent.

Individuals can make capital gains up to the annual exempt amount each year without having to pay CGT. For the tax year 2008/09 the annual exempt amount is £9,600. If the sale price is less than the value of the shares on the date they come out of the plan, there will be a loss for capital gains purposes. Further details of this can be found in our guidance ['Share Incentive Plans - A guide for employees'](#).

## **The trustees**

### *Income tax charge for trustees*

The trustees are liable to income tax on dividends or other distributions they receive in connection with shares held in the trust, if those shares have not been appropriated to employees. Income in the form of dividends and other distributions is liable to the dividend trust rate, currently 32.5 per cent, unless the shares are allocated to participants or are disposed of by the trustees within a fixed period from their acquisition (S686B ICTA 1988). The trustees are also liable to income tax on interest and other income they receive, at the rate applicable to trusts, currently 40 per cent.

If, at the time the trustees acquire the shares, any of the company's shares are readily convertible assets (RCAs), the allocation period is two years.

If at the time of acquisition none of the company's shares are RCAs the period is:

- five years following acquisition
- two years from the date on which any of the company's shares become RCAs, if earlier

If the shares are not allocated within this time, trustees have to account for tax at the dividend trust rate. The charge arises as soon as it is clear that the shares will not be, or have not been, awarded within the time limit.

For example, if the trustees sell the shares, those shares cannot be awarded to employees within the time limit. Tax at the dividend trust rate is due on any dividends received on those shares while the trustee held them. The trustees should account for this tax in their Self Assessment trust return covering the period in which the shares are sold.

When shares are held for a period beyond the time limit for relief, a tax charge also arises as soon as the time limit passes.

The trustees may be subject to PAYE and NICs obligations in certain situations.

### *When does capital gains tax (CGT) arise?*

Usually when a trust disposes of shares to a beneficiary, CGT arises on the gain made by the trustees. However, gains arising to the trustees on shares held in the plan are exempt from CGT provided the shares are allocated to employees within a fixed period from their acquisition. (Para 2 Sch 7D TCGA 1992).

If, at the time the trustee acquires the shares, any of the company's shares are RCAs, the allocation period is two years.

If, at the time of acquisition none of the company's shares are RCAs, the period is:

- five years following acquisition
- two years from the date on which any of the company's shares become RCAs, if earlier

Where Share Incentive Plan trustees acquire shares from the trustees of an approved profit sharing scheme, the allocation period runs from the date that the profit sharing trustees acquired the shares (Para 86(2) Sch 7 ITEPA 2003).

If the trustees do not comply with these time limits, then any gains on the disposal of the shares may be subject to CGT, in the normal way.

If the trustees of an approved profit sharing scheme transfer shares to Share Incentive Plan trustees, the Share Incentive Plan trustees are treated as acquiring the shares at a cost that gives rise to neither gain nor loss to the trustees of the profit sharing scheme (Para 86(1) Sch 7 ITEPA 2003).

*Are trustees liable to stamp duty?*

The trustees may be subject to stamp duty or stamp duty reserve tax in certain situations

## **Employers**

*When do employers operate PAYE and charge NICs?*

Employers of plan participants must pay tax under PAYE, and pay NICs if a income tax liability arises under Section 15 on an employee, and at that time, the shares are RCAs.

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*Can a company claim a deduction for costs in setting up a scheme?*

Companies are allowed a deduction in computing their taxable profits for their costs in setting up an approved Share Incentive Plan (Para 7 Sch 4AA ICTA 1988).

The company is also allowed a deduction for any contributions it makes towards the trustees' costs in running the plan (Para 8 Sch 4AA ICTA 1988). Operational costs do not include the cost of acquiring shares for the purposes of the trust, but may include other incidental expenses in providing the shares, such as:

- fees
- commission
- stamp duty and similar incidental costs
- any interest charges incurred by the trustees on money borrowed to enable them to acquire shares

If we approve the plan more than nine months after the end of that period of account in which the expenses are incurred, the expenses are treated as if they were incurred in the period in which the approval is given (Para 7(3) Sch 4AA ICTA 1988).

