Office of
Tax Simplification

# Review of unapproved employee share schemes: Final report

January 2013

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ISBN 978-1-909096-47-9
PU1432

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# Foreword

Up to now, as the Office of Tax Simplification interim report on unapproved share schemes showed, this area of tax legislation has been like a poorly tended bramble patch. In trying to get at the delicious blackberries the unwary have found themselves snagged on the thorns of complexity, a principal driver of which has been anti-avoidance legislation.

This final report proposes a significant pruning of the unapproved share schemes "bramble patch" to enable users to access the blackberries more easily and with fewer prickles. In making our recommendations, we are aware that our proposals will mean significant changes in tax law in this area. We know that change itself can bring complexity. However, we believe that these proposals are worthwhile as they aim to remove the uncertainties and difficulties of the old schemes whilst providing proper safeguards as far as tax avoidance is concerned.

In putting forward our recommendations, we have been very aware that share based reward programmes are much valued by both companies and their employees. In our report on the tax advantaged schemes, we noted, "if greater employee participation is seen as a priority, then there is clear scope for something of a relaunch of plans to encourage their use." These remarks can equally be applied to the findings contained in this report.

In developing these ideas, we have been greatly assisted by the members of a very active and fully engaged Consultative Committee. They proved to be a source of ideas as well as critical appraisal of the proposals which form the core of this report. Above all their contributions have meant that our ideas were founded on the ways in which companies use share based employee rewards in the real world. With this in mind we firmly believe that our recommendations will encourage more employee share ownership, with the resulting benefits of greater employee involvement.

Our package of recommendations is inevitably both technical as well as detailed. It is a reflection of the area of tax law at which they are aimed. They could not have been put together without the tireless work and deep understanding of this area of two of our secondees, Sarah Anderson and Tony Page. Their efforts together with the support they have received from the OTS's Mark Thompson will, I hope, be fully acknowledged by all practitioners in this field.

This report now concludes the work we have been undertaking on share schemes. We very much hope that the Chancellor of the Exchequer will look at our proposals in the same positive way that he did with our recommendations for improving tax advantaged share schemes.

Rt. Hon. Michael Jack

Chairman, Office of Tax Simplification

# Executive summary

In August 2012, following a period of research, the Office of Tax Simplification (OTS) produced an interim report on the areas of complexity relating to employee share schemes and share based incentives which do not benefit from any tax advantages: so-called "unapproved" share schemes.[1]

The current share plans legislation is a tangle of complexity, creating costs and traps for companies and their advisers, uncertainty for employees, and ongoing burdens for HM Revenue & Customs (HMRC) when seeking to apply the correct tax treatment. The complexity of the tax legislation throws up unnecessary barriers for companies looking to implement share plans for their employees, which is in direct opposition to current government policy to broaden employee ownership. At the same time, we recognise the concerns HMRC has about possible avoidance in this area, and the consequent need for careful rules to police the system.

The interim report identified a number of areas of complexity. These included:

- PAYE penalties and deadlines;
- Managing international employees;
- The form used to report share transactions to HMRC (Form 42);
- The "disguised remuneration" rules (Part 7A ITEPA 2003);[2]
- Valuation (particularly of private company shares); and
- The "employment related securities" rules (Part 7 ITEPA 2003).

Since the publication of the interim report, the OTS has sought further input and feedback from a variety of sources.

As a result, we now have six main recommendations to put forward to the Chancellor of the Exchequer. Each recommendation could be implemented separately, but they are complementary, and represent a balanced package of reforms in line with our mandate to simplify the tax system. We believe that implementation as a full package would provide the greatest benefit.

Overall, the large number of difficulties created by the legislation calls for a thorough overhaul, not minor tweaks. The main recommendations are radical to reflect this requirement.

## A. The "marketable" security

Our first recommendation involves a fundamental change to the taxation of employment related securities (ERS) to simplify it by closer alignment of the taxation of ERS with that of general earnings. At the moment, broadly speaking, employees are taxed on the value[3] of their shares when they are acquired even if they have no way of selling any of their shares to cover the tax. Our recommendation will allow individuals to choose the time when a tax charge arises – either

[1] http://www.hm-treasury.gov.uk/d/ots_unapproved_employee_share_schemes_interim.pdf

[2] Income Tax (Earnings and Pensions) Act 2003

[3] Section 62(2b) ITEPA 2003: "Any profit...of any kind if it is money or money's worth."

on acquisition of the security, or when the security can be sold for cash (when it becomes "marketable"). The default position, however, will be that no tax charge arises until the security can be sold for cash. This will remove the so-called "dry" tax charge that arises when an individual cannot sell their shares to cover the tax due. As a quid pro quo we recommend that "marketable" shares are deemed readily convertible assets (RCAs) and so subject to pay as you earn (PAYE) and national insurance contributions (NICs).

If this recommendation is adopted, a number of complexities of the employment related securities legislation will fall away. We recognise such a radical change will need further detailed consideration and consultation, in particular in connection with anti-avoidance. We therefore make three supplementary recommendations to the first recommendation. These could be adopted while the details relating to the first recommendation are being considered. The supplementary recommendations include changes to the definition of "readily convertible assets" in connection with employment related securities and alignment of tax reliefs where inconsistent treatment causes difficulties, especially in corporate transactions.

These supplementary recommendations are made with some misgivings – not because we consider them unimportant, but because if they are made and then followed by the major reform, that means more change and our own work recognises frequent changes in legislation as a major cause of complexity. Furthermore, we wish to emphasise that they do not stand as an alternative to the first recommendation (although they could stand alone, and still be a move towards simplification).

### B. International assignees

Our second recommendation is the alignment of the tax treatment of international assignees with the general earnings tax treatment, simplifying with a common approach and extending the corporation tax deduction in relation to employees from abroad seconded to work for UK companies where income tax is payable. Currently, the taxation of employment related securities for such employees is complicated, inconsistent, illogical and a source of huge frustration and confusion for employees, companies, advisers and HMRC alike. This is not just a question for larger organisations but also for smaller businesses in the UK where global business and internationally mobile employees are increasingly common. A consistent approach to this area will be welcomed by a variety of businesses and individuals and will help avoid innocent mistakes and unnecessary penalties.

### C. An Employee Shareholding Vehicle

Our third recommendation is the introduction of a simple vehicle to enable companies (mostly, but not exclusively unquoted) to manage their employee share arrangements and create a market for employees' shares. This could be a statutory "safe harbour" employee benefit trust (EBT). However, EBTs have acquired something of a bad name of late because of their use for tax avoidance purposes and we have no wish to create new avoidance opportunities. There is, though, a real need to create a vehicle – some form of entity that might be a form of EBT – which can be used safely and easily by private companies wishing to establish employee share schemes. Companies need such a vehicle to provide a marketplace for employee shares and to allow such shares to be warehoused until allocated to individuals. Accordingly, we recommend an 'Employee Shareholding Vehicle'; this may be a trust but in this report we use 'vehicle' so as not to prejudice reactions to this recommendation.

The aim is to provide companies with protection from some of the tax traps which exist in the extremely complex anti-avoidance legislation but at the same time ensure protection for HMRC by restricting carefully what this vehicle can be used for. This recommendation is of particular importance if Government policy is to encourage wider employee ownership in private companies.

### D. Form 42

On Form 42, we think there is a strong argument for curtailing considerably the amount of information collected by the form. However, to avoid too many changes to systems, we recommend online filing in the short term, with a move to an intelligent system and integration into real time information (RTI) over a longer horizon.

### E. PAYE simplification

For PAYE deadlines we recommend extending the deadline from 14 days to 60 days after the end of the tax month for all employment related securities. We also recommend removing them from the section 222 ITEPA 2003 charge if the tax is made good.[4]

### F. Valuation

Finally, on valuation we make several complementary recommendations. These include increased availability of pre-transaction valuations in certain circumstances, better provision of valuation information and more flexibility for companies on non-recognised stock exchanges.

The final three recommendations (i.e. D-F) relate to some of the 'everyday' complexities faced by advisers, companies and administrators. It is these recommendations that are likely to have the biggest impact day to day and they were the most cited areas of complexity in our survey.

If these six recommendations are taken as a whole they will make a significant difference to all the participants involved in unapproved share plans, including employees, businesses, administrators, advisers and HMRC.

The OTS's remit is to bring forward recommendations that are broadly revenue neutral. We think the proposals in this report will have little or no overall impact on tax revenues, though we suspect that there may be some small initial costs. HMRC has noted that the exact revenue impact of any proposals taken forward will depend upon the further detail that would need to be developed prior to implementation, which we would expect to be subject to further consultation.

The recommendations in this report have been submitted to the Chancellor of the Exchequer in advance of Budget 2013.

[4] Section 222 ITEPA 2003: payments by employer on account of tax where deduction not possible.

# 1 Introduction

1.1 The taxation of employee share schemes is widely regarded as one of the most complex parts of the UK's tax legislation. The main legislation is set out in Part 7 of the Income Tax (Earnings and Pensions) Act 2003 (Employment Income: Income and Exemptions Relating to Securities). Part 7 in itself is complex, requiring the reader to understand the concept of a number of different types of "security"[1] before even considering how each type of security is taxed. Identifying what type of security is being used in a share scheme – and therefore its tax treatment – is difficult not only for companies, but even for the specialist advisers we have spoken to as part of the review.

1.2 The complications feed through into the most basic administration – many of the companies we have spoken to need specialist advice simply to complete the annual return for their share schemes (Form 42) because it requires such a detailed knowledge of Part 7. Furthermore, the complexities of Part 7 result in inconsistent treatment of internationally mobile employees, and cause a number of difficulties for companies attempting to deal with Pay as You Earn (PAYE), and, in future, real time information (RTI) deadlines.

1.3 In addition to Part 7, businesses must also take account of other areas of tax legislation, including corporation tax and capital gains tax – and if an employee benefit trust (EBT) is used, this results in more possible pitfalls relating to inheritance tax and the recently enacted Part 7A ITEPA 2003 (the so-called "disguised remuneration" rules).

1.4 Some have made the point that in many ways the legislation is necessarily complex as it reflects the complicated commercial reality of remunerating employees and aligning their objectives with those of the company. Whilst we agree with this to some extent, there are clearly many ways in which the taxation of employee share schemes could, and should, be simpler. Simplification can also help align the interests of employees with standard investors. The recommendations in this report, if accepted, will go a long way to achieving that goal and opening employee ownership to many more companies and employees.

## The Office of Tax Simplification's (OTS) approach to the review

1.5 The review of unapproved share schemes has been delivered in two stages: an interim report published in August 2012;[2] and this final report with specific recommendations.

1.6 The original terms of reference for the review asked the OTS to examine which were the most commonly used types of unapproved share scheme and find out which areas of the tax system create unnecessary complexity and hinder their objectives. We hope that our interim report achieved these objectives: feedback received suggests it did. In this final report we have provided recommendations which will simplify many of the complexities identified.

1.7 As set out in our interim report we have taken a very wide view of what falls under the umbrella of employee share schemes and included any form of remuneration using employment related securities (ERS).

[1] Definitions of the terms used in this report are listed in the glossary in Annex C

[2] http://www.hm-treasury.gov.uk/d/ots_unapproved_employee_share_schemes_interim.pdf

1.8 In keeping with all OTS reviews we have canvassed views from a wide audience of advisers, businesses, scheme administrators and tax authorities. These were reflected in our interim report, but we have had further responses based on the questions posed in that report and further meetings with relevant parties. A summary of these responses can be found in an annex to the report.

1.9 In addition to the specific responses and meetings noted above, our team has continued to research and gather information as follows:

- Ongoing meetings with stakeholders, including private companies, legal advisers, accountancy firms and valuation experts;
- Establishment of sub committees of our Consultative Committee with additional specialist contributors to review particular areas such as private company valuation and international assignees;
- Keeping abreast of industry practice e.g. attendance at the annual ifs ProShare conference, and HM Revenue & Customs (HMRC) Employment-Related Securities and Fiscal Forums;
- Continual liaison with HMRC and HM Treasury, including a visit to HMRC's Shares and Assets Valuation team;
- Keeping up to date with other HMRC practice and current developments in the area, particularly changes to RTI;
- Taking into account concurrent reports and policy announcements, including *The Nuttall Review*,[3] the Department for Business, Innovation and Skills announcements on "employee shareholder employment status" and the subsequent consultation;
- Taking account of other OTS reviews and subsequent HMRC and HM Treasury consultations, such as the consideration of the integration of national insurance contributions and income tax in our small business review,[4] ensuring no duplication yet considering possible consequences; and
- Keeping abreast of other developments, e.g. the Loughborough University report: *Human & Organisational Impact of Employee Share Ownership*.[5]

1.10 Our Consultative Committee has played a prominent role in providing information and ideas, and producing recommendations for this report. Their expertise has been invaluable in helping us understand the technical issues, practical problems and possible simplifications in this complex area of tax legislation. We would therefore like to sincerely thank Committee members for their time and contributions to the review.

1.11 We would also like to thank a number of experts we have been fortunate enough to be able to call on, all of whom gave us valuable input into the report.

1.12 Finally, the OTS would like to thank both HMRC, particularly the share schemes specialist team, and HM Treasury for their considerable help and engagement with the review.

1.13 We readily acknowledge that this report would not have been possible without the contributions from those noted above. The report, though, is ultimately the responsibility of the OTS and we are responsible for its content and recommendations.

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[3] *Sharing Success: The Nuttall Review of Employee Ownership*, published 4 July 2012: http://www.bis.gov.uk/assets/biscore/business-law/docs/s/12-933-sharing-success-nuttall-review-employee-ownership.pdf

[4] http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

[5] http://www.ifsproshare.org/research/pdf/loughboroughresearch(fullresearchreport)september2012.pdf

## Structure of the report

1.14 The report is structured as follows:

- Chapter 2 lists the recommendations arising from the review;
- Chapter 3 explains the "marketable" security recommendation in detail;
- Chapter 4 sets out the supplementary recommendations to the marketable security;
- Chapter 5 details the recommendations on internationally mobile employees;
- Chapter 6 explains the recommendation for an Employee Shareholding Vehicle (a 'safe harbour employee benefit trust');
- Chapter 7 covers recommendations on the administration of the taxation of employee share schemes;
- Chapter 8 makes recommendations on valuation of securities; and
- Chapter 9 summarises the proposals we considered and rejected.

1.15 The annexes provide the reader with supplementary information including a summary of responses to the interim report and the terms of reference for this review.

# 2 List of recommendations

2.1 The recommendations made in this report by the Office of Tax Simplification (OTS) should further the Government's agenda to broaden employee ownership and help achieve that policy objective. Our proposals, if taken up, will make the tax treatment of employee share schemes easier to understand and manage, both for employees in the UK and abroad. They will also enable the establishment of a simple, onshore vehicle for the administration of share plans, a process which is currently fraught with difficulty for many companies. Our proposals relating to administration should reduce the time and costs associated with share plan returns, PAYE obligations and, particularly for private companies, the share valuation process. Finally, we think our recommendations will also assist HM Revenue & Customs and streamline their work in this complex area.

2.2 The main recommendations the OTS is putting to the Chancellor are set out below:

A. The "marketable" security: closer alignment of the taxation of employment related securities (ERS) with general earnings and removal of the current "dry" tax charge by defining the concept of a "marketable" security. A marketable security will, broadly, be one capable of sale for money or money's worth to a third party (and thus will automatically be treated as a readily convertible security, so subject to Pay as You Earn and national insurance contributions). The default position would be that a tax charge would only arise when employees acquire marketable securities (or the point when the securities become marketable). There would be no tax charge on the acquisition of non-marketable securities – although employees will be able to accelerate the tax charge if they wish;

B. International assignees: alignment of the tax treatment of international assignees with the tax treatment of general earnings and extending the corporation tax deduction in relation to employees from abroad seconded to work for UK companies where income tax is payable on share awards. This would include the exercise of share options or the vesting of conditional and deferred share awards;

C. An employee shareholding vehicle: introduce model rules for the provision of a trading/holding vehicle for employee shares which will avoid the tax pitfalls many legitimate employee benefit trusts face;

D. Form 42 changes: although simplification of Form 42 is desirable, we think the real answer is:

   a Short/medium term: online, intelligent filing;

   b Long term: integration with real time information (RTI);

   In the meantime no changes should be made to the form, though we have one administrative suggestion that will aid simplification;

E. PAYE changes: extension of the PAYE deadline for employment related securities to 60 days after the end of the tax month and the removal of employment related securities from section 222 ITEPA 2003 in the event the tax is made good; and

F. Valuation processes: changes in the approach to valuation processes for employment related securities.

2.3 Alongside recommendation A (above), we propose several supplementary recommendations:

A (1) Readily convertible assets: a clearer definition of readily convertible assets in relation to employment related securities combined with a retrospective number of days test;

A (2) Taxation of takeovers: establishing consistency in tax treatment of all employment related securities in share for share exchange and rollover situations; and

A (3) Corporation tax relief changes: amendment of Part 12 Corporation Tax Act 2009 to allow corporation tax relief where there is a takeover by an unlisted company.

