Introduction

The **CSOP** is a tax qualified discretionary option plan under which a company may grant options to any employee or full-time director to acquire shares at an exercise price which must be not less than the market value of the shares on the grant date. The exercise is generally tax relieved allowing gains to be taxed as capital on the sale of the shares.

Tax Reliefs

The CSOP tax reliefs are very generous:

- no income tax or social security on grant;
- no income tax or social security on exercise providing certain conditions are met (see below);
- capital gains tax on the sale of the option shares with no minimum holding period;
- the UK employing company will generally qualify for a corporation tax deduction equal to the spread for the accounting period in which the option is exercised (even where participants are relieved from income tax).

The conditions are met if the option is exercised within 10 years of grant and:

- at least three years after the grant date; or
- within six months of cessation of employment for certain "good leaver" reasons (injury, disability, redundancy, retirement or the transfer of the company that employs the participant out of the group or a transfer of employment on the sale of a business out of the group); or
- by the participant’s personal representatives within 12 months of death; or
- within 6 months of certain cash takeovers.

Gains made on the sale of the option shares in excess of the exercise price are subject to capital gains tax ("CGT") (assuming the exercise qualified for tax relief). Individuals benefit from a CGT annual exemption (of £12,000 for 2019/20) and thereafter gains are subject to CGT at the top rate of 20% (or 10% for individuals with income and chargeable gains below the higher rate income tax threshold of £50,000 for 2019/20).¹

If the option exercise does not qualify for tax relief, the spread (i.e. the difference between the market value of the option shares on the date of exercise and the exercise price) is subject to income tax. If the shares are readily convertible assets, PAYE and employers’ and employees’ NIC will apply (the employers NIC can be passed on to option-holders by agreement or election and, if passed on, is deducted from the amount

¹ Gains on residential property and certain carried interests remain at 28% (or 18% for basic rate taxpayers) for disposals or after 5 April 2016.
assessed to income tax). The base cost of the shares for CGT purposes will be the exercise price plus the spread so if the option shares are sold immediately after exercise (as is usually the case) the sale will generally give rise to a no gain/no loss transaction for CGT purposes.

**Flexibility**

There are very few requirements of the CSOP legislation relating to the option terms. The main ones are that the options cannot be transferred (other than to personal representatives), they must lapse within 12 months of death and it must be clear the option is a right to acquire shares (so cannot contain excessive discretion).

The options must be granted using a set of plan rules and an option agreement which comply with the CSOP legislation. The purpose of the plan must be to provide benefits in the form of shares or options and it must not provide benefits otherwise than in accordance with the legislation.

Companies often structure the exercise provisions so as to minimise the chances of the options being exercised in circumstances which give rise to an income tax and NIC liability. So, for example, it is common practice to permit options to be exercised only after three years (or within 6 months of cessation in good leaver situations). Alternatively it is possible to structure the exercise provisions so as to mirror an existing option plan.

CSOP options can be subject to any performance conditions providing these are objective and stated in the option agreement. If CSOP options are being granted in conjunction with non-qualifying options it makes sense to ensure the targets are looked at as a whole and treated as met first in so far as they apply to CSOP options to maximise the benefit of the tax relief.

**Conditions**

In order to qualify for beneficial tax treatment, a CSOP must meet requirements in respect of:

- eligibility of individuals to participate;
- shares which may be subject to option;
- limits; and
- self-certification.

**Eligible Employees**

Options may be granted on a discretionary basis to any employee or any full-time director of the establishing company (or any constituent company in the case of a group plan).

If the establishing company is a close company, participants are ineligible if they (or their associates) have (or have had within the previous 12 months) a "material interest" (broadly 30% of the ordinary share capital or assets) in the company.

**Plan shares**

Plan shares must be fully paid up, non-redeemable, ordinary shares which are:

- in an independent company; or
- listed on a recognised stock exchange (which includes for these purposes the London Stock Exchange, New York Stock Exchange, NASDAQ, the Australian Stock Exchange and Euronext Paris etc., but not AIM).

