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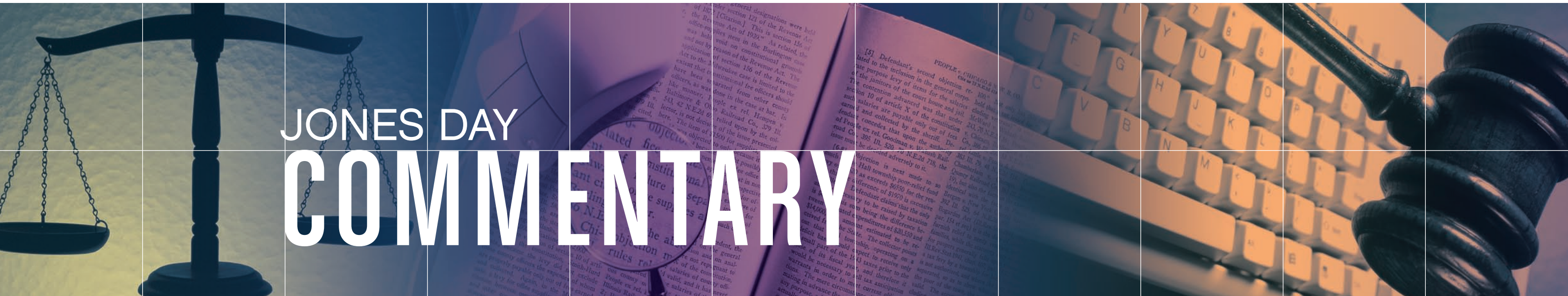

LOOK BEFORE YOU LEAP! A PRIMER ON EMPLOYEE STOCK INCENTIVE PLANS IN THE UK

US companies often use their existing US stock based incentive plans to grant options, restricted shares, restricted stock units and other forms of performance incentive to employees in different jurisdictions, including the UK. This *Commentary* provides a brief overview of some of the main considerations and pitfalls in extending such plans to the UK, although specific advice will be needed on each plan.

SECURITIES LAWS

Investor protection. The UK Financial Services and Markets Act 2000 regulates, amongst other things, the sale of shares and other securities in the UK. This law's primary impact on the communication and grant of stock related awards to employees is as follows:

- a general prohibition on carrying on a regulated activity (dealing or arranging deals in investments or giving investment advice) unless the person concerned is authorised by the UK Financial Services Authority (an "authorised person") or otherwise exempt; and
- a prohibition on the promotion of investments by anyone other than an authorised person, unless the content of any promotional communication is approved by an authorised person.

There are, however, some broad exemptions for investment activities connected with "employee share schemes" operated by companies for the benefit of their employees provided that:

- awards are only available to employees (and certain family members), i.e. not consultants, non-executive directors and other non-employees; and
- awards are settled in shares and not in cash.

Breach of the investor protection laws in the UK is a criminal offence. Approval of documentation by an authorised person is both time consuming and expensive. A company should consider adopting a UK sub-plan (i.e. a plan for UK employees derived from the US stock plan) to take advantage of the employee share scheme exemptions.

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Prospectus requirements. Under the EU Prospectus Directive ("Directive"), a company operating employee stock plans which does not have any securities traded on a major EU exchange may be required to issue compliant prospectuses in respect of offers under such stock plans, unless the offer falls within certain exemptions. The Directive applies to offers of securities that are transferable and negotiable on a regulated market and, in the context of employee awards, it is the incentive awards (and not the underlying stock) which are considered to be securities.

Consequently, stock option, restricted share and restricted stock unit awards which are not unconditional share awards should not fall within the prospectus requirements if the awards themselves are not transferable by the employee and not negotiable on a regulated market. Other forms of stock purchase plan may well fall within the prospectus requirements. If the employee stock offers do fall within the prospectus requirements, the main relevant exemptions are for employee stock offers made to fewer than 100 persons in each state in the European Economic Area (EEA), and where the maximum consideration payable under all offers of those securities made by the person making the employee stock offers within the EEA is less than €2.5 million over any twelve month period.

