TRAVERS SMITH

Employee Incentives Group

Autumn 2012 Bulletin

November 2012

Planning for the 45% Additional Rate

The additional rate of tax applies to income above £150,000 and has remained at 50% since it was introduced in April 2010. One of the headline announcements of this year's Budget was a 5% reduction in the top rate of income tax from 6 April 2013. Individuals currently within the additional rate tax band may want to explore ways of deferring income until the next tax year when the rate becomes lower.

How can income be deferred?

- *Bonus deferral*

Companies paying bonuses could consider deferring this year's award until the 2012/13 tax year. This might be a one-off arrangement to take account of the forthcoming tax change or prompt a review of the company's bonus policy in light of best practice. For example, firms regulated by the Financial Services Authority are already encouraged to defer bonuses under its Remuneration Code.

Bonus deferral can be voluntary (where the employee requests a deferral) or compulsory (where deferral is one of the terms of the bonus). The deferred element of the bonus can be paid in cash or provided in the form of a share option vesting after a period of time. The advantage of an option is that it gives participants more control over when their income tax charge arises. Sometimes executives are given a "matching" award in the form of a share option typically exercisable after three years and subject to the satisfaction of performance criteria.

- *Delaying the exercise of share options/long term incentive awards*

Individuals holding share options and long term incentive awards structured as options have the flexibility to choose when their tax liability arises. If their awards vest prior to 6 April 2013 but expire beyond that date, they might wish to consider delaying exercise until the 2013/14 tax year.

- *Salary sacrifice*

Under salary sacrifice arrangements, individuals give up part of their pay in exchange for other benefits such as employer pension contributions or childcare vouchers. Often, the replacement benefits are exempt from income tax and National Insurance contributions (NICs) but this is not always the case. Individuals currently paying tax at the 50% rate could sacrifice a proportion of this year's salary in return for either a non-taxable benefit or a benefit taxable in the 2013/14 tax year.

- *Dividend deferral*

From 6 April 2013, the rate at which dividends within the top tax band are taxed will fall from 42.5% to 37.5%, giving an effective rate of 30.6% when taking the associated tax credit into account.

Companies might wish to consider this when planning their dividend payment programme, however, they will be subject to company law which governs the circumstances in which dividends can legally be paid.

- *Individuals within the additional rate tax band can consider deferring income to the 2013/14 tax year when the rate falls to 45%.*

- *Bonuses, dividends, salary sacrifice arrangements and share incentives can be considered for deferral.*

Which factors should be taken into account when considering deferral?

- *Has the income already been received for tax purposes?*

The rules governing when income is "paid" for tax purposes are complex, especially for directors. Generally, income is taxable when a person becomes entitled to be paid as opposed to when he physically receives it. Therefore, if income within the additional rate band is paid to an individual during the 2013/14 tax year but he became entitled to it before 6 April 2013, the applicable rate will be 50% rather than 45%. Tax law treats directors as receiving income even earlier, for example, when it is credited in the company's accounts. Share incentives have their own rules governing when benefits are considered to be received.

- *An effective deferral needs careful planning and appropriate documentation.*

Additional complications can arise where income is provided by a third party, such as an employee benefit trust. Legislation introduced in 2011 means that individuals can be taxed on income that has simply been "earmarked" for them by such third parties.

The date on which a dividend is paid differs according to whether it is a final or interim dividend. Final dividends are taxed when they are declared by the company in general meeting whereas interim dividends are taxed when the date for payment arrives.

Companies will need to consider the impact of any income deferral arrangement on their own ability to claim corporation tax relief.

- *Are there contractual restrictions on the ability to defer payment?*

To be effective, any deferral of salary or a contractual (as opposed to discretionary) bonus will require the agreement of employees. It is therefore important that the correct paperwork is in place to demonstrate that income has been properly "sacrificed". Individuals seeking to delay the exercise of their options or LTIP awards will need to check the relevant plan rules. Where an option or award is due to expire before 6 April 2013, companies could consider amending its terms by extending the award's exercise period. An amendment of this kind is likely to be a "re-grant" for tax (and accounting) purposes although this will not have a practical effect for individuals holding unapproved options. Listed companies are likely to require prior shareholder approval to extend the option exercise date in this way and the accounting implications of any such amendment will need to be considered.