Plan shares qualify if there is only one class of shares in issue. If there is more than one class in issue, the majority of shares of the same class as plan shares must be either "employee-control" shares or "open market" shares. Shares will be employee control shares if employees and directors (and former employees and former directors) control the company by virtue of holding shares of the same class as plan shares.
Shares will be open market shares if (broadly) the majority of shares of the same class as plan shares are not held by persons who acquired them by reason of their employment or directorships (or by trustees who hold such shares on their behalf).

Since 17 July 2013 plan shares may be subject to any restrictions so, for example, it is possible for unlisted companies to require CSOP option-holders to enter into a power of attorney which allows the attorney to exercise the option and to sell the option shares on their behalf should an exit be achieved.

**Individual Limit and Exercise Price**

The maximum value of shares over which a participant may hold subsisting CSOP options is £30,000. The limit is calculated using the market value of the shares on the grant date.

The relatively low individual limit makes CSOPs attractive for companies that wish to make small awards to a large number of participants but companies that wish to do the opposite should consider alternatives to CSOPs such as joint share ownership arrangements and growth shares. Separate fact sheets are available for these (see below).

CSOP options must be granted at an exercise price which is not less than the market value of the shares on the grant date.

If the shares are listed on the London or New York Stock Exchanges HMRC accept the market value will be the mid-market closing price on the grant date. If the shares are not listed on either of these exchanges the market value must be agreed with HMRC before options are granted.

**Self-Certification**

On 5 April 2014 the previous system of applying to HMRC for formal approval of the plan was removed and replaced with a self-certification procedure. This has made CSOPs much easier and quicker to establish.

CSOPs now only need to be registered with HMRC on or before 6 July following the tax year in which options are first granted (i.e. on or before 6 July 2018 for options granted in 2017/18). When the plan is first registered the company must declare the CSOP meets the conditions of Schedule 4 ITEPA 2003. If the declaration is made after the options have been granted, the declaration must confirm the conditions were met at the time of grant.

**CSOPs in Practice**

There are broadly three types of companies that use CSOPs namely:

- UK listed companies;
- US companies extending plans to the UK; and
- UK private companies.

**UK Listed Companies**

Most listed companies operate executive option plans which can be made more attractive by structuring so the first £30,000 worth of shares under option qualify as CSOP options. A separate fact sheet is available on executive option plans for listed companies.

Those companies that operate all-employee plans should consider introducing a CSOP as an alternative (particularly to save as you earn plans). CSOPs allow employees to benefit from future growth at no cash cost until the option is exercised so can be granted to lower paid employees with no need for the employee to save from monthly salary.
US Companies Extending Plans to the UK

US companies typically wish to grant options to UK employees at the same time as other option grants to US employees and at the same fair value strike price. It is possible to draft a sub-plan of the US plan so it qualifies for tax relief as a CSOP and to grant options to UK employees within the £30,000 individual limit as CSOP options. Options granted in excess of the individual limit can continue to be granted under the main US plan as non-qualifying options.

For unlisted companies, the market value of the option shares should be agreed with HMRC in advance of grant (which can usually be agreed by submitting the most recent section 409A valuation to HMRC).

US companies that satisfy the conditions for enterprise management incentives should grant options as EMI options rather than CSOPs as the tax reliefs are more generous. A separate fact sheet on EMI is available.

UK Private Companies

UK private companies that do not satisfy the EMI conditions may wish to consider granting options so as to qualify as CSOP options. It has to be said there are tax efficient alternatives such as joint share ownership arrangements and growth shares which should be considered in addition to CSOPs.

Warning

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This paper is based on the law of the United Kingdom as at 11 July 2019.

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Other Fact Sheets Available:

- Growth Shares
- Discretionary Share Option Plans
- Employee Share Markets
- Entrepreneurs' Relief
- Enterprise Management Incentive Plans
- IR35: Upcoming reform in 2020
- Long Term Incentive Plans and Deferred Bonus Plans
- Share Incentive Plans

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