# 3 Recommendation A: the "marketable" security

**Recommendation A: closer alignment of the taxation of employment related securities (ERS) with general earnings and removal of the current "dry" tax charge by defining the concept of a "marketable" security. A marketable security will, broadly, be one capable of sale for money or money's worth to a third party (and thus will automatically be treated as a readily convertible asset, so subject to Pay as You Earn and national insurance contributions). The default position would be that a tax charge would only arise when employees acquire marketable securities (or the point when the securities become marketable). There would be no tax charge on the acquisition of non-marketable securities – although employees will be able to accelerate the tax charge if they wish**

## Reasons for recommendation A

3.1 When shares are acquired by employees they are usually taxed based on their money's worth. The money's worth concept does not work well when applied to shares, since the money's worth value on which the tax charge is based does not reflect the money the employee could actually realise from the share at the time of acquisition. This can lead to complexity and confusion.

3.2 The current charging structure results in an employee being charged to tax on the acquisition of shares. This means that an employee may need to sell some of their shares in order to realise funds to pay the tax due. Sometimes – in the case of many private companies, and some listed companies – it is not possible to sell the shares, so the employee may have to fund the tax bill themselves, a "dry" tax charge. This can be a disincentive for many employees and is inconsistent with a key objective of share based remuneration which is to encourage retention of shares by employees and align the interests of employees and shareholders.

## Summary of recommendation A

3.3 A charge to income tax and NICs (the "tax charge") should only arise on the acquisition of employment related securities (ERS) if they are "marketable".

3.4 ERS will be "marketable" only if they can be sold (whether or not they are actually sold) by the holder for a payment of money or money's worth which is (at least substantially) equal to the unrestricted value of the shares.

3.5 However, employees and companies whose securities are not marketable may enter into a joint election, on an employee-by-employee basis, to pay the tax charge earlier at the date of acquisition.[1] This will result in a dry tax charge, but only with the employee's agreement. As with the current section 431(1) ITEPA 2003 election, whether or not to operate PAYE and charge NICs will depend on the readily convertible status of the securities. The definition of readily convertible assets in relation to ERS should be amended so that such shares will only be treated

[1] We considered recommending a "floating election" – one that could be made at any time following acquisition – but concluded that a one-off opportunity to elect would be simpler. For more details, see Chapter 9.

as RCAs if they come within the new definition of marketable security. As such, PAYE and NICs would not apply if the new election was made.

3.6 In comparison with the current position, a deferral of the tax charge on acquisition would, in the case of non-marketable securities, be permitted, allowing employees to escape the dry tax charge.

**Box 3.A: Example 1 – whether shares are marketable**

Shares in a fully listed company would automatically be marketable securities (except for shares subject to forfeiture – see below). Shares in a private company would only be marketable securities to the extent that a ready market existed, such as an employee benefit trust (EBT) or other shareholder which (who) is in fact able and willing to purchase shares from employees. Where an EBT existed but only occasionally purchased shares in particular circumstances – e.g. when a shareholder ceased employment – the shares would only become marketable if and when those particular circumstances arose. Shares in a private company without an EBT (or any other market maker), would not be marketable.

3.7 The amount of the tax charge would be based on the unrestricted market value of the shares at the time they become marketable or the actual value of the consideration received on the disposal of the shares within 14 days of the time at which the charge arises. The market value will be based on the assumption that the shares are marketable and unrestricted. This will put employees in a similar position to standard investors as they will be taxed on the actual value they receive.

**Box 3.B: Example 2 – the tax charge**

A charge would arise automatically on the acquisition of shares in a fully listed company. Where there was an EBT or other shareholder that made occasional purchases – like the example in Box 3A above – no charge would arise until an event happened which caused the shares to become marketable. No charge would arise on shares in a private company without an EBT until an arrangement was put in place to purchase the shares. However, should the value of the shares in the private company increase between the date they are acquired and the date that the shares become marketable, the tax charge will be based on the higher value. There is a risk of a higher tax charge, but the employee will be able to sell his or her shares in order to cover that charge.

## Additional points

3.8 The marketable security principle should apply to all ERS, i.e. not just shares in the employing company or another member of the same group of companies. The criterion is simply whether the shares in question are marketable.

3.9 The shares in **a subsidiary** of a quoted company would not normally be regarded as marketable.

3.10 There will still be the option to transfer the employers' NICs charge for RCAs onto the employee, where relevant.

3.11 The definition of readily convertible assets in relation to ERS should be amended so that such shares will only be treated as RCAs if they come within the new definition of marketable security. One consequence of this will be to reduce the uncertainty for companies around the RCA status of their shares.

### Share options and other rights to acquire shares

3.12 The position will remain as it is now for options, in that no tax charge arises on grant. However, once options are exercised, and the individual acquires shares, the new tax treatment will apply. It will not be possible to make an election to pay the tax charge prior to the exercise of the option and the acquisition of the shares. For those private companies whose options are only exercisable on a sale of the company, the change will not make any difference to their arrangements.

3.13 In respect of other rights to acquire shares – e.g. conditional share awards or performance share awards – the same principle applies. There will be no tax charge due until the later of the vesting date and the date when the shares become marketable. It will not be possible to elect to pay the tax before the vesting date when the right to acquire the shares arises.

### Shares subject to forfeiture

3.14 Under current legislation, there is no income tax on the acquisition of shares subject to a short term risk of forfeiture (i.e. less than five years). However an election can be made under section 425(3) ITEPA 2003 to pay income tax upfront on the money's worth of the shares i.e. taking into account the forfeiture conditions when valuing the shares. An employee making this election will also be subject to a post-acquisition tax charge when the forfeiture lifts, calculated by applying the formula in section 428 ITEPA 2003.

3.15 Alternatively, employees can make an election under section 431(1) ITEPA 2003 for the shares to be valued ignoring the forfeiture condition. If they do so, the post-acquisition charge will not arise. For shares that are marketable at the time of acquisition we do not believe that the situation will change but Chapter 2, of Part 7 ITEPA 2003, will need to be retained to deal with the circumstances where a section 425(3) election is made.

3.16 For shares that are non-marketable on acquisition, there will be no tax charge on acquisition, unless an election is made to treat the shares as marketable (which would override section 425(3)) and pay the tax early on the unrestricted market value at that time. For shares that are not marketable on acquisition and not subject to an election to treat them as such, but become marketable while they remain subject to the short term risk of forfeiture, the charge would be deferred, as section 425(3) would continue to apply and the tax would be payable at the time the risk of forfeiture lifts. If the shares were not marketable at the time the short term risk of forfeiture lifts no tax charge would arise until the shares become marketable unless there was an election to treat them as marketable at the time the short term risk of the forfeiture lifts.

### Anti-avoidance provisions

3.17 We recognise that much of Part 7 ITEPA 2003 was introduced to deal with tax avoidance, in particular to prevent attempts to move remuneration connected with employment out of the income tax and NICs regime and into the more beneficial capital gains tax (CGT) regime. It is important to ensure that such tax avoidance activity is prevented. It is also important, however, to ensure that employees who invest in their employing company's shares are treated fairly and their tax treatment is aligned with investors' tax treatment when that is appropriate and reasonable.

3.18 Under the above proposal, the tax charge on ERS will be based broadly on what would now be considered the unrestricted market value of the shares with no discount for shares which are not immediately capable of being sold – or the amount actually received for the shares. Once this tax charge has been paid, any subsequent gain on the shares will fall into the CGT regime.

3.19 There is clearly a risk that if an election is made to pay the tax early, it might be possible to manipulate the value of the shares so that a large increase in value falls to be taxed to capital gains rather than income tax and NICs. Another approach might be to acquire non-marketable shares at a low value, defer the tax charge indefinitely, and in the meantime extract value from the shares by way of excessive dividends, again subject to a more beneficial tax charge.

3.20 We consider, however, that anti-avoidance rules relating to Part 7 can be effective without being unnecessarily complex. We propose the following approaches to anti-avoidance in respect of recommendation A:

- A new section 62A ITEPA 2003: whereby all income, dividends, gratuities, profits or incidental benefits of any kind obtained from shares on which no tax charge has yet been paid[2] count as employment income of the employee for the relevant tax year, and thus PAYE and NICs is applicable;[3]
- Chapter 4: Post Acquisition Benefits from Securities (Part 7 ITEPA 2003): this chapter should be retained and strengthened – significantly, if necessary – so as to continue targeting complex or contrived avoidance arrangements such as the "alphabet share scheme";[4] and
- The requirement to pay income tax and NICs on what is effectively the unrestricted market value of the shares reduces the ability of companies to manipulate the value of shares by reference to their inherent restrictions. This simple approach puts employees into the same category as external investors – once the unrestricted market value has been subject to income tax and NICs, without any discounts for restrictions, the employee should benefit from the same capital gains tax treatment as any other investor.

3.21 As we have noted this is a radical proposal and will require wide consultation, although we are confident from our own research that it has wide support in principle. We therefore accept that Finance Bill 2015 may be the appropriate timetable for implementing this recommendation rather than Finance Bill 2014, though the earlier date may be possible.

## How recommendation A will lead to simplification

3.22 We recognise that the devil will be in the detail, but we consider that the following parts of Part 7 might be redundant if recommendation A is taken forward:

[2] Unless the employee has paid the full market value for the shares and therefore no tax arose on acquisition.

[3] As part of the consultation care would need to be taken that legal dividends are not subject to employment taxation along the lines of section 189 ITEPA 2003.

[4] This scheme effectively provides a different class of share for each individual, paying out a different "dividend" to each which is, in reality, nothing more than a cash bonus, normally geared to the individual's own efforts/achievements.

**Box 3.C: Areas of Part 7 ITEPA 2003 potentially made redundant by the marketable security principle**

Chapter 2: Restricted securities (with the exception of rules relating to forfeitable securities) – because securities will be valued only with respect to their unrestricted market value;

| | |
|---|---|
| Chapter 3A: Artificially depressed value;<br>Chapter 3B: Artificially enhanced value;<br>Chapter 3C: Acquisition for less than market value;<br>Chapter 3D: Disposal for more than market value; and | Because these chapters will be covered by the broader anti-avoidance measures noted above |

Parts of Chapter 5: Securities options – because the difference between securities options and securities will be removed as a result of the alignment of general earnings treatment and Part 7 treatment.

3.23 Removing these complex chapters of Part 7 will have a very significant effect in terms of administration, in that Form 42 can also be simplified. Chapter 7 discusses recommendations on Form 42 in more detail.

3.24 In addition, recommendation A will have the following advantages:

- Removal of the “dry” tax charge;
- Closer alignment of the tax treatment of employees with standard investors; and
- Deferred payment ensures the participant has sufficient funds to cover the tax bill.

# 4 Supplementary recommendations to recommendation A

4.1 The OTS recognises that recommendation A, the introduction of a "marketable" security, is a radical proposal. We therefore understand the need to take time to get it right. Because of this we make three supplementary recommendations which would serve as interim solutions to some of the difficulties faced by companies implementing unapproved employee share schemes.

4.2 We make these supplementary recommendations with some trepidation as frequency of change has been highlighted many times by the OTS as the greatest source of complexity. They would stand alone as a step in the right direction, but we maintain that recommendation A should be the final destination, with these recommendations just a resting point along the way.

**Recommendation A(1): a clearer definition of readily convertible assets (RCAs) in relation to employment related securities (ERS) combined with a retrospective number of days test**

## Reasons for recommendation A(1)

4.3 When ERS are also RCAs, they are subject to Pay as You Earn (PAYE) and national insurance contributions (NICs). However, defining an RCA, in particular for smaller companies, is a "grey area" and causes much confusion as we noted in our interim report. In particular, RCAs are not always, in reality, "readily convertible" at the time of acquisition. For example, the legislation refers to trading arrangements which are "**likely to come into existence**"[1] (our emphasis). This allows a wide interpretation of the meaning of "readily convertible" which leads to uncertainty for companies and inconsistency of treatment. For a private company seeking a sale, it is difficult to know the point at which the shares become RCAs and, if the sale does not proceed, at which point the shares cease to be treated as RCAs.

4.4 Furthermore, if securities are not corporation tax deductible,[2] they are automatically deemed to be RCAs[3]. This is an additional complexity which can create difficulties for some companies and unfairness for others. For example, identifying the corporation tax deductible status of a company (e.g. whether or not it is under the control of an unlisted company in the case of a company with private equity investors) is not always straightforward. As another example, shares of companies listed on non-recognised stock exchanges, such as the Alternative Investment Market (AIM) or ISDX,[4] are not corporation tax deductible. This means that shares in their subsidiaries are automatically deemed RCAs. This automatic assumption that such companies' shares are RCAs results in inequitable treatment for companies operating in smaller and mid-sized markets. If recommendation A(1) is implemented alongside recommendation A this uncertainty will be removed.

[1] Section 702(1)(c) ITEPA 2003.

[2] Shares are corporation tax deductible if they meet the requirements of Part 12 CTA 2009. Broadly speaking they must be fully paid up, non-redeemable and shares in a company that is either listed, or under the control of a listed company, or in a company that is not under the control of another company. When such shares are acquired by employees as a result of their employment, the employing company benefits from corporation tax relief equivalent, broadly, to the market value of the shares acquired by the employee, less any consideration given for those shares.

[3] Section 702(5A) ITEPA 2003.

[4] ICAP Securities and Derivatives Exchange, a market for small capital and growth companies.

## Summary of recommendation A(1)

4.5 RCAs should be redefined for the purposes of Part 7 ITEPA 2003 so that only shares that are truly convertible can be RCAs and therefore subject to PAYE and NICs. This would be effected by the removal of the phrase "likely to come into existence", so that shares would only be RCAs if there were actually trading arrangements in existence, and the removal of section 702(5A) ITEPA 2003 in its entirety.

4.6 There will inevitably be situations where the RCA position is unclear, for example a company in the midst of negotiations for a sale or planning for an initial public offering (IPO), where the sale or IPO does not, in spite of expectations, actually occur. In these situations, we would recommend a 90 day grace period. If at any time during the 90 days the sale or IPO occurs, the shares would clearly be RCAs, and PAYE and NICs would arise. If, however, at the end of that 90 day period, the IPO or sale has still not taken place, it seems reasonable to assume that the shares cannot be deemed to be truly readily convertible.

4.7 There will need to be consideration of how the 90 day limit fits with RTI limits so that they are consistent.

4.8 The OTS recognises that it is impossible to define with absolute clarity whether a security is truly "readily convertible". However, we consider that our proposal will narrow considerably the grey area that currently exists.

4.9 How will this fit with recommendation A? If securities become "marketable" within 90 days of the date they are sold by the employee then they would be subject to PAYE and NICs.

4.10 The OTS would like to see this recommendation, if accepted, implemented in Finance Bill 2014.

## How recommendation A(1) will lead to simplification

- Provide clarity, certainty and simplicity for companies where there is no obvious market for the shares;
- Reduce investigation time and cost for companies with complex control structures;
- Potential removal of a large body of HM Revenue and Customs (HMRC) guidance; and
- Reduce the number of queries to HMRC.

**Recommendation A(2): establish consistency in tax treatment of all employment related securities in share for share exchange and rollover situations**

## Reasons for recommendation A(2)

4.11 Rollover provisions exist in relation to Chapter 5 of Part 7 ITEPA 2003 (options) but not for restricted/forfeitable securities under Chapter 2 or for nil/partly paid shares under Chapter 3C. This can lead to a crystallisation of the income tax charge on an exchange of these securities when a charge would not arise for employee option holders or other option holders.

