Institute of Financial Accountants

Corporate

Office of Tax Simplification review of unapproved share schemes: Marketable Security

Response to Consultations

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Institute of Financial Accountants
Burford House, 44 London Road, Sevenoaks, Kent, TN13 1AS
T: +44 (0)1732 458080 **F:** +44(0)1732 455848 **E:** mail@ifa.org.uk
www.ifa.org.uk

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Introduction

1. The Institute of Financial Accountants (IFA) and the Federation of Tax Advisers (FTA) welcome the opportunity to comment on the consultation documents in respect of the Office of Tax Simplification ("OTS") review of unapproved share schemes: Marketable Security published by HM Revenue & Customs (HMRC) on 17 July 2014.

2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. Information about the IFA and the FTA is given below.

Who we are

4. The IFA is an internationally recognised professional accountancy membership body whose members work for small and medium-sized enterprises (SMEs) or who run or work in small and medium-sized accounting practices (SMPs) that advise SMEs.

5. At the IFA, we put small and medium enterprises (SMEs) first, recognizing their role as vital wealth-creators, as employers to more than half of the UK's private sector workforce and as the power behind vibrant urban and rural communities. We hold the interests of small and medium practices (SMPs) in the accounting profession in equal regard.

6. The FTA is the Tax Faculty of the IFA and is the modern membership body for agents who provide tax compliance and planning expertise to SMEs and entrepreneurs. It is the tax representative for IFA and FTA members.

7. We are proud of our unique relationship with our members, who predominantly come from a SME/SMP background. As a professional accountancy body, we aim to provide the very best support and guidance to our members who operate within this arena, frequently tailoring policies and recommendations to meet the unique challenges and trading relationships associated with smaller business.

8. Founded in 1916, the IFA supports over 10,000 members and students in more than 80 countries with a programme of professional qualifications and education. As well as resources, events, training and seminars. IFA members uphold high standards of conduct, confidentiality and ethics and undertake annual continuing professional development (CPD) activities.

9. The IFA is a full member of the International Federation of Accountants (IFAC), the global body for the accountancy profession. As such, the IFA takes it place alongside the UK and Ireland's six chartered accountancy bodies, as well as 135 national and regional accountancy organisations representing 125 countries and jurisdictions.

10. The IFA is formally recognised as an awarding organisation by Ofqual, the public body responsible for monitoring standards, exams and qualifications (other than degrees) in England, underlining the quality of the IFA's work and the integrity of its qualifications; and is authorised by HM Treasury for Anti Money Laundering supervision.

General Comments

11. Thank you for the opportunity to respond the consultation on the OTS recommendations in respect of marketable securities dated 17 July 2014.

12. Our overriding comment in relation to the consultation is that we would welcome any simplification to the rules governing the taxation of employment related securities, particularly those aspects of the existing legislation relating to the regime in Chapter 2 of Part 7 ITEPA and the system of election, which predominantly impact on companies and employees who are not able to afford or are aware of the need to seek specialist tax advice. In

our view the proposed introduction of a marketable securities regime will only serve to exacerbate the difficulties experienced by unquoted companies in offering employees shares without yielding any practical simplification of the rules.

Specific comments on the consultations

13. In addition to our general comments, our comments on specific questions set out in the consultation documents are set out below.

    In relation to the proposal generally (Chapter 2 and paragraphs 3.1 to 3.3):

    Question 1 – What are the merits of the 'marketable security' proposal for businesses and individuals and are there any potential downsides?

14. The OTS is correct in identifying the potential for "dry" tax charges arising on the acquisition of shares by employees as being a disincentive for both employees and companies to widen employee share ownership.

15. There is a logic in deferring tax charges until there is a market in the shares, but our view is that the proposal itself will, in practical terms, prove to be neither a simplification of the system nor have the effect of incentivising employees to become long-term shareholders.

16. In a quoted company context it is the case that employees will dispose of shares to settle tax charges, in a private company, where there is no liquidity in the company's shares or only limited liquidity, it is unlikely that a similar disposal to fund tax liabilities will be made - the lack of market in the shares will ensure their retention by employees. For this reason, the introduction of the "marketable securities" regime is unlikely to add to the likelihood that shares will be retained by employees over the longer term.

17. By establishing a regime whereby the default position is that tax is deferred until shares become marketable and that income tax and NIC is charged on the whole value of the shares at the point that they do become marketable, there is a clear risk that employers and employees who are not advised will be at a significant comparative disadvantage to those who can afford specialist tax advice.

    Question 2 – In what ways would the proposal provide a significant and proportionate simplification of the tax rules for businesses and individuals?