No deduction is allowable for costs incurred if, before the plan is approved:

- any employee acquires rights under the plan
- the trustees acquire any shares for the purposes of the plan (Para 7(2) Sch 4AA ICTA 1988)

*Are there any deductions for contributions to Plan trusts?*

A deduction is available when a company makes a payment to the trustees of a SIP to buy a block of shares in the company on behalf of its employees. The block shares must not be acquired from a company (Para 9(1) Sch 4AA ICTA 1988).

The amount of the deduction is equal to the amount applied by the trustees in acquiring the block shares (Para 9(4) Sch 4AA ICTA 1988).

The deduction is only allowed if:

- at the end of a period of 12 months, beginning with the date of acquisition of the block shares, the trust holds at least 10 per cent of the ordinary share capital of the company, and carries rights to at least 10 per cent of any profits available for distribution and assets available in the event of a winding-up of the company (Para 9(2) Sch 4AA ICTA 1988).
- at least 30 per cent of the shares bought are transferred to employees through the SIP within five years
- the remaining shares are transferred to employees through the SIP within 10 years. (Para 10 Sch 4AA ICTA 1988)

There are additional tax exemptions (income tax on dividends and capital gains tax) on shares, held by trustees during the 10 year period they have to transfer shares, acquired with the money in respect of which a CT deduction has been given.

*Are there any deductions for free and matching shares?*

Companies are allowed a deduction against their profits for the costs of awarding free or matching shares. The deduction is equal to the market value of shares when they are acquired by the plan trustees. The deduction must be made for the accounting period during which the shares are awarded under the plan (Para 2 Sch 4AA ICTA 1988).

There are some circumstances where no deduction is allowed.

If shares are awarded under a plan, and a deduction has been made for the cost of those shares, it is not possible to claim a second deduction if the shares are forfeited and then awarded to another employee (Para 6 Sch 4AA ICTA 1988).

*What about group plans?*

Where free or matching shares are awarded under a group plan, the deductions are allowable for each group company in proportion to the number of shares awarded to each company's employees (Para 2(4) Sch 4AA ICTA 1988)

*What deductions are allowed for partnership shares?*

A deduction is allowed for the amount by which the market value of the shares at the time that they are acquired by the trustees exceeds the amount of partnership money deducted from a participant's pay (Para 3 Sch 4AA ICTA 1988).

The deduction is given for the accounting period during which the shares are awarded.

*When will deductions not be allowed?*

No deduction is allowable in respect of awards of shares:

- to an individual who, at the time of the award, does not or would not pay tax on general earnings, as defined in Chapter 4 & 5 Part 2 ITEPA 2003, of the employment by which he or she is eligible to participate in the plan. (Para 4(2) Sch 4AA ICTA 1988)
- that are liable to depreciate substantially in value for reasons that do not apply generally to shares in the company (Para 4(5) Sch 4AA ICTA 1988)
- for which a deduction has been claimed by the same or an associated company for providing the same shares to the same or another trust (Para 4(6) Sch 4AA ICTA 1988)
- if those shares are dividend shares (Para 5 Sch 4AA ICTA 1988)

*Is a company allowed deductions if plan approval is withdrawn?*

If plan approval is withdrawn, we may also withdraw the benefit of any deductions for providing the shares (Para 11 Sch 4AA ICTA 1988).

### **Issues arising in operating a plan**

This section deals with particular issues that may arise when you are operating your plan. These generally relate to one-off events that may occur.

*Can a company impose an administrative charge for shares held after five years?*

No. Employees may continue to hold their shares in the plan after five years have passed. This will enable them to continue to benefit from CGT relief available to plan shares, but the company cannot impose an administrative charge on employees who choose to leave their shares in the trust.

Our view is that this would be a discouraging feature of the plan, and one which was neither essential nor reasonably incidental to its main aim.

