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Discretion in tax-advantaged EMI share options

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Background

- EMI options (and CSOP options)
 - Discretionary in nature.
 - Broad spectrum of companies operating these arrangements.
 - Requirement for greater flexibility in operating the plans.
- HMRC guidance developed in the context of Approved Executive and CSOP options extended to EMIs
- HMRC tried to reconcile various cases on variations to options, with some inconsistency of approach
- Soundings from industry bodies taken in early 2022 and revised guidance published in the Employee Tax Advantaged Share Scheme User Manual (ETASSUM54300) in October 2022
- HMRC's announcement stated that the "updated guidance does not constitute a change in HMRC's position"
- CSOP guidance has not been rewritten, but similar principles should apply

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.

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

...vary or waive the performance conditions if events happen

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

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.

HMRC's approach to discretion

- HMRC guidance on discretion prior to the EMI updates (still applying to CSOPs) required:
 - 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 revised EMI guidance highlights that there are three “fundamental terms” to an option, making it a legally enforceable “right to acquire shares”.
- The option terms may also include “other conditions” which affect the optionholder’s entitlement, such as performance conditions.

Fundamental terms of the option

- The fundamental terms must be clearly stated at the time the option is granted. They form three of the five terms that must be included in the EMI option agreement under para 37(2) Sch 5:
 - The number of shares that the optionholder has a right to acquire (which should also include details of the class being available to acquire).
 - The price at which the option can be exercised.
 - The time at which the option becomes exercisable

Fundamental terms of the option

- Any amendment to one of the fundamental terms of an option will result in a release and re-grant of the option, unless the amendment is minor.
- The consequences of a release and re-grant include that the option will likely become discounted, the qualifying conditions must continue to be met and the EMI limits must be complied with.
- These will likely result in the option being fully taxable on exercise.

Key principles of discretion

- Exercise of a discretion to accelerate the vesting or to vary or waive a performance condition will generally be acceptable provided that the option agreement specifies in clear terms the circumstances in which this discretion can be exercised (i.e. the “mechanism” for varying the option).
- Absent exercise of discretion, the option terms should be clear as to the circumstances in which (i.e. when) the option will be capable of exercise. The exercise of discretion cannot bring forward the time for exercise otherwise specified in the option terms.
- HMRC will not generally be concerned with varying or waiving performance conditions provided this is done on a “fair and reasonable” basis. This is stated to be “consistent with the Burton Group decision”.

Key principles of discretion

- Options cannot be granted on the basis that the timing of exercise is entirely discretionary. Whilst a discretion to allow exercise in any other circumstances can be included, the exercise of that discretion would change the time for exercise and would result in a “regrant”.
- The terms of an option cannot be amended after grant to include a new right of exercise (or discretion to allow exercise) that did not feature in the original terms. That amendment would change the time for exercise and would result in a “regrant” unless the change can be viewed as no more than de minimis.
- EMI guidance does not refer to whether the exercise of discretion / variation to terms must improve the rights of the participant, but CSOP guidance refers to this possibility where “objective machinery” is included to add conditions, subject to the fair and reasonable override.
- Any dispute as to the operation of the provisions would be a matter of contract, and HMRC would not get involved.

Option agreement terms in summary

1. There must be a clearly stated right of exercise over a specified number of shares at a specified price, without the application of discretion. (NB “specified” effectively means maximum, with any formula which reduces the benefit to the option holder being an “other condition”)
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. Ordinarily, discretion should only improve the existing rights.

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 affecting the qualifying status of the option.
- 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, likely be fully 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.

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.

- Changing the proportion of an option that is treated as “vested” will not change any of the fundamental terms 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).

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; and
 - the exercise of discretion is linked to a clearly specified event – i.e. the cessation of employment.
- The discretion also provides an improvement for the optionholder.
- 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 (see “Absolute Discretion slide).
- Note the special CSOP pitfall in relation to leavers. Statutory (tax-advantaged) “good leaver” provisions must either be included as automatic rights of exercise or excluded from the discretion.

Performance conditions

The option may be exercised from the third anniversary of grant to the extent that the Performance Condition has been met. The Board may vary or waive the Performance Condition at its discretion if it considers this appropriate.

- HMRC now accept that performance conditions can be adjusted or even waived as these are “other conditions”, rather than “fundamental terms” of the option.
- Seemingly even if the option would have lapsed because the performance condition had not been met.
- No longer a reference to the amendment of a performance condition needing to be linked to “when events happen” (per previous CSOP guidance).
- The time that the option may be exercised must not be affected by the variation.

In summary...

- Discretion to alter the extent to which an option can be exercised is permitted without limitation provided the exercise date is not advanced.
- When drafting option agreements, discretion should always be linked to specified circumstances if it is to accelerate the timing of exercise.
- 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.

“Good Leaver” shall include such other circumstances as the Board may determine in its absolute discretion.

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