4.12 Currently companies can put in arrangements to ensure that the crystallisation does not occur, resulting in an unnecessarily complex and costly restructuring for non-commercial reasons. The incorporation of rollover provisions in connection with restricted securities would avoid this.

4.13 Additionally, in respect of nil or partly paid shares, if the outstanding amount is paid back before the sale, or as part of the sale proceeds, the notional loan charge under Chapter 3C is treated as discharged. If the outstanding amount is paid back later, a tax charge arises and no income tax relief is permitted to the extent the loan is repaid.[5]

4.14 We do not think there is any good reason for this different treatment. Nor do we think our proposed change will expose HMRC to an avoidance risk, as the problem can be managed with advance planning.

## Summary of recommendation A(2)

4.15 Amend Chapter 2 of Part 7 to allow rollover provisions for restricted and forfeitable securities and Chapter 3 for nil and partly paid shares.

4.16 The OTS would like to see this recommendation, if accepted, implemented in Finance Bill 2014.

## How recommendation A(2) will lead to simplification

- Alignment with tax treatment of other securities;
- Fairness; and
- Removal of the need for additional, complex arrangements (and advisers' costs) to avoid crystallisation of the tax charge.

Recommendation A(3): **amend Part 12 Corporation Tax Act 2009 (CTA 2009) to allow corporation tax relief where there is a takeover by an unlisted company**

## Reasons for recommendation A(3)

4.17 A corporation tax deduction is generally allowable under Part 12 CTA 2009 for the acquisition of shares by employees, the relief being equivalent to the gain made by the employees.

4.18 The relief is lost when a company is bought by an unlisted company (or one not listed on a recognised stock exchange) because the target company no longer meets the requirements for relief.

4.19 It is possible to structure a deal and time the transaction in order to retain the deduction but this is unnecessarily complex (and in some cases can be missed altogether where companies are poorly advised).

4.20 Again, we do not see that this recommendation increases HMRC's avoidance risk or costs HM Treasury any real tax revenues as it is currently a charge that can be managed.

## Summary of recommendation A(3)

4.21 The situation could be simplified by allowing corporation tax deductions for share acquisitions/option exercises by employees of companies that have recently become subsidiaries. We propose a time period, which would tie in with existing enterprise management incentive (EMI) time limits. This is currently 40 days, but will be extended to 90 days in Finance Act 2013.[6]

4.22 The OTS would like to see this recommendation, if accepted, implemented in Finance Bill 2014.

[5] Unpaid amounts fall to be treated as a notional loan under section 446S ITEPA. Section 446U taxes an employee on the outstanding loan amount of the disposal of the nil paid shares even if the value received takes into account the nil paid value.

[6] *HMRC Consultation: Office of Tax Simplification's report on tax advantaged employee share schemes: Summary of Responses December 2012*, page 29.

## How recommendation A(3) will lead to simplification

- Removes the need for companies to restructure the timing of transactions simply to retain the tax deduction; and
- Alignment of tax rules and fairness.

# 5 Recommendation B: internationally mobile employees

**Recommendation B: align the tax treatment of international assignees with the general earnings charge (section 62 ITEPA 2003) and extend the corporation tax deduction in relation to employees seconded to work for UK companies where income tax is payable**

## Reasons for recommendation B

5.1 The difficulties associated with the taxation of share plans for internationally mobile employees was one of the most commonly raised areas in our meetings with companies and advisers, and in the survey conducted for the interim report.

5.2 We also received a number of detailed responses to the question on internationally mobile employees that we posed in the interim report. Whilst a full summary of responses is provided in Annex B, we would highlight the following issues:

- Real uncertainty because there are too many taxing options with different and complicated rules and genuine disagreement over which rules should apply and when;
- The rules on write off of "notional loans" on the sale of shares are not obviously connected to share plans and are particularly difficult to administer, as employers are unlikely to know when an employee's shares are sold; and
- Deadlines for Pay as You Earn (PAYE) and Form 42 are difficult to meet, particularly for foreign share plans.

5.3 We think the most fundamental problem that needs to be addressed is that of consistency and uncertainty, particularly in relation to Long Term Incentive Plans (LTIPs) when structured as a contingent right or promise to receive shares. These are currently favoured from a corporate governance perspective as they are seen to reward long term performance. They are usually share based plans and are commonly used by companies as a means of incentivising and rewarding management, if they meet medium or long term performance targets, typically over a three year period.

5.4 These plans essentially all remunerate employees by way of a number of shares received for no consideration, but can be structured in several different ways. For example:

1. Grant of a share option (a nil cost option) which vests at the end of year three (depending on performance conditions) and is exercisable for no consideration immediately after vesting, or later if the employee so chooses but usually within 10 years of grant;
2. Grant of a contingent right or promise to receive shares at a fixed date i.e. the end of year one for nil payment in the event the performance conditions are met. This is often referred to as a restricted stock unit (RSU);
3. A restricted securities award made at the start of year one, wherein the shares awarded are forfeitable until the end of year three, at which point, depending on

performance, the shares are wholly owned by the employee, free from all restrictions; or

4 An LTIP linked to movements in the share value of the employing company in the period from year one up to the end of year three and paying out cash.

5.5 Whilst these four scenarios provide the same economic value to the employee the rules for taxing each of them are different, particularly for an internationally mobile employee, as explained below:

- Scenarios one and three are taxed under the employment related securities (ERS) rules.[1] The residence rules provide that UK tax will apply on exercise if the person was UK resident on the date of grant of the nil cost option or acquisition of restricted securities;
- Scenario four is taxed under the general earnings charge.[2] The general residence rules apply here so that the LTIP is treated as being earned over the three year performance period (not on the date of grant); and
- For scenario two there is a disagreement between HM Revenue & Customs (HMRC) and advisers as to how these are taxed. There is also inconsistency in HMRC treatment of awards made prior to coming to the UK and those awarded whilst resident in the UK, but which vest after departure. HMRC considers that for an inbound employee this should be taxed in the same way as scenario 4 above i.e. partly taxed under section 62 ITEPA 2003 on an award that vests when UK resident. On the other hand, for outbound employees with awards made while UK resident that vest after they have left, HMRC applies the securities options rules, as in scenario 1. The difference of opinion turns on the interpretation of the lead case of *Abbott vs. Philbin*[3] and the interaction between the general earnings charge (section 62) and the securities options charge. HMRC considers RSUs to be securities options and, accordingly, taxable on vesting under Chapter 5 of Part 7, ITEPA 2003, but also under section 62 on money's worth on vesting on the basis that the grant of an RSU is not money's worth. They distinguish this from the treatment of traditional share options that they refer as "legal" options which, according to *Abbott vs. Philbin*, have money's worth at grant and not on exercise. The respondents to our interim report indicated that they did not understand the reason for this distinction and pointed out that historically HMRC had sought a general earnings charge on grant of nil cost options, but were now arguing that the grant of RSUs do not amount to money's worth, even though these are economically similar to nil cost options.

5.6 Annex E provides some examples to compare the tax treatment of nil cost options and RSUs and the effect of the inconsistent treatment in the case of inbound and outbound employees.

## Summary of recommendation B

5.7 Our first recommendation is that there should be a certain and consistent treatment of each type of award made to inbound and outbound employees. This is not currently the case for RSUs.

[1] Chapters 5 and 2 of Part 7, respectively.

[2] Section 62 ITEPA 2003

[3] Abbott vs. Philbin (39 TC 82)

5.8 Secondly, we recommend that **all** share plans that give employees shares or a right to receive shares i.e. scenarios one, two and three above, should be treated consistently from a residence perspective. We see this as an important simplification of what is a very complex area.

5.9 Our Consultative Committee has discussed two different alternatives for these recommendations: changing the distinction made by HMRC between legal options and other securities options or, our preferred option, changing the existing residence rules applicable to share options (Chapter 5 Part 7 ITEPA 2003) and restricted shares (Chapter 2) such that these rules apply on an earnings basis. As explained below, our recommendation is simpler and goes further in aligning the treatment of international assignees with other employees.

5.10 The OTS would like to see this recommendation, if accepted, implemented in Finance Bill 2014 after consultation.

## How recommendation B will lead to simplification

5.11 Overall our recommendation will provide consistency and certainty for both employers and employees. It will also simplify international complexities for several different taxes and we detail each in turn here:

### Income tax

5.12 Alignment between ERS and other forms of remuneration removes additional burdens on companies and employees to understand and operate different tax rules for shares and other earnings.

5.13 The current rules for ERS can give rise to anomalous results that do not reflect the reality of where remuneration was earned. These can mean that there is no UK tax on rewards for UK employment simply because an employee was not in the UK at the time share options or restricted shares were awarded; or being charged UK tax in respect of work done overseas and when not resident in the UK because that work is in a country that does not have a double tax treaty with the UK. Under the proposals it would not be necessary to consider whether a double tax treaty applied as the rules would be the same irrespective of the overseas treatment. One commentator on the current position noted "the complexity is out of proportion with the perceived benefits of the plans".

5.14 The current rules have built in exceptions and special rules introduced to counter the perceived risk of taxpayers accelerating or deferring grants so that they fall into a period of non-residence. They might do this in order that there would be no UK tax charge on the gain made on exercise of an option, despite the performance period over which the income was earned being partly in the UK. These special rules (such as the Part 3C charge on certain pre-April 2008 grants and taxing grants whilst non-resident in the knowledge the employee would be returning to the UK before exercise) could be removed. Under this proposal, companies would no longer have to identify when a notional loan arises and when this is written off on the sale of shares, nor would they have to predict whether an employee is expected to return to the UK before vesting.

5.15 Such an approach would be much more in line with the Organisation for Economic Co-operation and Development (OECD) approved approach to the treatment of "employee stock options" (in Part 7 terms, ERS options), which is that, in general, the "employment benefit" arising from these is earned in the period from the date the option is granted up to the point at which the employee has the irrevocable right to exercise the option. In the interim report we found that in general international companies were looking to operate the same plan in all locations. The UK following the international accepted approach would help with this.

5.16 Companies reported that the practice of sourcing remuneration over the period in which it is earned is well understood as this currently applies in relation to the tax treatment of cash bonuses received by internationally mobile employees.

### Interaction with NICs

5.17 It can also be difficult to determine whether any NICs are due as it will depend on the specifics of the award and each employee's circumstances.

5.18 Different rules will apply to an award taxed under section 62 ITEPA 2003 compared with one taxed under Chapter 5 Part 7 ITEPA 2003. Broadly speaking NICs are charged only on the amount earned from activity in the UK (where tax is chargeable under section 62) and on the full amount for option grants whilst in the UK (where income is taxed under securities option rules).

5.19 The position will also depend upon what country the employee has moved to, whether that country is in the European Economic Area (EEA), whether there is a reciprocal social security agreement with that country and how long after leaving the UK the tax point arises.

5.20 Where an individual moves to a EEA country which looks to apply social security on the full award based on residence at exercise or vesting, the social security authorities are obliged to agree that dual social security should not apply. In practice this is difficult as there is no agreed position in relation to share plans. However the consensus approach is to apply social security based on the economic activity in each country, which follows the OECD model.

5.21 Work done by HMRC and external stakeholders in relation to NICs has identified the desirability of moving (subject to treaty requirements and so on) to apportionment for NICs to align as closely as possible with tax rules – or the OECD model recognising when the shares were earned between grant and vest/exercise. This would have the following benefits:

- There could be scope to mitigate the effect of double charges to social security arising in more than one country (particularly in the EU);
- There is also an opportunity to align the NICs treatment of LTIPs and share options; and
- Alignment of the NICs treatment of assignment to the EEA, reciprocal agreements and the rest of the world. Currently there is no NICs charge in relation to the exercise of an option granted in the UK, if the exercise falls outside the first 52 weeks of the period outside the UK. This is inconsistent with EU and reciprocal agreements. Any proposals for alignment should also consider the 52 week rule such that NICs continue to apply to foreign earnings for the first 52 weeks of an assignment.

### Corporation Tax (CT)

5.22 We recommend that the CT treatment of ERS income of internationally mobile employees should be reviewed such that the CT deduction matches the amount chargeable to income tax. This should be extended to include individuals employed by overseas companies but seconded to work for UK companies. Such companies can already claim a CT deduction for the secondee's non-share based remuneration costs.

5.23 Currently, in order for a business to claim a CT deduction on the taxable ERS income of an employee, the employee must be employed by an employing company that is within the charge to CT in relation to profits of the business at the relevant time. The relevant time is the date of grant of an option (where shares are acquired pursuant to a securities option) or otherwise at the time of acquisition of the shares. This means that if the employee was legally employed by a foreign subsidiary company at the time (even if seconded to and working for a host employer in the UK), there would be no CT deduction of equivalent value to the amount chargeable to income tax.

# 6 Recommendation C: an Employee Shareholding Vehicle

**Recommendation C: introduce model rules for the provision of a holding vehicle for employee shares and provide for such vehicles to be outside various tax provisions which currently cause problems for legitimate employee benefit trusts (EBTs)**

## Reasons for recommendation C

6.1 The Chancellor's 2012 Autumn Statement states that "The Government supports employee ownership as a business model, which offers benefits to employers and the wider economy, and recognises that a range of employee ownership models may be legitimately applied including employee share schemes and Employee Benefit Trusts that are not aimed at avoiding tax."[1]

6.2 Yet this message of government support is not one that is being heard in the business community that already uses EBTs as part of their employee ownership arrangements. On the contrary, the OTS has been told regularly that the establishment and maintenance of EBTs seems to be becoming ever more challenging. For those companies not using EBTs, the current position is that they are increasingly perceived as being just too complicated even to consider.

6.3 We spoke to legal advisers, companies of all sizes, accountants, administrators and remuneration consultants, all of whom have particular knowledge of this area, and some of whom are recognised as leading experts on share plans. From all of them the message was unequivocal: establishing EBTs is complex and expensive for companies, with increasingly detailed professional advice required for what should be a straightforward commercial transaction.

6.4 The pitfalls from a tax perspective are numerous, even when tax avoidance does not form part of the arrangements. There is also a continued and ongoing perception of EBTs as being "bad" and set up for reasons of artificial tax avoidance when in fact many EBTs are put in place for entirely sensible and commercial reasons with no avoidance motive.

6.5 The OTS fully accepts that EBTs, including trusts for employee share schemes, have been widely used for tax avoidance in the past, and continue to be so. HM Revenue & Customs (HMRC) has briefed us on the very considerable amounts of tax at risk from what are seen as tax avoidance-motivated EBTs. The area is the subject of current litigation.[2] So in framing any recommendation we need to come to a judgement that balances the simplification benefit against the tax avoidance risk. Therefore, in this chapter we consider:

- The reasons why companies use EBTs;
- The particular tax difficulties they face;
- How these could be mitigated; and

[1] http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf page 43

[2] See Murray Group Holdings Ltd v HMRC (and related appeals) [2012] UKFTT 692 (TC)

- Possible ways of reducing the tax avoidance risk from any changes (although the latter will undoubtedly be something HMRC will consider in detail when responding to our report).

6.6 Although we will use the 'EBT' term in most of this chapter, as convenient and well understood shorthand, we think a different vehicle may be needed. The requirement is for a vehicle that provides companies and their employees with what they need, i.e. share management, a trading route if required, and the ability to 'ring fence' shares for use in employee share schemes. If this new vehicle is adopted, we think it will make HMRC's risk assessment easier. We term this vehicle an "Employee Shareholding Vehicle"; it may well be a trust but we prefer to keep the format neutral at this stage.

6.7 In this chapter we also include some additional comments which do not form part of our formal recommendations, but which we feel should be taken into consideration in the wider context of Government policy relating to share plans and employee ownership.

## Why do companies use EBTs?

6.8 For private companies in particular, EBTs can form a key part of their equity based remuneration and reward strategy. This is largely because their shares have no liquidity – without a public listing, the shares cannot easily be bought and sold, even when employee owners leave the company. For example, a private company must meet stringent requirements in order to arrange a buyback of its own shares; and it cannot currently use treasury shares at all under company law.

