# Encouraging growth

Employment Tax



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*William Franklin* and *Alan Garrod* consider the importance of robust share scheme incentives in rewarding employees of all salaries and ages

## Key Points

## What is the issue?

Our erratic and illogical tax rates on income mean that bonuses paid in a single year for performance over  number of years can suffer unfairly high marginal rates of tax which can seriously detract from their effectiveness as  incentives.

## What does it mean for me?

This is a problem for middle managers and lower paid employees and will become an increasingly acute  problem for young graduates who face very high marginal tax rates on their income  because of the Disguised Graduate Income Tax.

## What can I take away?

Well designed share schemes can substantially moderate the distortions which have accumulated in  our tax regime on income over the past 30 years. But they are too often overlooked and undervalued for moderately or averagely paid workers.

In the UK our tax system is often said to encourage the use of employee share schemes. That view is based on the existence of a number of government tax favoured schemes such as CSOP, SAYE, SIPs and, in particular Enterprise Management Incentives (EMI) (see ***figure 1***). Broadly speaking, these schemes seek to put employees in a similar position to the owners of companies and align the interests of employees and owners. They aim to encourage and reward growth and achieve parity of tax treatment by taxing growth as a capital gain, in much the same way as the owner would be taxed.

Image

### FIGURE 1: BRIEF SUMMARY OF SIP SAYE CSOP AND EMI

These are the four government tax favoured schemes which in different ways allow employees to have capital growth taxed as a capital gain or entirely tax free, rather than have the gain subject to Income Tax and NICs. CSOPs and EMI are discretionary option schemes. The awards that can be made under CSOP are much smaller, but can be made by much larger companies and with less complex rules, than awards made under EMI.

SAYE and SIPs are all employee non-discretionary schemes, so companies cannot select who benefits and the schemes have quite low individual participation limits. SAYE has been around for over 30 years and is a common feature of the remuneration structures of larger UK quoted companies. Employees are required to save regular amounts from monthly salaries over a three year period to have the funds ready to allow them to exercise options when the options mature. SIPs involve employees being given or buying shares (with a tax subsidy) and requires the shares to be held in a special purpose trust for at least five years to get the full potential tax free benefits.

However, these schemes mask the underlying harshness of the overall ‘employment tax regime’ when these government schemes or other structures, such as Growth Shares or Joint Share Ownership Plans (JSOP) (see ***figure 2*** for summaries) are not available, or are not used. We have a tax regime on employment income, which as a result of cumulative changes over more than a couple of decades has become for

many key employees rather arbitrary and harsh. In particular, for many younger working people on whom growth in the economy depends, the employment tax regime could actually discourage them from participating in share based incentives if these tax favoured arrangements were not available.

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## FIGURE 2: BRIEF SUMMARY OF GROWTH SHARES AND JSOPS

Growth shares involve the creation of new classes of shares which only allow the participants to receive value from a subsequent sale if the value of the Company has grown above its value at the time the growth shares were awarded. In fact they usually strengthen the incentive effect by requiring growth above a threshold increase in value as well. They are designed to reward and incentivise growth. The growth shares are an employment security and so the original award of the shares gives rise to an Income Tax charge reflecting the hope value of the growth shares when awarded, but growth afterwards is taxed as capital as an owner is taxed. JSOPs are economically similar to growth shares and allow a similar tax treatment of growth using ordinary shares where it is difficult to create a new class of shares.

An option which is granted outside one of these schemes has no tax on its grant. Such options are known in outdated tax jargon as Unapproved Share Options. However, once such an option is exercised a harsh tax regime begins. The gain on exercise, (which is the difference between the market value of the shares on exercise and the exercise price of the option which the employee pays to acquire the shares) is taxed as income. Very often the shares at the time of exercise will fall within the now widely drawn definition of ‘readily convertible assets’ bringing them also into the regime of PAYE. As a result, the ‘gain’ will be subject to National Insurance (Employee’s and Employers) as well as income tax. Because PAYE applies these employment ‘taxes’ have to be paid to HMRC within a few weeks of the exercise of the options by the company which then has to recover the income tax and Employee’s National Insurance from the employees otherwise there is an additional penal tax charge.

