QUOTED COMPANIES ALLIANCE

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Dear Sirs,

**HMRC Consultation: Office of Tax Simplification: Review of unapproved share schemes**

***Introduction***

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The Quoted Companies Alliance Share Schemes Expert Group has examined your proposals and advised on this response. A list of members of the expert group is at Appendix A.

***Response***

We welcome the recommendations put forward by the Office of Tax Simplification (OTS), which will help reduce many of the tax pitfalls which smaller companies experience when operating employee share plans and the Government's willingness to consult on many of the recommendations. Our response is mainly intended to address the specific consultation questions asked by HMRC. However, we also comment on the other OTS recommendations, which are not being consulted upon at this stage.

**Responses to questions in the Consultation Document**

**Share for share exchanges and rollovers (OTS Supplementary Recommendation A(2))**

The current legislation can result in an income tax charge if restricted securities are exchanged for other securities, for example as a consequence of a successful takeover bid, even though the same restrictions continue to be attached to the replacement shares.

Similarly, where nil or partly-paid shares are exchanged, they are treated as if the notional loan has been written off and there is no subsequent tax relief when the balance of the payment for the shares is made by the employee.

The Quoted Companies Alliance is the independent membership organisation that champions the interests of small to mid-size quoted companies.

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These tax traps can be unexpected, both for companies and for their employees and are unfair because there has been no real economic disposal. The motivational impact of these arrangements can become very negative.

We therefore strongly support the OTS recommendation that the tax treatment for share exchanges should be made consistent with the rollover treatment which currently applies for share options and other employment-related securities options.

**Corporation tax relief following takeover of a company (OTS Supplementary Recommendation A(3))**

We consider that the current conditions relating to the shares acquired for corporation tax (CT) relief in sections 1008 and 1016 of the Corporation Tax Act 2009 are unduly restrictive. The exclusion of relief penalises the acquisition of shares in a company which is under the control of an unlisted company, including a company whose shares are traded on AIM.

There is a further unfairness, in that the definition of readily convertible asset (RCA), in section 702 of ITEPA 2003, specifically includes shares which would not otherwise be RCAs except that they are not “corporation tax deductible” (as defined in section 702(5B)). A consequence is that there is a PAYE and NICs liability on acquisition of such shares even though the shares may not be convertible into money or money’s worth at that time.

We strongly support the OTS recommendation that CT relief should be available for employee share acquisitions which take place within 90 days following a takeover. Companies are currently unfairly penalised in these situations, which can occur unexpectedly.

However, we would go further than the OTS and ask for the requirement for CT relief that the shares must not be shares in a company controlled by an unlisted company should be removed. At the least, shares in subsidiaries of shares quoted on AIM (and similar markets) should become eligible for the CT relief.

**Internationally mobile employees (OTS Recommendation B)**

*Non-resident, UK taxable individuals*

If a securities option that is a legal option is granted or forfeitable securities are awarded to a non-resident employee with taxable UK duties, the grant of the incentive is subject to income tax unlike where the employee is UK resident. This is the case regardless of whether the option or award subsequently vests or is exercised and the income tax cannot be reclaimed if there is no such vesting or exercise. In respect of an option, the exercise is then taxed within chapter 3C, creating a notional loan that is written off when the shares are sold.

Whilst it is generally a small proportion of the internationally mobile population that meet this fact pattern, for businesses with significant expat communities, it is common to have a small number of employees who will be subject to this tax treatment. This causes significant issues for employers and their employees:

- The income tax on the grant of options or on award of restricted stock gives a ‘dry’ tax charge. In some cases, this dry tax charge means that it is unattractive for such individuals to participate in unapproved share schemes.

- The income tax charge on grant can be inequitable where the employee makes no profit from the incentive (if it does not vest) but the income tax on grant cannot be recovered.
- The burden of compliance where the tax charge arises at a different point for a small number of expatriates is significant. It is a challenge for employers and their employees themselves to identify when to apply a different tax treatment.
- If the individual chooses not to sell the shares following exercise of the option, this creates an annual beneficial loan charge for the employee and a P11D reporting obligation for the employer. This is disincentive to hold shares following exercise.
- Since it is the sale of the shares that crystallises the final PAYE and NI charges, the employer needs to track the individual until he sells the shares. This is very difficult for the employer as the employee is rarely under any obligation to notify the sale of shares to his employer.