6.9 An EBT enables the purchase and sale of private company shares. In many cases, it provides a warehouse[3] – in some examples, it can act as an active marketplace. An EBT is of particular use where a company has multiple employee shareholders, even if the percentage of equity held on their behalf does not amount to a majority shareholding. Crucially, the EBT creates an equity pool which assists in reducing dilution issues[4] for existing shareholders; this would not be provided by way of a share buyback even if it were possible, nor would using the treasury shares approach.

6.10 Ring-fencing a proportion of share capital for employees within a trust also provides clarity and certainty for all the shareholders in the company: for the employees, there is a clear message sent that a proportion of equity has been set aside for them; for the existing shareholders, the equity pool prevents the dilution and valuation difficulties that can arise from ongoing buybacks and re-issues of shares.

6.11 In addition, the trustees of an EBT are required, by law, to act in the best interests of the beneficiaries. This independence is of crucial importance to safeguard employee shareholders and emphasise good corporate governance, particularly in the case of private companies where the trustees may also be directors of the company.

6.12 In short, using a standard EBT to hold shares on behalf of employees, and to administer employee share plans, is a practice that is convenient, practical and well understood – or at least, it should be. What, then, are the problems facing companies wishing to establish such EBTs?

## The difficulties with EBTs

6.13 When companies establish EBTs, they currently face a number of tax issues. These have been identified to the OTS as follows:

[3] The EBT can buy shares when a shareholder wishes (or is required) to sell their holdings and this prevents the shares being sold to a third party.

[4] The reduction in percentage terms of the holdings of existing shareholders when new shares are issued. For an EBT this is mitigated because it can acquire shares from existing shareholders who want to sell or from the stock market.

### 1. Risk of inheritance tax (IHT) charges unless certain rules are followed

6.14 In certain circumstances, inheritance tax charges may arise as a result of transfers into, or out of, an EBT. The charges can fall upon the trustee itself, or upon certain shareholders in close companies.[5] There are several sections of the Inheritance Tax Act 1984 (IHTA 1984) which relate specifically to EBTs: sections 13, 28, 72, 75 and 86. There are further sections which apply to employee trusts without expressly mentioning them.

6.15 Having identified which part of the legislation is relevant, it is then necessary to decide whether and how it applies. The key areas of exposure[6] are as follows:

- If a close company makes a transfer of value to an EBT an IHT charge will arise for the participators unless certain exemptions are met;[7]
- The gift of a controlling interest in shares in a company will be a chargeable transfer unless relief is available;[8]
- There is a risk of a ten year charge[9] and exit charges[10] on property held in the trust unless certain requirements are met;[11] and
- There is often uncertainty around whether certain exemptions from charges will be met, e.g. whether or not a disposition is intended to confer a gratuitous benefit, or whether a disposition is allowable for income tax.[12]

6.16 The majority of EBTs put in place by specialist advisers are drafted specifically as "section 86 trusts" so that these charges do not arise. However, HMRC have commented that some EBTs are drafted very carefully to preserve the tax treatment whilst still allowing the trust property to benefit only a small number of people rather than 'all or most' employees.

6.17 If EBTs are indeed to be welcomed as a form of business model, and if they do assist with wider employer ownership, then a trust for such a purpose (section 86 trust) should not be a creature of mystery and expense. Rather, it should be the default position for companies wishing to establish straightforward, non-tax-avoiding EBTs for the purpose of implementing employee share plans.

6.18 The current position, which has been pointed out by advisers, not the companies paying for their advice, privileges a certain type of taxpayer. Why should a small privately owned company – particularly a close company, wishing to establish a simple, non-tax advantaged EBT, need to employ the services of a tax adviser in order to do so?

6.19 Why, in fact, should any company need to pay advisers for specialist tax advice on what should be a straightforward, non-tax-driven arrangement? Why does legislation – historically put in place to deal with family trusts, continue to affect commercial EBTs where there is a pathway open to escape the charge, but a pathway open only to those who can afford it?

[5] A close company is one which is controlled by five or fewer participators, or under the control of any number of participators who are also directors, and those participators would receive more than 50 per cent of the company's assets on a winding up.

[6] We accept that Business Property Relief (BPR) may be available and will often mask the exposure, but BPR is hedged around with conditions and may not always be available 100 per cent.

[7] Section 94 IHTA 1984

[8] Section 94 IHTA 1984

[9] Section 64 IHTA 1984

[10] Section 65, 74 IHTA 1984

[11] Section 86 IHTA 1984

[12] Section 10, 12 IHTA 1984

## 2. Offshore EBTs: avoiding a risk of double taxation

6.20 Of the companies that responded to our online survey,[13] the majority of those using EBTs operated them offshore (80 per cent of listed companies, and 60 per cent of private companies).

6.21 The immediate reaction of the man in the street to hearing that EBTs are predominantly offshore is that, of course, the only reason to establish EBTs offshore is to avoid, or even evade, tax. However, we have been told that, in most cases, the reason that EBTs are based offshore is to avoid the double tax charge, explained below, that would arise for an onshore EBT.

6.22 An acquisition of shares by an employee from an onshore EBT falls within section 17 Taxation of Chargeable Gains (TCGA) 1992 (disposals and acquisitions treated as made at market value). This means that a UK resident trust is treated as having received consideration equal to the market value of the shares when the beneficial ownership of the shares is transferred for no consideration. Any increase in the value of shares when held by the trust is subject to CGT. In addition the employee is subject to an income tax charge based on the market value of the shares at the time of acquisition. Consequently, unless the trust is operated offshore, and thus outside the CGT regime, any increase in the value of the shares is taxed twice.

6.23 Section 239ZA TCGA 1992 (relief for disposals by trustees of employee trusts) allows some protection, but only if an amount equal to or exceeding the market value of the shares is chargeable to income tax. This does not apply where the employee exercises a market value option and is not taxed on the full value of the shares acquired.

6.24 This point was raised by a number of respondents to the OTS, and several pointed out the fact that this double taxation trap actually forces EBTs offshore. One of the big four accountancy firms was of the view that, were this issue removed, the majority of offshore EBTs (i.e. most of the legitimate ones) would be moved onshore. Such trusts would be cheaper to run and easier to administer, and thus vastly preferable for the companies wishing to operate them. Of course, for HMRC, an onshore trust can be overseen more readily. The "taint" of tax avoidance currently associated with offshore EBTs would be removed for normal situations.

## 3. Tax on loans to finance EBTs (the "loans to participators" rules)

6.25 Loans by close companies to finance their EBTs can result in charges under section 455 Corporation Tax Act 2010 (CTA 2010).

6.26 Section 455 CTA 2010 applies a tax charge that is equivalent to 25 per cent of the value of the loan made. The charge can be reclaimed when the loan is repaid, but can obviously cause cash flow issues, and there is no credit given for the loan against the company's liability to corporation tax.

6.27 To add to this complication, it is not always evident when a company is close. Broadly, a close company is one that is controlled by five or fewer shareholders. In some cases, companies can be close for the purposes of tax legislation even if their underlying investment base is actually rather wide – for example, companies backed by private equity firms established as limited partnerships. It is not uncommon for private equity backed companies to use employee share schemes for motivational purposes, and this particular charge can be a significant disincentive to their establishment.

6.28 It is worth noting, also, that companies may loan money to EBTs for commercial reasons when they are not close, but they may become close at another date. At this point, the loan may become treated as a debt owing to the participators, resulting in a charge under section 455 CTA 2010.

[13] See our interim report for more details on our survey: http://www.hm-treasury.gov.uk/d/ots_unapproved_employee_share_schemes_interim.pdf

6.29 For smaller companies which are aware of these issues, they can be a considerable disincentive against establishing an EBT at all. For companies which are not aware of the point, this is clearly a tax trap which could have significant financial effects. The charge can also be a disincentive for owners considering selling their shares to their directors and employees via an EBT, with shareholders choosing to sell their shares to external purchasers instead and therefore reducing employee ownership.

## 4. Other tax issues

6.30 Other tax issues for EBTs include stamp duty (or stamp duty reserve tax) which is payable on the purchase of shares by the trustees of an EBT, or by employees when they purchase shares from the trustees.

6.31 If the shares increase in value while they are in the trust, it is not clear whether double taxation can be avoided when the shares are disposed of by the trustee into the hands of an employee.[14] Shares sold to the trust can also be subject to the transactions in securities rules.[15,16]

## 5. Part 7A ("disguised remuneration" rules)

6.32 Part 7A of ITEPA was introduced in 2011 to tackle arrangements involving "third parties" (including EBTs) which "disguised" or deferred remuneration to avoid the payment of income tax or national insurance contributions (NICs). Where companies do not follow the disguised remuneration rules, or their activities do not fall within the exemptions, there can be an immediate charge to income tax and NICs.

6.33 As noted in our interim report, the introduction of Part 7A has caused companies and their advisers significant difficulties in the operation of their EBTs, irrespective of whether tax avoidance was part of the objective. Some have suggested that the introduction of the disguised remuneration provisions has caused employers to reduce their use of EBTs. As one respondent wrote:

**Box 6.A: Use of EBTs**

"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." (*Response to OTS's Interim Report by an independent organisation working on behalf of small and medium sized quoted companies.)*

6.34 Some examples that have been given to the OTS are set out below:

- The general difficulty of identifying "earmarking". For example, administrators, employers and EBT trustees are now prevented from sharing information about share allocation to employees, because of the risk of "earmarking" and an immediate tax charge arising;
- We repeat the example in our interim report of the private company wishing to establish a trust to hold the majority of its shares on behalf of its employees. Wanting to make provisions in the event that the trust is wound up, the company planned to identify potential beneficiaries for such a scenario. Under the Part 7A

[14] Section 144ZA TCGA 1992

[15] Anti-avoidance rules relating to transactions between close companies and their shareholders.

[16] Part 13, Chapter 1 ITA 2007

earmarking rules, this constituted earmarking; the company did not, as a result, establish the trust;

- The end of deferred payment share plans via an EBT. These plans were not seen as aggressive tax planning measures, and in fact can still operate provided a third party, such as an EBT, is not involved;
- Inconsistent, unfair and unexpected treatment of beneficiaries. One respondent gave an example of a client that had, for many years, run a trust which made shares available to individuals on a deferred payment basis. Following the introduction of Part 7A, its employees were caught under Part 7A, whereas the self-employed were not;
- Loans to employees to allow them to pay PAYE/NICs on the exercise of an option or to fund the exercise. This is of particular importance when there is an earn-out right, and the exercise price of the shares is much higher than the value of the shares, so the employee does not have sufficient cash to pay both the exercise price and the PAYE/NICs;
- Lack of clarity relating to family members working in the company. A controlling shareholder wished to gift shares to his daughter, who was also an employee. There is an exemption under Part 7 for such personal relationships, and the shareholder had had previous clearance for this. Part 7A, however, does not provide an exemption, and the guidance is unhelpful;
- Uncertainty arising from the newly introduced terminology which will need case law for clarification; and
- There is a clearance procedure but it can cause delays to commercial arrangements (and there is some concern amongst respondents on the strain this process puts on already over-burdened HMRC resources). The need to seek clearance also, of course, adds to companies' costs.

6.35 A common view reported to the OTS related once again to the difficulties which result in a privileged type of taxpayer. Those who can afford specialist advice will obtain it; for those who cannot, the tax consequences can be dire. If this is the case, then the complexity of the legislation has resulted in a two-tier tax system.

6.36 Following the publication of our interim report in August 2012, we spoke to a leading trusts specialist who described Part 7A as "the antithesis of simplification" and noted that, in the context of tax-avoiding EBTs, "Part 7A was not the solution".

6.37 This is not the forum for a detailed discussion of Part 7A ITEPA. It is not a popular piece of legislation, and its piecemeal introduction has caused problems. Part 7A has caused, and continues to cause, difficulties for companies setting up and running EBTs. David Heaton, Chairman of the Tax Faculty of the Institute of Chartered Accountants in England and Wales, noted in a speech in September 2012 that the "scattergun" approach of Part 7A has resulted in "collateral damage in perfectly ordinary situations." This phrase seems particularly relevant for those companies operating EBTs for the purposes of employee ownership.

6.38 Given the huge amount of feedback on this area, we feel we should suggest a detailed review of the legislation is carried out within the next few years. The review should seek ways of simplifying the language, reducing the length of the rules and, in short, making Part 7A more accessible to experts and the layman alike.

## How can we solve the EBT problems?

6.39 Not all EBTs are established to avoid tax. It is also plain to see that such 'legitimate' EBTs are severely hampered by the existence of anti-avoidance legislation which causes considerable cost and complexity for those wishing to operate such arrangements. What solution can be found to this problem?

6.40 One of the issues for EBTs is that they are covered by such a variety of codes – general earnings, benefit in kind rules, disguised remuneration, inheritance tax legislation, capital gains tax legislation, rules relating to close companies and corporation tax. Each of these parts of the tax code naturally covers a far wider field than the simple forms of EBT which we think are used in practice by many companies as part of genuine share plan agreements.

6.41 The OTS does not consider, for example, that amendments to IHTA 1984 would be wise or necessarily the best approach to simplification. Changes to CGT and close company rules may have unforeseen repercussions. The disguised remuneration rules were implemented too recently for further changes to be viewed as obviously welcome, or necessarily as simplification.

6.42 We have also considered the possibility of creating a new statutory "safe harbour" employee benefit trust which would provide a carve out from the key areas of legislation noted above. This is an approach that has been suggested by many respondents to the OTS and it would seem on the face of it to be a simple and straightforward approach.

6.43 However, we recognise that introducing new legislation is not in itself a simplification. Furthermore, we understand that more legislation commonly leads to more loopholes: the ongoing tendency of EBTs to be used as tax avoiding vehicles makes it very difficult to produce a new statutory vehicle which will not be abused. This has been tried before, with the Qualifying Employee Share Ownership Trust (QUEST): the statutory corporation tax deduction available for QUESTs was withdrawn in 2003 following widespread abuse of the concept.

6.44 The OTS is persuaded that introducing a statutory EBT would create additional complexity and increase the risk of avoidance activity, and for that reason we are unable to recommend definitive legislative changes in this regard.

6.45 However, we cannot ignore the difficulties that private companies, in particular, face when trying to create internal marketplaces for their shares, whether they are involved in broader employee share ownership, or a more limited form of employee participation.

6.46 We are also aware of ongoing work as a consequence of *The Nuttall Review*[17] which will not automatically result in new legislation (although changes to legislation cannot be completely ruled out). While Graeme Nuttall is concentrating on broader employee ownership, it is clear that his report and ours cover some common ground, and it therefore seems appropriate that our recommendations, below, take the work of that review into account.

## Summary of recommendation C

6.47 The OTS recommends the creation of a set of model rules for a vehicle which would provide a marketplace and/or warehouse for shares held on behalf of employees. We consider that any consultation should be undertaken within the context of work carried out as a result of *The Nuttall Review*. It seems likely, given the potential common ground, that the trust or vehicle arising out of that Review could be adapted to suit the needs of other types of company wishing to use an EBT for holding employee shares. It may be possible to combine the work into a single

[17] *Sharing Success: The Nuttall Review of Employee Ownership*, published 4 July 2012: http://www.bis.gov.uk/assets/biscore/business-law/docs/s/12-933-sharing-success-nuttall-review-employee-ownership.pdf

overall review. However, the OTS and the Nuttall reviews have differing situations in mind and any combining of the work would have to ensure that both objectives were kept firmly in view.

6.48 Certain existing anti-avoidance legislation – whether applicable to IHT, CGT or Part 7A – would be irrelevant to such a vehicle, as its activities would, under the model rules, fall outside those regulations. Provided a specific route was followed, those anti-abuse rules would never bite on the vehicle and its activities.

6.49 Because of the historical perception that EBTs exist for the purposes of tax avoidance, we suggest that a new term is coined for this vehicle – for example, Employee Shareholding Vehicle. A new name would provide comfort for users that the vehicle (although it will doubtless be a trust in some form or other) will not fall foul of the various tax traps set out in this chapter. It will also provide reassurance for HMRC that these vehicles are not being used for avoidance.

