TRAVERS SMITH

Employee Incentives

Budget 2008 and recent developments

In his first Budget as Chancellor of the Exchequer, Alistair Darling announced a number of measures that affect employee share plans. This briefing note considers these changes together with other recent developments in the field of employee incentives.

March 2008

Enterprise Management Incentives

Enterprise Management Incentives ("EMI") are a tax-efficient means by which eligible companies can grant share options to employees. One of EMI's attractions is that taper relief starts to accrue from the date of grant rather than when the option is later exercised. In this way the holder of an EMI option is able to reduce his effective rate of capital gains tax on his option to 10%. In last year's Pre-Budget Report the Chancellor announced that ***taper relief will be abolished from 6 April 2008***. Accordingly EMI options exercised on or after this date will lose any taper relief that has accrued since the date of grant. While this is a disappointing move, the other benefits of EMI remain and it continues to be an attractive way in which to incentivise employees.

The Chancellor has announced three further changes to EMI. The first of these is an ***increase in the maximum value of EMI options that any individual can hold***. On 6 April 2008 the limit will rise ***from £100,000 to £120,000***. This is calculated by reference to the market value of shares at the time of grant and takes into account any unexercised options held by the individual under an approved Company Share Option Plan. The change will be particularly welcome for the many companies that have found the existing limit too restrictive. Note, however, that the company limit of £3,000,000 worth of shares under option is unchanged.

HM Treasury stated that the second and third changes will be introduced "to ensure EMI continues to meet the EU State Aid guidelines". The first of these stipulates that a company can only grant EMI options if it has ***fewer than 250 full-time employees***. Where a company has part-time employees they will be treated as a fraction of a full-time employee according to how many days they work.

The third and final change to EMI states that companies involved in ***shipbuilding, coal and steel production will no longer qualify***. One piece of good news is that both changes will have effect only in respect of options granted on or after the date on which the Finance Bill 2008 receives Royal Assent later in the year. Options granted before that date will remain unaffected. If you are a company that will fall foul of the 250 full-time employee ceiling when it comes into force then it is worth reviewing your EMI options to check whether you have scope to make use of the increased individual limit before Royal Assent.

Taper Relief abolished from 6 April

EMI individual limit increased to £120,000 from 6 April

From Royal Assent, companies offering EMI must have fewer than 250 full-time employees

Shipbuilding, coal and steel production companies will not qualify for EMI

Changes to the Rules for Non-Domiciled Individuals and the Rules on Residency

The changes to the tax treatment of non-domiciled individuals ("non-doms") have received a great deal of press coverage since they were announced in the Pre-Budget Report. In his 2008 Budget the Chancellor made it clear that the new regime will come into force from 6 April 2008.

Currently UK residents who are non-doms (or not ordinarily resident in the UK) can use the remittance basis of taxation. This means that UK tax is not charged on foreign income and gains left outside the UK. Tax will only be charged when the income and gains are brought into (or "remitted to") the UK. From 6 April non-doms who have been UK residents for more than seven of the past ten years will only be able to claim the remittance basis if they pay an annual £30,000 charge. The way in which it was proposed this charge would operate attracted a great deal of criticism when it was announced. The following modifications in the Budget documentation indicate that the Chancellor has taken some of this on board:-

- Only adults are required to pay the £30,000 charge. This means that individuals can apply the remittance basis automatically until the tax year prior to that in which they turn 18.
- The charge does not apply to those with unremitted income and gains of less than £2,000 in a tax year. When the measures were initially announced this was set at the lower threshold of £1,000.
- The £30,000 will be a tax charge on unremitted income and gains rather than a stand-alone charge. This is important as it means that the £30,000 will not be taxed as a remittance in itself. It also means that the unremitted income or gain in respect of which the £30,000 has been paid will not be taxed again if and when it is eventually brought into the UK. Defining the £30,000 as a tax charge is also important as regards the way it is dealt with under double tax treaties.
- There will be an exemption for works of art brought into the UK for public display.

Another important change is to the way in which days will be counted when calculating whether or not someone is resident in the UK. Under current rules the date of arrival in and departure from the UK are ignored when working out how long an individual has been here. For example if an individual arrived in the UK on a Monday and left the next day, under the current residency rules he would not have spent any days in the UK. Proposals were announced in the Pre-Budget Report to replace this approach with one under which days of arrival and departure are taken into account. This has been modified so that from 6 April only a day where an individual is present at midnight in the UK will be counted as a day of presence for residence test purposes. Accordingly, in the example given above, the individual would only have spent one day in the UK.