If the option is exercised without the employee having the opportunity to sell the shares, because the company is unquoted, the employee not only has to fund the exercise price to acquire the shares but also has to pay tax on an unrealised gain. This is an example of a dry tax charge because the employee has a tax liability from an event (exercise) but no cash proceeds from the event with which to pay the tax. It is hard to imagine a tax regime less conducive to employees wishing to become

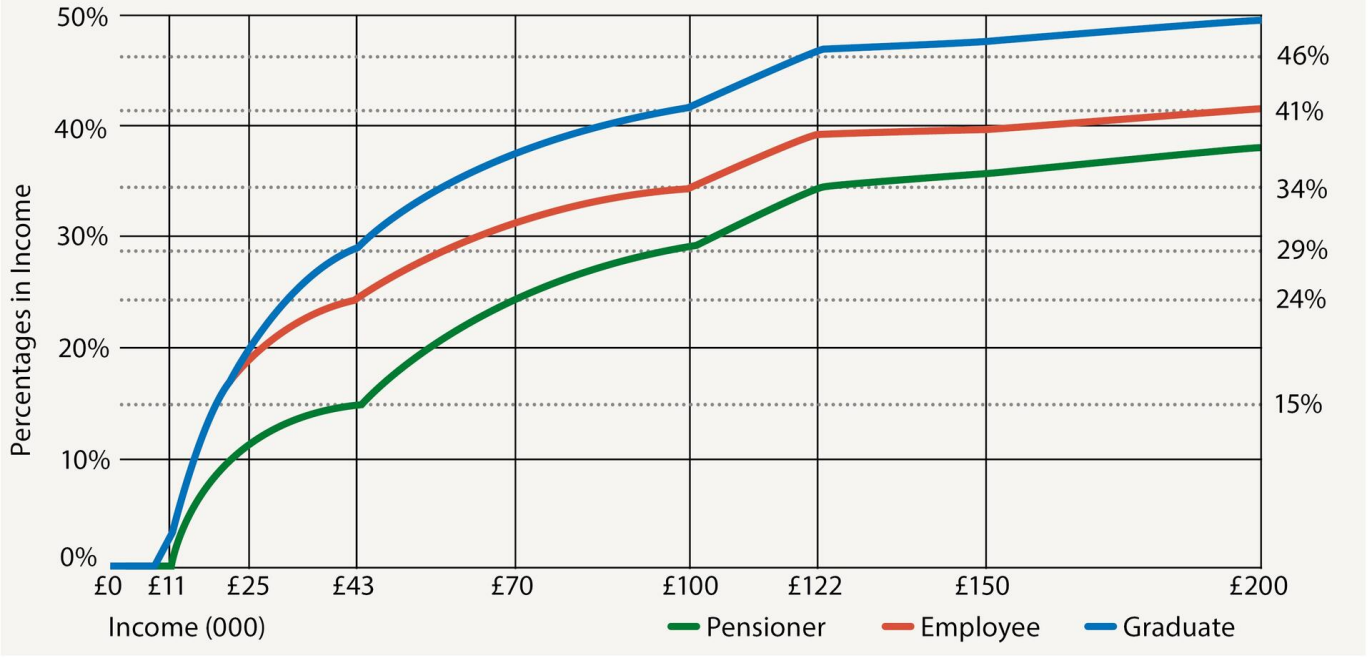
long term shareholders in unquoted companies that are not planning an imminent sale or other liquidity event. For a wealthy individual a dry tax charge might be just about tolerable but for a young worker hard pressed with student loans, rent or mortgages, the costs of starting a family and providing for retirement as well as normal living expenses, such as a dry tax charge is about the last thing one could want. This tax regime reinforces the UK's business culture which has for many years encouraged unquoted companies to seek early exits rather than long term independence, organic growth and the creation of large scale companies.

One way of alleviating the dry tax charge would be for the income tax and National Insurance to be deferred until the shares were actually sold and the employee had the money to pay the tax. Ideas along these lines were proposed to the Office of Tax Simplification a few years ago but fell on deaf ears at the Treasury, who were apparently more concerned about the risk of losing immediate tax revenue than encouraging long term employee share ownership.

In addition to the harshness of taxing unrealised gains, the employment tax regime can also cause employees to pay seemingly disproportionate amounts of their gains as tax. An employee who participates in a share scheme will usually receive the gains in a lump in a single tax year. But it would have been a long term incentive, which was intended to reward long term performance and contribution over a number of years. If the taxable value of the share based gain for an employee is large relative to the person's annual income in a particular year and is taxed as income not capital it can push the employee's total income in that year through the erratic 'tax' bands on employment income that now exist (see ***figure 3*** for a graphical illustration of 2016/17 tax rates). A surprisingly large proportion of gains will then be taken by the taxman, detracting significantly from the incentive effect of the equity incentives. It is not surprising therefore that, share schemes, such as EMI, which protect the gain from being taxed as income are so keenly sought by companies offering employee share based incentives.

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FIGURE 3: CHART OF TAX 'RATES' ON INCOMES BETWEEN £0 - £200,000 PER ANNUM




How is it that we have such erratic and irrational tax bands on income? While income tax rates have generally fallen since the 1970s National Insurance contributions have been increased and now the total revenues raised by the government from income tax and National Insurance is approaching parity. Other changes to the tax and benefits system such as the clawbacks of family allowances (child benefits) for incomes over £50,000 and of personal allowances for incomes over £100,000, the restrictions on working family tax credits and pension tax reliefs contribute to creating high, complex and erratic combined marginal rates of income tax and National Insurance.