6.50 We hope that introducing a recognised and acceptable form of shareholding vehicle will make standard, commercially driven employee ownership or participation arrangements simpler and cheaper for companies to implement. Creating a new vehicle such as this whilst retaining HMRC's ability to investigate arrangements will ensure that EBTs used for tax avoidance can still be investigated and shut down. Indeed, it may facilitate their identification.

6.51 We note that any arrangements put in place would need to be in a form which would permit companies currently using genuine EBTs to adopt the new vehicle with as little cost and complexity as possible – or to continue running existing, inoffensive EBTs without a requirement to adopt a new vehicle.

6.52 As a starting point we set out some considerations below, subdivided into two separate sections. The first section lists areas where we think serious thought should be given to guaranteeing that the rules will be irrelevant to the shareholding vehicle. The second section, "Tax avoidance and controls", sets out restrictions which should be included in the rules to provide protection for the Exchequer and limit tax avoidance.

### Tax traps excluded for the new vehicle

6.53 The following aspects of tax legislation should not apply to the Employee Shareholding Vehicle's activities:

- Certain aspects of the inheritance tax regime including the charge on participators for transfers to an EBT by a close company (section 94 IHTA 1984), the gift of a controlling interest (section 28 IHTA 1984) and the 10 year and exit charges;
- Capital gains tax on the disposal of qualifying assets to an employee (removing the current risk of a double tax charge for onshore EBTs arising out of section 239ZA TCGA 1992 which gives relief only in limited circumstances);
- Section 455 Corporation Tax Act 2010 (CTA 2010) (loans by close companies to finance an EBT) should not apply if a company loans money to the vehicle in order to finance its activities;
- Provided securities are not sold for more than market value they should fall outside the transactions in securities rules;
- Transfers of qualifying securities between the trading vehicle and the beneficiaries should be exempt from stamp duty/stamp duty reserve tax;
- Should the vehicle (which may or may not take the form of a body corporate) ultimately control more than 50 per cent of the sponsoring company, the sponsoring company should not be treated as being under the control of another body corporate, ensuring that it could continue to operate HMRC tax advantaged

schemes such as enterprise management incentive (EMI) and company share option plan (CSOP) schemes; and

- Certain aspects of Part 7A ITEPA 2003 (in particular in relation to "earmarking" activities).

6.54 Based on the feedback and discussions we have had with advisers we believe that the majority (if not all) of the points covered by this list need to be taken forward for the model rules to be a real simplification. Anything short of this will not be practicable for companies wishing to use a simple, HMRC blessed vehicle for holding employee owned shares.

6.55 It has also been suggested that this new vehicle should have two further exemptions. However, we are conscious that these are areas where either there is a high risk of avoidance or a wider policy objective. Thus we do not recommend their inclusion unless a convincing case is made during consultation:

- On winding up of the vehicle, surplus funds could be returned to the sponsoring company; and
- Tax relief for loans to directors from close companies would be extended beyond those either holding 5 per cent of the share capital or those employees spending time in actual management of the company.

### Tax avoidance and controls

6.56 The OTS recognises that EBTs have been, and continue to be used, for tax avoidance purposes, and that this is an ongoing problem for the Exchequer. Consequently, we recognise that there will need to be very specifically established rules to ensure that the activities undertaken by our proposed 'privileged' vehicle cannot actually result in abuse. However, for those companies wishing to make arrangements simply for the purpose of equity based rewards and remuneration for employees – as opposed to tax planning for its most senior executives and directors – the following rules should be acceptable.

6.57 We think these would represent appropriate safeguards for the Exchequer:

- The vehicle should be transparently within the UK tax system: therefore it should be UK resident and, if a trust, all its trustees should be UK resident;
- At the simplest level, the vehicle should exist for the purpose of enabling employees to hold or acquire shares or securities in their employing company (or in a company within their employing company's group). So, for example, it may be appropriate to limit any beneficiaries under the trust to employees and former employees (rather than the wider definition of "employees' share scheme" under the Companies Act 2006[18] which includes spouses, civil partners and minor children/step-children);
- Property held within the vehicle must not be applied other than for a specific purpose – i.e. for the encouragement or facilitation of employee shareholding; and
- HMRC has noted that avoidance activities undertaken by allegedly genuine EBTs have included the transfer of real property into trust. In the case of an EBT looking to reward its employees via shares, we see no reason for an EBT to hold real property. We propose therefore that the new vehicle may deal only with "qualifying securities" i.e. fully paid non-redeemable ordinary shares in the sponsoring company (or its holding company) – except in the case of a corporate transaction resulting in a share for share exchange; or in cash.

[18] Companies Act 2006 Section 1166

6.58 Breach of any of these conditions (for example, if the vehicle's property is applied for an 'unallowable' purpose) would mean the exemption from the various tax provisions noted above would cease to apply.

6.59 Consultation may identify other necessary safeguards.

### Legislation or not?

6.60 In discussing the complexities set out above the OTS considered whether to recommend legislating for a new type of vehicle to meet these needs. However, that creates risks of opening up a new route for tax avoidance. Thus our recommendation is that the Employee Shareholding Vehicle uses existing provisions. That will mean it will be constituted as a trust.

6.61 Legislation will be needed to exclude this new vehicle from various tax provisions, as set out in paragraph 6.53. The legislation should be simple, essentially providing that a trust that includes within its deed the conditions and restrictions set out in paragraph 6.57 will be outside the relevant provisions.

6.62 It would be made clear in the legislation that any breach of the conditions and restrictions would mean a loss of its privileges. Potentially this would be backdated, possibly for many years, unless it could be shown that the breach was trivial and accidental.

## How recommendation C will lead to simplification

6.63 The result should be legislation allowing private companies in particular to establish a vehicle which holds and trades shares on behalf of its employees easily and at minimum cost without falling foul of the various hurdles and pitfalls which currently exist for EBTs.

### Additional issues

6.64 The subject of EBTs is extremely complex. The OTS is limited to looking at simplification of legislation, and any of our recommendations should be broadly tax neutral. Clearly, simplifications that are of wide application would be likely to be of greater merit than those that apply to only a small number of taxpayers. We are also well aware that one strand of complexity is constant changes to legislation – "tinkering" without looking at the overall picture.

6.65 In spite of these points, in the context of EBTs we believe the following issues are ones that we should highlight. Even if they do not form part of our main recommendations, we think these are points that government would do well to consider, albeit in the context of other reports and consultations.

#### 1. *The Nuttall Review*

6.66 We refer – as we did in our interim report – to *The Nuttall Review of Employee Ownership*. The Review identifies the value inherent in the trust model of employee ownership, but also notes that there are some difficulties relating to the legal, tax and other regulatory considerations of that model. Amongst other things, the Review states that "[t]here is a strong case for a unified set of model documents with official endorsement".[19] In respect of the taxation of EBTs, the Review suggests that "[the] Government's agenda for promoting employee ownership [is] coordinated so that any tax initiatives are linked with wider work undertaken to promote awareness of employee ownership."[20]

[19] *The Nuttall Review*, Chapter 5, page 59.
[20] *The Nuttall Review*, Chapter 5, page 72.

6.67 The OTS strongly recommends that any changes made to legislation governing EBTs in their current form – whether relating to company law, regulatory issues or tax legislation – are only made following detailed consultation and input from individuals and groups with expertise in this area. A unified approach is essential to ensure that EBTs – or arrangements carrying out the same function as an EBT, such as the OTS's recommendation for a new vehicle – can be established in the most practical and straightforward manner in order to simplify the operation of private company share plans and to encourage and enable the wider use of employee ownership.

### 2. EBTs and significant/majority employee share ownership

6.68 In some specific cases, private company owners wishing to retire from their company will establish an EBT to help in the transfer of all or part of their equity on behalf of the employees as part of their exit strategy. *The Nuttall Review* has further identified those companies which wish to set up EBTs to hold shares in perpetuity for their employees. The OTS has also spoken to some of these companies and we recognise the importance of working towards a specialised EBT (or equivalent) that will assist those business owners looking to transfer significant proportions of their equity into the hands of employees.

6.69 This undoubtedly falls outside the scope of simplification. As a result, the recommendation we make in this chapter refers to a straightforward trading vehicle that would be appropriate for companies setting aside only limited pools of equity for employees. From the responses we have heard the share schemes industry does not feel that employee ownership as a concept should be limited to those companies wishing to transfer significant proportions of equity; a company setting aside only 5 per cent of shares for its employees can still use the concept of ownership to incentivise employees and drive performance and productivity.

6.70 Nonetheless, we express the hope in this report that consultation on a new share holding vehicle would take into account the particular type of EBT considered in *The Nuttall Review*. We can see that there are potentially two differing needs here:

1. A vehicle to hold a (probably generally static) large percentage of the shares in a company for the benefit of employees; or
2. A vehicle to facilitate sales by employees of relatively modest quantities of shares that they have acquired via a share ownership plan.

6.71 Both vehicles may be satisfied by the same thing; or it may be that different vehicles are needed. We are convinced there is a real need for the second of these entities, hence our proposal for an Employee Shareholding Vehicle (a 'safe harbour EBT'). It may be that the same rules, possibly slightly adapted, would suffice for the first vehicle. Certainly the two needs should be considered together in order to have a consistent approach to a common theme, and to avoid complexity and contradiction in any resulting legislation.

# 7 Administration recommendations

**Recommendation D: online filing of Form 42. Until such time do not make any further changes to Form 42**

## Reasons for recommendation D

7.1 Form 42 was the third most common area of complexity in the survey we conducted for our interim report (second for companies with fewer than 250 employees). Similarly, in meetings with companies and amongst our Consultative Committee it was widely cited as complex. As we reported in our interim report one business told us their Form 42 ran to 1,200 pages.

**Box 7.A: comment on Form 42**

"We have a very simple employee share scheme which covers a large number of our employees and Form 42 takes us around 2 weeks' worth of resource to fill in" (*Large PLC with more than 1,000 employees and a turnover of more than £100m*)

7.2 All companies must submit a Form 42 return each year to notify HM Revenue & Customs (HMRC) of any actions taken in the operation of their unapproved share plans. However, no tax is charged on the basis of a Form 42 return. Much of the feedback we received on Form 42 questioned why information needs to be reported when no taxable event has occurred, in particular the grant of options which may lapse without ever incurring a tax charge.

7.3 The form follows the complexity of the employment related securities (ERS) legislation with sections related to each of the chapters in Part 7 ITEPA 2003. It is also written in tax, rather than commercial language. Because of this the person (or people) filling in the form need(s) to understand Part 7 in some detail. This is often difficult for smaller companies that do not have dedicated tax managers.

7.4 In discussing Form 42 with our Consultative Committee it was generally agreed that the form is a useful discipline on companies, especially in keeping a record of their unapproved employee share schemes. There was also recognition that in most instances the information reported on Form 42 is required by HMRC. However, certain sections of the form were seen as unnecessary, such as the section relating to the grant of options. And for companies that are fundamentally compliant in paying PAYE liabilities on time many questioned why such extensive information on Form 42 is really needed.

7.5 Overall, it was felt that HMRC needed to explain more clearly why this information is needed and what it is used for in this era of self assessment. The OTS endorses this call and believes it would be in HMRC's interests to make the need for Form 42 transparent.

7.6 Possibly the biggest issue with the form is that it is paper based. The form also changes from year to year. Companies therefore have to go through each section to decide whether they need to fill it in or not – many companies told us that there is a lack of clarity as to when events do **not** need to be reported.

7.7 Some of the recent changes to Form 42 have been as a result of HMRC reviewing and improving the form, but the constant change means that companies and administrators have to update their systems each year which is costly and time consuming.

7.8 The administrators that we have spoken to were keen to see either radical change, such as online filing, or no change at all. Their point is that constant incremental change only adds to complexity.

7.9 As with all of our recommendations we have had discussions with HMRC. For HMRC Form 42 does not offer enough information in the right format for high risk companies. For low risk companies HMRC ends up with thousands of paper forms which need to be processed and stored. We therefore hope that our recommendations on Form 42 will dramatically benefit companies, administrators and HMRC.

## Summary of recommendation D

7.10 The OTS is proposing short, medium and long-term recommendations for Form 42, recognising the time and resources required for each. Each of the recommendations builds on each other.

### Short term

7.11 We have considered the possibility of **releasing Form 42 at the beginning of the year**, as suggested by a respondent to our interim report. We agree that it would be a useful and very straightforward simplification. It would allow companies to fill in the form throughout the year instead of having to rely on information that, in some cases, is over 12 months old. As long as no further changes are made to Form 42 before online filing is introduced we believe this would be an excellent simplification.

7.12 We acknowledge that releasing Form 42 at the start of the tax year would mean it was issued before the year's Finance Bill was published or passed. However, given the Government's commitment to consultation, it should be rare that Form 42 is affected by unexpected, last minute changes.

7.13 It is possible that online filing, if implemented quickly, will overtake this solution. However, even if online filing is introduced in the near future then the principle that the (electronic) form should be in a format that enables completion in stages during the year should be adhered to.

7.14 **Online filing of Form 42** – this is the key to the medium and longer term recommendations as it will allow HMRC to better target the form and reduce the burden on compliant companies. Currently companies must print out Form 42, fill it in manually and then return it to HMRC. Many companies use spreadsheets which they send to HMRC instead of the form and this can cause extra work for HMRC in trying to understand a non-standard format. Online filing would use a standard interface which companies could simply import their data into and submit electronically to HMRC. For nil returns, one box could be ticked online removing many thousands of paper Form 42s.

7.15 The OTS would like to see this recommendation, if accepted, implemented in 2014 alongside the current commitment to online filing for tax advantaged plan returns.

### Medium term

7.16 **Intelligent filing** – once online filing of Form 42 has been established the next logical step is to direct the user through the form depending on their inputs to specific questions. This cuts down the time taken for companies to fill in the form. Intelligent filing will also allow HMRC to target compliance checks by random selection of particular companies or types of share scheme.

HMRC could also ask for extra information from higher risk companies without requiring it from all companies as is the case with the standard, paper based Form 42.

7.17 As this is a fairly logical step the OTS would like to see this recommendation, if accepted, implemented in 2015, if it is not possible to do so alongside online filing in 2014.

### Long term

7.18 Integrate the information on Form 42 into real time information (RTI) – this would mean adding an extra field to RTI which would split out income from ERS for each employee. Most companies already produce this information on their payroll systems in order to operate PAYE on ERS income so this would not place a greater burden on their reporting systems. Compared with Form 42 in its current guise it would allow HMRC to receive the data in a much more timely fashion.

7.19 It has been suggested to the OTS that with this change the need to submit Form 42 altogether could be removed for low risk companies, with simple share plans, who operate PAYE consistently on ERS. At the very least the amount of information Form 42 requires could be significantly reduced. We also believe that the more timely and detailed information would benefit HMRC in detecting avoidance and help to focus resources in this area. As RTI stands there would need to be changes to the system in order to report this information which is why this is a longer term recommendation. We would hope to see this implemented by 2016 if the recommendation is accepted.

**Recommendation E(1): extend the statutory deadline for the reporting of employment related securities income under real time information (RTI) to 60 days after the end of the tax month**

## Reasons for recommendation E(1)

7.20 One of the biggest concerns we heard was from companies and their administrators struggling to operate PAYE on ERS which are also readily convertible assets (RCAs). The processes and procedures for calculating the tax liability are significantly more complex than those for simple cash payments.

7.21 The current deadline for an RTI return is 14 days after the end of the tax month in which employment related securities income arises. Many companies have described this deadline for the operation of PAYE in relation to share schemes as "impossible". There are many reasons for this, and they are set out in detail in our interim report.[1]

7.22 HMRC has issued a statement summarised below:[2]

[1] *Review of unapproved share schemes: Interim Report*, Chapter 5, page 27

[2] http://www.hmrc.gov.uk/rti/on-or-before.pdf

**Box 7.B: Reasonable excuse for PAYE and RTI**

HMRC will not charge a penalty where employers have a "reasonable excuse" for not complying with the statutory deadline and have issued the following guidance on the circumstances where this could apply:

1. HMRC does not expect employers to depart from reasonable and accepted practices such as "sell to cover", "sell all" or "hold all"; and
2. It does expect that any late reporting of share schemes income would normally be made no later than the next available regular monthly payroll date, and the relevant payment of PAYE and national insurance contributions (NICs) due would be made within the normal payment deadlines for that month.

