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CHANCE

Employee Benefits News

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Deferrals of income and tax-efficient share plans

As we reported earlier this year, the Chancellor is reducing the additional rate of tax (which applies to income over £150,000) from 50% to 45% from 6 April 2013. A number of companies have therefore already taken action to defer employment income in order to take advantage of this forthcoming drop in the highest rate of income tax.

Key issues

- Highest rate of income tax to drop in 2013
- Defer income to take advantage of 45% tax rate
- Access CGT treatment through employee share plans

Deferrals of income

One way of achieving the deferral of income is through the use of employee share plans. For example, structuring share awards so that there is a greater flexibility as to when a tax charge is crystallised. To achieve this, many companies have re-visited the use of nil-cost options and/or other forms of delayed-vesting awards instead of "simple" conditional awards of shares for new grants. Some companies have also made changes to existing conditional awards (either by delaying the vesting date or by other means) to achieve greater tax-flexibility and others are actively considering this.

Companies are also making changes to the timing of payment of bonuses so that bonuses are paid after 5 April 2013. In some cases, employees are being offered the choice of receiving any bonus in the current tax year or the next tax year.

There are a number of issues to consider in relation to deferring employment income, particularly in relation to making changes to existing share plan awards (e.g. changes to plan rules/documentation) and ensuring effective tax deferral in the case of bonuses. Please contact us for further details.

Access to capital gains tax (CGT) treatment

Even with the reduction in the additional rate of income tax to 45% in 2013, the UK tax system will still be asymmetrical in that CGT treatment (at a maximum rate of 28%) is invariably preferable to income tax treatment. One particular benefit arising from CGT treatment (aside from the more obvious benefits such as the CGT annual exemption (which is in effect doubled for married couples and civil partners), spreading disposals over several years to use up several annual exemptions etc) is that, in some circumstances, individuals may qualify for "Entrepreneurs' Relief". Entrepreneurs' Relief operates to apply a CGT rate of 10% to qualifying gains up to a lifetime limit (currently £10 million). There are a number of conditions that must be met in order for Entrepreneurs' Relief to apply. These include that the individual must have held at least 5% of the company's ordinary shares and voting rights for at least a year ending on the date of disposal. (The Government is to disapply the 5% rule for shares acquired under EMI options from 6 April 2012, although this change has not yet been enacted).

Even where Entrepreneurs' Relief is not available it remains extremely worthwhile to consider arrangements which are designed to make the employee's gain subject to CGT rather than income tax/NIC. One method of achieving this is through "growth share" arrangements. Under growth share arrangements: (1) any income tax/NIC is normally payable at the outset on a relatively low value and (2) any growth in the value of the shares should be chargeable to CGT. Growth share arrangements are also worth considering in circumstances where shares would otherwise have considerable value at the outset, which may make them too expensive for executives to acquire (or executives would not be able to afford the income tax charge if they acquired the shares at less than market value). There are a number of different ways of achieving the tax treatment outlined above, including: (1) joint ownership equity plans (under which the executive acquires an interest in shares jointly with a third party, typically an EBT), (2) hurdle shares (under which the executive acquires shares with fairly minimal rights (e.g. as to voting and/or dividends) and such shares only participate in the future value of the company above a prescribed value "hurdle") and (3) contracts for differences (CFDs) (which is effectively a bet on future movements in the price of the underlying assets (e.g. shares) which are the subject of the CFD). In all cases the tax benefits depend on agreeing a favourable (i.e. low) upfront value for tax purposes with HMRC.

To discuss these arrangements and others (e.g. making greater use of tax approved share plans) to achieve CGT treatment, please do get in touch.

New proposals for CGT relief on employee-shares "exchanged" for employment rights

The Chancellor has announced plans for CGT relief on employee-shares acquired in return for the waiver of certain employment rights. Under proposals outlined in his speech to The Conservative Party conference earlier this week, the Chancellor is proposing that new hires may be offered between £2,000 and £50,000 worth of shares in their employing company. In exchange for the shares, the employee will give up certain employment rights including in relation to unfair dismissal, redundancy and rights to request flexible working. Gains made on these shares will be exempt from CGT.

This new form of employment contract – to be known as an "employee-owner" contract - is principally intended for fast growing small and medium sized companies (i.e. the same audience as is the main focus of EMI). However, in principle companies of any size will be permitted to use the new employee-owner contract. The HM Treasury/DBIS press release outlining the proposals suggests that the employer-owner status will be optional for existing employees but employers may choose to make it compulsory for new hires. The proposals are intended to come into force as from April 2013.

Income tax treatment?

Further details are to be released when a consultation on the proposals is launched, which is expected to be later this month. Clearly, one key question which must be addressed is what the tax treatment will be on the acquisition of the shares by the employee-owner. Will the giving up of employment rights be treated as full consideration for the acquisition of the shares (i.e. so that no income tax will be payable) and/or will there be an income tax-exemption for shares acquired at less than market value? Initial views from HMRC suggest that income tax will be payable on receipt of the shares. It will also be interesting to see how the proposals deal with the valuation issues associated with providing unquoted shares to employees.

