UK EMPLOYEE SHARE PLANS ROADMAP TO SIMPLIFICATION?

SQUIRE SANDERS

The UK Office of Tax Simplification has now published its final report on the tax treatment of unpproved employee share schemes. Its recommendations are, for the most part, welcome and should not prove controversial. However, some aspects will need careful consideration and could cause more problems than they solve.

When reading the OTS report, one can't help feeling like the proverbial traveller trying to locate his hotel, only to be met with the response:

"Well, to be honest with you, if I was going to that hotel, I definitely wouldn't start from here…"

Comments like "the current share plans legislation is a tangle of complexity, creating costs and traps for companies and their advisers, uncertainty for employees, and on-going burdens for HM Revenue & Customs when seeking to apply the correct tax treatment" leave one wondering how, with such a sophisticated tax system, we could possibly have got into this pickle. We can't even put the blame on antiquated rules as the most recent set (introduced in 2011) were described by one specialist as "the antithesis of simplification".

In spite of the scale of this challenge, the OTS has pulled together some helpful recommendations.

Giving Up Booze and Tax

As many of us are delighted/relieved(!) to see the end of our self-imposed dry January (having managed to negotiate the entire month without touching a drop of alcohol), so the OTS has developed a set of proposals to end the dry tax charge that currently arises when the shares are received, regardless of whether they are sold and turned to cash at that time. One of the key recommendations in the OTS report is to link the timing of any tax charge to the ability actually to realise some value for the shares being paid out under an award. The tax charge should be coincidental with the shares becoming marketable. The idea of the shares becoming marketable will, so the OTS says, put employees in a similar position to standard investors.

Purely from a timing point of view it will help unlisted companies to allow options to be exercised or awards to vest before they become marketable on an exit event. Our experience of this is that it might help companies who have had to manage options lapsing when the exit event didn't arise within ten years of the grant of an award. Having said that, private companies are usually more concerned about the existence of minority shareholders prior to an exit event than the consequences of a dry tax charge for employees.

The report suggests the introduction of an interesting anti-avoidance provision to this notion of a marketable security. If the employee holds shares on which no tax charge has been levied, any income received from those shares (e.g. dividends) will be treated as employment income and subject to income tax and NICs. The recommendation does not explore whether there is any tax deduction for the employer company flowing from the employment income. Presumably not in respect of the dividend itself, but what about the employer's national insurance cost? Logic might suggest that there should be such a corporate tax deduction.

Whether or not such a tax deduction is available, there will be clearly be additional costs to the company when paying dividends on shares which are held by employees who didn't suffer an income tax charge at the time of receipt. Rather than suffer those additional costs, companies may choose to issue a different class of shares so that, ultimately, dividends are not due on those employee shares. Alternatively, they might choose to pass the employer's national insurance cost onto the employee (if the rules allowing employers' NICs to be passed onto employees are extended to permit this). Are you also beginning to see some erosion to the "simplification" notion that led to the "S" in OTS?!

20/20 Hindsight

One very helpful suggestion is that, when determining whether PAYE and NICs apply to shares allocated to employees, the rather broad question of whether trading arrangements are "likely to come into existence" will be abolished. Instead, 20/20 hindsight can be applied to determine whether, in reality, the shares were sold within 90 days of the allocation – if so, only then will they be treated as marketable.

As the OTS notes, this should allow HMRC potentially to remove a large body of guidance, not to mention provide some certainty. Certainty in tax matters – now there is a dying concept whose return we would all cheer for most heartily!

Valuation – That Old Chestnut

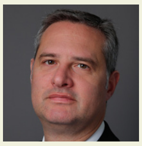
The OTS has addressed, head on, many of the difficulties and challenges of valuation for the purposes of paying employees using shares. Practical suggestions, like using closing prices rather than the quarter up principle (which has always been somewhat awkward to explain) and allowing, for example, AIM listed companies to rely on the same valuation principle as fully listed companies, will be warmly welcomed.

Unhelpfully (sorry, OTS), the application of the valuation recommendations to unlisted companies has picked up some HMRC preferences that will extend the paperwork that they are entitled to see. A little bit of care may be needed to ensure that the simplification exercise does not result in HMRC becoming entitled to request more documentation than is currently the case.

What do we mean? Well, if a company is planning to allot a small number of shares to an employee, how much information would the company realistically give that employee (or any investor) who is only buying one or two per cent of the company? The answer is probably none. The employee can look at the publicly available accounts and, well, that's about it! Yet the OTS report suggests that "a full checklist that includes all the information that is required by Shares and Assets Valuation before a valuation can be agreed" would also include recent transactions, proposed transactions and most worryingly of all, business plans. HMRC would, presumably, like to see this kind of information. Even if a third party investor wanted to see this it is highly unlikely that the directors would release it (or indeed are permitted to do so under their fiduciary duties) and almost certainly not to an employee acquiring a small percent of the company.

We hope that all the energy goes into delivering practical and concise amendments, and not hiding inappropriate extensions of power under the cloak of simplification!

Please feel free to contact us should you wish to receive any further information on the recommendations in the OTS report.



Bernhard Gilbey
Partner, London
T +44 207 655 1318
E bernhard.gilbey@squiresanders.com

Lawrence Green
Consultant, Birmingham
T +44 121 222 3394
E lawrence.green@squiresanders.com

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