

## DISGUISED REMUNERATION: FINANCE BILL 2011

### Paper sent by *ifs ProShare* to HMRC and The Treasury.

This paper relates to the proposed legislation published by the Government on 9 December 2010, intended to counter the use of third party arrangements for awarding remuneration in a manner that would avoid liability to income tax. The legislation is to take effect from 6 April 2011; and the accompanying Ministerial statement describes it as an attempt to tackle arrangements which seek to avoid or defer the payment of income tax or NICs.

The draft legislation provides for an employee to be charged to income tax when he receives from a third party “what is in substance a reward or recognition, or a loan, in connection with [his] employment”. It is very widely drafted and appears capable of applying in circumstances where no tax avoidance exists, and where the employee receives no benefit.

*ifs ProShare* champions and encourages employee share ownership in all forms. *ifs ProShare* is seeking to protect employee share plans; approved or unapproved, all-employee, discretionary and executive, UK and internationally implemented. These plans are introduced with the clear intention of offering and promoting employee share ownership, not as tax-avoidance vehicles. *ifs ProShare* is seeking to ensure that such arrangements are not caught by the proposed legislation published on 9 December.

*ifs ProShare* previously sent a short form paper to HMRC and the HM Treasury seeking confirmation as a matter of principle that employee share plans, which are operated on a normal commercial basis with no tax avoidance motive, are not intended to be affected by this legislation. We were pleased with the response received to date from HMRC confirming that it is not HMRC’s intention to interfere with the operation of ordinary share plans operated on a commercial basis with no tax avoidance motive.

*ifs ProShare* would welcome the opportunity to work with the Government and HMRC to ensure that the legislation hits real tax avoiders, not the innocent. As mentioned, we have a number of detailed comments on the drafting, which we include in this paper below:

- 1) We welcome the clear intention to provide exemptions for employee share plans, in section 554 E for approved plans and in section 554H for unapproved plans. However, we are concerned that, as drafted, both these exemptions will fail to meet their objectives.
- 2) The main problem with section 554E is that it only applies if a relevant step is taken “under” the plan, that means it covers things like the award of shares to an employee under a SIP, or the grant or exercise of an option, but it does not cover steps taken outside the formal rules of the plans, under which the employer makes arrangements for the provision of the shares. A typical step which would not be covered by the exemption is funding the trustee of an

employee trust to buy shares in the market, so that they can be held ready for the employees to exercise their options. Clearly this should be covered by the exemption, because this kind of activity is merely ancillary to the operation of the plans, and does not provide the employees with any extra benefit. We suggest solving this problem as follows:

- add after the words “if the step is take under” the words “**or in connection with**”;
- 3) Another problem with 554E is that it does not cover steps taken before the plans have formal approval, or cases where steps may relate to more than one plan, possibly including both approved and unapproved plans. For example, an employer may establish an employee trust to hold shares for delivery to employees under a number of different employee share plans, so the “sole purpose” requirement cannot be satisfied. Again it seems to us that the exemption should apply, because the step is merely ancillary to the plans, even though taken before their formal establishment. We suggest:
- amend (a), (b) and (c) by amending the words “an approved” to read “an existing or proposed **approved**”;
  - amend (d) to cover all options granted under the EMI legislation to read as follows – “**an arrangement relating to options granted or to be granted under Chapter 9 of Part 7, including any option which fails to qualify, in full or in part, due to the limit imposed by paragraph 5 of Part 2 to Schedule 5 ITEPA**”;
- 4) Turning to section 554H, there are two problems. The first is that it only exempts the acquisition of shares by employees in certain circumstances. For example, it exempts an acquisition of shares that are forfeitable (within section 425), but it does not exempt an acquisition where shares are restricted, or where they are free of any restrictions, or where the employee makes a 431 election to disapply section 425. It may be that the reason for this apparent inconsistency is that relief for the tax paid on those acquisitions is thought to be available under section 554N (but see paragraph 10 below, where we explain our concerns about the scope of that relief), but we think it would be more logical to provide the same exemption in all cases. We would suggest as follows:
- Add a new 554H(1)(c) to read “an acquisition of employment-related securities which gives rise to an income tax charge”.
- 5) The second problem with section 554H is that it does not cover preparatory steps taken outside the formal rules of the plans, under which the employer makes arrangements for the provision of the shares, as described in relation to approved plans above. This type of arrangement appears to be covered by the earmarking provision