- *Is deferral the right choice for the individual?*

Individuals will need to consider carefully whether deferral is the best course of action for them to take. For example, participants holding share awards are likely to be influenced by how they believe the company's share price will perform and whether or not they intend to keep their shares after exercise. If a fall in share price is anticipated and the participant does not intend to hold his shares in the long term, he might take the view that it is better to exercise now and sell his shares when they are most valuable rather than wait for the 45% tax rate.

- *Individuals need to consider whether deferral is the right choice for them.*

Employees intending to participate in a salary sacrifice scheme need to check that it will not have an impact on their other financial arrangements such as death in service benefits, pensions or mortgages.

- *Will HMRC challenge deferral schemes that seek to take advantage of the lower tax rate?*

No "anti-forestalling" measures have been introduced to prevent deferral of income to the 2013/14 tax year. Indeed, the Government appears to have anticipated this with the Office for Budget Responsibility estimating deferral of around £6.25 billion. In any event, it would be difficult to introduce legislation preventing deferral when this is something that is currently encouraged as a matter of good corporate governance.

What we can expect is that HM Revenue & Customs (HMRC) will look carefully to check the effectiveness of any purported income deferral. It is therefore crucial that the timing of and paper work for such arrangements is correct and able to stand up to such scrutiny.

If you are interested in discussing the planning opportunities surrounding the change in the additional rate of tax then please contact a member of the Travers Smith Employee Incentives team.

New Guidance for Service Companies

Background

The Government promised to review the taxation of intermediaries as part of its Coalition Agreement. Colloquially known as IR35 (after the 2000 Budget press release that announced it), the legislation applies where individuals are engaged by clients through intermediaries (often limited companies) in circumstances where, but for the intermediary, they would be regarded as a direct employee of the client. In such cases, the IR35 legislation treats the intermediary as making a deemed employment payment to the individual which, in turn, is subject to income tax. Although it sounds straightforward, in practice, the measure has been difficult for taxpayers to apply and for HMRC to enforce.

- *IR35 is to remain, but steps have been taken to simplify its operation.*

Initially, the aim of the Government's review was to abolish IR35 and replace it with simpler provisions that both prevent tax avoidance and remove undue administrative burdens on the self-employed. Ultimately, the Government decided to retain IR35 but simplify the way in which it operates.

Business entity tests and example scenarios

In light of this, HMRC has published guidance that should help individuals working through service companies assess whether or not IR35 applies to their business. This guidance sets out a series of classic employment status tests to each of which it allocates points. In HMRC's view, the higher the overall point score, the lower the risk that IR35 applies. If taxpayers can demonstrate that they are within the low risk category (more than 20 points), the guidance confirms that HMRC will close any existing IR35 review and will not undertake another in the next three years. Factors indicative of self employment carry higher points than those indicating employment. For example, a right of substitution that is put into practice equals 20 points whereas evidence of a previous employment relationship with the end client scores minus 15.

Although some "classic" employment status tests have been omitted (for example, the provision of your own equipment), publication of the guidance is helpful in that it gives taxpayers a better understanding of HMRC's approach and the relative importance it attaches to the different factors.

- *HMRC have published new guidance with business entity tests to assess the risk of IR35 applying.*

The guidance helpfully sets out a number of scenarios involving intermediaries stating HMRC's view on whether or not IR35 applies. These are useful in that they include less clear cut situations where the application of IR35 is debateable.

The following is a link to the HMRC guidance: VIEW HERE

IR35 Helpline

HMRC offers a confidential helpline (0845 303 3535) staffed by specialists who are able to deal with IR35 queries. The helpline can provide answers to one-off queries and will review contracts between service companies and clients to assess whether IR35 applies. If the contract is determined to be outside IR35, the business will be given a certificate with a unique number that is valid for three years. If an IR35 review is later opened, the taxpayer can give HMRC this number and HMRC will suspend their review while they consider all the information. They will then close their review if the contract they reviewed is typical of the business's engagement terms and the information provided is accurate. Note that guidance will only be given on signed contracts; it is not available for draft documents.

Consultation on Taxation of Controlling Persons

At the beginning of the year, concerns were raised within the Government over the number of senior public sector workers engaged through personal service companies. This led to a review which concluded that there was a lack of transparency around the tax arrangements of some such individuals. One of the recommendations of the review was that most senior staff should be on the payroll rather than engaged as consultants or through service companies. The issue has hit the headlines recently with revelations that many high profile presenters within the BBC have been providing their services through companies rather than as direct employees.

