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Dear Sirs,

Office of Tax Simplification Review of Unapproved Employee Share Schemes: Interim Report – Areas for Further Input

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 opportunity to respond and to help shape the way forward for unapproved employee shares schemes and supports the proposed changes. Specific comments are set out below. Please note that, unless otherwise stated, all references to chapters are references to chapters in part 7 of ITEPA 2003 and all legislative references are references to ITEPA 2003.

1. Difficulties with valuation of private company shares

What experience do you have of difficulties with the valuation of private company shares and how does this impact on the design and implementation of your share plans?

Shares in our members are traded or listed on public markets and therefore private company issues are not relevant for our members.

2. Internationally mobile employees

What are the main difficulties you face when managing internationally mobile employees in the context of unapproved share plans?

2.1 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 in 2.2 below.

2.2 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 apply, 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.

2.3 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.

2.4 Tracking leavers

We agree that 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.

3. Readily convertible assets (RCAs)

What are the main difficulties you face in determining whether your shares are or will be RCA's or not?

One of our corporate members raised the point around the complexity of calculating and paying PAYE and NI in relation to shares. Calculations for leavers and also the transfer of employer's NI to the employee are both key factors that have led to the view that PAYE and NI on share based payments should not apply in any event.

Notwithstanding the above, we have set out the main difficulties in response to the question.

3.1 Trading arrangements likely to come into existence

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.

3.2 Shares not corporation tax deductible

Shares are RCAs if they are not 'corporation tax deductible' (s702(5A) ITEPA 2003). This means that shares in companies that are under the control of an unlisted company are RCAs. This provision was included to avoid employers undertaking tax avoidance using dependent subsidiaries. Given the anti-avoidance provisions included in part 7 ITEPA 2003, we are not aware that avoidance using dependent subsidiaries would become undertaken if s702(5A) ITEPA 2003 was removed.

In addition, it seems particularly unfair that the provision refers to whether the parent company is an unlisted company. Companies whose shares are traded (for example on AIM and PLUS) are not 'listed' for this purpose. Therefore, shares in subsidiaries of these companies are RCAs whereas shares in subsidiaries of companies listed on the main market are not RCAs. This discriminates against markets geared towards small and mid-sized quoted companies.

We propose that the provisions of s702(5A) ITEPA 2003 should be removed as it does not appear to prevent any abuse or avoidance. The removal would create a more equitable system.

4. Form 42 – the process HMRC has set up to notify them of awards of options or shares to employees

What are your main issues with Form 42?

Our key issue with the Form 42 is the overriding view that it is a time consuming administrative exercise where the vast majority of information provided is never referred to by HMRC. We consider that it would be more appropriate if HMRC was to notify specific employers on a selected or random basis to prepare forms so that it can review those as appropriate samples. It can also notify employers that are the subject of an employer compliance review that it needs to prepare a form at that time. The purpose of this approach is that the Form 42 compliance obligation is limited to those companies where HMRC will review the information.

5. 'Disguised Remuneration'

Can you provide any particular examples of how the disguised remuneration rules (Part 7A of ITEPA 2003) have impacted upon the design, implementation or administration of your unapproved plans?

The introduction of the disguised remuneration provisions has caused employers to reduce their use of Employee Share Ownership Trusts (ESOTs) or other Employee Benefit Trusts (EBTs). Many ESOTs were used as genuine share warehouses to hedge and to source shares to satisfy unapproved (and approved) share plans. The challenges of ensuring that the trustees do not undertake relevant steps through earmarking and needing to ensure that such steps are always within an exemption means that the commercial, non-aggressive use of EBTs has reduced.

Prior to the introduction of the disguised remuneration rules, it was common for employers to operate 'deferred payment' share schemes. Under such schemes, employees would purchase shares from an EBT with the purchase price left outstanding and deferred. The purchase price would most likely be paid at the time of the sale of the shares. The benefit of the purchase price deferral would fall within the notional loan benefit in kind rules. This was not aggressive tax planning.

The introduction of the Disguised Remuneration rules meant that deferred payment schemes with EBTs are no longer effective.

6. Tax issues for Employee Benefit Trusts (EBTs)

Can you give examples of when the taxation of EBTs (e.g. Inheritance tax rules, loans to participators) has provided a barrier to the establishment of an unapproved share plan or caused you to restructure, or alter the design of, your share plan in a manner which has adversely affected the attainment of your commercial intentions?

6.1 Loans to participators

The tax charge under s455 of the Corporation Tax Act 2010 (CTA 2010) provides a significant barrier to close companies being able to use EBTs for commercial share incentivisation. There are a number of reasons that it is attractive for the shares to be used under employee share schemes to be acquired by and warehoused within an EBT. In order for the EBT to play this role, the EBT needs to be funded and it is often desirable for the employer to provide this funding by making loans.