TAXATION

This is a very broad overview of UK taxation of certain common US stock incentives, particularly stock options and restricted stock. UK equivalents of the US incentive stock option regime are less generous and will require UK plans or sub-plans to be set up to meet UK Revenue requirements. Gains realised by employees from stock incentives will either be subject to regular income tax or to capital gains tax.

Taxation on grant of stock awards. A grant of stock for no consideration or at a discount to market value will be treated as ordinary income for income tax purposes on the share's market value less the amount actually paid. If stock is readily convertible to cash (e.g. stock of a class traded on an exchange and freely disposable when awarded), an ordinary income tax liability will arise immediately, usually subject to income tax withholding. In addition, social security contributions (known as national insurance contributions or "NIC") will also be payable.

An employee stock option (including a right to stock that will automatically vest on a certain date or on the occurrence of a specified event), will not give rise to income tax (or NIC) provided that the employee stock option is not treated as a different kind of security which is taxable on receipt. For example, the payment of dividend equivalents will probably mean that the option is a taxable security, leading to an ordinary income tax charge at the time of grant.

Taxation on vesting/exercise of stock awards. Where an award of company stock is subject to vesting requirements, ordinary income tax is charged when the stock award becomes vested. In the case of an ordinary stock option, therefore, taxation occurs only when the option is exercised. In the case of any other stock award which vests without exercise, ordinary income tax applies at the date of vesting. In most cases, NIC will also be chargeable. The taxable amount is generally calculated by deducting the aggregate of any exercise price and any consideration given for the award from the market value of the stock at the point of exercise/vesting. Where, however, the stock is acquired subject to restrictions, the tax consequences are complicated by the restricted securities income tax charge. (See relevant section below.)

The main exceptions to the requirement to pay ordinary income tax (and NIC) on exercise/vesting of awards arise in the case of UK Revenue approved plans. (See relevant section below.)

Taxation on sale of stock. The later sale of the underlying stock will be treated as a taxable event for capital gains tax ("CGT") purposes. This is calculated as the difference between the sale proceeds and the amounts paid for the stock plus amounts already subject to income tax. The CGT rate is equal to the individual's highest marginal rate of income tax (currently 40 percent) subject to various exemptions and reliefs. The most important relief is "taper relief", whereby the CGT rate is reduced if the stock has been held for a period of time before disposal. An ownership period of two years will secure maximum taper relief, with the rate of CGT falling from 40 percent to 10 percent.

The restricted securities regime described below may also impact at the point of sale.

Restricted securities income tax charge. Where stock is acquired subject to restrictions on an employee's ability to freely transfer the stock, or subject to the possibility of forfeiture, and the employee pays less than the initial unrestricted market value ("IUMV") for the stock, an ordinary income tax charge (and associated withholding and NIC liabilities for the employer) will arise when any of the restrictions are lifted and the stock becomes unrestricted, or is sold subject to the restrictions. The ordinary income tax imposed will be on a proportion of the proceeds of sale (if they are disposed of whilst still restricted) or on a proportion of their value at the time restrictions fall away. The proportion of the subsequent gain chargeable to ordinary income tax is equal to the same proportion as the discount to the IUMV. If no election is made, as the shares rise in value, a larger proportion of the subsequent gain will therefore be chargeable to the less favourable income tax regime.

On a profitable disposal, it would clearly be preferable for any gain to fall under the CGT regime (i.e. with the prospect of a 10 percent tax rate after two years (with no NIC), annual allowances and brought forward losses to claim, and payable after the end of the tax year of disposal) rather than the restricted securities income tax charge (of 40 percent with no allowances or reliefs available, possibly payable immediately after disposal under withholding, with employee's and employer's NIC also due).

Tax planning tip. It is possible to elect for ordinary income tax and NIC to be paid on the IUMV of the stock when it is acquired by means of a formal joint election (signed by employer and employee) before or within 14 days of the stock acquisition. If the employee pays tax on the difference between the price paid and the IUMV of the stock, any later growth in value will fall into the CGT regime.