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*What if there is a company reconstruction?*

Company reconstructions include one company taking over another in exchange for an issue of shares or securities, or a company making a bonus issue of shares or securities. The tax reliefs allowable in respect of the existing plan shares can be carried forward into the new shares or securities, provided:

- the new holding of shares or securities is equated with the original holding for CGT purposes (or would be if the new holding did not consist of or include a qualifying corporate bond)
- the new shares or securities do not include:
  - redeemable shares or securities issued as mentioned in s209(2)(c) Income and Corporation Taxes Act (ICTA) 1988 - this refers to shares or securities issued other than wholly for new consideration or not properly referable to new consideration
  - share capital issued in circumstances that s210(1) ICTA 1988 applies - this covers share capital issued as paid up other than by way of new consideration
  - share capital to which s249 ICTA 1988 applies (stock dividends)

The date on which the new free, matching or partnership shares or securities are treated as being awarded is the date on which the original shares they replace were awarded. In the case of dividend shares, the date of acquisition is taken as the date on which the original dividend shares were acquired (Para 87(3) Sch 2).

*What about shares acquired under a rights issue?*

Shares acquired by trustees under a rights issue are treated for all purposes of the plan as if they were identical to the shares in respect of which the rights were conferred. They are treated as being awarded in the same way and at the same time as the original holding of shares (Para 88(2) Sch 2). The following conditions apply:

- the trustees fund the exercise of the rights by disposing of other rights in respect of the participant's plan shares and in accordance with the participant's wishes (Para 88(4)(a) Sch 2)

- similar rights arise to all ordinary shares in the company (Para 88(4)(b) Sch 2)

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*How does a company terminate a plan?*

The company's plan rules can allow it to issue a notice terminating its plan in certain circumstances. The notice must be given three months before termination to:

- Revenue & Customs
- the trustees
- employees with shares in the plan and (Para 89 Sch 2)
- employees who have entered into a partnership share agreement (Para 89 Sch 2)

The effect of the notice is that no further shares may be awarded under the plan.

The trustees must remove the plan shares from the plan after the expiry of the notice, or, if later, the first date on which shares may be removed without giving rise to a tax charge. (Para 90(3) Sch 2) The shares may be removed earlier with the consent of the participants (Para 90(5) Sch 2)

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*Can shares be transferred to Individual Savings Accounts (ISAs) and Stakeholder Pensions?*

Yes. Employees may transfer shares acquired through a plan into the stocks and shares component of an ISA. There is no charge to CGT on the transfer. However, the transfer must take place within 90 days after the shares ceased to be subject to the plan. The trustees of the plan may give the ISA manager documentary evidence, such as, a copy of the notice of award or acquisition, that the shares have been transferred from the scheme. Otherwise, the investor must provide this evidence.

Companies may make arrangements with an ISA manager to offer their employees a stocks and shares ISA into which the shares may be transferred. This ISA can also accommodate other qualifying ISA investments in addition to the shares.

The market value of the shares at the date of transfer counts as a subscription to the ISA. This means that the market value of the shares, plus the value of any other subscription to the ISA, cannot currently exceed £7,200 in a tax year.

For further details see our [website](#) and the '[ISA Fact Sheet](#)'.

Employees can also transfer shares acquired through a plan directly into a Stakeholder Pension.

## **Section 3 – Some terms explained**

### **Accumulation period**

A period of up to 12 months during which employees' salary deductions are accumulated in a building society or bank, before being used to buy partnership shares.

### **Close company**

A close company is one controlled by five or fewer participators, or by participators who are directors (s414 Income and Corporation Taxes Act (ICTA) 1988).

### **Constituent company**

A company that is participating in a group plan.

### **Dividend shares**

Shares bought out of dividends earned by employees' plan shares.

### **Forfeiture**

An allowable restriction on the plan shares requiring employees to give up ownership of the shares if they leave.

### **Free shares**

Plan shares awarded free to employees participating in a plan.

### **Group plans**

Plans established by a company that controls other companies (the parent) and extends to all or any of those other companies.

### **Holding period**

The period that an employee must hold shares in the plan, which must be at least three years for free and matching shares, and must be three years for dividend shares.

### **Matching shares**

Free shares awarded to employees to match their partnership shares.

### **Partnership shares**

Plan shares bought by employees out of pre-tax and NICs pay.

### **Readily convertible assets (RCAs)**

Any assets including shares that can easily be turned into cash (s704(1) ITEPA 2003).

### **Recognised Stock Exchange**

A stock exchange that has been designated as a recognised stock exchange by order of the Board of Inland Revenue under s841(1)(b) ICTA 1988.

### **Same terms requirement**

The requirement that the terms of the award apply equally and fairly to all the employees participating.

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