HM Revenue
& Customs

Consultation: Office of Tax Simplification review of unapproved share schemes: Marketable Security

Summary of Responses
December 2014

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1. Introduction

The consultation

1.1 Income tax and National Insurance contributions (NICs) are generally due where an employer awards share options, shares or other employment-related securities (ERS) to employees. In certain circumstances corporation tax relief is available to companies in respect of employee share acquisitions.

1.2 The OTS published the final report of its review of unapproved employee share schemes on 16 January 2013, and this can be found at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/198440/ots_unapproved_employee_share_schemes_final.pdf.

1.3 A number of the OTS's recommendations in that report have already been implemented, for example:

- Income tax and NICs relief for exchanges of restricted and nil or partly-paid employee shares;
- Extending corporation tax relief for employee share acquisitions following certain takeovers of a company;
- New income tax and NICs rules for employment-related securities awarded to internationally mobile employees; plus corporation tax relief for shares awarded to these employees will also be extended; and
- Change to the deadline under section 222 of the Income Tax (Earnings and Pensions) Act 2003 for an employee to 'make good' PAYE amounts paid on their behalf by an employer, if a tax charge is not to apply.

1.4 The Government announced at Budget 2014 that HM Revenue and Customs (HMRC) would publish a discussion document on the recommendation in relation to the 'marketable security'.

1.5 This proposal would require significant change to the taxation of ERS. It is designed to address circumstances in which employees have to pay tax (and possibly NICs) on ERS at the time these are awarded, even where there is no immediate opportunity to sell the ERS to fund the charges. The OTS referred to this as a 'dry tax charge'. It recommended that, broadly, individuals should be able to choose whether the tax charge on ERS arises at the time they are acquired or, if different, at the time at which they can be sold for cash (when they become 'marketable').

1.6 This consultation sought to explore areas in which the Government believed that further discussion and evidence of the potential impact would help it consider whether to proceed with any changes.

Consultation responses and outcome

1.7 HMRC received 10 responses to its consultation: five from specialist tax or legal advisers and five from representative bodies. Annex A contains a full list of respondents. Several of these respondents, together with other stakeholders, attended a meeting to discuss the proposal. The Government is grateful to all stakeholders for their contributions and for taking the time to respond and attend the meeting. These responses have contributed to a better understanding of the potential impact, costs and benefits of the proposal.

1.8 Chapter 2 outlines points made during the consultation. Respondents welcomed in principle the suggestion that tax due on ERS could be deferred, and some saw the consultation proposal as a possible means by which this might be achieved. However, more respondents questioned whether the far-reaching changes recommended were proportionate or well-targeted. Some respondents believed that certain features of the proposal could create new complexity, or that the current rules were sufficiently flexible to allow deferral. It was also suggested that some aspects of the proposal could disadvantage or provide unwelcome outcomes for companies or employees that do not have access to specialist advice. Some respondents said that OTS recommendations already implemented by the Government have ameliorated some of the problems this proposal sought to address. Alternative approaches to deferral of tax were suggested by some respondents. While these alternative approaches have been noted, they are not summarised in this document.

1.9 In view of this response, the Government has decided that it will not proceed with this proposal. Further details are set out in Chapter 3.

1.10 Finally, the Government is grateful to the OTS for highlighting important issues – both in this recommendation and in its reviews of employee share schemes more generally.

2. Responses

2.1 This chapter contains the headings and questions in the consultation document and summarises the responses received.

Introduction

Question 1 – What are the merits of the 'marketable security' proposal for businesses and individuals and are there any potential downsides?

2.2 The benefits of the proposal identified by respondents included that taxpayers could avoid a dry tax charge, employers and employees could benefit from improved cash flow, and the reduction in error by those who are currently unaware that tax may payable on ERS before the recipient is able to sell them. One respondent said that applying tax when shares become 'marketable' – and can therefore be sold – matched the economic reality of the award of shares as an incentive and avoided the need for special arrangements to compensate the employee for a dry tax charge (eg 'grossed up' bonuses).

