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Corporate

New employee shareholding vehicle

Response to Consultations

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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 open consultation on the new employee shareholding vehicle published by HM Treasury 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 to the Open consultation on the new employee shareholding vehicle published 17 July 2014

12. Our overriding comment in relation to the consultation is that we welcome the proposed changes to simplify the rules governing the holding of issued shares for use in an employees' share scheme and, provided that the tax reliefs are accessible and do not impose significant administrative or compliance burdens on companies, we would expect to see the new vehicle widely adopted by companies.

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.

Heading 1

Question 1: Which of the issues identified by the OTS create the greatest complexity and administrative cost for companies? Please give practical examples if possible, including any behaviour that specific examples encourage, such as establishing offshore EBTs.

14. Our experience is that companies wishing to use EBTs to support their share schemes are faced with three principal issues:

    - The CGT issues described by the OTS - this is the prime motivation for companies to establish employee share trusts off-shore; although there are reliefs set out in the legislation (primarily at s144ZA and s239ZA TCGA), there are gaps in these reliefs which mean that CGT can be a significant frictional cost for EBTs;

    - Tax on financing - many companies choose to initially fund employee share trusts using loan funding, instead of making outright contributions - there are a number of reasons for this, not least the risk that significant residual assets may be left in an EBT after employees have exercised options or acquired shares under other types of award. The rules in s455 CTA 2010 can mean that companies funding their employee share trusts in this way suffer a cash-flow disadvantage and the EBT itself can suffer tax charges if the company decides to replace its loan funding with an outright contribution and writes off the loan;

    - The disguised remuneration rules - the reliefs for share schemes in part 7A ITEPA are not unambiguous and there is a genuine concern among companies and trustees that the ordinary operation of employee share schemes in conjunction with a trust will give rise to unexpected income tax charges, even where the transactions in question are manifestly not motivated by an intention to avoid or defer taxes.

15. The other issues highlighted in the report also represent significant concerns for companies and for trustees. One particular point, that of access to the statutory share schemes, seems to be a product of a fundamental misunderstanding of the nature of a trust on the part of HMRC - a corporate trustee holding shares in a company is not acting in its capacity as an owner, but in its legal capacity as trustee.

Question 2: What would be the effect of providing simpler access to existing inheritance tax exemptions through this vehicle?

16. The existing regime of inheritance tax ("IHT") charges is counterbalanced by an extensive range of reliefs, but many such reliefs can only be accessed by employers who are able and willing to pay for specialist tax and legal advice. The complexity of the rules means that there may be significant failures of compliance on the part of employers, which may only be picked up as part of a due diligence process before a transaction, and acts as a discouragement for employers to operate employee share schemes.

17. In our view, providing simpler access to employers to the existing exemptions would mean that more employers could offer participation in equity to employees and would reduce the costs of offering that participation.

18. We do not consider that providing such simplified access would constitute a significant extra opportunity for taxpayers to abuse the system - as has been highlighted by the consultation document, these reliefs are already available to employers with access to specialist advice and those seeking a tax advantage will also have access to such advice.

Question 3: Which conditions of s239ZA TCGA are most onerous for onshore EBTs to meet, and why? What would be the effect of relaxing the conditions for capital gains tax relief under s239ZA to the new vehicle?

19. There are two common scenarios where relief under s239ZA will not be available, both of which are regularly encountered by employers operating share schemes:

- Where an award of shares is being made for consideration, often significantly less than the market value of the shares; and

- Where the employees in question are neither UK resident nor performing UK duties and will therefore not meet the requirements of subsection (2)(a).

20. In practice, EBTs are sited offshore to deal with both such issues. The first issue could be resolved by aligning the relief in s239ZA with s144ZA, which treats the consideration given on the exercise of an employment related securities option as the proceeds of disposal for the CGT purposes in the hands of the trustees. The second issue could be resolved by adopting similar wording as that used in section 1009(3) CTA 2009.

Question 4: What would be the effect of continuing to apply s455 CTA 2010 to any new vehicle? How often, given the considerations above, do circumstances arise where its application is an issue for companies?

21. A large proportion of the private company sector is represented by close companies. Many such companies actively examine opportunities to establish share schemes for the benefit of employees and to spread ownership of equity more widely to the employee group. Often, in a close company context, the opportunity to offer shares to employees arises when one of the existing participators retires or otherwise leaves the business.

22. For many companies in this situation, there is not always certainty that all of the shares so acquired will be ultimately distributed to employees, for example: options or other awards may be granted subject to performance conditions or subject to there being a whole company exit. In such cases, the company may initially debt fund the EBT in order to ensure that, if the share awards do not vest or are not otherwise realised, there is not a pool of value locked into an EBT.

23. Many such companies will subsequently find that all of the employee share awards actually vest and may seek to settle the EBT's indebtedness. Although this could be done by making a formal contribution to the trust, which would be used to repay the debt, it would be simpler to allow the company to write off the debt without a charge arising under s458.

Question 5:What would be the effect of continuing to apply the transaction in securities rules to any new vehicle? Is there an alternative approach, such as guidance, that could address the issue identified by the OTS and provide companies with confidence about its use of the vehicle without providing an exemption from the rules?

24. In our view, most disposals by shareholders to EBTs will fall within the exemptions in the legislation, as they will be motivated by a desire to exit from the business or to provide shares for use in an employee share plan, for this reason, we consider that there would be limited value in disapplying the transaction in securities rules for the purposes of the new vehicle. We would be pleased to see refreshed clear and accessible guidance for companies on these rules if the new vehicle is introduced.

