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Discretion in tax-advantaged share plans

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Which plans and why?

- SIP and Sharesave Schemes
 - Sharesave has some, but limited, flexibility in relation to design, but cannot include discretion.
 - SIP can be operated much more flexibly via the free/partnership share agreement, but cannot include discretion.
- CSOPs and EMI options
 - Discretionary in nature.
 - Broader spectrum of companies operating these arrangements.
 - Requirement for greater flexibility in operating the plans.

Examples of discretion

“Good Leaver” ...
(e) any other reason at the discretion of the Board.

The Board may, at its discretion, and notwithstanding any other provision of the Plan, allow the exercise of an Option at such time as the Board determines and to the extent specified by the Board.

If there has been a Disqualifying Event, the Committee may, at its discretion, determine that an Option may be exercised during the period of 90 days following such Disqualifying Event.

...vary the performance conditions if events happen

The Board may, in its absolute discretion, decide to vary the Vesting Dates....

The Board, in its absolute discretion, may permit Unvested Options to Vest immediately before a Sale to the extent specified by the Board.

HMRC's general approach to discretion

- Current HMRC guidance on discretion requires:
 - There must be a clearly stated right without the application of discretion.
 - The application of discretion should only improve the existing rights.
 - The discretion must be applied on a fair and reasonable basis.
- The option must provide the optionholder with a legally enforceable “right to acquire shares” which means that the documentation must provide for the fundamental terms of the option to be clearly stated at the time it is granted, including:
 - Details of the shares under option that the optionholder has a right to acquire (i.e. the number of shares and specified class).
 - The price at which the option can be exercised.
 - The time when the option is exercisable.

Eurocopy, Reed International and Burton

Inland Revenue Commissioners v Eurocopy Plc [1991] S.T.C. 707

- Whether the approved status of options could be retained if the exercise provisions of the options were altered from between 9 and 10 years after grant to between 6 and 10 years after grant.
- Held that existing optionholders obtained new rights at that the point of alteration that they did not hold before the alteration.
- In effect, the alteration was treated as a new grant.

Eurocopy, Reed International and Burton

Inland Revenue Commissioners v Reed International Plc [1995] S.T.C. 889

- Whether the removal of an exercise and lapse trigger should be considered an amendment to an existing right or the creation of new or different rights.
- Reed proposed to remove a right of exercise on a merger which would also have had the effect of triggering the lapse of the option to the extent unexercised six months later.
- Held that no new right obtained but only a variation to rights that the optionholder previously had.
- A very minor improvement in existing rights does not give rise to the optionholder obtaining a new or different right; although the Court of Appeal acknowledged that the question of what constitutes a *de minimis* improvement is a matter of degree.

Eurocopy, Reed International and Burton

Inland Revenue Commissioners v Burton Group plc 63 TC 191

- Whether an amendment could be made to an approved scheme in relation to the setting and varying of performance conditions after grant, or whether this would lead to option terms not being sufficiently clearly stated such as to constitute a “right to acquire shares”.
- Held that the proposed amendments could be made as they set out a mechanism which would be included as a term of the option under which additional conditions could only be imposed or varied in certain clearly stated specified circumstances.
- The directors cannot have unlimited discretion. Any alteration or variation at a later date would need to be done in good faith and in order to ensure the effectiveness of the scheme.

Where does this leave HMRC?

1. There must be a clearly stated right without the application of discretion.
2. The option terms need to include details of any discretion which may be exercised, discretion cannot be added in later unless de minimis.
3. It is possible to vary the terms which determine the extent to which an option may become exercisable (i.e. vesting/performance conditions) provided that the time at which the option becomes exercisable does not change.
4. The time when the option may be exercised cannot be changed unless exercise is permitted under a discretion linked to clearly stated specified circumstances.
5. The application of discretion should only improve the existing rights.
6. HMRC not generally concerned with amendments to performance conditions – amendments will usually be beneficial to participants.

Absolute discretion

The Board may, at its discretion allow the exercise of an Option at such time as the Board determines and to the extent specified by the Board.

- Would not be permitted in CSOP rules.
- If this were the only exercise right in an EMI option then Sch 5 para 37(2)(e) would not be met as the option terms would not state “when and how the option may be exercised”.
- HMRC accept that such a discretion can be included in the terms of an EMI option to supplement other exercise rights without disqualifying the option ab initio.
- The exercise of that discretion would, however, not be linked to specified circumstances and would create a new right of exercise.
- Any exercise based on this discretion would, therefore, be taxable.

Changing the vesting schedule

The option shall vest in 36 equal monthly instalments, provided that the Board may accelerate the vesting of the option at its discretion.

- Changing the proportion of an option that is treated as “vested” will not change any of the fundamental features of the option if it does not change the time for exercise.
- If an option is exercisable immediately on vesting, this will, however, change the time for exercise and will be treated as a fundamental change...
- unless the exercise of discretion is linked to a clearly specified event (such as leaving employment or an exit event).

The option may be exercised by a Good Leaver within 6 months following the Date of Cessation to the extent Vested or to such greater extent as the Board may at its discretion determine.

Leavers

...any other reason at the discretion of the Board.

- Accepted by HMRC as a permitted discretion because:
 - the discretion is included in the terms of the option;
 - the discretion provides an improvement for the optionholder; and
 - the exercise of discretion is linked to a clearly specified event – i.e. the cessation of employment.
- Cannot use a general discretion in connection with leavers in order to achieve the same result if the leaver provisions are not included in the terms of the option.
- Note the special CSOP pitfall on leavers!

Performance conditions

The option may be exercised from the third anniversary of grant to the extent that Y3 EBITDA \geq £3m. The Board may vary or waive the performance condition at its discretion if it considers this appropriate.

- HMRC now seem to accept that performance conditions can be adjusted or even waived as these are vesting conditions, rather than fundamental terms of the option.
- Query whether the amendment of a performance condition needs to be linked to “when events happen” (per CSOP guidance)?
- Provided that the time that the option may be exercised is not affected by the variation then this seems to be acceptable, at least for EMI.
- But what if the option would have lapsed because the performance condition had not been met?

In summary...

- HMRC are receiving a significant number of queries from companies wishing to exercise discretion, and we hope that further formal guidance will be produced shortly.
- When drafting option arrangements, it is prudent to ensure that discretion is always linked to specified circumstances.
- If in doubt, repeat the discretions that can be exercised in each circumstance.

An Option may be exercised by a Good Leaver within 6 months following the Date of Cessation (or such longer period as the Board may determine): (1) to the extent Vested or to such greater extent as the Board may at its discretion determine; and (2) to the extent that the performance conditions have been met, unless varied or waived at the discretion of the Board. Whether an employee who ceases to hold office or employment is to be considered a “Good Leaver” shall be determined by the Board in its absolute discretion.

Disclaimer

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