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Employee Benefits News
April 2011

Employee Benefits News

Revised "disguised remuneration" legislation published

In brief

On 31 March 2011 HMRC published, as part of the Finance (No.3) Bill, a revised draft of the disguised remuneration (DR) legislation originally published on 9 December 2010 together with an updated version of its "Frequently Asked Questions" ("FAQs"), which were originally published in February 2011. The publication of further HMRC FAQs is promised *"…as and when appropriate"*.

As anticipated, the revised draft of the DR legislation contains some helpful changes as well as a number of new exemptions from the DR tax charges for innocent/ commercial arrangements, including employee share plans and deferred bonus arrangements. However, these new exemptions are complex and the revised draft of the DR legislation is far from perfect.

Any amendments to the DR legislation will be subject to the vagaries of the Parliamentary legislative process, resulting in a further period of uncertainty for companies. Moreover, the equivalent provisions for NIC have not yet been published. Once enacted, the DR legislation will apply from 6 April 2011 (subject to certain anti-forestalling rules which apply from 9 December 2010 to 5 April 2011).

Action to be taken

The DR legislation is complex and there remains a risk that employers/employees/ trustees may inadvertently find themselves caught by its provisions. We recommend that companies operating share plans/bonus deferral arrangements through an employee benefit trust ("EBT") should seek advice now as to what steps to take to minimise the risk of DR tax charges. For a company operating "normal" employee share plans and deferred bonus arrangements, it should be relatively straightforward to avoid the impact of DR.

Background

Under the DR legislation the following events (called "relevant steps") potentially result in the employee being taxed as if he had been paid employment income by his employer (references to EBTs below also include other third vehicles such as EFRBS):

(1) sums or assets being "earmarked" (*"however informally"*) or otherwise starting to be held for an employee (and/or linked persons) by an EBT;

(2) payments being made, loans provided, or assets being transferred by an EBT to the employee (and/or linked persons); and

(3) any assets being "made available" by an EBT to an employee (and/or linked persons) without the ownership being transferred.

Where a relevant step occurs, the tax charge (which will be subject to PAYE and NIC (including employer's NIC) in all cases) will normally be based on the amount paid (in the case of cash payments, including loans) or the market value of the asset (even if not being transferred outright).

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Although its principal focus was stated to be on benefits provided by EBTs and EFRBS, the December 2010 draft of the DR legislation was far too widely drawn and could have caught many innocent/commercial arrangements, including deferred bonus arrangements and conventional employee share plans. HMRC has stated that, in light of responses received on the consultation draft of the DR legislation, it has made a number of changes in order to take account of the concerns raised. However, because *"the primary aim of the legislation remains to protect the Exchequer…the legislation is also necessarily comprehensive"*. It therefore remains the case that some standard arrangements which have no tax avoidance purpose may be caught.

Revised DR legislation

The main changes to the December 2010 version of the DR legislation in the context of employee share plans/bonus arrangements include as follows.

Scope of "third parties"

As noted above, the DR legislation will apply where a relevant step is taken by a third party. The definition of "third party" was originally very widely drawn and could have caught, amongst others, the employer and other group companies. The revised draft now generally (subject to an exception in the context of EFRBS) excludes the employer and group companies from being a relevant third party, unless the relevant company is acting as a trustee (which would not normally be the case). These new carve-outs are subject to an anti-avoidance test. This change is particularly helpful in the context of e.g. employee loans (see further below).

"Earmarking"

HMRC has attempted to take account of (some) concerns expressed during the consultation period regarding the scope of the earmarking provisions by adding some new exclusions, including for deferred remuneration and employee share plans. Whilst their inclusion is good news, the exemptions are somewhat complex. Having said that, the exemptions are only relevant if there is any earmarking in the first place.

HMRC has confirmed in its FAQs that where shares or funds to acquire shares are put into an EBT to meet future awards, but not in respect of named employees, then no earmarking takes place. Equally, there is no earmarking where new shares are issued by the parent company in the group.

Approved share plans

The consultation draft of the legislation included exclusions for relevant steps *"taken under"* UK tax approved share plans and EMI. These exclusions have been extended to make it clearer that (provided certain conditions are met) an EBT holding shares in connection with such a plan should not, of itself, give rise to a DR tax charge.

Loans

As a matter of underlying policy, HMRC is particularly concerned with certain kinds of employee loan. Indeed, in his Budget speech, the Chancellor referred specifically to *"…ending the practice of…highly paid employees [being] offered tax-free, lifetime loans, that are never repaid…"*. Therefore it was relatively certain that any specific exceptions for making loans as a "relevant step" would be fairly limited. This has indeed turned out to be the case.