However these loans to EBTs are invariably loans to a 'participator' in the company and this means that the loan would give rise to a charge to corporation tax in respect of 25% of the loan. The tax is repayable to the company when the loan is repaid or written off. The application of s455 of the CTA 2010 makes the commercial use of an EBT in share incentives less attractive and also causes companies to take more complex approaches to the way that they fund EBTs so as to minimise the risk of the charge arising.

We do not consider that there would have been an intention that s455 CTA 2010 should apply on these circumstances and that there should therefore be an exclusion from the provision where the loan is made to an EBT. If there was a concern that this could lead to the EBT being used as a conduit for loans that would otherwise give rise to charges under the provision, a simple anti-avoidance provision could be introduced to address this.

6.2 Inheritance tax provisions

Dispositions by close companies to employee benefit trusts can give rise to transfers of value by the 5% participators in the company and transfers from the trustee can give rise to inheritance tax charges for the trustee. These rules are complex and it is easy for companies to fall within the rules inadvertently if they are not well advised. In addition, the complexity of the rules mean that HMRC's interpretation is different to the interpretation of many taxpayers. We would therefore propose the following changes to the relevant provisions of the Inheritance Tax Act 1984:

- Increase the 5% threshold that applies to determine both whether inheritance tax charges may arise to a higher percentage (20% would be a reasonable new threshold).

- Simplify the inheritance tax provisions to remove the opportunity for HMRC or the taxpayer to apply a discretionary opinion.

7. Employment related securities rules

Can you give examples of when the employment related securities rules – in particular the rules relating to restrictions on shares – have caused you difficulties in connection with your unapproved share plan arrangements?

7.1 Restricted security elections

It is often the case that employers and employees wish to enter into restricted securities elections under s431(1) ITEPA 2003 and it is not uncommon for the parties to fail to enter into the election within the 14 day period within which to elect. Whilst we understand and accept the desire to include the deadline so that there is no opportunity to exercise hindsight in relation to the accelerated income tax charge, we feel that it should be possible to enter into elections at later points to accelerate the tax charge to the point at which the election has been entered into.

The election would in effect crystallise a chargeable event under chapter 2 at that point. This addresses the situation where employees and employers innocently forget to enter into elections. Allowing the crystallisation of the chargeable event would avoid employers taking steps to trigger chargeable events simply to allow an election under s430(1) ITEPA 2003 to be entered into which we are aware takes place.

7.2 Share for share rollovers

Charges under chapter 2 can arise on (amongst other things) the disposal of the restricted securities. This includes if the shares are exchanged under a ‘share for share’ exchange. There are times when it is desirable for companies to add a new holding company to the top of their corporate structure. In this case, there are provisions under s135 of the Taxation of Chargeable Gains Act 1992 for capital gains tax charges to not arise on the exchange of shares. However, there are no such provisions in relation to restricted securities where the disposal would crystallise an income tax charge.

We suggest that rollover provisions should be incorporated into the restricted securities rules so that a share for share transaction does not crystallise a charge to income tax.

8. Timing of the income tax charge

Chapter 4 sets out some of the difficulties that arise as a result of an income tax charge and PAYE arising on the date the beneficial ownership of the shares is acquired. There are possible arguments that this would be a simplification if in certain circumstances the income tax charge (or PAYE obligation) arose on the receipt of money on the sale from the shares. We welcome views on whether this would be a simplification and in what circumstances?

8.1 Close Period

Where long term incentive awards vest during a close period, this gives rise to a charge to income tax even though the ‘insiders’ are not able to sell the shares and raise funds to pay PAYE or NI charges. These dry tax charges are inequitable. We would suggest that the income tax charges should not be crystallised until the close period has expired.

8.2 Valuation issues

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.

9. Employment reward vs. Capital growth

Do you agree that the current rules get the balance right when distinguishing between employment reward and capital growth. Could this be achieved effectively in a more simple way?

Having sought the views of our corporate members, a number expressed the view that share options should be fully subject to capital gains tax when the shares are sold rather than being subject to income tax on exercise (and then subject to capital gains tax on sale). This would negate the need for approved plans that give rise to complexity.

Subject to the above views that would give rise to significant overall changes in the tax treatment of share options, we consider that the current application of part 7 ITEPA and its interaction with the Taxation of Chargeable Gains Act 1992 is successful in order for people to either pay tax or make an investment in order to fall within capital gains

10. Small/private companies

Do you think there should be separate rules for small/private companies to account for the particular issues they face. How would this look?

Shares in our members are traded or listed on public markets and therefore private company issues are not relevant for our members.

If you would like to discuss any of this in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

Share Schemes Expert Group

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Barbara Allen, Stephenson Harwood
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