7.23 The OTS asked companies for evidence of HMRC issuing penalties in relation to ERS. We received some very helpful responses from the Quoted Companies Alliance, the British Private Equity and Venture Capital Association and the Chartered Institute of Taxation for which we are very grateful. However, there were no specific instances of penalties being enforced. Our Committee, particularly the company and administrator representatives, believe the issue here reflects companies' fears about RTI rather than current penalties levied by HMRC.

7.24 At the moment it is very difficult for HMRC to detect when a company has paid PAYE in the wrong month. Under RTI it will be much easier and this is what worries companies. It was highlighted in the OTS report on tax advantaged share schemes that for Share Incentive Plans (SIPs) in particular companies have great difficulties in meeting the deadline.[3]

7.25 HMRC has also confirmed that no penalties for late returns will be issued in year for 2013-14, the first full year of RTI, provided the employer reports the final payments it has made in the tax year by 19 May 2014.[4] There will be no automatic penalties for lateness in the first year of RTI and as such taxpayers will not have to place reliance on the reasonable excuse defence if these deadlines are not met in the first year. This will give HMRC additional time to put in place realistic deadlines for accurate reporting of ERS before automatic penalties are introduced and will give companies time to get used to the new system.

7.26 We note, though, that HMRC may charge penalties for an error on an in-year RTI return, even if rectified during the tax year. A penalty would not apply in this circumstance under the current rules. This will be a cause for concern for companies since the reporting of ERS income in a later period will mean the original return contains an inaccuracy as the return was incomplete and this could result in significant penalties in the event HMRC contends the taxpayer has not taken reasonable care to avoid the inaccuracy.

7.27 Setting unrealistic targets and expectations as to the accuracy of in year returns and then adjusting outcomes later is clearly not good practice in any field, including tax legislation. All targets should be achievable and realistic, or they become ineffective.

7.28 Extending the deadline for accurate reporting in connection with ERS will create realistic targets for companies. Furthermore, because the majority of companies should be able to meet the deadlines, it will make it easier for HMRC to enforce penalties consistently where deadlines are missed.

7.29 We recognise that a key driver for RTI is the needs of Universal Credit (UC) and suggesting a longer deadline for reporting income details flowing from share transactions does conflict with

[3] *Review of tax advantaged employee share schemes: Final report*, Chapter 3, page 28
[4] http://www.hmrc.gov.uk/news/payerti-payments.htm

UC demands. However, it is surely better for UC and HMRC that consistent, accurate returns of income details are made.

## Summary of recommendation E(1)

7.30 We recommend that the deadline for telling HMRC about PAYE and NICs on employment related securities on a RTI return be set at 60 days after the end of the tax month in which employment related securities income arises (but no later than 31 May after the end of the tax year). It would follow that the deadline for payment of the PAYE would be 14 days after the end of the tax month in which the RTI return was filed, provided it was filed on time.

7.31 This would give employers between 60 and 90 days to file an RTI return from the date ERS income arose, depending on the time in the month that the event occurred. Employers would have more time than under the current deadline set out above, but we think this reflects the difficulties in this area and would provide more certainty to employers than the reasonable excuse approach proposed by HMRC. This would also give certainty that provided the ERS income is reported within this timeframe then this would not constitute an incorrect RTI return alleviating uncertainty as to the incidence of penalties for inaccuracy.

7.32 To the extent this deadline is not met then HMRC **should** enforce penalties.

## How recommendation E(1) will lead to simplification

- Significant simplification and ease of processing for companies and administrators operating share plans where PAYE is applicable (including SIPs); and
- More certainty on the operation of penalties.

Recommendation E(2): **remove employment related securities from the section 222 charge if the tax is made good**[5]

## Reasons for recommendation E(2)

7.33 Section 222 ITEPA 2003 imposes a charge on employers whereby, if the company does not recover the PAYE on a notional payment (e.g. a share award) from the employee within 90 days, the amount of PAYE tax due is treated as additional income in the hands of the employee and is therefore taxed under the benefit in kind rules. However, even if the PAYE is recovered later, the additional charge cannot be recouped. To the vast majority of those charged this is viewed as a tax penalty.

7.34 Section 222 was originally introduced in 1994 as section 144A of the Income and Corporation Taxes Act 1988, when it was aimed at specific tax avoidance activity which, at the time, included payments to employees in the form of fine wines and gold bullion. In 1996 these rules were extended to own company share plans in response to their use for tax avoidance.

7.35 The underlying principle was that if the tax was not made good by the employee, the section 222 charge was necessary to put the employee in the same net position as if they had received an equivalent cash payment. The problem in practice is that the charge arises when making good is not made in time. The original 30 day time limit caused serious problems, only partly assuaged by the 90 day limit (introduced in 2003) as this can still catch innocent situations where there is no real loss of tax to HMRC. The level of additional charge through section 222 seems out of proportion to the offence, assuming that the tax is in the end made good.

[5] Section 222 ITEPA 2003: payments by employer on account of tax where deduction not possible.

7.36 Therefore in formulating our recommendations we considered whether it would be possible to structure the charge such that it would not arise in the event the tax was made good, but would apply when it was not.

7.37 We note there were also discussions on the meaning of "making good" in this section, with many practitioners arguing that, for example, an undertaking or some kind of indemnity should be sufficient in respect of the section generally (not merely in respect of ERS). We believe this is the right approach.

**Box 7.C: Section 222 example**

A foreign subsidiary does not notify the UK host employer of a share option gain of £100,000 arising on 15 October 2012 in relation to one senior employee. PAYE of £40,000 should be deducted and paid to HMRC by 19 November 2012. No PAYE is operated in 2012-13 and this income was not reflected on the employee's P60 for the year.

The error is discovered by HMRC in December 2013 during a routine compliance visit. The tax of £40,000 is paid to HMRC on 17 January 2014 by the company together with penalties for not operating PAYE on this at the time and late payment interest. The employee leaves the business in March 2014 in difficult circumstances and either 1) the company agrees not to recover the tax from the employee or 2) the company does recover it.

For the employee the situation is as follows:

The section 222 charge is £40,000 x 40% = £16,000. Under the current rules, this applies in both examples since the £40,000 has not been made good within 90 days of the 15 October 2012.

1. If the tax is never made good by the employee income tax is paid of £56,000 (£40,000 + £16,000) on income of £140,000 (£100,000 + £40,000). A tax rate of 40%. This is the same tax rate as if he had received a gross cash payment of £140,000; or
2. If he does make good the tax in March 2014 income tax of £56,000 is paid on an income of £100,000. A penal tax rate of 56%.

7.38 The OTS recognises that section 222 has wider application than just for ERS, and we make our recommendations below in full knowledge of this.

## Summary of recommendation E(2)

7.39 The OTS recommends that ERS are removed from the scope of section 222. We discussed this issue at length amongst our Consultative Committee and believe this is the right course of action. If the Government decides not to proceed with this recommendation we have also proposed an alternative.

7.40 These two recommendations are detailed below.

### Main recommendation: remove employment related securities from the scope of section 222 ITEPA 2003 in the event the tax is made good

7.41 The OTS has been told of situations where all parties intended that the PAYE would be made good, but for whatever reason this did not happen within the time limit. Often this is in international situations where timely making good was simply impractical, or not understood in overseas associates. The result is a significant charge for the company yet no real loss of tax for HMRC (assuming the tax was indeed made good). This does not fit with the principles governing the new HMRC penalty regime following the *Review of HMRC's Powers, Deterrents and*

*Safeguards*.[6] Nor does it seem fair to impose a penalty aimed at deterring avoidance in an everyday practical situation.

7.42 We considered whether the existing charge should be retained where there was no making good of the PAYE, provided the charge could be repaid if the amount was made good at a later date. This would presumably mean HMRC repaying the charge (possibly subject to a set deduction per year). This is a plausible route but does add some burdens for HMRC and companies, but this is already the case for other charges such as loans to participators in close companies.[7]

7.43 We think it would be preferable for the employment related loans rules to police this area. If the PAYE was not made good, employees would be taxed on the beneficial loan interest for periods between the payment of tax by the employer and the making good by the employee. A loan write off charge would apply if the loan was subsequently written off on leaving employment.

### Alternative: retain but extend time limit, also replace Class 1 NIC charge with Class 1A NIC

7.44 As in Ireland, extend the period in which the amount must be made good to 6 July following the end of the relevant tax year. This would align with the period when the P11D must be submitted such that, if the amount had not been made good by this date, the employer would report a charge on Form P11D and pay Class 1A NICs on this "benefit". Currently, the section 222 charge is liable to Class 1 NICs.

7.45 It has been noted, and is recognised by the OTS, that this would give employers who need to recoup PAYE from employees early in the tax year much longer to do so than those who need to right at the end. Whilst this argument of a level playing field is a valid consideration, for all but the last few days of the tax year all employers will have significantly longer than the current 90 days to recover the PAYE. Further, with just one deadline, they will not need to worry about different 90 day periods for different employees.

7.46 Under this alternative we would also recommend improvements to the HMRC guidance to clarify what arrangements need to be in place in order to constitute making good as noted at 7.37.

## How recommendation E(2) will lead to simplification

7.47 Main recommendation:

- Fairness and certainty that a charge in relation to PAYE on employment related securities will not apply if the PAYE is made good, even if making good is not within 90 days of the event. This reflects that there may be good reason why making good cannot occur within 90 days; and
- The beneficial loan rules are known to companies already and changes proposed will not make these significantly more complex. It should be noted that it may be necessary to introduce a deeming provision into the beneficial loan legislation to make it clear that the payment of PAYE on a notional payment is a form of credit to the employee.

7.48 This would add complications as it introduces further questions about when the loan is paid back or written off – otherwise the "loan" could be reportable for years and there is potential for a consequential charge on loan write off. However, in each case, this would apply to any normal beneficial loan so it is not clear whether this would create any additional burden.

[6] http://www.hmrc.gov.uk/about/powers-appeal.htm

[7] Section 455 etc. CTA 2010

7.49 Alternative recommendation:

- Allows employees acquiring shares more time to make good any tax (even those acquiring shares at the end of the tax year will have a minimum period of 90 days to make good); and
- Extending the definition of making good would include arrangements where an undertaking has been given within the period to make good the tax.

# 8 Valuation recommendations

**Recommendation F: changes in the approach to valuation for employment related securities (ERS)**

## Reasons for recommendation F

8.1 The valuation of private company shares was identified in our interim report as a significant area of difficulty. Some listed companies, however, also voiced concerns about particular aspects of share valuation.

8.2 Since the interim report we have had additional and valuable feedback on this area and are able to summarise the key drivers behind our recommendations as follows:

- The difficulty of valuing a private company share: it is acknowledged that valuation of private company shares is, in some situations, complex in itself;
- The inability for private companies to agree a pre-transaction valuation with HM Revenue & Customs (HMRC) Shares & Assets Valuation (SAV) for shares offered under an unapproved scheme. Uncertainty about the value of the shares leads, inevitably, to uncertainty about the tax and national insurance contributions (NICs) consequences both for the company and the individual participants;
- For companies listed on non-recognised stock exchanges such as the Alternative Investment Market (AIM), an inability to rely on the closing market price for such markets;
- Confusion about when pre-transaction valuations can be agreed with SAV at all. For example, the SAV website suggests that pre-transaction valuations can be obtained for capital gains tax purposes. In fact there are some situations when they can be obtained for income tax purposes, but this is not widely known beyond those who specialise in the area; and
- For fully listed companies, there are complications relating to the quarter up valuation methodology, particularly when shares are sold over one or more trading days.

## Summary of recommendation F

8.3 This is a particularly complex area and so recommendation F in fact consists of a number of separate recommendations. Together these form a holistic and long term approach to the valuation of ERS which we consider would improve the position for companies and SAV alike.

8.4 We are grateful to a number of individuals at HMRC SAV for the considerable time they have given us in helping with this section of the report. Their input has been extremely helpful and has helped us formulate a considerable proportion of these recommendations, and we would like to take the opportunity to thank them directly for their input.

8.5 The OTS considered a number of ideas which we will not be putting forward as recommendations. These included creating standardised valuation methodologies for private companies, and the ability for SAV to charge a fee for pre-transaction valuations. More details about these ideas are set out in Chapter 9.

8.6 The OTS would like to see all of our recommendations on valuation, if accepted, implemented in 2013-14.

## Background note on valuation

8.7 Currently, companies and their advisers will often seek to agree a valuation formally with HMRC SAV in order to provide certainty as to the potential tax consequences of a transaction involving ERS.

8.8 In fact, should a company have taken due care in connection with valuing its shares, and provided the value reached is not demonstrably unreasonable, there should be no cause for the value to be challenged by SAV at a later date. Furthermore, provided the value is not unreasonable, no company should have cause to be concerned about an enquiry opened at a later date as to the valuation of their shares.

8.9 This is in fact the official SAV position – and it is aligned with the general move towards self assessment by HMRC – but we do not consider that it is made clearly enough as it is not how companies and their advisers see it. As an aside to our recommendations relating to valuation, we suggest that it is explained clearly on the SAV website that they will not seek to challenge valuations unless they are demonstrably unreasonable and that in the majority of cases there should be no requirement for companies to seek a valuation from SAV for ERS (whether pre- or post-transaction) at all.

8.10 SAV do of course have the ability to open enquiries, and will be aware of advisers whom they consider to be more aggressive in their approach to valuation. Provided they use those powers sensibly, which the OTS believes they do, this should have two results: firstly, the numbers of valuation clearances sought will be reduced; and secondly, the negotiation of valuations undertaken should be improved and simplified.

8.11 Realistically, however, we recognise that, with the best will in the world, this will not achieve the certainty that companies would like when they seek an agreement with SAV as to the value of their shares. Consequently, we make some recommendations below which we believe will help provide certainty for businesses, while allowing SAV to challenge where necessary, and ease the process of agreeing valuations.

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

8.12 The single most helpful approach in terms of valuation for companies (particularly for private companies) operating unapproved share plans would be to offer a pre-transaction valuation service.

8.13 Clearly, however, SAV resources are limited, so we do not wish to make a blanket recommendation that all companies should be able to seek a pre-transaction valuation. Nonetheless, we consider that in the following situations, it may be appropriate for a pre-transaction valuation to be agreed without excessively complex negotiations:

- Where a company has agreed a share valuation for the purposes of a tax advantaged plan,[1] it should be possible to extend that value to any unapproved awards made at the same time;
- If a company wishes to use an enterprise management incentive (EMI) share valuation for other purposes then this should be made clear on their EMI application so that HMRC SAV can, if necessary, perform a more rigorous risk assessment of the valuation;
- Where a company has used the same valuation procedure as previously, has confirmed in writing that no significant changes have occurred in the company's business since the agreement of the last value and provides a "blacklined"[2] comparison of the valuation methodology;
- Where a company has undergone a recent arm's length transaction (e.g. within the last three months) and wishes to agree a value broadly equal to that transaction;
- Where the situation is straightforward (e.g. offer of shares in a new start up company);
- Where the company has followed an outline valuation methodology set out in SAV's guidance (see recommendation F(2) below); and
- Where the situation is straightforward and involves an offer of shares, broadly, to all employees in the company.[3]

8.14 We have considered carefully the concerns relating to SAV resources and recognise the difficulty of quantifying accurately the impact of this recommendation. On balance, however, we consider that allowing a quick and simple approach to low risk valuations of the type listed above should, in the long run, result in freeing up SAV resources for the more challenging valuation agreements where there is a higher risk of imaginative tax planning.

8.15 In addition, SAV should always have the ability to reject pre-transaction valuation requests where they consider they are too complex or high risk, although reasons should be given for this (see recommendation F(2) below).

8.16 An alternative approach to agreeing pre-transaction valuations in the circumstances above would be for SAV to make it explicit on their website and other communications that no valuation need be sought in such circumstances and that SAV would not seek to open any enquiries provided these circumstances applied. This would give companies the same certainty as a pre-transaction valuation but we consider this approach would be too high risk for SAV and therefore do not recommend it.