We consider that it would be more practical for all UK tax charges arising on unapproved share plans to be aligned and subject to the same general provisions regardless of residence, for example all securities options to be subject to income tax under chapter 5 and all restricted securities to be subject to chapter 2 even where the recipient is resident but with UK taxable earnings.

It would clearly be necessary for these provisions to incorporate an appropriate apportionment provision for non-resident individuals which we address below.

*Apportionment of gains on securities options and restricted securities*

Where an individual is UK resident on grant of a securities option or restricted securities such that chapter 2 or chapter 5 applies, an apportionment of the gain may apply as follows:

a) If there is income tax payable in another jurisdiction, there may be relief under the double tax treaty that could allow for apportionment between the two jurisdictions.

b) If the remittance rules under chapter 5A of part 7 ITEPA 2003 apply, a proportion may only be subject to income tax on a remittance basis.

Agreeing whether and how apportionment may apply is a complex process, particularly given the complexity of the remittance rules. The remittance rules are also biased against individuals employed by UK resident companies where the shares are automatically treated as remitted.

We recommend the introduction of a ‘standard’ apportionment principle to apply which would simplify the calculation in a number of cases. This simple principle would exclude from the taxable gains under chapters 2 and 5, a proportion that relates to periods during vesting where the individual is not resident and has no UK taxable earnings from employment.

The remittance rules would still be relevant for determining a further proportion relating to years when the individual is not ordinarily resident and has earning subject to the remittance basis but this would mean that these complex rules only become relevant in a smaller number of scenarios.

Introducing a simple apportionment as suggested above that does not need reference to double tax treaties or to the remittance rules will achieve:

- A system that is aligned to the majority of other jurisdictions.
- A simple principle that will achieve the same conclusion as is achieved in the vast majority of cases under the current system.

*Securities Options and Contingent Rights*

There is a distinction in current practice between contingent rights and securities options. In particular, HMRC guidance states that Restricted Stock Units ('RSUs') are generally seen as being contingent rights rather than securities options. For expatriates, this means that a different treatment will apply between very similar instruments. Contingent rights granted to an employee before he becomes subject to UK taxation but vesting whilst in the UK will be partly taxed in the UK whereas securities options under this fact pattern will be outside of UK taxation.

Minor factors can impact on whether an award is a securities option or a contingent right, such as the right for the employer to deliver cash instead of shares. This means that there are significant risks that employers will apply the wrong treatment. It is also sometimes a subjective point so that employers who choose to do so may be able to take a 'view' to apply the tax treatment that is favourable for the majority of their expats.

We consider that the system would be more simple and equitable if awards that are currently treated as contingent rights were to be included in the treatment for securities options.

*Tracking leavers*

The requirement to track leavers is a particular challenge for employers of internationally mobile employees. This is the case even when they remain in the UK but it is even more so for internationally mobile employees.

By way of an example, if an employee is resident in the UK on the grant of a share option and then leaves the UK to work in France, the company would need to know to apply withholding in the UK on exercise. If the employee no longer works for the group at that point, it is extremely difficult to identify a withholding obligation in the UK.

We believe that HMRC should consider whether tax payable on share based payments for leavers should be paid through self assessment. If this is not acceptable, they should give consideration to at least making this change for non-resident employees.

As is identified above, tracking is even harder if an employee has crystallised a notional loan under chapter 3C on the exercise of an option and the income tax charge is due when the shares are sold. For an employer to track the sale of the shares in order to identify withholding obligations is very difficult and to do this for leavers and non-residents is virtually impossible. We believe that this tax charge (if required at all) should become a self-assessment requirement.

**Section 222 of ITEPA and "making good" (OTS recommendation E(2))**

We have found that there can be considerable difficulties for many companies and their employees in "making good" the PAYE and NICs in relation to shares and other employment-related securities acquired by employees even within the 90-day period currently allowed.

We regard the current charge as penal because it is not currently refunded if the employee subsequently refunds the income tax and NICs after the deadline.