- *A consultation on taxing those with managerial or financial control has been published.*

Although existing measures in the form of IR35 could be applied to ensure that individuals working through personal service companies are taxed appropriately, the Government appears to be seeking additional powers in this area. One reason for this might be that IR35 only applies to employments and not to office holdings and perhaps these are more prevalent in the public sector.

Earlier this year, HM Treasury and HMRC jointly published a consultation document entitled "The Taxation of Controlling Persons". The subject of the consultation was the engagement practices of individuals who "controlled" the staff and/or budget of an organisation.

In the document, the Government proposed introducing measures that would require organisations engaging "controlling persons" through an intermediary to deduct tax and NICs from payments and account for employer NICs as if the individual was on the payroll. In other words, the new proposals would take priority over the IR35 and agency rules. Micro-businesses (defined as those employing fewer than 10 people and whose turnover or balance sheet does not exceed 2 million Euros) would be excluded from the measures.

- *Measures would require companies to operate PAYE and NICs on payments in respect of controlling persons.*

One of our main concerns over the proposals is that they are potentially far reaching. A "controlling person" for example, is defined as someone who is "able to shape the direction of the organisation having authority or responsibility for directing or controlling the major activities of the engaging organisation during the year". The consultation goes on to describe this as "someone who has managerial control over a significant proportion of the organisation's employees and/or control over a significant proportion of the budget of the organisation".

The measures would not be limited to the public sector (where the issues over tax transparency principally exist) and could extend to circumstances beyond those affected by IR35. For example, if an individual exercises a sufficient level of control, the new proposals would apply even if absent the service company, he would not be treated as a direct employee. While such situations will be rare in practice, it demonstrates the difficulties that are inherent within the proposals.

We have identified a number of other concerns such as the period of time over which control should be measured, the meaning of "significant", what happens if there are changes throughout the year and how double taxation risks will be dealt with. Our response to the consultation expressed the view that IR35 should be sufficient to deal with this and a further layer of legislation will only serve to create confusion at a time when the Government is concerned with making IR35 simpler.

- *Travers Smith have responded to the consultation expressing our concerns with the proposals.*

Government Announces Support for Employee Owned Businesses

In January, the Deputy Prime Minister, Nick Clegg, outlined his vision for more companies within the private sector to be employee owned, maintaining that these have proven flexible and resilient in difficult economic times. At the end of October, the Government published its response to an independent review of employee ownership. It pledged its support for the review's recommendations to increase awareness of employee ownership and provide greater access for those interested in taking it up. Although the focus of discussions is "John Lewis style" arrangements where employees own the company (often through an employee trust), there are aspects that will be relevant to employee share incentives generally.

- *The Government has pledged its support for employee ownership and proposed measures to make it more accessible.*

In terms of raising awareness, the Government plans to develop a voluntary guide that can be used to prompt discussion of employee share ownership between employees and companies. Such dialogue would not be limited to full employee ownership and could relate to other forms of share incentive. Keen to reduce the regulatory burdens for companies, there is little appetite to give employees a statutory right to request participation in a share plan but this will be kept under review.

The Government is looking at whether it should establish an independent employee ownership institute to provide companies with support and guidance. Further, it intends to create "off the shelf" templates for the key documentation necessary to set up an employee owned company. Meanwhile HM Treasury has been carrying out an internal review of the tax issues surrounding employee ownership and is due to report on this soon.

- *HM Treasury is due to report following an internal review of the tax issues relevant to employee ownership.*

One of the most significant steps taken so far is the launch of a consultation to simplify share buy backs for private companies and to give them the power to hold shares in treasury. These proposals are designed to overcome the difficulties currently faced by private companies with no internal market for their shares. It will be interesting to see how these proposals develop.

If you would like to discuss any aspect of this Bulletin or have any queries in relation to employee incentives, please contact a member of the Travers Smith Employee Incentives Group:

Mahesh Varia (partner), Elissavet Grout (senior associate), Chris Fallon, Robin Hartley and Kulsoom Hadi.

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

www.traverssmith.com

Mahesh Varia
Partner
mahesh.varia@traverssmith.com
+44 (0)20 7295 3382

Elissavet Grout
Senior Associate
elissavet.grout@traverssmith.com
+44 (0)20 7295 3439