A limited new exclusion has been added for third party loans made to fund exercises of share options, provided certain conditions are met and subject to an anti-avoidance test. In addition, as noted above, the revised "third party" provisions will now generally exclude employers and group companies making loans. Thus, a loan by an employer or another group company to enable an employee to purchase shares in the group should not be caught by DR.

Generally, however, the loan provisions remain very wide and an employee loan from an EBT will be caught. In addition, allowing employees to purchase shares from an EBT on deferred payment terms will also be caught. Note also that the fact that the employee may later repay the loan or later pay for the shares does not avoid the DR charge, nor lead to a tax-reclaim.

Employee providing consideration

The circumstances in which the employee will get "credit" for the consideration he gives in respect of certain relevant steps has been extended to include consideration given not just in cash but also in assets. Also, consideration given *"at or about"* the time of (and not just before) the relevant step will now be given a credit against any DR tax charge. In its FAQs, HMRC state that it would accept that *"at or about"* means a few days/possibly up to a week or potentially longer, depending on the circumstances. However, these changes will not be helpful in the case of e.g. employee shares acquired on deferred payment terms over a longer term.

A new provision has also been included so that where shares are earmarked by a third party to satisfy the exercise of options such that an earmarking DR charge arises, then provided certain conditions are met the employee will get credit (i.e. the DR charge will be reduced) by the amount of the option exercise price.

Conclusion

As noted above, the DR legislation is extremely complex and the DR tax charges may apply to entirely innocent/commercial arrangements. We would be very pleased to help you carry out a "health check" on your incentive and benefit arrangements. It should be relatively straightforward to ensure DR does not apply to you. Please get in touch with us on this.

Revised PAYE requirements: some good news for employee share plans!

As reported in our February 2011 newsletter, the PAYE withholding requirements changed from 6 April 2011. The changes relate to the PAYE tax code which HMRC requires employers to operate in certain specific circumstances, including where an employer makes a payment to an ex-employee.

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As from 6 April 2011, the employer is generally required to operate PAYE on post P45 payments using an "0T" code. The 0T code disregards the personal tax allowance and means employers must withhold at the basic, higher and additional rate as appropriate, on a non-cumulative basis. (Prior to 6 April 2011 employers were required to withhold tax at the basic rate (20%) only, with the employee paying any additional tax due under self-assessment). The operation of the 0T code means that, to the extent a payment is in excess of £12,500, withholding will have to be operated at the rate of 50%. This will often mean that the ex-employee has paid too much tax and will need to reclaim the overpayment of tax back from HMRC.

However, due to lobbying by *ifs*Proshare, HMRC has made some further last-minute amendments to the PAYE regulations (also with effect from 6 April 2011) so that the 0T code will not apply to shares provided to employees after the issue of the P45. Withholding should be operated by the ex-employer on such payments at the basic rate only.

This change of heart by HMRC for share plans will be welcomed by many employers and employees. However, the new 0T Code requirement remains in place for cash payments and will remain relevant for e.g. cash termination payments. Employers may therefore wish to consider whether it is possible to make the relevant cash payments before the issue of the P45 to the ex-employee. This is likely, in most cases, to result in a lower PAYE deduction being made. Alternatively, if cash payments are to be made after the issue of the P45, it may be beneficial, depending on the circumstances, to spread the payment over more than one tax month (although care must be taken to ensure that entitlement to the relevant instalment of the payment does not arise before the relevant tax month).

More generally, employers will still need to ensure that PAYE is operated on the correct basis and that they have sufficiently robust processes in place in order to recover the correct amounts of PAYE from ex-employees.

Budget 2011

The Government's Budget on 23 March 2011 contained no new announcements specifically targeted at employee share incentives (other than in relation to the DR legislation). However, a few Budget measures which will be of interest to employers are set out below.

Employment income tax/NIC

50% tax

The Chancellor confirmed in his Budget speech that he considers the 50% income tax rate to be a *"temporary measure"*. Following the Chancellor's speech, speculation has mounted that the 50% rate could be removed as soon as 2013 (although nothing has been officially confirmed).

In light of the Chancellor's comments it may be appropriate for companies to consider whether deferrals of income would be a sensible approach in order to take advantage of any future drop in income tax rates. To this end, we are aware of a number of companies that are re-visiting the use of nil-cost options and/or other forms of delayed-vesting awards instead of "simple" conditional awards of shares. These awards provide the employee with greater flexibility in relation to when he chooses to receive income/is subject to income tax. Please contact us for further details.

