TRAVERS SMITH

Employee Incentives

Emergency Budget Alerter

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June 2010

On Tuesday 22 June the Chancellor of the Exchequer, George Osborne, gave his anxiously awaited "emergency" Budget. His announcement of a new 28% Capital Gains Tax rate ended weeks of speculation and gives some certainty to those involved in share incentives. In this alerter we look at how the Chancellor's announcements will affect existing incentives and the choices that employers might make for their share plan strategy going forward.

New Top Rate of Capital Gains Tax (CGT)

- *CGT to rise to 28% for higher rate taxpayers*

From Wednesday 23 June 2010 a new rate of CGT will apply to individuals whose income and gains take them into the 40% income tax band. Based on the current year's tax thresholds, this will mean that an individual entitled to the full personal allowance will pay CGT at 28% once he or she has gains and income of £43,875 or more (subject to available allowances and reliefs). Basic rate taxpayers who do not exceed this level will continue to pay CGT on their gains at the rate of 18%.

It is unusual for a change to CGT rates to be made part-way through the tax year and it has been stated that Ministers chose to do this in order to provide "certainty to investors". The change is a very simple one and there has not been any "carve-out" for particular assets or any relief for those held for a certain length of time. Despite speculation in the Press, taper relief will not be making a return. There is also no protection for assets acquired or gains deferred before the new rate came into effect.

- *Entrepreneurs' Relief: lifetime limit rises to £5 million*

In the Coalition Agreement it was stated that there would be "generous exemptions" from CGT for entrepreneurs. Many share plan practitioners had hoped that this signalled some relief for employee shareholders. The only new "exemption" from CGT set out in the emergency Budget is the enhancement of an existing measure known as "entrepreneurs' relief". Provided certain conditions are satisfied, entrepreneurs' relief can be used to reduce the tax rate for applicable gains to 10%. There is a lifetime limit on the amount of gains on which entrepreneurs' relief can be claimed and from 23 June this will be increased from £2 million to £5 million. Unfortunately, the conditions attaching to entrepreneurs' relief (such as the requirement to hold at least 5% of the voting rights and ordinary share capital in your employer) are such that employee shareholders are only likely to be able to take advantage of it in a limited number of circumstances.

Fortunately the Chancellor has chosen not to reduce the annual exemption for CGT for this current tax year which stands at £10,100 and can be used to reduce gains that fall within the new 28% CGT band.

It is likely that these changes will be included in a Finance Bill that will be enacted before MPs break for their Summer Recess.

What does this mean for Share Plans?

Clearly an increase in CGT rates makes share plans that give individuals capital growth taxed as capital gains less favourable than when CGT was charged at a flat 18%. Nevertheless, given the fact that CGT rates are still lower than the higher and additional rates of income tax, there are still advantages in holding awards under share plans that are taxed under the CGT regime. This is particularly the case for those paying income tax at 50%. Share plans (especially HMRC approved plans) therefore still have a very important role to play. As we cannot rule out further increases in CGT, holders of existing awards that become exercisable before the end of the tax year might consider exercising and selling before 6 April 2011. Holders of awards that are subject to income tax and National Insurance contributions (NICs) will also need to be mindful of the rises in NICs rates that we know will come into effect next year.

Also, irrespective of the rate of CGT, share incentive arrangements that deliver capital gains as opposed to income are not subject to NICs – resulting in a saving for both the employee and employer.

In terms of structuring their share plans, companies should take account of the following:-

- Share options and awards remain an important means of incentivising employees and give them a real stake in the company for which they work.
- Approved share incentives (such as Company Share Option Plans, Savings-Related Share Option Plans, Enterprise Management Incentives and Share Incentive Plans) can benefit from CGT treatment which is still advantageous. Even if an individual is subject to the 28% rate of CGT, he or she can use his or her annual exemption to reduce gains and can consider no-gain, no-loss transfers to a spouse or civil partner. Unlike income tax he or she will usually only have to pay the tax once the asset in question is disposed of.
- Although the bonus rates for Savings-Related Share Option Plans are currently very low, these incentives have a number of advantages: shares can be offered at a discount of up to 20%, they provide a "no loss" award to employees and, even if they are chargeable to income tax on exercise, they will not give rise to a NICs charge.
- Share Incentive Plans have the advantage that shares remaining within the plan trust can escape capital gain tax and income tax altogether.