2.3 The main downsides identified included the risks that the proposed changes could create complexity and uncertainty, that there might still be a dry tax charge at the point ERS become marketable, and that there would be additional administrative burdens on employers. Some respondents said that unwary companies or employees without access to specialist advice could be disadvantaged by the proposal, or could face higher tax or NICs charges, as well as uncertainty over the timing and amount of any charges. One respondent was concerned that the proposed change could mean that tax treatment of certain ERS in the UK would not be aligned with other jurisdictions – potentially leading to a double tax charge.

2.4 One representative body's summary reflected the majority:

> *"There is a logic in deferring tax charges until there is a market in the shares, but our view is that the proposal itself will, in practical terms, prove to be neither a simplification of the system nor have the effect of incentivising employees to become long-term shareholders."*

Question 2 – In what ways would the proposal provide a significant and proportionate simplification of the tax rules for businesses and individuals?

2.5 One respondent argued that the proposal was a logical simplification which matched expectations of how ERS ought to be taxed. Another said that a reduction in the length of Part 7 of the Income Tax (Earnings and Pensions) Act (ITEPA) would be a welcome simplification, although they feared that the introduction of anti-avoidance rules alongside the change might counteract that benefit. Many respondents questioned whether the proposal would simplify the legislation: some said it could substitute one set of complexities for another.

2.6 Several respondents said that it was already possible under the current rules to make share-based awards without a dry tax charge arising – for example, by granting share options. They therefore suggested that the proposal could involve a significant degree of change to achieve limited additional benefit.

2.7 Some respondents said that the proposed arrangements for taxing dividends, and possible difficulties around accounting for tax when ERS are sold, risk creating disproportionate burdens. Respondents generally agreed that well-advised companies and employees would, if possible, elect to pay tax when ERS are awarded (and thereby voluntarily incur a dry tax charge) so as to minimise these risks.

2.8 One respondent said that the change to section 222 ITEPA in Finance Act 2014 – in response to another OTS recommendation – already mitigates the problems the OTS intended to address to some extent.

2.9 One specialist tax adviser commented:

> *"In our view, the simplification benefit of the proposal is useful but limited. While it is undoubtedly helpful for employees to avoid dry tax charges and for employers to [not] have to interpret whether the readily convertible asset rules apply, once it is determined that they do the mechanical application of the PAYE/NIC rules is relatively straightforward. In that sense it is not inherently more complex for individuals to be subject to tax on the acquisition of securities, rather than at some later point."*

Question 3 – What impact would implementation of the proposal have in terms of costs and administrative burdens for businesses and individuals? How would this differ by types of businesses or individuals? Views on the initial assessment of impacts provided at Chapter 4 would be welcome.

2.10 Respondents agreed that there would be one-off costs of implementing the new rules. Thereafter, there could be additional and ongoing burdens on companies. These include those associated with tracking the 'marketable' status of ERS and taxing dividends arising from non-marketable ERS as employment income, within PAYE.

2.11 Some respondents thought that there would be little impact on listed companies as their shares may be more likely to be marketable at the time they are awarded. However, smaller private companies could be affected significantly. One respondent said there would be a substantial impact on new companies which are more likely to be unadvised and therefore miss out on the potential benefits arising from the proposal.

2.12 Again, respondents generally agreed that well-advised companies and employees would, if possible, elect to pay tax when shares are awarded (regardless of whether or not they were 'marketable' at that time), in order to achieve the most advantageous tax outcome.

2.13 On NICs one tax adviser observed that as it can currently be problematic to collect PAYE and NICs on dry charges from employees, the proposal offered some simplification. However, the proposals would mean that the employer would *"need to operate PAYE and NIC on a higher proportion of employee equity transactions"*, placing an additional administrative burden on the employer. Another tax adviser was concerned that:

> *"…businesses will be faced with substantial additional employer's NIC costs in relation to dividends and sales where the business is 'inadvertently' within this regime… [T]he analysis in Chapter 4 of the consultation document substantially understates the impact of the proposals on new businesses."*

The 'dry tax charge'

Question 4 – How far do you agree that the prospect of a 'dry tax charge' on the award of ERS provides a disincentive to ERS-based remuneration? Would implementation of this recommendation have any impact on the number or type of ERS awards offered or taken up?

