FACT SHEET:
LONG TERM INCENTIVE PLANS

Wedlake Bell

Introduction

Long term incentive plans ("**LTIP**") is a widely used term that can capture arrangements (with many different forms) that are implemented by different types of entity for the purposes of the recruitment, retention and/or incentivisation of senior executives and other employees.

Whilst there is no universally recognised definition of an LTIP, the common thread is that it is a plan that grants, on a discretionary basis, rights over shares subject to conditions which are measured or applied over a period that could be considered long-term in the context of the particular business.

Main features

- Awards typically entitle participants to free shares after a performance period (of at least, say, three years) provided service and performance conditions are met.
- Awards are typically made annually, based on a multiple of base salary;
- Awards are invariably subject to comparative and graduated performance targets which are designed to be stretching in order to align the interests of participants and shareholders;
- Participants benefit from the "whole value" of shares subject to the award in contrast to "market value" options which are more geared in that they reward only increases in value from the date of grant;
- Share awards are usually sourced using shares held in an employee benefit trust ("**EBT**") which can purchase or subscribe for shares.
- More recently, plans have included a retention period of up to two years after vesting and (particularly in the financial services sector) malus and claw-back provisions triggered by business performance or personal misconduct.

Different LTIP Structures

Awards that may be granted under an LTIP will typically comprise one or more of the following:

Nil cost options

Participants are granted an option at the outset which becomes exercisable at the end of a performance period of at least three years to the extent service and performance targets are met. Options typically have a 10 year life. No tax is due until exercise so participants can retain the option after vesting and benefit from the upside on the gross number of shares subject to the award.

Restricted stock units

Participants receive a promise or contractually binding right to receive free shares at the end of a performance period of at least three years to the extent service and performance targets are met. Participants are typically taxed on the receipt of the shares.

Restricted stock

Participants receive beneficial ownership of shares at the outset but the shares are subject to forfeiture on cessation of employment or on failure to meet performance targets at the end of a performance period of at least three years. UK participants can elect to pay income tax on the value of the shares at the outset thereby benefiting from capital treatment on future gains. However, restricted stock is relatively rare in the UK, as the up-front tax cost represents a cash-flow disadvantage and the tax cannot be recouped if the shares are later forfeited.

Tax treatment

The tax treatment of LTIPs depends on the nature of the underlying award:

Nil cost options

No income tax arises until the option is exercised. Pay as you earn ("**PAYE**") and National Insurance contributions ("**NIC**") will arise on exercise if the shares are readily convertible assets ("**RCAs**"). If the shares are not RCAs at the point of exercise, income tax will be payable via self-assessment and there will be no NICs liabilities. Participants will typically sell all their shares on the date of exercise and part of the sale proceeds will be paid to the employer to enable it to operate withholding.

Restricted stock units

No income tax arises until participants become unconditionally entitled to the shares on vesting, and PAYE and NIC will arise at that point if the shares are RCAs. Participants will typically be required to sell sufficient shares on vesting to fund the tax withholding liability. If the shares are not RCAs at the point of vesting, income tax will be payable via self-assessment and there will be no NICs liabilities.

Restricted stock

No income tax arises on acquisition (assuming forfeiture conditions lift within 5 years of acquisition).

Income tax arises instead when the forfeiture conditions lift on the full value of the shares at that point.

PAYE and NIC apply if the shares are RCAs on each tax point. If forfeiture conditions may apply over more than 5 years (or there is no time limit), then the UK tax rules will likely result in income tax payable on both grant and exercise.

Alternatively, participants can make an election pursuant to section 431(1) ITEPA 2003 to pay income tax on the "unrestricted market value" of the shares within 14 days of acquisition with the result that subsequent gains on sale are taxed as capital. If the shares are not RCAs at the point of exercise, income tax will be payable via self-assessment and there will be no NICs liabilities.

Corporate tax deduction

A statutory corporation tax deduction is available on the exercise of options, vesting of restricted stock units or on the receipt or vesting of restricted stock (whichever event is taxable) provided certain conditions are met. The relief is generally given to the employer for the accounting period in which the tax charges arise in the hands of participants on the amount assessed to income tax in their hands.

Shareholder approval

The Listing Rules (broadly) require companies listed on the full list to seek shareholder approval for plans sourced using new issue shares or in which main board directors are eligible to participate and which measure performance over more than one financial year.

No such rules apply to private or AIM traded companies, but the latter may be obliged to seek shareholder approval for good governance reasons or due to prior commitments to shareholders.

Administration and valuation

As with other employee share plans in the UK, there is a requirement to register an LTIP and then make annual filings under HMRC 's employment related securities ("**ERS**") regime.

Next steps

Many LTIPs are bespoke to the company with individual rules and performance targets. Wedlake Bell can help with all aspects of the design, drafting and implementation of your LTIP, including communication, valuation and ongoing compliance requirements.

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