in section 554B, and in our view should be exempted, because it is merely ancillary to the operation of the share plans. Companies often need to use employee trusts to satisfy share plans because they cannot issue new shares directly to employees. They have genuine commercial reasons for buying shares in advance of giving them to employees. For example, if a company makes an award of 100,000 shares to an employee on the basis that he will receive the shares in 3 years time so long as performance conditions are met and the employee remains in service, the company would sensibly hedge its obligation to provide the shares in the future by buying them at or around the time the award is made, as protection against share price rises. Pre-funding a trust and pre-acquiring shares in this way is very common and is endorsed by institutional investors as well as making sound commercial sense. The acquisition of the shares gives the employee no extra benefit, as his entitlement to shares derives from the award, not from the holding by the trust. It is therefore wrong that the employee should be taxed as if he had received an extra benefit. We would suggest that this problem should be resolved by amending section 554H as follows:

- Amend the opening words of 554H(1) to read "...does not apply if the relevant step is in connection with....";

6) Alternatively, the draft legislation could be simplified by replacing both the exemptions in 554E and 554H with a single exemption for all employee share plans/acquisitions. In order to avoid abuse, there could be a requirement:

- the award (whether in cash or shares) must be capable of vesting (i.e. becoming unconditional) or otherwise triggering a tax liability within a specified time period – say, 5 years;
- participants (and their linked persons) cannot derive any benefit from the holding of the shares (as distinct from the award itself); and
- the purpose of making the award does not include the avoidance of tax.

Where these conditions are satisfied, a tax charge would only arise if and when the relevant award vests. An exemption along these lines should ensure that innocent arrangements (where tax avoidance is not the motive) can continue to be operated without inadvertently being caught by Chapter 2.

7) Please confirm that Treasury Shares are not caught by this proposed legislation, ie that a company would not be regarded as a trustee of shares held in Treasury, or as earmarking those shares for employees.

8) Please confirm that the making of provision by a company within its corporate accounts would not be considered "earmarking" of the amount provided. We consider this would not be the case, since

accounts are merely a record of a company's assets and liabilities, rather than any form of allocation of setting aside.

- 9) We are concerned about the absence of relief for the repayment of loans. In the share plan context this could have widespread implications, because it is common for employees' acquisition of shares to be arranged through "cashless exercise", whereby the amount payable for shares is left outstanding for a short time, and then paid out of the proceeds of sale of some of the shares. Please can you confirm that the exemption for share plans is intended to cover these circumstances?
- 10) We are concerned that the overlap relief in sections 554M and 554N is too narrow to cover genuine cases of double taxation. In particular section 554N only applies if the relevant step "gives rise" to taxable earnings. That would not cover a case where, for example, an employee receives a cash bonus, on which he is taxed, and uses the money to buy shares from a trust, which have been earmarked for him. The relevant step is the earmarking, but it does not "give rise" to the tax liability on the cash bonus, so no relief is available. Again, the relief in section 554O is too narrow, because it only applies where the payment is made before the earmarking, not afterwards.
- 11) One of the aims of the Remuneration Code published by the FSA is to increase deferral of bonuses by arranging for bonuses to be provided in and released in shares over a number of years; in essence it promotes/requires the greater use of deferred share awards for all employees, not just senior executives. This will inevitably lead to trusts acquiring shares up-front which will be delivered to employees over a number of years. Under the draft legislation, this type of deferral will lead to an upfront tax charge which is surely not expected or fair, and so we hope that the opportunity will be taken to give comfort on this point too. It is important that the disguised remuneration legislation does not result in individuals suffering tax and NICs charges on compensation which is required to be deferred (and which may never ultimately be paid) pursuant to the Remuneration Code.

We think these amendments are vital given the recognised value of employee share ownership in promoting economic growth. **ifs ProShare** is seeking to protect employee share plans and ensure that the ability for these plans to be offered and promoted is not adversely impacted by the proposed legislation.

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**"The voice of employee share ownership"**