2.14 Many respondents suggested that dry tax charges were not a major disincentive to ERS-based remuneration. One said that a dry charge can be an unexpected or unwelcome consequence of participation in a share plan, but it is not usually a disincentive. However, another saw such a charge as a disincentive to employee involvement in companies as shareholders. Respondents pointed out that many companies and employees already elect to pay dry tax charges at the time ERS are awarded, as this is beneficial in terms of controlling NICs costs and ensuring future growth can be taxed as a capital gain. Respondents told us that companies can, and frequently do, assist their employees in paying dry tax charges on ERS.

2.15 One representative body whose members are or represent small and medium-sized businesses told us:

> *"The change to the marketable securities regime may lead to a small number of employers offering their employees share awards instead of unapproved/ non-qualifying options. However, the difficulties associated with dealing with leavers' shares and Companies Act concerns about the rights of minority shareholders are likely to result in the majority of employers continuing to prefer to grant options instead of making share awards."*

2.16 Some respondents pointed out several common instances where a dry tax charge would not arise on ERS, and one pointed out that the new rollover relief for ERS in Finance Act 2014 – in response to another of the OTS's recommendations – has removed one instance of an unwelcome dry tax charge.

Readily convertible assets

Question 5 – Would the OTS recommendation increase the incentives for employers and employees to elect for the employee to pay tax on the unrestricted value of ERS before they become marketable? If so, to what extent would the number of these elections increase?

Question 6 - If so, how can this risk be addressed, consistent with the objective of mitigating difficulties that can arise where tax is due before ERS become marketable?

2.17 Respondents broadly agreed that such elections are already common and most thought the number would increase under this proposal. Such elections may be more advantageous in tax terms, and would secure greater certainty about tax and NICs costs. One respondent thought the increase would be by less than 10%. Others thought the increase might be larger, though could not say by how much.

2.18 Although most agreed that the number of elections would increase, respondents generally did not see this as presenting any new risks. It was argued that companies and employees are always likely to prefer the benefits of such an election (including the taxation of future ERS growth as capital) to the cash-flow benefit that could arise from deferral of the tax.

Question 7 – If the OTS proposal were modified so that <u>either</u>:

- **the current definition of readily convertible assets were retained within the framework of the 'marketable security' proposal; <u>or</u>**
- **a joint election by an employer and employee for the employee to pay tax on the unrestricted market value of ERS also became an election for these ERS to be 'marketable securities' and readily convertible assets (meaning income tax and NICs would be payable under PAYE);**

Would either of these options address the risk while still being consistent with the underlying objectives of the proposal? If so, how?

2.19 Respondents were not in favour of either option. One representative body said that the first would be contrary to simplification and the second would increase the number of ERS brought into the definition of readily convertible assets.

When would ERS become 'marketable securities'?

Question 8 – Would treating ERS as 'marketable securities' only "*when they can be sold… by the holder for a payment of money or money's worth which is (at least substantially) equal to the unrestricted market value*" provide an acceptable basis for simplifying the tax rules? In which type of cases would further clarity and guidance on how this applies to different ERS arrangements be required? What proportion of ERS would be 'marketable securities' on acquisition by an employee?

2.20 Most respondents agreed this definition would be sufficient, subject to adequate guidance on the meaning of key terms. Respondents identified some of the cases in which consideration and guidance on whether ERS were 'marketable' would be required. These included:

- ERS subject to a 'put' or 'call' option;
- ERS for which an internal market exists only periodically (eg an annual trading window);
- ERS acquired subject to temporary trading restrictions or forfeiture provisions; and
- ERS acquired by an employee who has a binding agreement to retain a certain level of shareholding in their employer.

2.21 One respondent thought the proposed definition was not a simplification and suggested that less than 5% of private companies have an active market for their shares.

Question 9 – In addition to the anti-abuse approaches suggested by the OTS, would other measures be needed to prevent abuse? If so, what?

2.22 Most respondents argued that no further measures would be needed. Some said that existing anti-abuse provisions – such as the General Anti-Abuse Rule – provided sufficient protection. However, one representative body suggested that provisions similar to Chapter 3A of Part 7 ITEPA could be required to prevent the artificial depression of a share price.

