

Company Share Option Plans ("CSOP")

June 2024

Introduction

The CSOP is a tax-advantaged discretionary share option plan, under which a company may grant options to any UK employee or full-time director, to acquire shares at an exercise price which must not be less than the "unrestricted market value" of the underlying shares on the grant date. The exercise is generally tax relieved allowing gains to be **taxed as capital** on the sale of the options' shares at a fixed rate of **20%**.

Tax Reliefs

The CSOP tax reliefs are very generous. Broadly, there is:

- 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 ("**CGT**") 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 gain that the optionholder has made for the accounting period in which the option is exercised (even where participants are relieved from income tax) and also for the plan's set up costs.

The conditions are generally 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 specified "**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 the optionholder dying; or
- within six months of certain takeovers.

Gains made on the sale of the option shares in excess of the exercise price are subject to CGT (assuming the exercise qualified for tax relief). Individuals benefit from a CGT annual exemption (of £3,000 for 2024/25), 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 £50,271 for 2024/25).

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 ("**RCAs**"), pay as you earn ("**PAYE**") and social security will apply (employer's social security can be passed on to optionholders by agreement or election and, if passed on, is deducted

from the amount assessed to income tax). Shares will be RCAs if, broadly, arrangements are in place (or are about to be put in place) to create a market in the shares, or certain deeming provisions apply.

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 an optionholder dying, and it must be clear that the option is a right to acquire shares (so the terms cannot contain excessive discretion).

However, companies often structure the exercise provisions so as to minimize the chances of the options being exercised in circumstances which give rise to an income tax and social security liability. So, for example, it is common practice to permit options to be exercised only after three years (or within six months of cessation in good leaver situations). In addition, there are a number of potential pitfalls in the HM Revenue & Customs ("**HMRC**") guidance for CSOP options, and so legal advice should always be sought.

CSOP options can be granted subject to any time-vesting and/or 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.

The options must be granted using a set of plan rules and a grant document which comply with the CSOP legislation. The purpose of the plan must be to provide benefits in the form of share options, and it must not provide benefits otherwise than in accordance with the legislation.

Conditions

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

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

Individual Limit and Exercise Plans

The maximum value of shares over which a participant may hold subsisting CSOP options was increased from £30,000 to £60,000 on 6 April 2023. The limit is calculated using the unrestricted market value of the shares on the grant date, and can make CSOP seem like a poor relation to Enterprise Management Incentive ("**EMI**") options. However, the restrictions on the type of shares which can be used for CSOP were also removed on the same date, making it possible for the £60,000 limit 'go further' by granting CSOP options over a highly geared class of shares commonly known as "growth shares" (see below).

Prior to 5 April 2023, the relatively low individual limit of £30,000 and the restrictions on the share classes which could be used meant that, generally speaking, CSOPs were only attractive for companies that wished to make small awards to large numbers of participants. Companies that wished to make large awards to key

participants had to consider alternatives to CSOPs, such as joint share ownership arrangements and growth shares. Separate fact sheets are available for these (see below).

Unlisted companies that can amend their articles to create a new class of growth shares (or who already have growth shares) should now consider granting CSOP options over these shares, as the increased limit of £60,000 and the relatively low value of growth shares means they may now be able to make relatively large CSOP awards to key employees.

CSOP options must be granted at an exercise price which is not less than the unrestricted 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 as the mid-market closing price on the grant date. If the shares are not listed on either of these stock exchanges, we strongly advise that the market value is agreed with HMRC before options are granted.

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).
- note that "ordinary shares" has a specific meaning for these purposes, and so generally shares without a fixed return should meet the requirements.

Prior to 5 April 2023, if the issuing company had more than one class of shares the plan shares had to be either "**employee-control**" shares or "**open market**" shares. Shares were employee-control shares if employees and directors (and former employees and former directors) controlled the company by virtue of holding shares of the same class as plan shares. Shares were open market shares if (broadly) the majority of shares of the same class as plan shares were not held by persons who acquired them by reason of their employment or directorships (or by trustees who hold such shares on their behalf).

In a major boost for unlisted companies, these requirements were removed with effect from 5 April 2023. Since then, it has been possible to grant options over a specially created class of "growth shares" which are highly geared and have an initial low value, thereby allowing the increased individual limit of £60,000 to 'go' much further.

Since 17 July 2013, plan shares may be subject to restrictions so, for example, it is possible for unlisted companies to require CSOP optionholders 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.

Self-Certification

On 6 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 2024 for options granted in 2023/24). When the plan is first registered the company must declare the CSOP meets the conditions of Schedule 4 of the Income Tax (Earnings and Pensions) Act 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 used to operate discretionary option plans which could be made more attractive by structuring so that the first £60,000 worth of shares under option qualified as CSOP options. Such tax-advantaged plans fell out of favour with shareholders, who generally prefer those they already consider to be well-paid to pay income tax and social security rather than CGT. A separate fact sheet is available on discretionary option plans for listed companies.

However, 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.

UK 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 £60,000 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 would be well-advised to 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 CSOP options. If they already have growth shares (or are able to amend their articles to create them), CSOPs are now an attractive alternative to the direct issue of growth shares or to JSOPs.

In contrast:

- the UK employing company will obtain a corporation tax deduction for the spread when CSOP options are exercised;
- leavers are easier to deal with if they hold options, as they can simply lapse with no need to buy back the shares or interests in shares;
- participants need pay nothing for the grant of the option and have no risk of a dry tax charge on grant; and
- HMRC will agree valuations for CSOP grants in advance, which can be prepared at far lower cost than a professional valuation and should provide greater tax certainty.

Some caution is required, however, as participants risk an income tax charge if they exercise their options within three years in circumstances which do not qualify for tax relief. If CSOP options are granted over growth shares, a lot depends on HMRC agreeing a low initial value for the shares. If a low enough value cannot be agreed, it may be necessary to top up the awards by the direct issue of growth shares.

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Warning

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