18. For employees and companies who do not elect out of the marketable securities regime, the proposals would eliminate the need to consider the rules in Chapters 2-4 of Part 7 of ITEPA, although the need to process dividends through the payroll may present a challenge for both employers and payroll providers.

19. Where elections out of the proposed regime are not made, companies will also need to monitor the potential liquidity of shares held by employees: factors beyond a company's control, such as an offer to employees made by an acquisitive shareholder, could trigger tax and NIC charges without the company necessarily being aware that the need to collect taxes and account for NIC had been triggered.

20. As most employers and employees who take advice are likely to wish to make elections out of the regime, in order to enjoy CGT treatment on the growth in value of any shares acquired by them, they would remain subject to anti-avoidance rules of the sort currently set out in Part 7 ITEPA. For these tax-payers, the introduction of the marketable securities regime would simply represent the elimination of one element of complexity, the restricted securities regime, in substitution for another.

    Question 3 – What impact would implementation of the proposal have in terms of costs and administrative burdens for businesses and individuals? How would this differ by types of businesses or individuals? Views on the initial assessment of impacts provided at Chapter 4 would be welcome.

21. For most quoted companies, which tend to make share awards over listed shares, the proposals would not represent a significant change.

22. In a private company context, companies and employees who do not make elections will need to monitor the status of shares, to ensure that tax and NIC charges are properly collected when there is liquidity in the company's shares. Companies will also need to ensure that arrangements are put in place to payroll dividend payments.

23. Where companies and employees make elections, the proposals will represent little change to the administrative burdens that companies currently face. If, as is proposed, PAYE and NIC will apply where elections are made, this will have a cash-flow impact on employees as well as adding to the costs of acquiring shares, as NIC will also be in point.

In relation to the impact of the 'dry tax charge' (paragraphs 3.5 to 3.7):

Question 4 – How far do you agree that the prospect of a 'dry tax charge' on the award of ERS provides a disincentive to ERS-based remuneration? Would implementation of this recommendation have any impact on the number or type of ERS awards offered or taken up?

24. While dry tax charges are a genuine disincentive for companies and employees to widen employee share ownership, most employers with access to professional advice are able to alleviate the cash-flow implications of any tax charges, through the provision of loans or by either structuring share awards as awards of forfeitable securities (within the regime set out in s425 ITEPA) or granting unapproved/non-qualifying options to employees.

25. In practice, the prospect of dry tax charges only serves to change the structure of share awards offered to employees, and rarely impacts the actual offer of awards. In our view, the adoption of these proposals would have little impact on the number of ERS awards offered and taken up.

26. The change to the marketable securities regime may lead a small number of employers offering their employees share awards instead of unapproved/non-qualifying options. However, the difficulties associated with dealing with leavers' shares and Companies Act concerns about the rights of minority shareholders are likely to result in the majority of employers continuing to prefer to grant options instead of making share awards.

In relation to changes to the rules for readily convertible assets (paragraphs 3.8 to 3.13):

Question 5 – Would the OTS recommendation increase the incentives for employers and employees to elect for the employee to pay tax on the unrestricted value of ERS before they become marketable? If so, to what extent would the number of these elections increase?

27. The effect of not making an election would be that any future gain on the value of ERS would fall to be taxed as income and subject to PAYE and NIC, rather than as capital. This would mean that the net benefit of holding ERS for an employee who does not make an election would be, potentially, significantly less than for an employee who does enter into an election.

28. At present, under the restricted securities regime, most employers and employees who take professional advice will make elections to be taxed on the unrestricted value of ERS on acquisition. Not only does the making of an election prevent future charges to income tax and NIC from arising, but it can have a significant impact on the employer's compliance obligations; future transactions in shares in respect of which an election under s431(1) ITEPA has been made do not need to be reported under s421J ITEPA unless the transaction gives rise to a charge under another chapter of Part 7.

29. Our expectation would be that, under the proposed marketable securities regime, the potentially greater tax burden associated with a failure to elect to be taxed on the UMV of shares on acquisition would raise the profile of such elections further.

30. However, our view is that the great majority of companies and employees who have access to tax advice will choose to make elections, as is the case under the existing regime, while companies and employees who do not have access to such specialist advice are likely to continue to be unaware of the potential advantages of making

elections; in our assessment, the number of elections being made will increase over time, as awareness spreads, but the level of that increase will be quite small.

Question 6 - If so, how can this risk be addressed, consistent with the objective of mitigating difficulties that can arise where tax is due before ERS become marketable?

