Identifying the boundaries

Employment Tax



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Stephen Woodhouse considers the effect of the tax avoidance debate on share plan design

Key Points

What is the issue?

The tax avoidance debate has had an impact on how share plans are perceived.

What does it mean for me?

If you have an interest in the design or operation of share plans (or are a participant), the impact of tax requires ever greater consideration.

What can I take away?

Share plans need careful consideration to be structured to take into account tax issues without being seen as inappropriately avoiding tax.

The debate about tax avoidance continues unabated, with the controversial leaking of the ‘Panama papers’ adding fuel to it. Yet much of the discussion has been ill-informed with the media and public opinion not unduly concerned to understand the detail of the underlying facts. Distinctions between offshore funds and offshore trusts have been blurred in much the same way that the difference between tax evasion and tax avoidance seems like an archaic nuance in public perception. It is apt that a former chancellor, the late Denis Healey, measured this difference in terms of the thickness of a prison wall.

This has an acute impact on the design of share plan and remuneration structuring, as the plethora of cases in the area and changing legislation demonstrate.

Commercial context

Irrespective of the tax avoidance debate, the starting point for plan design should be the commercial context and the commercial objectives. A plan which is primarily designed to achieve a particular tax objective with commercial issues being secondary is likely to be commercially ineffective. Further, if the structuring involves seeking tax advantages that are not intended to be achieved by the underlying legislation, the venture is likely to fail to obtain those advantages, possibly leading to a worse tax result than if the planning had not been undertaken at all.

Stakeholder expectations

In the 21st century, it is not just the interests of the taxpayer and HMRC that need to be considered. Shareholders are more active and ready to criticise both the context and structure of remuneration packages, and tax is part of this. This has various

consequences:

- Investor associations warn against plans that offer executives tax benefits at the cost of the company or its shareholders. As an example, plans that offer personal tax savings at the cost of corporate tax relief for the company are likely to be viewed unfavourably unless award levels are adjusted to compensate the business for any resulting loss of tax relief.
- In turn, this implies the need for a more holistic approach to tax structuring. It is not enough to identify a particular saving and any planning must take into account the overall effect, not just on the participants but related parties and external stakeholders.
- This extends to media perception and the potential for adverse reputational effects of a tax-based approach even where this is consistent with the intended purpose of the underlying law.

The avoidance debate

The final point leads to consideration of the impact of the debate about tax avoidance and what is and is not acceptable. Views will vary from person to person and circumstance to circumstance but it is clear that the traditional bright line distinction between avoidance and evasion is no longer so clearly delineated. In 2009, Alastair Darling, when Chancellor of the Exchequer, stated in reply to a parliamentary question:

> *'Tax planning has been with us … since the beginning of the 19th century … It is perfectly legitimate for people to tax-plan. They are only obliged to render until Caesar what is due to Caesar and that has always been a feature of their case.'*

Although that statement was made only seven years ago and correctly states established legal and policy orthodoxy, it now seems dated in the light of developments in statute and case law, to say nothing of public opinion.

Statutory changes

The range of statutory changes affecting tax planning have been extensive and fundamental, ranging from general anti-avoidance law (such as the GAAR, DOTAS

and Advance Payment Notices or APNs) to provisions specific to employment tax and employee incentives.

This is illustrated by some changes announced in this year's Budget:

- Restricting the capital gains tax relief for employee shareholder shares to a lifetime limit of £100,000 a person, substantially limiting the value of the relief and reducing the efficacy of the entire relief, mainly to counteract the potential use of the provisions for tax planning purposes.
- Imposing a prospective tax charge to take effect in 2019 on the capital value of loans from employee benefit trusts (EBTs) if no settlement was reached with HMRC under the EBT settlement offer which closes on 31 July 2016. Although the legislation is prospective, when combined with the impact of the disguised remuneration legislation introduced in 2011 and being applied to loans made before then, it will affect historic loans and in substance have retrospective effect.
- The message from these provisions is that statutory changes will be introduced to counter perceived abuses of reliefs. The intended purpose of reliefs will need to be considered, not just the explicit terms of the legislation.