**Recommendation F(2): provision of outline valuation methodologies, checklist and procedure for valuation**

8.17 This recommendation applies to pre- and post-transaction valuations equally.

8.18 When companies approach HMRC Employee Shares and Securities Unit (ESSU) for approval of schemes such as a company share option plan (CSOP), ESSU provides a checklist of documents required for approval, together with some reasonably clear guidance as to the steps

[1] Enterprise Management Incentives (EMI), Company Share Option Plan (CSOP), Save as You Earn (SAYE) or Share Incentive Plan (SIP).
[2] http://www.hmrc.gov.uk/shareschemes/ess-approval.htm
[3] In fact, SAV already offer this service on an informal basis.

that will be required to put a scheme in place.[4] The ESSU manual also provides links to precedent documents that can be used by companies implementing schemes.[5] ESSU has also been streamlining its approval processes by, for example, allowing advisers to seek approval of new sets of CSOP rules by sending in "blacklined" rules to show changes made from rules that have previously been approved by HMRC.

8.19 While it is recognised that a valuation of private company shares does not lend itself to formulaic documentation in the same way as an HMRC approved scheme, there are certain aspects of this approach that could be used effectively by SAV to help streamline the process for companies seeking valuations. We recommend the following:

- Some examples of typical valuation approaches for common situations – for example, start-up companies – and tables of standard discounts for minority holdings which a company can use as guidance (although companies will be free to argue a different discount);
- Clearer signposting on the SAV website about the provision of valuations for ERS;
- A full checklist that includes **all** the information that is required by SAV before a valuation can be agreed.[6] This should go beyond the basics such as last three years' accounts and also include requirements such as recent transactions, proposed transactions, business plans and any other information that SAV might consider is necessary;
- To reduce "fishing expeditions", SAV could request copies of pro-forma plan rules, and copies of shareholders' resolutions and other relevant ancillary documentation with respect to the proposed awards;
- A return to the more detailed guidance HMRC used to offer on valuation;
- A standard covering letter including the valuation methodology used (e.g. price to earnings ratio, dividend yield, based on recent arm's length transaction) and details – if appropriate – of the valuer who has provided the valuation;
- A standard procedure, including estimated timelines, and the proviso for pre-transaction valuations that if the valuation is too complicated the company will have to seek a post-transaction valuation. When this is the case, SAV should provide reasons; and
- The ability to submit all of this documentation online, using preset forms, wherever possible.

**Recommendation F(3): increased flexibility for non-recognised stock exchange listed companies**

8.20 Companies listed on AIM, ISDX[7] and other non-recognised stock exchange (non-RSE) listed companies must seek a valuation from SAV for shares used in their employee share plans.

8.21 In practice, SAV will almost always agree that the value can be set at the closing price on the day before the date of award or grant.

[4] ESSUM 46200
[5] ESSUM 47000
[6] SVM105055 contains a short list of information but this could be significantly improved.
[7] ICAP Securities and Derivatives Exchange, a market for small capital and growth companies.

8.22 This value should be accepted automatically, without the necessity for a written agreement from SAV. This would reduce the administrative burden both on SAV and the companies involved.

8.23 A concern has been voiced by HMRC that it is easier for non-RSE listed companies than for fully listed companies to manipulate their share price, which would only be identified if SAV were involved in agreeing a valuation of the shares and thus overseeing the company's activities. However, this happens only in a very small minority of cases and consequently the OTS considers, in the interests of simplicity for the majority, that to make this recommendation is valid. HMRC would still have enquiry powers, after all.

**Recommendation F(4): simplify the approach to "quarter up" valuation for listed companies**

8.24 We recommend that the value of listed company shares is based on the closing price on the day of trading, rather than using the quarter up valuation methodology as is currently the case.

8.25 Currently, where there is a transaction involving listed employment related securities (whether or not on a recognised stock exchange), if the share price changes during the trading day, the value of the shares is based on the quarter up valuation methodology. This is used, for example, in relatively illiquid markets, where not all of the shares can be sold in one day, or when the shares are sold over the course of a weekend, or in other situations where brokers will sell the shares in tranches to avoid flooding the market.

8.26 The quarter up approach is complex and particularly difficult to explain to participants. Taking a single price would be considerably simpler for individuals and administrators. We recognise that there will be some winners and some losers from this change of methodology, but believe the simplification outweighs this impact.

8.27 It should be noted that for the purposes of this report, the quarter up valuation methodology applies to the calculation of income tax and national insurance contributions. However, the approach generally also applies to capital gains tax calculations. The OTS considers this recommendation should be a general reform extending further than just to ERS.

8.28 Moving from quarter up to closing price will produce winners and losers both for HMRC and for taxpayers. Our recommendation is a pragmatic one driven by simplification.

# 9 Ideas considered and rejected

## Default section 431(1) ITEPA 2003 elections

9.1 Currently, when employees acquire restricted securities, they and their employers can make an election as to the tax treatment. They can choose to pay income tax and national insurance contributions (NICs) upfront with the charge based on the full and unrestricted market value of the securities, which is done by making a section 431(1) election. Any increase in the value of the shares subsequently will fall to be charged to capital gains tax (CGT).

9.2 Alternatively, they can choose not to make an election; in this case they will pay tax and NICs on the restricted market value of the securities at acquisition. Where the shares increase in value because restrictions have fallen away, a proportion of that value will be charged to income tax and NICs (including uncapped employers' NICs).

9.3 The advantage of making a section 431(1) election is that it guarantees any future gain is taxed beneficially under the capital gains tax regime; in addition, the employing company does not have the risk of future uncapped NICs charges at a future date when restrictions are removed. The disadvantage is that, should the share price fall, the individual and the company may have overpaid income tax and NICs, and there is no way of clawing those amounts back.

9.4 In practice, we were told by some advisers that it is almost an automatic choice for smaller companies to make section 431(1) elections, mainly because of the uncapped NICs charges. However, several advisers were concerned that some companies were unaware of the existence of section 431(1) elections, which put them at a disadvantage in particular in connection with the uncapped employers' NICs. It was suggested that it might be easier for many smaller private companies if making a section 431(1) election was the default position, so that a positive decision had to be made to pay the tax later.

9.5 We considered this approach but eventually rejected it for the following reasons:

- Despite its advantages, a section 431(1) election results in some individuals and companies paying a higher amount of tax immediately and before they are required in law to do so. It would be unreasonable to make this position the legal default, particularly as by doing so individuals would be automatically opting into a position which carries some risk (i.e. if the shares decrease in value); and
- While making a section 431(1) election the default position would be advantageous for some private companies, many other companies prefer to defer the tax. (For example, larger listed companies using shares with forfeiture restrictions as part of long term incentive plans (LTIPs) or bonus deferral arrangements.) Under the current arrangement, section 425 ITEPA 2003 applies to defer the tax until the forfeiture lifts, but this would be made more complex by the introduction of a deemed section 431(1) election.

9.6 We concluded that making a change to the legislation would be a simplification for some but not for all. Bearing in mind the overriding requirement for simplification, the proposal was rejected.

## Electronic submission of section 431(1) ITEPA 2003 elections

9.7 We considered a requirement for companies to submit section 431(1) ITEPA 2003 elections electronically. This is because it is not possible to check that the section 431(1) elections have in fact been signed within the correct timeframe; it was also suggested that electronic submission may make record keeping easier.

9.8 However, at the moment there is no requirement for section 431(1) elections to be submitted to HMRC at all; furthermore, HMRC does not currently have a system in place to enable such electronic submissions to be made. As a result we rejected the idea. However, the OTS notes that electronic filing may be appropriate in the future, as and when other e-filing in connection with share plans (e.g. Form 42) becomes the norm.

## Changing the PAYE and NICs treatment applicable to employment related securities (ERS)

9.9 One of the complications relating to ERS is deciding whether or not the ERS are readily convertible assets (RCAs) and thus subject to Pay as You Earn (PAYE) and NICs on acquisition. One approach to simplifying this would be to ensure all ERS were treated in the same way. For example, if all ERS were automatically treated as RCAs, this would clearly align the treatment of ERS with that of earnings and would be very easy to understand. Conversely, if all ERS were deemed not to be RCAs, this would be equally easy to understand.

9.10 We debated these suggestions at length but concluded:

- Making all ERS subject to PAYE and NICs would be a significant disadvantage for smaller companies trying to implement employee share ownership and would be a clear shift in government policy in this area;
- Excluding all ERS from PAYE and NICs would result in a significant loss to the Exchequer, and would further misalign the treatment of ERS with that of earnings;
- Clarifying the definition of RCAs (see recommendation A(1)) would be a more straightforward approach to this area; and
- The adoption of recommendation A with its approach to marketable securities is likely to simplify this area considerably.

9.11 For the reasons above, we rejected the proposal.

## Floating election for marketable securities

9.12 While discussing recommendation A in connection with marketable securities, we considered the possibility of allowing employees and employers to make an election to pay the tax on the securities **at any time after acquisition**.

9.13 We accepted that this would give employees and employers more flexibility in managing their tax affairs. We also recognise that the current section 431(1) legislation permits elections to be made at any time following acquisition. For companies with particularly variable share prices, this may result in perceived unfairness because of the lack of choice.

9.14 However, we also note that recommendation A provides a very significant advantage to individuals and companies in that no tax charge need be paid on the acquisition of ERS, deferring that tax charge until cash is available to pay the charge. We consider that this advantage could be seen as a reasonable quid pro quo for the lack of flexibility in timing of the election.

9.15 For this reason, and again bearing in mind our overriding requirement to provide simplicity rather than flexibility, we rejected the proposal to allow elections at any time following acquisition, and concluded that a one-off election at acquisition would be more appropriate.

## Valuation ideas

9.16 We considered but rejected the following ideas in connection with valuation:

### 1. Standard valuation methodologies for private company shares

9.17 Several practitioners have suggested that providing standard valuation methodologies for private companies, including examples of typical discounts for common restrictions relating to private company shares, might assist private companies in agreeing a value for their shares with HM Revenue & Customs Shares and Assets Valuation (HMRC SAV).

9.18 On the face of it, this seems a helpful approach. However, after careful consideration and debate with a number of valuation experts, we concluded that this is unlikely to be a practical approach for the following reasons:

- The valuation of private company shares is, generally, too complex to be distilled into two or three valuation models, because each company is different and so many external and unique factors can influence the value of the company's shares;
- Providing valuation models other than in the very simplest of cases could result in company owners with little or no valuation experience following an inappropriate model and producing a wholly inaccurate value. This is in itself could lead to protracted debates with HMRC SAV; and
- There are other approaches to the very simple cases which are set out in recommendation F above.

9.19 We do suggest however, in recommendation F(2) that examples of typical discounts could be made available on the SAV website – although these should be for general guidance only.

### 2. Paying a fee to HMRC SAV to agree a value

9.20 Feedback from a number of practitioners and companies suggested that in some cases companies would be happy to pay a fee to HMRC SAV in order to obtain the certainty of a pre-transaction valuation.

9.21 Once more, this seemed in the first instance to be a sensible approach. However, further discussions both with practitioners and HMRC SAV identified the following problems with this approach:

- What would companies actually be prepared to pay for a pre-transaction valuation? A price that realistically reflected HMRC SAV's time and expertise is unlikely to be acceptable to most companies;
- If a valuation negotiation became complex and protracted, would HMRC SAV be in a position to make an additional charge and if so on what basis?;
- Is there a risk that, having paid for a valuation, companies would expect HMRC to provide "the right value", possibly leading to longer negotiations?; and
- A fee-based approach would disadvantage smaller companies for whom seeking a valuation is already a relatively expensive undertaking.

### 3. Random sampling of valuations from 'trusted' valuers

9.22 An idea that was proposed by one of the valuers who we met with was for SAV to review only a small, random sample of valuations from valuers who had a track record of submitting sensible valuations. This would free up resources for both SAV and those 'trusted' valuers. If during the sampling it was discovered that a valuer was submitting inappropriate valuations then they would be removed from the 'trusted' group and checked thoroughly.

9.23 Again, this seemed like a sensible approach and of benefit to both sides. However, there were some issues with this idea.

- Difficulties for new entrants to the valuation market in establishing a track record and client base;
- An unfair competitive advantage for certain valuers; and
- A risk that too many valuations might pass through SAV unchecked.

9.24 For these reasons we do not make this recommendation, though we do feel it has some merit and is worth further exploration.

# A Consultative Committee members

## Consultative Committee members

| | |
|---|---|
| Andrew Richens | Bishop Fleming and ex-OTS |
| Ann Govier | Marks & Spencer |
| David Cohen | Share Plans Lawyers Group and Norton Rose |
| David Fleming | Unite |
| David Pett | Pett Franklin & Co. |
| Diane Hay | PricewaterhouseCoopers |
| Fiona Bell | Quoted Companies Alliance and RM2 |
| Geraldine Pamphlett | Foster Wheeler and ex-OTS |
| John Collison | ifs ProShare |
| John McLoughlin | HM Revenue & Customs |
| Kay Ballard | Kingfisher |
| Martin Osborne-Shaw | Killik & Co. |
| Martyn Drake | Computershare |
| Matt Ray | HM Treasury |
| Michael Landon | ESOP Centre and MM&K |
| Peter Vassallo | BP |
| Philip Fisher | PKF |

# B Summary of responses to interim report

B.1 As with our report into tax advantaged employee share schemes the OTS sought feedback from a variety of stakeholders to identify areas of complexity in the unapproved share schemes legislation. These included professional advisers, lawyers, accountants, large, medium and small companies, share scheme administrators and representative bodies. The interim report published in August 2012 reflected this feedback, but we were keen for more input and set out ten key questions for further answers.

B.2 The responses to the interim report are set out below. Feedback has not been attributed individually as many points were raised by several organisations. Furthermore, not all of the respondents had views on all of the questions set out in the interim report.

B.3 Finally, the OTS would once again like to thank the organisations who took the time and effort to respond to both our initial survey and the interim report, and also the many individuals and companies who were willing to meet and share their experiences and suggestions with the OTS team. We hope that as many views as possible have been reflected in our report and assure that all have been taken into account when proposing recommendations.

### Question 1: Difficulties with valuation of private company shares

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

- A pre-transaction valuation process would be very helpful in providing certainty, but would need to be carefully structured to avoid abuse;
- Valuations agreed for approved schemes e.g. enterprise management incentive (EMI) schemes should be valid for unapproved schemes within a certain window;
- Companies who appoint valuers have a significant advantage over those who don't, especially in navigating the intricacies of agreeing a value with HMRC;
- HMRC guidance is opaque and difficult to make sense of;
- There is a lack of consistency between different valuers in HMRC Shares and Assets Valuation (SAV);
- It should be made clear that post transaction valuation checks are available for income tax as well as capital gains tax;
- SAV should question when valuations are too high as this is often the case for companies who have not sought professional valuation advice; and
- 'Fair value' as determined by the articles of association can be different to 'fair value' on an open market basis.

### Question 2: Internationally mobile employees

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

- Time limits on reimbursement of notional payments, Pay as You Earn (PAYE) and Form 42 (and in future real time information) are difficult to comply with;
- Clarification on the application of NT tax codes to relevant chargeable employee share transactions;
- The interaction of the earnings charge and Part 7 ITEPA 2003 is uncertain, particularly for restricted stock units (RSUs) and long term incentive plans (LTIPs) with a fixed vesting date;
- The separate rules to charge part of a gain on exercise of an option under Chapter 3C of Part 7 ITEPA 2003 where granted overseas, if it was expected that the employee would be working in the UK by the time the option vests;
- The tax charge and PAYE obligation under 3C is on the sale of shares, not on exercise. It is impractical for public limited companies with large share registers to track the sale of shares and therefore in practice, employers usually tax the exercise gain in full at exercise, even if the shares are retained;
- The lack of clarity of interaction with capital gains tax and income tax leading to uncertainty and potentially double taxation;
- Don't understand the distinction that HMRC has created for legal options;
- HMRC are seeking the best of both worlds such that section 62 applies for inbounds (pro rata award on earnings basis) and securities options treatment (100 per cent UK charge) for UK grants;
- There should be consistent rules for corporation tax (CT) deductions for secondments to the UK where income tax is paid by the employee;
- Tracking movements cross border and determining tax implications of awards vesting many years after an employee has left the UK;
- The remittances rules are biased against employees employed by UK companies with UK quoted shares as these are deemed to be remitted; and
- The cost of getting a sub plan of an overseas share plan approved in the UK is too difficult for a few employees so most overseas plans are unapproved.