31. Our view is that this is not a risk that can be addressed; companies and employees are unlikely to consider that the cash-flow advantage offered by the new regime is more valuable than the significantly higher tax cost of having the growth in the value of the ERS taxed as employment income, rather than capital.

Question 7 – If the OTS proposal were modified so that either:

- **the current definition of readily convertible assets were retained within the framework of the 'marketable security' proposal; or**

- **a joint election by an employer and employee for the employee to pay tax on the unrestricted market value of ERS also became an election for these ERS to be 'marketable securities' and readily convertible assets (meaning income tax and NICs would be payable under PAYE);**

Would either of these options address the risk while still being consistent with the underlying objectives of the proposal? If so, how?

32. In our view, neither proposal would be beneficial:

- The retention of the current definition of readily convertible assets would not impact on the behaviour of taxpayers, who are accustomed to making elections under the existing restricted securities regime in the context of the RCA regime) but would mean that some elements of the desired simplification would be lost;

- The alternative proposal would have the effect of exacerbating the impact of "dry" tax charges on employees, adding to their disincentive effect.

33. If the objectives of the proposed changes are to simplify the legislation on ERS and to encourage wider share ownership, then the first proposal fails to achieve simplification, while the second only adds to the costs and disincentives for companies and employees to offer or acquire ERS.

In relation to the time when ERS become 'marketable' (paragraphs 3.14 to 3.21):

Question 8 – Would treating ERS as 'marketable securities' only "when they can be sold… by the holder for a payment of money or money's worth which is (at least substantially) equal to the unrestricted market value" provide an acceptable basis for simplifying the tax rules? In which type of cases would further clarity and guidance on how this applies to different ERS arrangements be required? What proportion of ERS would be 'marketable securities' on acquisition by an employee?

34. In our view, defining a marketable security as one that can be freely sold for a price at least equal to its unrestricted market value would be satisfactory, if the intention is to prevent "dry" tax charges from arising. As set out above, it is not clear that this change to the legislation on ERS would actually result in any simplification of the legislation.

35. Further clarity and guidance would be required in relation to the impact of transactions among individual shareholders on perceptions of a share's marketability; the point during a transaction process at which a share will be treated as "marketable' (current HMRC practice is to treat shares as readily convertible assets at the point at which corporate finance advisers are appointed); and on the relevance of the existence of employee share trusts.

36. We are unable to give a view as to the overall proportion of ERS that would be treated as marketable, as, quantitatively, the bulk of ERS transactions take place in the context of listed companies, the shares in which would be treated as marketable under these proposals. In a private company context we estimate that fewer

than 5% of the companies that offer ERS to employees have any kind of active market in their shares.

Question 9 – In addition to the anti-abuse approaches suggested by the OTS, would other measures be needed to prevent abuse? If so, what?

37. Provisions equivalent to chapter 3A of Part 7 ITEPA would be required to ensure that shares prices are not artificially depressed prior to a company providing an artificial market in its shares, so that tax charges are not crystallised on market values that are artificially depressed.

Question 10 – Would there be any undesirable or unintended consequences, including costs to employers, of taxing any income, dividends, gratuities or incidental benefits obtained from ERS as employment income where recommended by the OTS?

38. The main implication of the proposal to tax dividends and other benefits as employment income would be the need to ensure that companies and payroll providers are ready to treat employee shareholders in an anomalous way.

39. There would also be a need to ensure that there is clearer guidance on what other post-acquisition benefits of holding shares would be caught by the new rules (e.g. the impact of bonus issues, demergers and other group reorganisations).

Question 11 – If the Government were to apply a backstop date at which the ERS would be deemed to be 'marketable securities', at what point should this apply?

40. We would recommend that charges should crystallise on the earliest of the tenth anniversary of the date on which the ERS are acquired and the day before the date on which the shares cease to be treated as ERS.

In relation to the amount of tax chargeable when ERS become marketable (paragraphs 3.22 to 3.24):

Question 12: Would linking the amount of ERS income to be taxed to the value of consideration received on disposal of the ERS create any abuse risks or administrative difficulties for companies in complying with their PAYE obligations?

41. Our recommendation would be that PAYE and NIC should be operated on the value of the shares on the date that they become marketable securities - if it is intended that relief be given if the shares are sold for a lower price within 14 days then we recommend that this relief should be claimed through an employee's self-assessment return. As is set out in the consultation document, sales by employees would be difficult for many employers to monitor and may prove to be a further incentive for employers to offer ERS on condition that an election is made.

Should you wish to discuss our responses further, please contact AdamL@ifa.org.uk in the first instance.