Increase in NIC rates

The Budget confirmed an increase in the rates of NIC by 1% (for both employees and employers) from the 2011/2012 tax year. This means that, as from 6 April 2011, the rate of employer's NIC is 13.8% (uncapped) and the employee's NIC rates will be 12% up to the salary cap and 2% thereafter. This increase will be of concern to employers as it is a clear additional cost for them in the operation of their remuneration arrangements, including their employee share plans. It may lead to employers revisiting the use of tax-approved plans, where NIC does not usually arise. Alternatively, it may encourage employers to transfer the employer's NIC cost to employees in their share plans.

Integration of income tax and NIC

The Government is to consult later this year on *"the integration of the operation of"* income tax and NIC. Whilst any such integration should deliver administrative benefits for employers in the longer term, the harmonisation process may be complex and we are likely to be a few years away from seeing any significant changes implemented.

Tax reliefs

The Government intends to remove a number of tax reliefs. Many of these will be uncontroversial. However, the proposed abolition of the exemption from tax and NIC for late night taxi travel for employees could result in a significant increased cost for those employers which decide to bear the employee's tax and NIC (which would have to be on a grossed-up basis). A consultation is to be issued this year with a view to this relief being abolished from April 2012.

Capital gains tax

The Chancellor announced a further change to the lifetime limit for Entrepreneurs' Relief, increasing it from £5 million to £10 million of qualifying gains from 6 April 2011. The relief reduces the capital gains tax (CGT) rate from the usual 28% (for higher and additional rate tax payers) to 10% for qualifying gains. Whilst this is good news for those who can qualify for Entrepreneurs' Relief, it is disappointing that there is to be no relaxation of the qualifying conditions. These conditions (in particular, the 5% shareholding requirement) mean that the vast majority of ordinary employee shareholders are unable to benefit from the 10% CGT rate.

However, all employee shareholders will benefit (to the extent they have sufficient capital gains) in an increase in the CGT annual exemption, which is increased to £10,600 for the 2011/2012 tax year.

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Internationally mobile employees

The Chancellor announced a number of changes which will be of interest to employers with expatriate employees. Firstly, for "non-doms" who remain UK tax resident for at least 12 years, the charge for the continued availability of the remittance basis of taxation will be £50,000 per year. The charge is currently £30,000 per year for non-doms who have been resident for at least 7 out of 9 tax years and that existing charge will remain in place.

The Government has also announced that in the future there will be no tax on funds remitted to the UK where the remittance is used to make "commercial investments" in UK businesses. Currently, no further details have been released as to what will qualify as a commercial investment in a UK business, although it is hoped that the Government may consider including employees' purchases of shares in their UK employer/group company. A consultation is due to be published in June 2011, so further details are expected to be available then.

In addition, there is to be a consultation (also to be published in June 2011) on a statutory residence test, with the intention that the relevant legislation (together with the other changes outlined above for internationally mobile employees) will be included in the 2012 Finance Bill.

Finally, the Chancellor also announced that there would be no further changes to the taxation of non-doms in this Parliament.

EU Prospectus Directive – update on forthcoming changes for companies offering employee share plans

In our February 2011 newsletter we reported that a number of favourable changes had been made to the EU Prospectus Directive (EU PD) which should assist companies operating employee share plans. Member States have until 1 July 2012 to implement the changes.

The Government has now issued a consultation on the early implementation of two of the changes to the EU PD exclusions/exemptions which companies may apply to employee share plans:

- the exemption which applies to offers made to fewer than 100 individuals per member state is to be increased to 150 individuals per member state.
- the exclusion which applies where the consideration for the offer over a period of 12 months is less than Euro 2.5 million (across the EU) is to be increased to Euro 5 million (across the EU).

Under the consultation the suggested date for implementation of these two changes is 31 July 2011. Early implementation in the UK will be very helpful, although companies making multi-jurisdictional offers in the EU will still need to consider the relevant limits in the other EU states i.e. other states may not implement the changes as quickly as in the UK.

Unfortunately, the Government's consultation does not also extend to the changes which are to be made to the scope of the employee share plans exemption. These changes will mean that the exemption is extended to all companies whose head office or registered office is in the EU (regardless of whether or not they are listed). In addition, companies which are "established" outside the EU will qualify for the exemption if they are listed on an EU regulated market (as is the case under the original exemption wording) or if they are listed on a "third country market" which has been approved by the EU Commission. There is currently no indication that these changes will be implemented prior to 1 July 2012. We are lobbing, through *ifs*Proshare, for these changes to be implemented as soon as possible so that a wider variety of both EU and non-EU companies can take advantage of the employee share plans exemption.

This publication does not necessarily deal with every important topic nor cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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