Case law

This is reinforced by case law. The Rangers case (*Advocate General for Scotland v Murray Group Holdings Ltd and Others* [2015] CSIH) heard at the Court of Session in Edinburgh related to an EBT that the lower courts had found in favour of the taxpayer. The Court of Session overturned the decisions in earlier hearings, accepting arguments advanced by HMRC which had not been raised previously. Potentially, these have wide-reaching and negative effects for other structures, many of which (such as salary sacrifice into pension plans) have been operated for many years without controversy.

Similarly, in the case relating to planning implemented by two banks, UBS and Deutsche Bank *(DB Group Services (UK) Limited v HMRC* and *HMRC v UBS AG* [2014] EWCA Civ 452) decided by the Supreme Court, a gloss was added to the wording of the statute. The broad effect of this was to disapply tax reliefs relating to restricted securities if the restrictions were included to avoid paying tax. This went beyond the application of Ramsey principles in that there was no artificial step inserted with no commercial purpose other than the avoidance of tax which was ignored for

determining the tax consequences of the arrangement – but construing the express words of the statute by extending them to achieve the presumed purpose of parliament in introducing the reliefs.

Both of these cases – together with earlier examples such as *PA Holdings* (*HMRC v PA Holdings Ltd* [2011] EWCA Civ 1414) – demonstrate the extent to which the courts will strive to prevent plans having a perceived tax avoidance motive achieving the planned tax saving.

Planning traps to avoid

The direction of the developments is clear. The more difficult question is in identifying planning which would and would not be likely to be effective in terms of the response of HMRC and taking into account the positions of other stakeholders.

Although it is not possible to be definitive on specific traps, some principles can be identified.

Parliamentary purpose

The *UBS* case demonstrates the focus on the intention of parliament. This creates a difficulty for companies and their advisers as discerning Parliamentary intention looking beyond the immediate wording in the legislation.

Equally, if a plan has artificial features that are included simply to achieve a beneficial tax result, it will often not be difficult to recognise that this is likely to result in HMRC and the courts identifying tax avoidance and seeking to counteract the intended saving accordingly. Whatever the technical merits of the judicial analysis in *UBS*, there are several features of the planning which, viewed through the prism of the approach to tax in 2016, could be seen as likely to fail. These include:

- A clear intention to mitigate tax in a way running contrary to the purpose of the legislation, in this case allowing the economic value of a discretionary bonus pool to be paid to the individual participants without incurring income tax or national insurance contribution charges.
- Offshore companies incorporated for no purpose other than to facilitate the achievement of the intended tax saving.

- Features of the plan to create minimal and, aside from tax, unnecessary commercial risk.

Artificial features

Similarly, including elements of the structure which are artificial – typically inserted for no material purpose other than to achieve a tax saving – would be an indicator of tax avoidance.

Too good to be true

HMRC has made the point that, if the tax benefits of a plan look too good to be true, they probably are. A particular example of this arises if a plan lacks tax symmetry – where the employer is seeking to obtain corporate tax relief but without a matching income tax or NIC charge – other than when this is explicitly contemplated by the legislation.

Conflicts of interest

Although this does not affect the likely efficacy of the planning with HMRC, other stakeholders (mainly shareholders) will be concerned to ensure that tax planning to deliver benefits to employees, particularly senior executives, does not prejudice their position or that of the company. An example of this is a plan implemented to deliver potential employment tax savings for the individual at the cost of the company losing corporate tax relief without adjusting the level of the awards to compensate the business for the less of that relief.

Planning is not dead

The question is whether no planning is likely to be effective. That is not the case but in determining whether planning is likely to be suitable, the principles for identifying unacceptable planning should be considered.

Taking that into account, some areas of acceptable planning would include a number of approaches.

All employee plans

Some plans still attract statutory tax advantages. As long as they are established in compliance with the detailed requirements of the legislation and without including artificial provisions designed to avoid an intended tax result, significant benefits can be obtained.