Question 10 – Would there be any undesirable or unintended consequences, including costs to employers, of taxing any income, dividends, gratuities or incidental benefits obtained from ERS as employment income where recommended by the OTS?

2.23 Most respondents agreed that the proposed changes to the treatment of dividends and other payments would not be a simplification and would be unwelcome to many companies and employees. In particular, it was suggested that it would increase the administrative burden on smaller companies by introducing new PAYE obligations in respect of some dividends. Companies and payroll providers would need to track certain ERS to ensure PAYE tax was paid on dividends. This would treat dividends paid to employees differently for tax purposes to those paid to other shareholders.

2.24 Some respondents were concerned that companies without access to specialist advice could omit to account for PAYE liabilities, and could therefore find themselves responsible for funding tax and NICs due if the errors were discovered much later and the employees in question had moved on. One respondent said there would need to be clarity around the meaning of "gratuities" and "incidental benefits". Another said it was not clear how the proposed PAYE tax on dividends would interact with withholding tax paid by overseas companies and Double Tax Agreements.

2.25 One respondent warned that this tax treatment could limit companies' ability to take commercial decisions. Another suggested there would be a potential disadvantage for those who paid market value for their ERS but omitted to make an

election to pay tax on the unrestricted value, as their dividends could be taxed as employment income.

Question 11 – If the Government were to apply a backstop date at which the ERS would be deemed to be 'marketable securities', at what point should this apply?

2.26 Some respondents suggested that a backstop date would not be needed if anti-avoidance measures were in place and one said this might only be necessary for avoidance cases. Several others agreed that if required the backstop could be 10 years after acquisition of the ERS or at the point shares cease to be ERS.

The amount of the tax charge on 'marketable securities'

Question 12: Would linking the amount of ERS income to be taxed to the value of consideration received on disposal of the ERS create any abuse risks or administrative difficulties for companies in complying with their PAYE obligations?

2.27 Most respondents agreed that there was not a risk of abuse from this feature of the proposal, but that this would represent an additional administrative burden. Several pointed out that it would be difficult for companies to track when ERS were sold, especially where an individual is no longer employed by that company, or the company was not otherwise involved in the sale. Some were concerned that employers would be caught out and become responsible for repaying underpayments of tax and NICs, and potentially liable for a penalty. One respondent thought that the employer should only be required to account for tax on the value of the ERS when they became marketable and any adjustment for the sale value should be the responsibility of the employee.

2.28 Some respondents felt there would be a need for clarity on how to treat deferred consideration and what 'best estimates' would be acceptable for companies operating PAYE.

3. Next steps

3.1 Responses to the consultation raise fundamental questions about the potential effectiveness of the OTS recommendation as a means of simplifying and improving the tax system. In particular:

- Respondents were concerned that the overall simplification benefit of the proposal would not be proportionate to the degree of change it would require.
- Respondents were concerned that the recommendation would create additional administrative burdens for employers: especially in connection with the requirement to tax some dividends as employment income, or in tracking the 'marketable' status of ERS throughout their lifetime.
- Respondents were concerned that smaller companies could be disadvantaged by the proposals in terms of additional costs and administrative burdens they could face, while not always being in a position to take advantage of the changes the proposal would offer.
- Respondents generally agreed that there would be more elections to pay tax at the time ERS are awarded under this proposal, leading to an increase in the number of dry tax charges. This would be contrary to the objective of the proposal, which is to address issues and difficulties arising from such dry tax charges.

3.2 The Government has therefore decided not to proceed with these changes. However, the Government is grateful to the OTS for highlighting important issues with this recommendation and during its wider work on the simplification of employee share schemes. The OTS's recommendations have enabled the Government to undertake the most significant package of reforms to the tax rules for employee share schemes for many years.

Annexe A: List of stakeholders consulted

The following advisers and representative bodies submitted written comments:

- CBI
- Chartered Institute of Taxation
- Deloitte LLP
- Grant Thornton UK LLP
- Institute of Financial Accountants/ Federation of Tax Advisers
- Pett Franklin & Co LLP
- PricewaterhouseCoopers LLP
- Quoted Companies Alliance
- The Law Society
- The RM2 Partnership Ltd