UNAPPROVED AND UNATTRACTIVE

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The unapproved share option has surely had its day. In the not so brave new world of tax planning business assets taper relief reigns supreme. So taxpayers want business assets. The problem with an option is that the asset acquired under the option agreement is treated for taper purposes as acquired at the date the option is exercised, not when the option is granted (TCGA 1992 Schedule A1 para. 13). This can give rise to particular disadvantages for employees. The employee who is given an unapproved share option pays tax under Schedule E on the value of his shares on the date of exercise under Section 135 TA 1988. Assuming he wants to cash in his stake in the company immediately he will have paid tax at 40% on the whole value of his shares. Contrast the employee who received a deferred share at the outset which has grown nicely in value. He gets the benefit of taper relief throughout his period of ownership and when he comes to sell he pays tax at a rate of possibly 10%. It's good to see the capital/income distinction back on such form.

What is to be done with a valuable unapproved option yet to be exercised? It is possible to defer the immediate problem by rolling over. Section 136 TA allows the employee to swap Option 1 for Option 2 without a tax charge. At the least, this is a route for the employee in bubble.com to acquire an interest in a less volatile investment. Curiously, the 10 year period in which Option 1 must be exercised (s.135(5)) appears to have no application to replacement options, so the charge can be deferred indefinitely.

There are further more sophisticated strategies to defer the immediate charge on exercise of an option. Take an employee who has an option over shares in his employer company. The employer has set up an offshore employee benefit trust. The employee may be able to assign his option to the trustees on terms that the trustees will grant a replacement option over shares in a new company holding investments. If that exchange falls within section 136(1) TA there will be no Schedule E charge (and see also section 237A TCGA). The trustees could then

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create a sub-trust for the benefit of the employee's family. The sub-trust then acquires the trustees' shares in the new company. Care must be taken to avoid a significant charge under section 154 TA at this stage. This should be possible as the shares acquired by the sub-trust may have little value, in light of the employee's valuable option to acquire further shares. (Section 154 should not apply at all if the discretionary beneficiaries of the sub-trust extend beyond the employee's "family and household" as defined in section 168(4) TA).

The day comes for the employee to exercise his option to acquire his shares in the new company. The employee does no such thing. His option lapses and as a consequence the sub-trust owns all the shares in the new company outright. Could section 135(8) TA apply? This provision gives rise to a Schedule E charge when a person omits to exercise an option, but only where the person receives a benefit in money or money's worth. The inheritance tax position needs careful attention as the omission to exercise is likely to give rise to a transfer of value by the employee.

For the future, deferred shares which increase in value in accordance with preordained rights look a more attractive prospect. EMI options are also favoured because the employee does get taper relief from the date the option is granted. The discouraging feature of EMIs is that employer and employee will have to comply with the excessive conditions of Schedule 14 of FA 2000, which run to a hefty 20 pages.