Assuming that the employee has the means to meet the tax, there are advantages to the employer in insisting on the election because it fixes the employer's NIC liability (currently 12.8 percent of the value of the benefit to the employee). For the employee, however, there is the risk that the income tax and NIC paid at the outset would be wasted if the stock did not vest or the value fell over the restricted period, because there is no clawback or income tax set off of any such losses.

If stock will be forfeited for less than market value under certain circumstances, but these restrictions will fall away within five years of the award date, the restricted securities income tax charge (and any other income tax charge that would normally have arisen at grant) will not arise until the restrictions fall away, unless an election is made up front on the full IUMV of the stock.

Corporation tax. Although for accounting purposes the cost of the stock benefits will be accounted for over the vesting life of the benefit (in accordance with the international accounting standard, IFRS 2), the deductibility of such costs for tax purposes is governed by different rules. The first requirement is that the business for the purposes of which the award is made (whether a UK company or a permanent establishment of a foreign company in the UK) must be within the charge to UK corporation tax. The second requirement is that the shares to which the award relates must be (i) listed on a recognised stock exchange (which includes most major stock exchanges, but not the AIM exchange operated by the London Stock Exchange), or (ii) in a company not under the control of another company, or (iii) in a company under the control of another company whose shares are listed on a recognised stock exchange (subject to certain exceptions). Finally, the recipient of the award must be within the charge to UK income tax.

If these conditions are satisfied, the employing company will be entitled to deduct the cost of the award at the time that the recipient receives the stock. The amount of the deduction is equal to the difference between the market value of the stock on receipt and any consideration given for the stock. No deductions are allowed for other related costs of operating the stock plan. Specific UK advice should be sought on the availability of this relief.

REVENUE APPROVED PLANS

There are a number of UK Revenue approved plans which a company may want to consider as the approved plan may mitigate some of the tax consequences described above. Specific legal advice should be obtained to determine whether or not such plans may be made available over the parent company stock.

LABOUR LAWS

There is a wide range of anti-discrimination laws in the UK covering sex, race, sexual orientation, disability, religious belief, age and employees on part-time or fixed term contracts. Any company stock grant which is tainted by an act of discrimination may give rise to a cause of action, even though the plan is likely to be governed by US law.

An example of potential issues that can arise is demonstrated by the recently introduced UK age discrimination laws. US stock plans often contain favourable vesting terms where termination of employment occurs as a consequence of "early retirement". Even where this only takes place as a consequence of an exercise of discretion, this would still result in age discrimination unless all "good leavers" were afforded the same treatment (and for these purposes, "good leavers" would include almost any employer-driven termination excluding those for misconduct).

Furthermore, an employer's discretion under a company stock plan (even if absolute) remains subject to an implied duty of good faith and trust and confidence existing between employer and employee. If a discretionary benefit becomes implied into the employee's contract of employment the company's unilateral withdrawal of that benefit may constitute a breach of contract. It is generally preferable, therefore, for any company stock incentives to be expressly separate from the employment contract and to include language limiting the employee's rights to recoup stock award losses in any employment related damages claim.

US award agreements also often provide that vested stock or the proceeds of stock sold may be recovered in the event of employee misconduct, for example where the employee breaches an anti-competition agreement with the company. There is some doubt as to the enforceability of these restrictions from a UK labour law perspective.

CONCLUSIONS

- In the context of UK securities laws, be aware that company stock plans available to non-employees, or which may pay out benefits in the form of cash, need careful review if the intention is to use them for UK employees. You also need to check whether a prospectus may be required.
- A careful review of company stock grant documentation will be needed to put the appropriate mechanism in place for the recovery and payment of tax on awards. The correct categorisation of the type of award for tax purposes is critical.
- The labour law implications need to be clearly understood in the context of restrictions in the awards themselves as well as employees' rights on termination of employment.

FURTHER INFORMATION

For further information please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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