Increase in National Insurance Contributions from April 2011

- *NICs to increase by 1% from April 2011*

The Labour Government's proposal to increase the rates of employers' and employees' NICs by 1% from next April (the so-called "Jobs Tax") will come into effect. This means that employees will pay NICs at the rates of 12% and 2% with employers subject to a 13.8% rate. Employers will benefit from an increase in the secondary threshold (the point at which employers start to pay NICs) by £21 (above indexation). Therefore the secondary threshold will be at least £131 in the 2011/12 tax year.

- *NICs holiday for new businesses in targeted areas*

The Chancellor stated that the Government will shortly announce details of a NICs holiday for businesses in specified parts of the UK. It is proposed that, during a three-year period, "new businesses" in those areas will enjoy an exemption from the first £5,000 of Class 1 employers' NICs due in respect of employees in the first year of employment. This NICs holiday will apply to each of the first ten employees hired in the first year of business. The countries and regions identified for the new exemption feature those likely to be hit hardest by cuts in public sector employment.

Enterprise Management Incentives

- *EMI "permanent establishment" change expected in the Autumn*

In our March Bulletin we referred to a change that HM Revenue & Customs (HMRC) had proposed to widen the scope of the approved share plan known as "Enterprise Management Incentives" (EMI). The statutory rules governing EMI state that awards can only be made by companies trading wholly or mainly in the UK. At the end of 2009 HMRC announced that legislation would be introduced to modify this requirement so that a company could offer EMI provided it has a permanent establishment in the UK (or in the case of a parent company, that one company operating a "qualifying trade" (as defined) has a permanent establishment here). The Chancellor has confirmed that appropriate legislation will be included in a Finance Bill after the Summer Recess (i.e. the third Finance Bill this year!) that will take effect for options granted on or after the date on which the Bill becomes law.

Income Tax Changes

- *Income tax personal allowance to increase by £1,000*

From April 2011 the individual personal allowance for those aged below 65 will increase by £1,000 to £7,475. To ensure that this measure is limited to basic rate taxpayers, the amount that you can earn before paying tax at the higher rate will decrease.

Warnings for the Future

The Budget documentation contained a number of announcements that mean there might be future tax increases for employee incentives. Those of particular interest are as follows:-

- Future increases in the rate of CGT cannot be ruled out. In a Question and Answer leaflet published by HMRC on Tuesday, one of the queries is whether rates might be aligned with income tax (as indicated in the Coalition Agreement). The response is simply that the CGT rates for the next tax year will be decided in the 2011 Budget. It is therefore entirely possible that CGT rates will rise in future tax years. It is to be hoped that any such increase will be accompanied by some form of relief for employee shareholders.
- Consultation is to be undertaken during 2010 on the tax treatment of employment-related securities offered under "geared growth" and similar arrangements. By this we understand that the Government is referring to joint share ownership plans, ratchet shares, growth shares, flowering shares and the like. This consultation was originally announced by the previous government in March and Travers Smith will continue to monitor and contribute to the process.
- As part of its proposals to tackle avoidance arrangements, the Budget documentation repeats the statement in the Coalition Agreement that legislation will be introduced from April 2011 to counter the use of family benefit trusts and employee benefit trusts to avoid income tax. We do not know precisely what these measures will mean (one rumour is that income tax will become payable when amounts are allocated to a sub-trust for an employee and his or her family). Our continued concern is that any such legislation should not affect employee benefit trusts that are not used for avoidance purposes.
- The Government has repeated its Coalition Agreement proposal to review the tax treatment of non-domiciliaries this Summer.

- *Future CGT rises a possibility*
- *Consultation on employment-related securities to go ahead*
- *Legislation to be introduced to counter avoidance using FBTs and EBTs*
- *Tax treatment of non-doms to be reviewed*

If you would like to discuss any aspect of this alerter or Employee Incentives generally then please do not hesitate to contact a member of the Travers Smith Employee Incentives team.

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