### Question 3: Readily convertible assets (RCAs)

### What are the main difficulties you face in determining whether your shares are, or will be, RCAs or not?

- Determining if shares are CT deductible can be problematic for certain private equity fund structures, particularly where there is a general partner who could be deemed to control the board of the investee company;
- Qualifying shares in unquoted trading subsidiaries are treated unfairly as RCAs, but without CT relief;
- It is unfair that shares in overseas private companies, which are not within the charge to CT, are deemed as RCAs regardless or not of the existence of trading arrangements;

- It is difficult to identify what 'trading arrangements' are given the broad definition and exactly when shares become RCAs;
- In some circumstances the existence of an employee benefit trust (EBT) will cause shares to be RCAs and in others it will not e.g. what if the EBT occasionally buys and sells shares?;
- Put options can cause difficulties depending on the wording of the arrangement – some may be RCAs whilst others are not;
- It is unfair to require PAYE on subsidiaries with no realistic opportunity of selling the shares for cash;
- An individual's circumstances, such as being close to retirement, can affect RCA status; and
- The inability to have a meaningful discussion with HMRC about the facts in time for the PAYE deadline.

### Question 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?

- It is time consuming and administrative and the vast majority of information is never referred to by HMRC. Many incorrect Form 42s are never rejected by HMRC;
- HMRC need to decide what information they really need about share schemes and when they need it;
- Electronic submission is needed;
- Does HMRC make timely use of the information?;
- Unclear what the primary focus is. Does this require a detailed annual form to be completed by all or could HMRC focus on circumstances where PAYE has not been operated or other areas of risk? Could the employer just tick a box to say it has a share plan?;
- Could the form be issued at the start of the year so it could be completed in year?;
- The form is difficult because the regime is difficult – the person filling it in needs a deep knowledge of the tax area;
- Events such as grants, which do not trigger a tax charge, should not be reported on the form;
- It is difficult for internationally mobile employees where gains on exercise of options may be chargeable under Chapter 5 and others under Chapter 3C of Part 7 ITEPA 2003; and
- There are opportunities from the introduction of RTI. Chargeable events could be reported in summary form on the full payment submission (FPS) and HMRC could pull this information together internally as it saw fit.

### Question 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 share plans?

- The disguised remuneration (DR) rules apply to commercial situations which they were never designed to catch e.g. a loan from an employee benefit trust (EBT) to employees;
- It cost two weeks' work to understand the rules;
- Part 7A is too broad and employers using EBTs find it hard to know how much information to give in order to prevent earmarking;
- Deals are being constructed to fall into a DR exclusion rather than for commercial reasons;
- There is no exclusion where a limited liability partnership (LLP) takes a relevant step where its wholly owned subsidiary is the employer, but there is vice versa;
- Under sections 554J-554M ITEPA 2003 a person employed by an LLP has to pay tax when they have shares notionally earmarked for them, but someone who is not employed by an LLP does not; and
- The DR rules create a difference in tax treatment between nil and partly paid share issues by a company and the disposal of shares by an EBT on deferred payment terms.

### Question 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 have to restructure, or alter the design of, your share plan in a manner which has adversely affected the attainment of your commercial intentions?

- The loans to participators rules can be a disincentive to establishing share schemes for private companies;
- Private equity investee companies can be considered 'close' even when the underlying investor base is very wide;
- The loans to participators rules can cause major cash flow issues for close companies;
- The main barrier is nearly always cost;
- Companies have to trade off between paying offshore trustee fees, but having no unexpected tax charges or administering the EBT themselves in the UK, but risking a capital gains charge in future;
- The notional "advance corporation tax" charge distorts the commercially preferred decision to lend money to an EBT; and
- The inheritance tax rules are complex and companies can easily fall into them if not well advised.

## Question 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?

- Only very well advised companies and individuals can navigate the legislation;
- Restrictions can result in multiple occasions of charge if removed piecemeal (unless a section 431(1) ITEPA 2003 election is made) which is complex and costly if a valuation is required each time;
- The section 431(1) election deadline could be extended to longer than 14 days;
- It does not seem correct that shares with restrictions are usually given a discount between 10 per cent and 15 per cent regardless of the types of restriction or terms of forfeiture, these are often subjective;
- The convertible share provisions are generally superfluous as most convertible securities are also restricted and taxpayers elect to be taxed under the restricted regime;
- There should be no charge under Chapter 3C of Part 7 ITEPA 2003 if shares are sold for a price where no profit is made and the shares had been paid for in instalments or were issued partly paid;
- Problems can arise where shares have differential rights, particularly in relation to the rights to the proceeds in the event of a sale;
- Clients are often unaware of Chapter 2 in Part 7 ITEPA 2003 or the ability to make section 431(1) elections;
- Identifying whether something is a restriction or not; and
- Share for share rollovers.

## Question 8: Timing of income tax charge

### Chapter 4 [of the interim report] 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 it 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?

- Some support for moving the tax point, but fears that it may lead to another layer of complexity if done incorrectly;
- It would deal with the fundamental problem of valuing shares;
- The quantum of tax should still be determined with reference to the position at acquisition;
- There needs to be an election available to accelerate the tax charge;
- How will it fit with HMRC’s real time information project?;
- There will be an un-hedged exposure to employer NICs for companies;

- Where a long term incentive plan vests during a close period this can give rise to a tax charge for 'insiders' even when they cannot sell their shares;
- There should be a longer period to achieve a sale of shares where there is a lack of liquidity; and
- The 90 day rule for section 222 ITEPA 2003 charges is still harsh and the charge should at least be reversed when the employee repays the PAYE.

### Question 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?

- The rules are probably about right, but at the cost of substantial complexity;
- They should be rewritten under the Tax Law Rewrite style;
- More favourable treatment could be given to those who participate in high risk, growing companies – we welcome the extension of Entrepreneur's relief to enterprise management incentive (EMI) shares;
- The disguised remuneration rules do not achieve the aim, nor does Chapter 3 of Part 7 ITEPA 2003 as it can convert what would be a capital gain for a non-employee into employment income for an employee-shareholder; and
- Share options should be fully subject to capital gains tax (CGT) on sale, rather than income tax on exercise and CGT on sale.

### Question 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?

- Generally there should not be separate rules for smaller companies;
- The OTS should research the costs for small, medium and large companies of putting share schemes in place, in particular how much is spent considering the legislation;
- It is better to fix the main issues that affect small companies; and
- A simplified valuation matrix would be helpful for small companies which they can use if they wish.

# C Glossary

| | |
|---|---|
| BIS | Department for Business, Innovation and Skills |
| CGT | Capital gains tax |
| CSOP | Company Share Option Plan |
| CTA 2009 | Corporation Tax Act 2009 |
| CTA 2010 | Corporation Tax Act 2010 |
| EEA | European Economic Area |
| EBT | Employee benefit trust |
| EMI | Enterprise Management Incentives |
| ERS | Employment Related Securities |
| ERSM | Employment Related Securities Manual |
| ESSU | Employee Shares and Securities Unit |
| FA 2003 | Finance Act 2003 |
| HMRC | Her Majesty's Revenue and Customs |
| ICTA 1988 | Income and Corporation Taxes Act 1988 |
| IHT | Inheritance tax |
| IHTA 1984 | Inheritance Tax Act 1984 |
| ITA 2007 | Income Tax Act 2007 |
| ITEPA 2003 | Income Tax (Earnings and Pensions) Act 2003 |
| LTIP | Long Term Incentive Plan |
| NICs | National Insurance Contributions |
| OTS | Office of Tax Simplification |
| PAYE | Pay as You Earn |
| RCA | Readily convertible asset |
| RTI | Real Time Information |
| RSU | Restricted Stock Unit |
| SAYE | Save as You Earn |
| SIP | Share Incentive Plan |
| TCGA 1992 | Taxation of Capital Gains Act 1992 |

# D Terms of reference

## Employee share schemes

### Terms of reference for review of unapproved schemes

D.1 The OTS consultations with business have found that employee share schemes are perceived to be a highly complex area of the tax code. This complexity is seen as a frequent cause of error in tax returns and as a source of administrative burdens on employers, their advisers and employees.

D.2 Reflecting this, the Government asked the OTS to carry out a two stage project. The first stage, which was reported on prior to Budget 2012, looked at the four tax-advantaged, or Government approved, share schemes and made recommendations to simplify them.

D.3 The second stage is to look at non tax-advantaged or unapproved share schemes and share-based incentives. The second stage will comprise two parts:

1. An initial fact finding exercise to report by 31 July 2012, which will examine:
    - The most commonly used types of unapproved share scheme such as share option schemes, long-term incentive plans, deferred share purchase plans and share matching plans;
    - Ad hoc arrangements falling within the employment related securities regime;
    - The drivers for companies to use such arrangements;
    - Which parts of the tax system help or hinder their objective;
    - Where the current tax rules create inappropriate complexity and disproportionate administrative burdens for users, including PAYE and NIC requirements; and
    - Where users make common mistakes that lead to unexpected tax problems.
2. A detailed examination of priority simplification areas identified in the fact finding stage, leading to specific simplification proposals in a final report by Budget 2013. The terms of reference for this part of the project will be settled after the conclusion of the first part and will be informed by consultation with the project's consultative committee, HMRC and HM Treasury.

D.4 The final report will probably have regard to the following points, though these will be confirmed after the conclusion of the first part of the work:

- The impact on companies and their employees and on HMRC; including the impact on employers with international workforces;
- The Government's corporate tax reform agenda including the need for fairness;
- The wider economic and policy implications of any proposals – including the original purpose of the legislative provisions and overall tax receipts;

- The take–up of the schemes by companies and employees;
- The risk of non-compliance and avoidance opportunities, recognising especially that many of the tax rules are anti-avoidance in nature; and
- The Spending Review resource constraints on HMRC and HM Treasury.

D.5 The Office's work will be informed by full consultation with interested parties including the employee share schemes consultative committee.

# E Illustrations of tax treatment for international assignees

E.1 To illustrate the complexity of the share scheme rules for international assignees, this annex considers three typical types of long-term incentive arrangements, entered into at the start of year one and, if the employee meets performance targets over the period up to the end of year three, and is still in employment six months after the end of year three, "paying out" at that time.

1 A "Long Term Incentive Plan" (LTIP) – linked to movements in the share value of the employing company in the period from year one up to the end of year three and paying out cash;

2 A restricted securities award made at the start of year one, wherein the shares awarded are forfeitable until six months after the end of year three, at which point, the shares are wholly owned by the employee, free from all restrictions; and

3 A share option which vests and is exercisable for no consideration six months after the end of year three.

E.2 For employees who are UK resident throughout the entire period from year one to six months after the end of year three, the tax treatment of each arrangement will be broadly similar:

1 Taxable earnings will arise in the amount of the payment, in the year in which it is received;

2 Taxable specific employment income will arise in the amount of the value of the shares at the time the restrictions lift; and

3 Taxable specific employment income will arise in the amount of the value of the shares at the time the shares are acquired (by the option exercise).

E.3 For internationally-mobile employees the picture is a lot more complicated.

E.4 For employees who are UK resident and working full-time in the UK at the start of year one but from, say, the middle of year two onwards, while remaining in the same employment, are not UK resident and are working full-time outside the UK:

1 Normally, but always dependent on the facts of any particular case, the taxable earnings will be a fraction of the total payment, apportioned according to the time that the employee is UK resident compared to the total period from the start of year one to the end of year three;

2 The taxable specific income will be the whole value of the shares at the time the restrictions lift, but if, at six months after the end of year three, the employee is living and working in a country with a double tax treaty with the UK, then normally on a claim under the treaty, the amount will be apportioned according to the time that the employee is UK resident compared to the total period from the start of year one to the end of six months after year three; and

3 The taxable specific income will be the whole value of the shares at the time of the option exercise, but if, at that time, the employee is living and working in a country

with a double tax treaty with the UK, then normally and without a claim under the treaty being made, the amount will be apportioned according to the time that the employee is UK resident compared to the total period from the start of year one to the end of six months after year three.

E.5 For employees who are not UK resident and are working full-time outside the UK at the start of year one but, while remaining in the same employment, are UK resident and working full-time in the UK from, say, the middle of year two onwards:

1. Normally, but always dependent on the facts of any particular case, the taxable earnings will be a fraction of the total payment, apportioned according to the time that the employee is UK resident compared to the total period from the start of year one to the end of year three;
2. There will normally be no charge to income tax as there was no UK employment in the year when the shares were acquired; and
3. There will normally be no charge to income tax as there was no UK employment in the year when the share option was acquired. However, if the option was awarded in the knowledge that the employee would be working in the UK for part of the period up to the vesting of the options, then the value of the shares at the time of the exercise (apportioned according to the time that the employee is UK resident compared to the total period from the start of year one to the end of six months after year three) would be treated as a notional loan made at the time of the exercise, and an amount produced by applying an interest rate to the loan would be treated as employment income until the shares were sold, at which point the amount of the notional loan would count as employment income.

## Consequential problems

E.6 It can be seen that one of the major differences in treatment is that, in some circumstances, rewards related to UK work, but provided by way of restricted securities or securities options are not taxed in the UK. These differences are not only themselves complex to understand, but also lead to some further complexities.

### "LTIPs", "RSUs" and similar incentive arrangements

E.7 General earnings can arise on the "pay-out" from such arrangements, even where such pay-outs are in the form of shares, if the award of the right to participate in such schemes is itself not "money's worth". Where such arrangements, in addition to giving rise to general earnings on pay-out, are also "securities options", but a Chapter 5 (Part 7 ITEPA) charge is prevented by the residence rules, it is sometimes disputed by employers, taxpayers and their advisers that there can be a general earnings charge.

### Problems with CG treatment where a section 62 ITEPA earnings charge is applied

E.8 Following on from the treatment of the payout from securities options as general earnings, one prominent adviser has been pressing HMRC to address the question of capital gains tax base cost for LTIP/ RSU shares taxed under section 62 ITEPA 2003.

### NICs

E.9 NICs treatment of long-term reward arrangements is not in line with the income tax treatment generally, and the discrepancies in income tax treatment between different forms of long-term arrangements further complicates the NICs picture. HMRC face demands from external groups to align NICs treatment more closely with income tax on the matter of apportionment of long term rewards.

### Chapter 3C

E.10 The reliance on Chapter 3C where Chapter 5 and/or section 62 don't apply gives rise to its own difficulties.

E.11 Where Chapter 5 and a general earnings charge do not apply, Chapter 3C of Part 7 can apply because an employee has acquired shares at less than market value. The result is that the employee is taxed not on the amount of the reward (the value of the shares less any option exercise price), but as if that amount had been lent to her interest-free as a beneficial loan.

E.12 The "notional loan" concept, which makes sense in the normal circumstances where Chapter 3C applies (partly-paid shares or shares purchased on deferred payment terms), makes less sense in the context of the exercise of share options by internationally mobile employees. The employee is charged annually on the notional interest forgone at the official rate on the interest-free notional loan aggregated with all other actual beneficial loans, providing she is within the scope of the benefits code at the time. If and when the share are sold (and regardless of whether she remains within the scope of the benefits code), she is then taxed on the principal amount of the notional loan, as if it had been released.

E.13 Compliance difficulties arise because for each year in which the employee remains in the employment and keeps the shares, the employer must continue to report on the employee's form P11D the annual taxable amount of notional interest foregone at HMRC's official rate; and the employee must pay the tax each year through Self-Assessment. If the employee leaves the employment, the employer needs to continue to keep records of the shares held by ex-employees chargeable under Chapter 3C. This is because if and when the ex-employee sells the shares, the tax on the principal amount of the notional loan must be accounted for by the employer under PAYE, and Class 1 NICs accounted for, even though the ex-employee may have left the employment or, if still employed, may have left the UK years before.

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This document can be found in full on our website at:
http://www.hm-treasury.gov.uk/ots

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ISBN 978-1-909096-47-9

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