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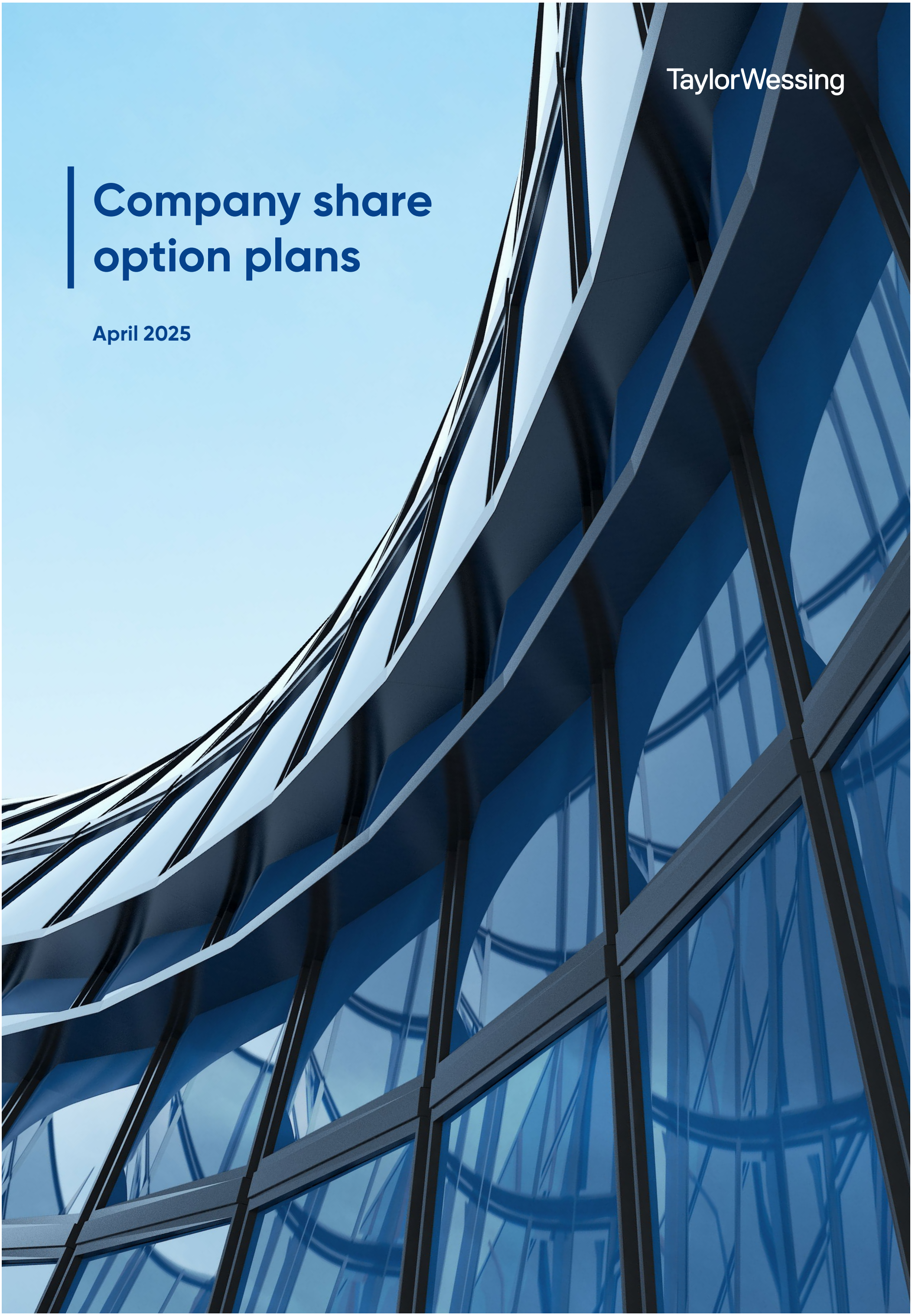
Company share option plans

April 2025



The company share option plan (or CSOP) remains a popular share plan in the UK despite the introduction of Enterprise Management Incentive options (EMI options). A CSOP can provide significant tax benefits to both employees and employers and is often used by companies who do not qualify for EMI options.

Changes were made to CSOPs in April 2023 that increased the individual CSOP limit from £30,000 to £60,000 and removed share class restrictions that have prevented many companies with multiple share classes from operating a CSOP.

This brief guide provides background information for companies seeking to introduce equity incentives for their employees in the form of options and who are looking to take full advantage of the tax benefits available to them, focussing on the CSOP and comparing this with EMI options. If you would like further information, please contact a member of the team.

How does a CSOP work?

A CSOP is a discretionary share option plan. This means that offers to participate do not have to be made to all employees and the value of awards can vary between individuals.

CSOP options can be used to incentivise directors and employees to grow the company, by giving them the right to buy shares in the future if they pay a price equal to the market value of the shares at the outset.