We will update you with further details once the consultation has published.

Update on HMRC "EBT Settlement Opportunity"

We have previously reported on the disguised remuneration legislation ("DR") which was introduced during 2011. DR is a wide-ranging anti-avoidance regime which was introduced by HMRC to prevent the use of EBTs (particularly those with sub-trusts), retirement/pension trusts and other third-party vehicles to benefit employees in a way that avoids or defers income tax and/or NIC. For the future, therefore, DR will be HMRC's primary anti-avoidance weapon in dealing with EBTs.

However, HMRC remain extremely keen to resolve what they view as the historic abuse of (in particular) EBT sub-trust arrangements. HMRC have so far failed to successfully challenge the PAYE/NIC aspects of EBT sub-trust arrangements in the courts. Perhaps because of this, HMRC published an "EBT Settlement Opportunity" during 2011. Employers with EBT arrangements who were willing to reach a settlement with HMRC were invited to discuss how this could be achieved. In broad terms, under the EBT Settlement Opportunity, HMRC will apply PAYE and NIC to the contributions made into the EBT at the rates which applied at the time the contributions were made. Under a "credit" system, later distributions from the EBT would then generally be exempt from any DR tax charges. However, although there would generally be no penalties, interest would apply. During 2011 HMRC stated that if they did not receive a response by 31 December 2011 then it would be assumed that the employer in question was not interested and HMRC would then "look to progress enquiries formally".

Clarification of EBT Settlement Opportunity

However, it seems that most employers were not too impressed with the EBT Settlement Opportunity, not least because the addition of interest meant that the effective rate of tax could be increased to at least 50% and possibly more. The lack of any significant take-up of the EBT Settlement Opportunity, together with the number of technical points that were originally unclear, has resulted in the publication by HMRC of a "Frequently Asked Questions" document (FAQs). The FAQs seek to clarify HMRC's view on a number of important issues. The fact that the FAQs have been published makes it clear that despite HMRC's original 31 December 2011 "deadline" they remain willing (and indeed keen) to enter into settlement discussions with employers.

Not all of the clarifications set out in the FAQs are good news for employers/employees. For example, HMRC has confirmed that it is determined to impose trust-based IHT charges in certain circumstances. (This seems to be based on the somewhat contradictory analysis that on the one hand the EBT can be "looked through" to the employee in order to apply PAYE and NIC when contributions were made into the EBT, whilst on the other hand, the formal trust structure is respected in order to apply IHT charges.) The FAQs also include commentary on, amongst other things, how the DR "credit" will work in respect of EBT contributions made in "out of date" years (i.e. years in respect of which HMRC is out of time to assess to PAYE/NIC).

Overall, although the FAQs are helpful in clarifying HMRC's view in relation to particular aspects of the EBT Settlement Opportunity, it remains far from certain whether the opportunity will appeal to many employers.

It may be the case that some companies will only assess (or re-assess) the pros and cons of the EBT Settlement Opportunity once the outcome of the long running and highly publicised "Rangers" EBT sub-trust tax case is known. The Rangers judgment is in fact expected to be released later this month. That said, unofficial reports have suggested that the facts of the Rangers case are so "extreme" (in the sense of being unfavourable to the taxpayer) that even if HMRC does succeed, it will have little bearing on whether HMRC may succeed in other EBT sub-trust cases.

If you would like to discuss further the various issues involved in relation to the EBT Settlement Opportunity, please get in touch.

OTS review of unapproved share plans

In our last newsletter we reported that the Office of Tax Simplification (OTS) had commenced its review of unapproved share arrangements. The review has been split into two stages. The first stage was a fact-finding exercise to assist the OTS in identifying, amongst other things, the type of unapproved share arrangements used by companies, and which parts of the tax/PAYE/NIC systems help or hinder those arrangements. The second stage of the review consists of a detailed examination of the priority areas for simplification as identified by the fact-finding exercise.

Key tax-related difficulties

In August 2012 the OTS published its interim report following its fact-finding exercise. The report summarises the current approach to the taxation of unapproved share plans and key tax-related difficulties so far raised with the OTS. These difficulties include:

- PAYE deadlines and penalties arising from late payments;
- taxation of share incentives for internationally mobile employees;
- the disguised remuneration legislation;
- the legislation that largely governs the taxation of unapproved share arrangements (Part 7 ITEPA (2003)); and
- the administrative burden of completing the annual return (Form 42).

The report lists a number of questions about matters on which further input would be especially welcome, including in relation to the key difficulties referred to above. In addition, the interim report poses more general questions – such as:

- Whether the deferral of income tax/PAYE until the sale of the employees' shares might be a helpful simplification. If so, under what circumstances should this apply?
- Whether the current tax rules get the balance right in distinguishing between employment reward v. capital growth?

Further input to the review is requested by 26 October 2012. If you have any views which you would like to discuss with us and/or pass on to the OTS, please get in touch. The OTS aims to produce its final report, including recommendations for simplification, before the 2013 Budget.

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