United Kingdom

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Red-flag issues

1. Prospectus requirements for non-EU issuers.

2. New 'disguised remuneration' rules where shares are provided from an employee benefit trust.

1. Securities laws

1.1 What prospectus and/or securities law requirements arise in connection with the grant, vesting or exercise of a long-term incentive award or on the eventual sale of the shares by the executive?

The United Kingdom is subject to the provisions of the EU Prospectus Directive (2003/71/EC), which provides rules for the publication of a prospectus when securities are offered to the public. The UK provisions implementing the Prospectus Directive are contained in the Prospectus Rules issued by the UK Listing Authority of the Financial Services Authority (FSA), and also in Part VI of the Financial Services and Markets Act 2000 (as amended).

The Financial Services and Markets Act 2000 provides that a prospectus must be issued whenever transferable securities are offered to the public, or a request for the admission of securities to a regulated public market is made.

In relation to employee share plans, the FSA has provided guidance on what constitutes a 'transferable security' for the purpose of the Prospectus Rules. The FSA does not consider that options granted to employees, provided that those options are non-transferable, fall within the provisions of the Prospectus Rules, either at the time of the option grant or when that option is exercised and the underlying securities are acquired. This is because the option is not a transferable security itself and, on exercise, there is no offer to the public, but rather the fulfilment of a contractual entitlement. The Prospectus Rules will not, therefore, apply to share option grants.

The definition of an 'offer to the public' is set out within the legislation as being any communication giving sufficient information to enable an investor to decide to 'buy or subscribe' for securities. The FSA has confirmed that it does not consider offers of shares to employees for nil consideration (ie, free shares) to fall within this definition, as there will be no purchase or subscription for those shares. The Prospectus Rules will not, therefore, apply to free share awards.

Offers to employees to subscribe for or purchase shares will, however, fall within the Prospectus Rules and will require a prospectus to be published, unless one of the relevant exemptions applies. A short-form prospectus may be produced in relation to employee offers by issuers with securities admitted to trading on a market which requires ongoing financial information publication.

Where a prospectus has been produced and approved in another EU jurisdiction in respect of the offer, an application can be made to the FSA to use that prospectus in the United Kingdom for the offer being made, without the need to produce and file a separate prospectus. This procedure is referred to as 'passporting'.

1.2 Is there an exemption from securities laws requirements either because the shares are being offered only to executives or because shares are being offered to a distinct group of named individuals?

There are a number of exemptions which may apply where an offer does not fall outside the requirement to produce a prospectus. The exemptions which are most likely to be used in connection with employee share plans are:

- offers to fewer than 100 persons in each EU jurisdiction. Under Directive 2010/73/EU, this limit is due to be increased to 150 persons once UK implementing rules have been adopted;
- securities included in an offer where the total consideration of the offer is less than the equivalent of €2.5 million (€5 million once UK implementing rules have been adopted) when aggregated with the consideration for all other offers of the same securities made by the offeror throughout the European Economic Area (EEA) within the preceding 12 months; and
- offers to existing or former directors and employees of transferable securities which are already admitted to trading on a recognised EU market, provided that a document is made available containing information on the number and nature of the securities offered, and the reasons for, and details of, the offer. This exemption is to be extended, subject to UK implementing rules being adopted, to cover all companies with their head office or registered office in the European Union (or, as a result of the EEA Agreement, in a non-EU member state of the EEA), or which have securities traded on a regulated market in the EEA or on a market which the European Commission has confirmed has a sufficient legal and supervisory framework for it to be equivalent to an EEA regulated market.

It is important to note, in relation to the exemption for offers to directors and employees, that this is not currently available to unlisted companies or to companies which do not have a listing (whether primary or secondary) on an EU market, but may be once the Directive 2010/73/EU amendments have been approved. It is therefore important for non-EU issuers to consider whether the Prospectus Rules will apply to them and whether there are other exemptions available on which they may rely.

1.3 If there is an exemption, will the exemption apply automatically or are there any applications/filings that need to be made?

Where an exemption from the need to produce a prospectus applies, there will be no requirement to make any application or filing to the FSA. Generally, exemptions will apply automatically without the need for the issuer to produce any documentation.