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What are the key requirements?

- **Eligibility**: CSOP options can only be granted to full-time directors and qualifying employees. They cannot be granted to non-employee consultants. Individuals are not eligible to participate if they hold a material interest in a relevant close company, defined as an interest of more than 30%.
- **Exercise price:** The price payable to buy the shares on exercise must not be manifestly less than the market value of the shares of the same class at grant (or such earlier time as may be agreed with HMRC).
- **Individual limit:** The aggregate market value of shares under all CSOP options held by an employee (normally calculated at grant) must not exceed the individual limit. The individual limit is £60,000 with effect from 6 April 2023 (double the previous limit).
- **Aggregate limit with EMI:** If an EMI plan is also operated, the market value for CSOP purposes also counts towards the EMI individual limit. Once an individual has been granted EMI and/or CSOP options over shares with an aggregate market value of £250,000, no further EMI or CSOP options can be granted to that employee.
- **Share capital and control:** The shares used for the options must form part of the ordinary share capital of the company. That company must not be under the control of another company unless it is listed on a recognised stock exchange or subject to an employee-ownership trust.
- **Share class restrictions:** The share class restrictions were removed with effect from 6 April 2023. Previously, for companies with more than one class of share, the majority of the shares of the class used for a CSOP would need to be either 'employee-control shares' or 'open market shares'. Broadly speaking, a company's shares are 'employee-control shares' if they are held by employees or directors who together control the company. The shares are 'open market shares' if they were not acquired as a result of a right or opportunity as directors or employees (unless it was as a

result of an offer to the public), or by trustees on behalf of any such persons.

The above summarises the key requirements only. A number of other requirements apply in relation to the establishment and operation of a CSOP.

The change to the individual limit and the removal of the share class restrictions provides a fresh opportunity for companies to consider CSOP options as of April 2023.

The changes will be of particular interest to growth companies who do not qualify for EMI. This includes those who have outgrown the EMI employee limit and gross assets test, but are currently prevented from operating a CSOP because of the share class restrictions (including venture-capital backed companies and others with multiple share classes).

What are the tax benefits of a CSOP?

CSOP options can benefit from significant income tax and National Insurance Contributions (NICs) breaks, both for the company and the director or employee, provided the plan has been registered with HMRC and meets certain requirements.

Tax on grant of the options

No income tax is payable on the grant of an option, provided the exercise price is equal to the market value of the underlying shares on the date of grant.

Tax on exercise of the options

No income tax or NICs (employee or employer) are payable on the exercise of an option provided that:

- the plan continues to comply with all legislative requirements; and
- the option is exercised on or after the third anniversary of grant and no later than the 10th anniversary of grant.

Subject to the various exceptions noted below, if an option is exercised within three years of its date of grant, income tax will be payable on the difference between the exercise price and the market value of the shares at the date of exercise.

NICs (both employee's and employer's) will also be payable if the shares qualify as readily convertible assets. The income tax and NICs will often be payable through the PAYE system (but, where NICs are not payable, it will be paid by the employee through self-assessment).

Subject to the plan rules, the exercise of options before the third anniversary of grant may also be free of income tax (and any NICs) on leaving employment in certain circumstances.

Those circumstances include exercise within six months of leaving due to injury, disability, redundancy, retirement, sale of the employing company or TUPE transfer of a business out of the group; or exercise by personal representatives up to 12 months after death. Exercise in connection with certain cash takeovers and similar corporate events will also be free of income tax (and any NICs).

Tax on sale of the shares

Capital gains tax is normally payable when shares acquired on an option exercise are subsequently disposed of, subject to any available reliefs and tax-free allowance. For CSOP options exercised free of income tax, the taxable gain would be based on the difference between the exercise price and the market value of the shares at the date of disposal.

Where income tax was payable on the exercise of an option, capital gains tax is payable on the increase in the market value of the shares between the date of the exercise and the date of disposal.

How do CSOP and EMI options compare?

EMI plans are targeted at small trading companies, with gross assets of £30m or less and fewer than 250 employees, amongst other qualifying conditions. Companies who are larger than this, or who otherwise do not qualify for EMI, for example due to undertaking excluded financial services activities, will need to consider other types of incentive arrangement to incentivise and reward their people, including CSOPs.

The table below highlights some of the similarities and differences between CSOP and EMI options. Generally speaking, once a company qualifies for EMI it is more flexible than a CSOP.