There are age based effects as well that add to the distortions. Employee National Insurance is not payable after reaching retirement age. By contrast, the new generation of graduate workers who went to university after 2012 ('new graduates'), are now burdened with even higher levels of student debt than their immediate predecessors. For post 2012 students it is hard not to conclude that (because the loans are much larger and will normally increase each year by interest charges of about 3% + RPI) the student loan regime is effectively an additional Disguised Graduate Income Tax of 9% on most of their earnings for at least the first 30 years of their working lives.

For employees on less than twice national average earnings even a modest gain can be sufficient to push an employee into the higher rate 40% tax band and if they have children trigger the clawback of child benefit or family allowances, giving eye-wateringly high effective marginal rates of ‘tax’ on their remuneration from work.

This is a very different and much more complex overall employment tax regime than a basic rate of 20% and a higher rate of 40% established in the late 1980s when the then Chancellor Nigel Lawson cut higher income tax rates but failed to integrate National Insurance with income tax.

The jargon of National Insurance can mislead people into thinking that they have paid into a fund. Over the years various Chancellors (e.g. Lawson and Osborne) have raised the possibility of recognising reality by consolidating income tax and National Insurance into a single combined tax on income but have backed away from making changes from the fear of the political backlash of vested interests such as the retired who escape National Insurance on their retirement income.

When Lawson changed the rates of income tax he also equalised the rates of income tax and capital gains tax. However, subsequent, governments in order to encourage growth and entrepreneurial activity reduced the tax rates on capital gains significantly and after 2000, EMI options were introduced which allowed option gains to be taxed as capital and encouraged the use of options among smaller companies with growth potential. As is illustrated in the examples of employees with different incomes in ***figure 4***, a capital gains tax treatment considerably moderates the harsh effects of lump sum options gains being taxed as income.

Image

## FIGURE 4: EXAMPLE OF EMPLOYEES WITH DIFFERENT INCOMES

Mr A is over 70 (so does not pay employee's NICs) and continues to work as a part-time non-executive director and is paid a salary of £50,000 a year. Some unapproved share options mature and he exercises his options with a gain of £50,000. He has to pay income tax on this unrealised gain of £20,000. If the options had been CSOPs and he had no other gains in the relevant tax year he could have paid capital gains tax only after the shares were actually sold through self-assessment of £7,780 and there would have been no employers NICs.

Mr B is 32 and has two children and is highly qualified engineer working for a large company. His salary is £45,000 a year. He was granted unapproved options a few years ago which he can now exercise and these are standing at a gain of £50,000 but he would have to pay Income Tax and NICs of £22,800 on this unrealised gain and lose his child benefit for his two children of about 1,800 if he exercises these options. His employer would also have to pay Employers NICs on the unrealised gain of £2,760. If the options had been granted as CSOPs he would only have paid tax after selling the shares and the amount payable (assuming he had no other gains in the tax year) would have been £7,780 and he would not have lost his child benefit.

Ms C is a new graduate who has to pay the Disguised Graduate Income Tax. She works for a tech start up and is paid a salary of £25,000 but was granted unapproved share options which have now matured giving a gain of £50,000. But she has to pay income tax, NICs and Disguised Graduate Income Tax of £23,700 on this gain through PAYE. Had the options been granted as EMI options she would have paid £3,890.

Ms D is Mr B's boss. She has an annual salary of £100,000. She receives the same unapproved option gain of £50,000 and would have to pay income tax and NIC on this of £25,400.

Mr E is the managing director of the Mr B and Ms D's company and earns over £200,000 a year. On the same unapproved gain of £50,000 he would have income tax and NICs of £23,500.

Mrs F works for a large retailer and is paid £12,000 a year. After five years some unapproved options mature and she makes a gain of £10,000 but has to pay income tax and NICs on that of £3,200 and can suffer reductions in working family tax credits. Had the options been granted as CSOP or SAYE options she would have no extra employment income and paid no more tax because the gain would have been covered by the CGT annual exemption. Had she been over the retirement age she would have paid no NICs and the tax on the unapproved options gain would have been £2000.

Faced with a seemingly intractable deficit and growing demands for increased spending, the pressures on government to raise more taxes show no sign of abating. But as Britain approaches Brexit and the pressures on our companies to compete in global markets intensify our political leaders would be well advised to remember that our tax system needs to encourage and reward growth and enterprise and

work, rather than penalise them; and do this for the many and not just the few.

Share schemes have an important role to play in encouraging growth and softening the basic harshness of a tax regime which would otherwise treat unrealised lump sum gains as income and subject them to the complex and distorted system of ‘taxes on employment income’ which the UK now has. It is important that they do because if an award falls outside these favoured schemes it suffers a treatment reminiscent of the tax regime of the 1970s stagflation era.