An important aspect of corporate growth is attracting employees and maintaining their loyalty. Stock option grants can achieve this goal, but companies must be aware of the diverse legal and tax consequences that arise when granting such options to employees or consultants who work overseas.

The UK’s handling of employee stock options does not always imitate that of the US. When designing or amending a stock option plan to include a UK plan, US companies should consider UK restrictions and the tax, labor and securities law consequences of granting, exercising and selling options or their underlying shares in the UK.

Can options be granted to UK employees to purchase a US company’s stock?
Yes. It is possible to issue options to acquire US stock to a company’s (or group company’s) employees in the UK. However, UK stock option plans (“employee share schemes” or “schemes”) do not always imitate those of the US.

What types of schemes will be available?
In the UK, there are “approved” and “unapproved” schemes. Approved schemes require prior approval from the Inland Revenue (the UK’s version of the IRS). Options granted under approved schemes are similar to Incentive Stock Options. There are a number of UK approved schemes. The most frequently used in the UK are (i) the company share option plan (CSOP) and (ii) the save-as-you-earn (SAYE) scheme. An “unapproved scheme” in the UK is any scheme which is not an approved scheme.

What are the main differences between approved and unapproved schemes?
Approved schemes are not very flexible since they require pre-approval by, and frequent reporting to, the Inland Revenue. Approval can take a few months. While there are tax benefits for employees under approved schemes, such schemes also contain various restrictions which need to be satisfied before a scheme is approved. For example, the option price (i.e. the price at which the employee can purchase the shares) must be the market value at the date of the grant, the market value of shares over which options can be granted is limited to £30,000 per employee and the exercise of options must take place between the third and tenth anniversary of the date of grant. In general, unapproved schemes do not have the same tax benefits as approved schemes, but consequently they will have fewer restrictions. However, high growth start up companies (including US parent companies) whose gross assets do not exceed £30 million can take advantage of enterprise management schemes (EMIs), which have distinct tax benefits despite being unapproved schemes.
How can a US company grant options under a UK scheme?
It is generally possible to grant options in the UK under an existing US-designed plan with few modifications to that plan’s terms and, for UK purposes, the US-designed plan will be an unapproved scheme. The plan itself must still abide by US state and federal securities laws, as well as applicable listing/exchange rules in the case of a publicly-traded company. Depending upon the terms of the US plan, it is also often possible to set up an approved scheme in the UK that is a sub-plan of the US plan.

What is the tax and social security regime of UK schemes?
Employees need to consider UK income tax, national insurance contributions (NICs) and capital gains tax (CGT) in relation to options and the sale of option shares. Income tax is currently levied at the rate of 40 percent for the average executive, while a lower paid employee might be taxed at 22 percent. NICs are similar to US social security contributions and may be triggered by option exercises, as discussed below. CGT is generally levied at the rate of 40 percent subject to various exemptions and reliefs, especially taper relief, which can lead to an effective CGT rate of 10 percent for higher rate tax payers.

What are the tax implications of an unapproved scheme?
Employees are not liable to income tax on the grant of an option (provided that the option is not capable of being exercised more than ten years after the date of grant). There will, however, be an income tax charge at the date of exercise on the market value of the option shares at the date of exercise, less the option price (i.e. the purchase price plus the cost of grant to the employee, if any).

On a sale of the option shares, an employee will incur a CGT liability calculated on any subsequent increase in the value of the shares from the date of exercise until sale. CGT at the rate of 40 percent may be reduced to 10 percent if the option shares are held for more than two years before sale. There is also a small annual personal CGT exemption. It is possible that an income tax charge will also arise on some of the sale proceeds from the option shares if they are restricted shares (equivalent to restricted stock).

What are the tax implications of an approved scheme?
Provided the exercise price of an EMI option is the same as the market value of the shares at the date of grant (which is normally the case), there is no income tax charge on the exercise of the option. The major advantage of an EMI scheme is that the employee will benefit from very favorable CGT treatment on a sale of the option shares because taper relief starts from the date of grant of the option rather than the date the employee acquires the shares (as per all other types of option scheme, either approved or unapproved).

Are there any other employment tax or social security contribution issues?
Both employees and employers may have to pay NICs upon the exercise of options under unapproved schemes. Employer’s NICs are charged at 12.8 percent of the gain. Employee’s NICs tend to be much less significant (in most circumstances, about one percent on this type of gain). NICs are charged...
on the fair market value of the shares at the date of exercise less the amount actually paid for the shares (and the cost of grant of the option itself, if any). The employer and the employee can jointly elect to pass the employer NIC charge onto the employee. This election can be a condition of participation in the scheme and in which case, will be provided for in the scheme rules. There is generally no NIC charge under an EMI, CSOP or SAYE scheme.