	CSOP	EMI
Discretionary or all employee plan	Discretionary	Discretionary
Exercise price	Must not be manifestly less than the market value of the shares at grant	Can be set at any value (but setting it at or above market value will allow for full tax relief)
Tax treatment of exercise of options granted at a market value exercise price	No income tax or NICs	No income tax or NICs
Minimum period for tax-free exercise	3 years (subject to exceptions)	No minimum holding period
Limit on value of shares that can be held by individual under unexercised options	£60,000	£250,000
Limit on value of shares under options that company can grant	No limit	£3 million

Business asset disposal relief (BADR) is also more readily available for EMI options. Where BADR applies, gains are taxed at a flat rate (currently 14%, but increasing to 18% from 6 April 2026), rather than the usual capital gains tax rates (currently 18% and 24%). Ordinarily for BADR to apply, certain conditions need to be met, including trading, employment and holding period requirements. However, unlike for CSOP options, for EMI options the option period from grant counts towards the two-year holding period requirement and the usual 5% shareholding, voting rights and economic interest requirements for BADR do not need to be met.

EMI options are likely to remain the first choice where companies qualify for that regime, but the recent changes now also position CSOPs as a viable alternative where they previously may not have been.

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Frequently asked questions

Do we need to agree our share value with HMRC?

Unless the company is listed on one of certain stock exchanges, the company must agree a market value for its shares with HMRC before granting options.

Can I make awards subject to performance?

Yes. Conditions can be attached to options to require an employee to attain a certain level of performance before the options can be exercised. Any performance conditions must be objective and must be specified in the terms on grant. They can be subsequently varied, but only in accordance with a mechanism stated when the option is granted and applied in a fair and reasonable way.

What do investors think of CSOPs?

Generally, investors support equity participation by employees, and recognise that these incentives act as a powerful motivational tool and improve performance. However, shareholders do monitor dilution and UK listed companies are expected to follow investor best practice guidelines including the IA Principles of Remuneration in this respect (as well as the requirements of the Listing Rules, Corporate Governance Code and other related guidance).

What are the alternatives to CSOP?

Non tax-advantaged share option plans can be used to make larger awards, or awards structured differently for example conditional awards or forfeitable shares, but do not offer the same favourable tax treatment as a CSOP.

EMI options allow option grants of up to £250,000 but EMI option plans are aimed at smaller companies, as there are limitations on group gross assets and the number of group employees; and companies operating an EMI option plan must operate a 'qualifying trade'. Some companies may use growth shares as an alternative, but this involves the ownership of a separate class of shares rather than an option.

Other available UK tax-advantaged share plans are: the savings-related share option plan, which allows discounted option grants linked to a savings contract; and the share incentive plan, which can be used to award free shares or act as a share purchase plan, with the ability to award matching shares and dividend shares.

The savings-related share option plan and share incentive plan are generally used by larger, often listed, companies and must invite participation by all employees (ie the company cannot choose who participates).

What is the procedure for introducing a CSOP?

The Employee Incentives team at Taylor Wessing LLP will help you to design the plan so that it supports your business strategy and allows you to take advantage of the available tax benefits. Once that is done, you will need a set of rules and some supporting documents and we can advise on participation, performance measures, communication and ongoing compliance requirements.

Once the plan rules have been drafted, you will need to register the plan online with HMRC and certify that the plan complies with all legislative requirements, as well as complying with annual reporting requirements.

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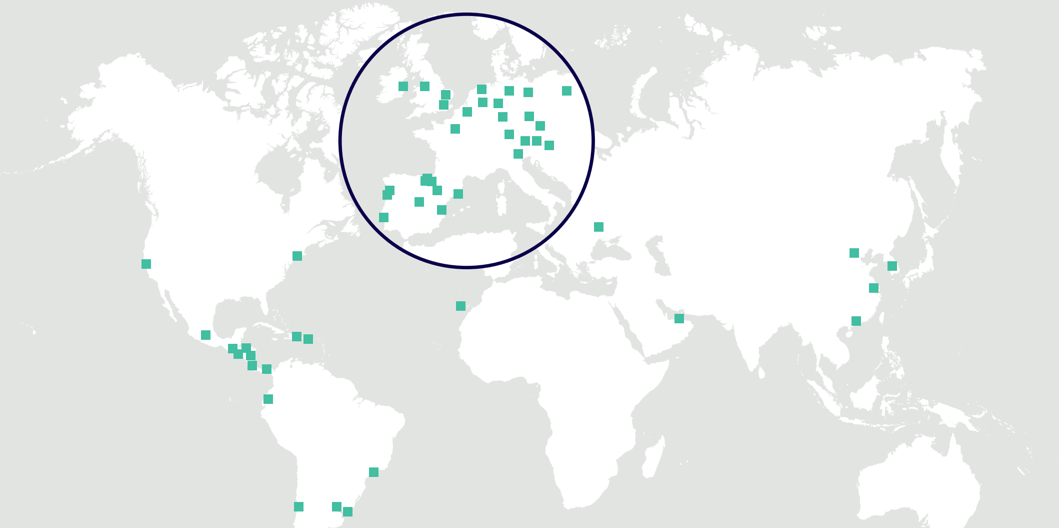

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