We strongly support the OTS recommendation that there should be no additional tax charge if the amounts are made good by the employee by 6 July following the end of the tax year. This will overcome the administrative difficulties in most cases.

In cases where even the new deadline cannot be met, we regard it as fair and reasonable that the amount due should be given the same treatment as notional loans and that the full tax charge should only be applied in circumstances where the notional loans are written off – or deemed to be written off.

We very much welcome HMRC's commitment to update their guidance on what constitutes "making good" and look forward with interest to hearing how HMRC will react to the recent tribunal decision (Benedict Manning v HMRC [2013] UKFTT 252 (TC)).

**The valuation rules for listed company shares: quarter up valuation (OTS Recommendation F(4))**

Although we understand that the OTS recommendation to replace the current "quarter up" method of valuing quoted shares with a closing price approach would lead to simplification, we have reservations about the impact on small and mid-size quoted companies whose shares are often thinly traded. The proposed new approach could result in unfairly higher tax charges for employees of these companies and we would therefore prefer to retain the existing system.

**Comments on other proposals made by the OTS**

**Recommendation A: the "marketable security"**

We support the OTS recommendation that there should be no automatic income tax charge when an employee acquires employment-related securities at a time when there is no market for the shares, in particular in cases where the securities concerned are shares in the employing company (or group). The current legislation discourages employees from accepting shares because they cannot dispose of any of them in order to fund the tax liability.

However, employees should be given the flexibility to opt to be taxed at an earlier date – either the acquisition date or any other date up to when the shares do become marketable.

**Recommendation A(1): clearer definition of "readily convertible assets"**

For the same reasons, we support the recommendation to remove all shares which are not "marketable" from the definition of RCA. There should be no NICs or PAYE when employees acquire shares – at least those in their employing company - which are not convertible into money or money's worth.

When a company is considering a listing, the shares become RCAs when 'trading arrangements are likely to come into existence'. It is generally accepted that shares become RCAs at the point that a broker is

appointed. There are two issues with shares becoming RCAs when trading arrangements are likely to come into existence:

- There is an element of subjectivity to the point at which arrangements are likely to come into existence. We are aware of companies refraining from appointing brokers in order to argue that shares are not RCAs. This clearly goes against the spirit of the rules.

- If shares are RCAs by virtue of arrangements 'likely to come into existence' there are still a number of examples where such arrangements do not come into existence. This makes it challenging for employers proposing to list where individuals exercise options or receive share awards as the PAYE and NI obligations arise whilst the shares are illiquid and never then become liquid.

We propose that the definition of RCAs should be amended to remove the reference to trading arrangements 'likely to come into existence'. This avoids ambiguity and the scope for differing interpretations or 'planning' to result in different treatment for different companies.

If this change to the rules was seen as unacceptable, an alternative (which is less straightforward but more desirable than the current regime) would be that PAYE and NI charges arising on securities where trading arrangements as 'likely to come into existence' should be payable only at the time that the trading arrangements do come into existence. That would avoid dry tax charges arising where there never becomes the opportunity to convert the shares into cash.

We welcome HMRC's commitment to improve their guidance on RCAs, particularly in situations where a company sale or IPO is contemplated but may not in fact go ahead.

**Recommendation C: employee shareholding vehicle**

We support the OTS proposal for an employee shareholding vehicle which will allow companies to hold surplus shares, act as a market for employees and deliver them to employees while avoiding the numerous tax pitfalls described in the OTS report. This will make the operation of share plans much easier and less costly for smaller companies.

The new vehicle need only apply to straightforward employee share plans which deliver shares in the employing company (or group) to their employees. This will minimise the risk that it will be used for tax avoidance.

We are, however, concerned about two aspects of this proposal:

- the suggestion that the vehicle might not be an EBT; and
- the requirement for the trustees all to be resident in the UK.

The proposal only makes sense if the large number of existing straightforward EBTs, used in conjunction with standard employee share plans, will qualify. Although the flexibility of not having a trust structure could be useful to some companies, the safeguards to employees which it offers mean that most will want to go down the trust route.