From 6 April a £30,000 tax charge is payable by adults wanting to pay tax on the remittance basis

De minimus of £2,000 unremitted gains and income

Only days when present in UK at midnight will count for residency purposes

Non-Residents and Share Incentives

Although it has not received a great deal of press attention the changes to the residency and domicile rules will have an impact on non-resident employees working in the UK who participate in share incentive arrangements.

- A fully UK resident individual does not suffer an income tax charge at the time that an option is granted to him. By contrast someone who is not ordinarily resident ("NOR") and is granted an option with a discounted exercise price is charged to income tax. When the proposed changes are introduced, an NOR individual will not suffer an income tax charge on grant.
- A person who is NOR at the time of grant and remains so at the time of exercise suffers an income tax charge on the difference between the market value of the shares and the exercise price that he pays. If the NOR individual performs some of the duties of his employment outside the UK, then HMRC will treat part of his option gain as outside the scope of UK tax. In contrast, a person who is fully UK resident when an option is granted to him is subject to UK tax on the whole of his option gain even if he works abroad for some days. When the new provisions come into force, NOR individuals will be taxed on the whole of their option gain subject to an apportionment for non-UK duties. The apportionment will only apply where the individual has elected under the new regime to be taxed under the "remittance basis". Non-domiciled but fully UK resident individuals will also be able to use an apportionment mechanism if they have elected to be taxed on the remittance basis. Such individuals can only avoid UK tax if their gains relate to non-UK duties of a non-UK employment.

- An NOR resident option holder who ceases to be UK resident altogether can, in some circumstances, escape a UK tax liability. This contrasts with a fully resident option holder who remains liable to UK tax when he exercises his option. Under the new rules NOR individuals will be taxed in the same way as fully resident option holders subject to apportionment for non-UK duties.
- A company operating an ***Approved Savings-Related Share Option Scheme*** or an ***Approved Share Incentive Plan*** is currently only required to extend participation to those who are UK resident and ordinarily resident (although awards can be made to non-residents). From 6 April schemes will have to extend to NOR employees although we do not yet know whether this means that existing schemes will need to be amended.
- Employee ***share offers*** have become popular in recent years. Unlike an option scheme, participants in such arrangements are shareholders from the outset. Employee shareholders who are fully UK resident are potentially liable to income tax under specific charging sections that apply to "employment-related securities". These are securities (including shares) that an individual acquires by reason of his employment. An example of the type of charge that can arise is where the shares are subject to restrictions. In such circumstances a charge may arise when the restrictions are lifted. Under current law, NOR individuals are not subject to these charging provisions. When the rules change, NOR individuals will be governed by the same charging rules as fully resident employees, subject to apportionment for non-UK duties.

From 6 April NOR individuals will have share options and employment-related securities taxed in the same way as fully UK resident individuals

Apportionment rules will apply between UK/non-UK duties for those taxed on the remittance basis

One welcome piece of news from HM Treasury is confirmation that the ***change will apply only to securities (including shares) acquired and options granted after 5 April 2008***.

Bonus Payments

Bonus payments are taxed at the time employees receive the payment for income tax purposes. However, a bonus is usually earned by reference to individual and/or company performance over a given period of time, for example a financial year (the "bonus period"). Quite often it is also a condition of entitlement that the employee remains in employment on the bonus payment date (the "employment condition"). Given this employment condition, HM Revenue & Customs ("HMRC") have until recently treated bonus payments as being earned on the day that the employment condition is satisfied rather than by reference to the bonus period. Going forward, HMRC confirmed that, in appropriate circumstances, they will treat bonuses as being earned during the period which begins at the start of the bonus period and ends on the date the employment condition is satisfied (the "earnings period").

Bonus payments to be calculated by reference to the period over which they are earned

This change in practice is relevant for employees who are non-UK resident for part of the earnings period. Where this is the case, the amount of the bonus which relates to the non-UK resident period should not be subject to a UK income tax charge. However, it should not change the time at which bonus payments are charged to income tax.