The exception to this rule is in relation to the exemption for offers to directors and employees. For this exemption to apply, the issuer must produce a document which sets out specific information in relation to the offer. The details for the content of the document are set out both in the Prospectus Rules and also in guidance issued by the Committee of European Securities Regulators (CESR), now the European Securities and Markets Authority (ESMA). The Prospectus Rules provide that the document must contain details of the number and nature of the securities available and the reasons for, and details of, the offer. In addition, the CESR/ESMA guidance provides that the document should also set out the identification of the issuer and details of where further information can be found (and generally this will be a reference to the company's website).

Where a company produces an employee guide in connection with the offer, it is likely that this guide will suffice as a 'document' for the purposes of the Prospectus Rules.

2. Employee tax and social security

2.1 When will the executive be liable to tax or social security (and at what rate) in respect of the long-term incentive award?

(a) Share options

In relation to share options (including market value, discounted and nil-cost options), there is no charge to tax at the time that the option is granted provided that the employee is resident and ordinarily resident in the United Kingdom at the time of the grant (and, for options granted from April 6 2008, this tax treatment is also extended to employees who are resident but not ordinarily resident at grant). Neither is there a tax charge when the option becomes exercisable (ie, at vesting). At the time that the option is actually exercised and the employee acquires the shares, the value of the shares acquired, less the amount of the price paid (if any), will be a taxable benefit and will be subject to income tax and national insurance ((NI), social security) contributions.

For options granted prior to April 6 2008, if the employee was resident but not ordinarily resident in the United Kingdom at the time of grant, then there would have been no tax at grant provided that the option was granted with an exercise price at least equal to the market value of the shares at that time. Any discount to market value would, however, have been treated as a benefit and subject to income tax and NI contributions. On the exercise of such an option, the employee will be treated as acquiring shares at an undervalue, and any difference between the market value of the shares and the price paid (plus any amount which has already been subject to income tax at grant) will be treated as a notional loan until the shares are sold. Each year, or part year, that the shares are held, deemed interest on this notional loan (currently, 4%) is treated as a benefit and is subject to income tax for the employee, but not NI contributions (although employer NI is due – see below).

When the shares are sold, this is treated as a write-off of the notional loan, and this benefit is subject to income tax and NI contributions.

(b) Free shares – conditional allocations

There is no charge to tax at the time that the conditional allocation is granted to the employee, as the employee has only an unsecured promise to the shares. When the shares are transferred to the employee, the value of the shares received will be a taxable benefit and will be subject to income tax and NI contributions.

(c) Free shares – restricted securities

Where an employee acquires shares which are subject to a forfeiture provision which lasts for no longer than five years from the date on which the shares were acquired, the default position for an employee who is resident and ordinarily resident in the United Kingdom is that there is no charge to tax at this time (and, for restricted securities acquired from April 6 2008, this tax treatment is also extended to employees who are resident but not ordinarily resident at acquisition). At the stage that the forfeiture provision is lifted (or falls away), the value of the shares received will be a taxable benefit and will be subject to income tax and NI contributions. Shares will be subject to forfeiture provisions if the terms on which they are acquired provide that they must be cancelled or transferred for less than market value if certain conditions have not been met within a specified period.

For restricted shares acquired prior to April 6 2008, if the employee was resident, but not ordinarily resident, in the United Kingdom at the time that the shares were acquired, then the value of the shares at that time would have been treated as a benefit and subject to income tax and NI contributions. There will, however, be no additional income tax or NI at the time that the forfeiture provision is lifted (or falls away).

(d) Tax rates

Where income tax arises, this will be due at the employee's marginal rate of income tax (where, for the tax year April 6 2011 to April 5 2012, the income tax rates are 20% for a basic rate taxpayer, 40% for a higher rate taxpayer and 50% for an additional rate taxpayer).

NI contributions are due at 12% on annual earnings of up to £42,475 (for the tax year April 6 2011 to April 5 2012) and at 2% thereafter.

NI contributions will not apply in the above circumstances if the shares which are acquired are not 'readily convertible assets', essentially where there are no trading arrangements (eg, a listing on a stock market, or an employee benefit trust willing to purchase the shares) in place which would allow the employee to realise the value of the shares at that time. Shares will, however, be deemed to be 'readily convertible assets' where they do not meet the qualifying conditions for a statutory corporation tax deduction (see below).

2.2 How will the executive's tax and social security be collected? Will the executive be responsible for paying any liabilities himself or will the executive's employer be responsible for paying tax or social security liabilities on the executive's behalf?

Where both income tax and NI arise, these amounts must be accounted for to HM Revenue & Customs by the employing company under the PAYE (Pay As You Earn) system within 14 days following the end of the tax month in which the liability arises. This amount will then need to be reimbursed by the employee to his employer within 90 days of the tax liability arising. If the employee has not made this reimbursement, the outstanding amount will be treated as a benefit and will be subject to an additional charge to income tax and NI.