Under the pay as you earn regime (PAYE), employers are obliged to withhold employee tax and NICs at source and account for this to the Inland Revenue. Employees therefore are paid a net amount.

Are there any US/UK taxation issues? The US and UK have taken steps to avoid double taxation on gains related to stock option plans. Under a treaty signed by the US and UK, if the grant, exercise or sale is taxable, it is generally taxable in the employee’s country of residence. However, the gains may be taxable in the other country if services in connection with the employment were performed there. This treaty assumes that employees will be able to take advantage of foreign tax credits in their country of residence as well.

Are there any consequences if beneficiaries move from the UK to the US or vice versa? A US individual who is resident in the UK will be liable to tax on income arising in the UK. However, if a stock option has been granted to an individual when resident in the US, the exercise of the option while the individual is resident in the UK will not give rise to any UK income tax. There may be a charge to CGT on a sale of the option shares but this can probably be avoided provided that the option shares and any disposal proceeds are kept outside the UK. A US individual who is not resident in the UK is subject to tax on income arising in the UK. Where a stock option has been granted to an individual in connection with employment undertaken in the UK, then the exercise of that option after the individual has left the UK and returned to the US will give rise to income tax. However, relief may be available under the double tax treaty as described above or under US tax law if the tax payer is US resident. Assuming that the double tax treaty applies, a US employee seconded to the UK on a short term assignment is likely to be exempt from UK income tax. If, however, an employee spends approximately 183 days or more in the UK during a tax year or if he/she visits the UK for periods averaging 91 days or more in four successive tax years, such employee will automatically be treated as being tax resident in the UK.

Are there any consequences on a restructuring of the US parent company? If the US parent company undergoes any corporate restructuring, then the terms of the stock option plan may deal with such an event by re-pricing the stock options accordingly. The UK scheme will ordinarily mirror these provisions. However, if the UK scheme is an approved scheme, there are only certain re-pricing provisions which are permitted to be included in the rules of the UK scheme for it to receive its approved status. The Inland Revenue will need to approve these rules in advance for the options to attract the favorable tax treatment. If the approved scheme does not provide for such an event or re-pricing in the manner approved by the Inland Revenue, then the US parent will still be able to effect its restructuring and re-price the options, but the tax benefits under the approved scheme relating to any re-priced shares may be lost.

Are there any “works council” or discrimination issues in the UK? Works councils are not as common in the UK as in other jurisdictions within the European Union. However, there may be trade unions or other types of collective representation of the employees in the UK. If there are employee representatives, the terms of their representation should be checked to see whether they should
be consulted prior to any proposed changes to the stock option plan.

English law prohibits employers from providing different rates of pay for men and women performing the same work or work of equal value. This would be extended to stock option grants. English law also prevents less favorable treatment of part-time workers. It would therefore be difficult to exclude part-time workers from the right to participate in a stock option plan. In general, employees on family care leave have the right not to be subjected to any detriment for any reasons which are related to their having taken leave or the reasons for the leave—this may impact on the vesting rules of some plans which will have to be reviewed in this regard.

**Are UK securities laws’ restrictions relevant to the grant, exercise or sale of options under approved and unapproved schemes?**

Yes—in relation to the grant, when unlisted securities are offered to the public in the UK for the first time (which would include an invitation to participate in most share schemes), the offeror must publish a prospectus. This would take a lot of time and be expensive. However, there are exemptions - including the offer of securities in, and made by, a private company to its own employees, or offers to group company employees, former employees and certain family members only. Similarly, any financial promotion originating from the UK or capable of having effect in the UK (which would include an invitation to participate in most share schemes) would have to be communicated or approved by an “authorized person”, typically an investment bank or other investment professional. This may take time and be expensive. There is an exemption for financial promotions for the purposes of employee share schemes which should apply, so long as the scheme is marketed to employees only (which can include employees of group companies).

In relation to exercise or sale, insider trading issues should be considered, which are similar to US insider dealing laws. It is a criminal offence for an “insider” to deal in, encourage someone else to deal in or to disclose to another person price-sensitive inside information. The UK legislation catches on-market dealings on NASDAQ (but not on the NYSE) if the insider is in the UK. Off-market dealings through a professional intermediary are also caught.

**What are the cultural considerations of granting stock options in the UK?**

Most senior executives of UK companies expect that a significant part of their remuneration will be paid in the form of share options. This will typically be a mixture of approved and unapproved options, given that the limit on approved options is only £30,000.

Share options are not exclusive to companies whose shares are publicly traded. Many private companies that are looking to float their shares, or merge with another company (an “exit event”), grant options that can only be exercised if an exit event occurs. Most technology start-up companies have set up some form of share option scheme such as an EMI.