In practice, many tax-advantaged plans are not considered due to the limits on the value of awards that can be delivered under them. As an example, company share option plans are limited to awards for each person over shares with a maximum value at any one time at the date of grant of no more than £30,000.

Equally, in suitable circumstances, tax-approved plans can deliver significant benefits. This can arise when there are either substantial numbers of employees or substantial increases in share prices.

A well-publicised example with both these features is the British Telecom share save plan. This was reported to have resulted in gains of £1.3bn being shared among employees across the workforce, with individual profits of £46,000 on average.

EMI

The potential value of enterprise management incentives (EMI) for smaller companies – those with gross assets of less than £30m at the date of grant – should not be underestimated. The limit on the value of awards for each participant, measured at the date of grant, is £250,000 with a total company limit of £3m.

As an incentive targeted at smaller companies, many will have substantial potential for equity value growth. EMI options granted with an exercise price equal to or greater than the market value of the underlying shares at the date of grant offer a potential tax treatment with, for suitable companies:

- No tax or NICs on the grant of the awards.
- No tax or NICs on the exercise of the awards.
- Corporation tax relief on the exercise of the awards on the excess of the market value at the date of exercise over the exercise price.
- CGT on sale subject – where the options were granted at least one year before the disposal of the shares – to the benefit of entrepreneurs’ relief reducing the effective tax rate for the employee to 10%.

If an employee received options over shares worth £250,000 at the date of grant subject to a gain of five times over the life of the options, the potential outline tax treatment would result in:

Option gain = £1m
Tax on sale = £1m x 10% = £100,000
Corporation tax relief (at 17%) = £170,000

The overall effective tax rate, due to the benefit of corporate tax relief, is 7%.

Growth interests

Growth interests take different forms. They may be a separate class of share participating only in corporate value above a stipulated threshold (growth shares) or through a joint share ownership plan where the ownership of ordinary shares is split, with the employee being granted a right to share in future value growth and their co-owner (being a third party such as the trustee of an employee share ownership trust or ESOT) owning the balance of the shares.

The structure and resulting valuation dynamics of each structure are different, but with a similar tax treatment, namely:

- Income tax on award equal to the market value (of the interest at the date of acquisition).
- CGT on sale with the possibility of entrepreneurs' relief depending on the nature of the interest and the company whose shares are subject to the award.
- No corporate tax relief on the realisation of value on sale subject to capital gains tax.

With the significant differences between corporation tax rates (due to fall to 17% in 2020), capital gains tax rates and the combined income tax and NIC rates, this approach can offer significant tax benefits without provoking controversy at HMRC (other than possibly in relation to the determination of the initial market value). This is reflected in Research Report 372, published but not written by HMRC, which recognised the nature of growth interests and their role in providing effective incentives.

Subsidiary shares

As a variation on growth interests, there may be scope for awards to be made over shares in subsidiary companies. If the subsidiary operates a separate trade, in particular one in the early stages of development, the resulting value profile and tax treatment is similar to growth shares, with a market to allow for the realisation of value being provided through a sale to the parent company, either for cash or by way of a share for share exchange.

Pension replacement

Tax relief for pension contributions for higher earners has been significantly restricted. At the same time, there is growing pressure, particularly in the financial services industry, for senior executives to be required to hold share interests over an extended period.
The combination of these factors leads to the possibility of combining share plan awards with long-term pension provision in a manner similar to the approach in many US companies. This may offer the deferral of tax for the participants leading to them achieving a tax profile similar to that for a conventional pension scheme with tax (and NICs) only payable at the time of the delivery of shares.

Summary

The boundaries of acceptable tax planning have changed substantially. This has resulted in part as a response to changing economic circumstances that have added to the pressure to reduce Treasury deficits and partly due to political and social pressures.

This affects the design of share plans and other incentives. It does not mean, however, that tax and achieving an optimal tax result is no longer relevant to plan design. Instead, the focus should be on delivering incentives to make full use of the intended reliefs offered by tax legislation while balancing the interests of participants with other stakeholders.