As regards the residence of the trustees, most existing trusts operate "offshore" – eg using trustees in the Channel Islands – partly because there is a good supply of experienced trustees based there and partly to

avoid the potential double tax charge which may apply to a UK-resident trust, under existing laws, whereby part of the same gain may be subject to income tax on the employee and capital gains tax on the trustee. We seek a level playing field for UK-based trusts, not a ban on those based outside the UK, which would mean that large numbers of existing EBTs would need to be re-located at great potential expense.

**Recommendation D: Form 42 changes**

We warmly welcome HMRC's proposals to simplify Form 42 and to provide clearer guidance for companies which need to complete it. The current form requires a detailed knowledge of the complex legislation relating to employment-related securities and many companies are confused about which sections need to be completed and which do not. Intelligent online fling has the potential to reduce this problem.

We understand that much of the information which currently needs to be submitted is never used by HMRC and therefore hope that the form can be made considerably shorter in future.

**Recommendation E(1): extend PAYE deadline for reporting employment-related securities**

The current deadline of 14 days after the end of the tax month is impossible for many companies to comply with for many events which result in an income tax charge under the employment-related securities legislation. This is a particular problem for smaller companies. Although HMRC's guidance on their application of the "reasonable excuse" principle is helpful, this still does not give sufficient flexibility and certainty to companies.

We therefore welcome the OTS recommendation to extend the deadline to 60 days after the end of the tax month in which the taxable event occurs and the Government's commitment to this extension once RTI has been fully implemented.

**Recommendation F(1): increased ability to provide pre-transaction valuations for unapproved share plans**

The current HMRC practice of not agreeing pre-transaction valuations for unapproved share plans causes considerable uncertainty for unlisted companies (including those with shares quoted on AIM) and their employees.

We therefore welcome the OTS recommendation that HMRC should not challenge the valuation used by companies in certain simpler situations, such as:

- where a valuation has been agreed for a tax-advantaged share plan;
- where the same valuation approach has been agreed by HMRC in the past;
- where the valuation matches a recent arm's length transaction
- offers of shares in a start-up company.

This is a good practical solution which will help many companies without a significant threat to the Exchequer.

**Recommendation F(2): HMRC to provide valuation methodologies**

HMRC provide guidance as to how the market value should be determined for quoted companies and it is acceptable for HMRC to substitute the sales proceeds as long as, broadly, the shares are sold on the same or following date as the date on which the tax charge (i.e. vesting or exercise) arose. However small and mid-size quoted companies do not always have the liquidity in order to execute share sales in that period of time. In that case, the income tax charge may apply on a greater amount than is actually realised on sale.

We believe that HMRC should amend their guidance to allow for a longer period to achieve the sale of the shares where there is a lack of liquidity.

We note the point that has been made to you around hardship and the suggestion that the income tax charge should be allowed to defer until the sale of the shares. Our views on this suggestion are:

- We agree that the principle is an attractive one for certain employees.
- We would not want the treatment to be compulsory since there are certain individuals who prefer the accelerated tax charge.
- This is not appropriate if the tax charge at a later point is subject to PAYE and NI since it potentially requires tracking for leavers as well as international participants.
- We would suggest that the ability to defer tax should be by way of a joint election between the employee and the employer.

**Recommendation F(3): increased flexibility where shares are quoted but not on a recognised stock exchange**

We accept that there are circumstances in which the closing share price quoted on AIM (and similar markets) may not be a fair market value. However, the quoted share price will be the fairest in many circumstances and so we would appreciate clearer guidance from HMRC about the circumstances when the AIM-quoted price will or will not be accepted.

Yours faithfully,

Tim Ward
Chief Executive

**APPENDIX A**

**Quoted Companies Alliance Share Schemes Expert Group**

| | |
|---|---|
| Nicholas Stretch (Chairman) | CMS Cameron McKenna LLP |
| Fiona Bell (Deputy Chairman) | RM2 Partnership Limited |
| Anika Chandra/ Barbara Allen | Stephenson Harwood |
| Emma Bailey | Fox Williams LLP |
| Martin Benson | Baker Tilly |
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| Vanessa Cundy Cooper | KPMG LLP |
| John Daughtrey | Equiniti |
| Matthew Findley | Pinsent Masons LLP |
| David Firth | Penna Consulting PLC |
| Philip Fisher/Andy Goodman | BDO LLP |
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