Entrepreneurs' Relief

HM Treasury's announcement last year that taper relief would be withdrawn attracted a great deal of criticism from the business community. It is partly in response to this that the Government announced the introduction of a new type of relief to be known as "entrepreneurs' relief".

The relief is based upon the, now defunct, retirement relief. The effect of entrepreneurs' relief is to broadly reduce a person's chargeable capital gain when they make qualifying disposals to an effective tax rate (under the new 18% flat rate regime) of 10%. This is subject to a £1 million lifetime cap on the amount of capital gains that will qualify for relief. This cap will only include gains realised after 5 April 2008

From 6 April Entrepreneurs' Relief will be available for certain shareholders who own at least 5% of a company's shares

One of the circumstances in which relief will be available is where an individual makes a disposal of shares in a trading company which throughout the period of one year ending with the date of disposal is his "personal company" (i.e. one in which he holds at least 5% of the ordinary share capital). A further requirement is that the individual must be able to exercise at least 5% of the voting rights in that company.

As most employee incentive arrangements involve individuals with holdings of less than 5% it is unlikely that entrepreneurs' relief will be of great assistance to participants in them.

Re-categorisation of Self Employed Earners as Employed Earners

The distinction between a self-employed person and an employee is important for tax purposes. Whereas a self employed person pays tax under self assessment, the tax on employment income is collected under the PAYE system. If a self-employed individual is subsequently found to in fact be an employee then his employer is liable to account for income tax under PAYE. Where the individual has paid income tax under self assessment it had been HMRC's practice to offset this against the PAYE owed by the employer. This practice came under scrutiny in the Special Commissioners' decision Demibourne Ltd v Revenue and Customs Commissioners SpC 486. That case confirmed that it is in fact the employer who is responsible for operating PAYE. HMRC does not have a discretion to choose whether to collect tax from the employer of the employee. Acknowledging that this created difficulties for employers, HMRC formed a working party from the tax and accountancy professions and the business community to find a solution. Legislation has been published giving HMRC the power to direct the transfer of a PAYE liability from an employer to an employee. The effect of such a direction is to relieve the employer from paying the amount transferred. The employee's liability is limited to the amount of tax they have paid under self assessment. The employer will remain liable for any excess PAYE and will be potentially liable to penalties. Interest will be payable by the employer on the balance of tax payable after a direction has been made. The employer will not, however, be liable for interest on amounts covered by a direction. The new legislation comes into force on 6 April 2008.

New regulations published to permit the offset of tax paid under self-assessment against an employer's PAYE liability

SAYE Bonus Rates

Last year bonus rates for SAYE schemes increased for all invitations made on or after 1 September 2007. The current rates are 4.23%, 4.48% and 4.46% for 3, 5 and 7 year savings contracts respectively with the early closure rate set at 3%. In light of recent interest rate cuts we understand that HM Treasury are to announce a reduction in SAYE bonus rates soon. This is unusual as any change is normally made in September of each year. HM Treasury does have the power to make changes to the rates at other times if the market reference swap rates are above or below a specified level.

SAYE bonus rates expected to fall

"Bed and Breakfasting" and UKLA statement on the Model Code

With the abolition of taper relief only days away, some shareholders may seek to trigger capital gains before 6 April in order to benefit from an effective 10% rate of capital gains tax. "Bed and breakfasting" arrangements are where a shareholder sells shares and then (not less than thirty days later) re-acquires them. The UK Listing Authority ("ULKA") issued a statement recently in response to a question whether such dealings by directors would breach paragraph 8(b) of the Model Code. This prohibits listed companies from giving clearance to deal on considerations of a short term nature. The UKLA statement reminds companies and directors of their need to comply with the Model Code and states that clearance for "bed and breakfasting" should not be given in a prohibited period. It goes on to say that the terms of the re-purchase should be fixed at the time of the sale. This is so that it would not matter if the re-purchase took place during a prohibited period. This second requirement might prevent a "bed and breakfasting" arrangement from effectively triggering a gain. Anyone who is in this situation should take advice on the matter as soon as possible.

Compliance with UKLA statement on "bed and breakfasting" could cause CGT planning to fail

If you have any queries on this edition of Employee Incentives briefing, please contact any member of the Employee Incentives Group.

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