Where PAYE is due, the employer is liable for this amount to HM Revenue & Customs, who may only seek direct payment from the employee in certain specified circumstances (eg, where the employee is aware that PAYE has been operated incorrectly).

Where income tax arises but NI does not (eg, in respect of the notional loan charge referred to above for certain options exercised by employees who are not ordinarily resident in the United Kingdom, or where the shares acquired are not 'readily convertible assets'), the income tax is accounted for by the individual completing a self-assessment return. Where income tax is to be accounted for under self-assessment, the return (along with the payment of the tax) must be submitted by January 31 in the year following the end of the tax year in which the liability arises.

2.3 If the employer is responsible for the executive's liabilities, can the employer withhold the liabilities from the executive's salary? Are there any formalities in this respect?

The statutory rights to deduct PAYE amounts from an employee's salary are strictly limited. Generally, it is only possible to recover PAYE amounts from payments made to an employee in the same tax month. However, by agreement, the employee can allow deductions to be made either from salary in future months (but note the penal tax charge where reimbursement is not received within 90 days), or he can make alternative arrangements for the recovery of the PAYE. Where an employer makes a payment in respect of PAYE on behalf of an employee, the employer has a legal right in restitution to such reimbursement and may bring a claim for such recovery (although in most cases this will not be necessary as the employee will have agreed to make arrangements for reimbursement).

2.4 If the executive's salary in the month of exercise/release is not sufficient for the employer to withhold all of the liabilities, can the employer (or the parent company, if different) arrange for the executive to authorise to sell some of the executive's shares in the market and pass the money to the executive's employer?

Although not a statutory right, plan rules should provide that on the exercise of an option, or on the transfer of shares, the employer or parent company of the employer can arrange for sufficient shares to be withheld and sold on behalf of the employee in order to reimburse the employer for the PAYE amount. Alternatively, the employee can agree with the employer that this withholding is made. Generally, the employer will instruct a broker to sell sufficient shares to cover the PAYE and will retain the proceeds of such sale.

2.5 Will the executive pay tax on the eventual sale of his shares and if so at what rate?

On a sale of the shares acquired by the employee, capital gains tax may be due on the difference between the sale price and the purchase price paid for the shares (plus any amount on which income tax has already been paid). Any gains made may be reduced by the employee's annual exemption. Individuals are allowed to make £10,600 of capital gains per year (for the tax year April 6 2011 to April 5 2012) before becoming subject to capital gains tax. Any gain above this amount will be subject to capital gains tax at 18% for basic rate taxpayers and at 28% for higher and additional rate taxpayers.

No NI contributions are payable on capital gains.

Employees or directors who hold at least 5% of the shares (and 5% of the voting rights) in their employer will be able to take advantage of a relief in respect of their first £10 million of lifetime chargeable gains on such shares, which will result in their paying capital gains tax at the rate of 10%. This relief is known as 'entrepreneurs' relief'.

3. Employer's social security

3.1 Is the employer liable to pay (on its own account) any employer's social security in connection with the long-term incentive award?

The rate of employer's NI is currently 13.8% and applies generally whenever income tax and NI is collected via PAYE.

In relation to the notional loan which arises, on the exercise of an option granted prior to April 6 2008, by employees who were not ordinarily resident in the United Kingdom at the time of the option grant, although NI is not payable by the employee, employer's NI is due on this amount.

3.2 Can the liability of the employer be put onto the employee? What steps are required?

In certain circumstances a transfer of employer's NI to the employee is possible. In the context of options and free shares, these circumstances are limited to the exercise of a share option and the award of restricted (forfeitable) securities. Where the liability is passed to the employee, the employee will receive a deduction against income tax for the amount of the liability for employer's NI.

The Social Security Contributions and Benefits Act 1992 provides for two methods of passing the liability for employer's NI to the employee. The first method is for the employee to agree with his employer that the liability is to be transferred. In this case, the liability to HM Revenue & Customs for the employer's NI remains with the employer, although the employer has a contractual right to recover this amount from the employee. The second method is a more formal approach and requires the employee and employer to enter into an 'election' in a form which has been approved by HM Revenue & Customs. By entering into the election, the liability to HM Revenue & Customs for the employer's NI is formally transferred from the employer to the employee. The benefit of this is that the employer is no longer