Question 6: Would a new vehicle be at a tax disadvantage compared to other EBTs if there is no exemption from stamp duty/stamp duty reserve tax on transfers of qualifying securities between the vehicle and the beneficiaries?

25. Companies use employee share trusts to fund a number of different types of employee incentives, including share options and awards made for consideration - the motivation is often that employers may wish employees to demonstrate a personal financial commitment to the company. In these cases, a stamp duty charge will arise as a frictional cost of operating the share scheme, which will either have to be met by the employees or, ultimately, the employer company.

26. Our view is that the attractiveness of the new vehicle would be increased by exempting it from stamp duty/stamp duty reserve tax on qualifying transactions.

Question 7: How important would this change be for the proposed new vehicle? In what circumstances and how often would companies be likely to place a controlling shareholding in the hands of a corporate trustee of a

potential new vehicle, particularly given the introduction of employee ownership trusts?

27. The operation of the legislation in this area can create difficulties for companies, as the test very often turns on ownership of ordinary share capital. In a private company context there may be a number of different classes of share in issue, which may have differing nominal values - it is possible for a small number of shares that have a disproportionately large nominal value to constitute a majority of the ordinary share capital of a company. While detailed advance planning should ensure that a company does not fail the independence tests on the basis of ownership of ordinary share capital by corporate trustees, there may be situations that the resolution of the problem may require disproportionately complex steps to be taken (for example, an existing shareholder wishes to dispose of shares to an employee share trust to fund employees' share awards, because of the history of the company, the shares have a disproportionately large nominal value; the company would need to undertake a capital reduction to allow the shares to be acquired by the trust without jeopardising the company's qualifying status for EMI).

28. In our view, a simplification along the lines of that enacted for Employee Ownership Trusts, would be a welcome feature of the proposed legislation.

Question 8: What would be the effect of continuing to apply Part 7A to a new vehicle? Is there an alternative approach, such as guidance, that could address the issue identified by the OTS and provide companies with confidence about its use of the vehicle without providing a carve out from the rules?

29. The rules in Part 7A represent a significant disincentive for businesses to operate share plans in conjunction with an employee share trust. The principal reasons being that the exemptions in sections 554H-s554N ITEPA are not wholly transparent (for example, companies often express concern about whether the risks of forfeiture set out in the terms of their share awards are sufficient to fall within the requirements of the legislation).

30. In our view, the tax treatment of employee share awards should be blind to the way in which those awards are satisfied - whether through the issuance of new shares or through the transfer of shares held in an employee share trust structure and enhancing guidance on the operation of Part 7A would be unlikely to achieve this objective.

31. Provided that the terms of the new shareholding vehicle are clearly defined in such a way as to prevent unacceptable deferral or avoidance of tax liabilities, by limiting both the nature of the assets that such a vehicle can hold and the nature of the awards that can be made using the assets of the vehicle, our view is that there would be little risk of exploitation if the new vehicle is explicitly exempted from the legislation in Part 7A.

Question 9: More generally, do you agree with the OTS that if the government is unable to address to all (or most) of the tax issues identified by the OTS then the vehicle would not be an attractive proposition for those seeking a simpler vehicle for companies wishing to establish employee share schemes? Please explain why.

32. We agree that if a majority of the tax issues highlighted by the OTS are not addressed by the new vehicle, take-up is unlikely to be significant.

33. In particular, if those issues that currently lead companies to establish trust off-shore are not resolved, then companies will continue to utilise off-shore trusts. In addition, the new vehicle is likely to offer companies significantly less flexibility than many existing arrangements; unless the new vehicle is materially superior to those existing arrangements then it will be unlikely that employers will view the additional restrictions in the new vehicle as being sufficiently attractive.

Question 10: Do you agree that further exemptions are unnecessary to make the potential vehicle a viable and attractive proposition? Please explain why.

34. We would view it as advantageous if the vehicle is able to return surplus assets to its sponsoring company. As set out above, there is a concern among private companies that a position may be reached which results in surplus assets being effectively "stranded" in an employee share trust. If assets can be returned to the sponsoring entity, then this would allow more companies to consider funding such a trust through contributions instead of loans.

Question 11: Do you agree that these safeguards would provide sufficient protection for the Exchequer? What, if any, opportunities would be open to those wishing to engage in tax avoidance and how could these be prevented?

35. We confirm that we agree that these safeguards would offer sufficient protection to the Exchequer. The main area where there would still be scope for avoidance would, in our view, be indefinite deferral of tax charges; for this reason, we recommend that awards are limited to a maximum 10 year lifespan, in line with existing requirements for qualifying options granted under EMI or CSOP schemes.

Question 12: Would companies choose to establish the vehicle onshore if it could not be legislated for that the vehicle and its trustees should be UK resident?

36. In our view, companies would seek to avoid the costs associated with the operation of off-shore structures if onshore structures enjoyed the reliefs envisaged by the OTS report.

Question 13: What would be the effect be of limiting the beneficiaries to current employees? What time limit would be appropriate for former employees to redeem shares or incur charges?

37. If the intention of the new vehicle is to facilitate employee share ownership, then we would suggest that the beneficial class of the trust should mirror the class of permitted participants in the existing statutory share schemes, namely current and former employees and the estates of deceased employees.

38. We also recommend that the time limits for the realisation of charges should also match those provided in the statutory plans - for EMI an option must expire within ten years from the date on which an option is granted.

Question 14: What would be the effect of excluding those who have a significant influence over the management and direction of the company? What level of restriction would be appropriate?

39. In our view, such a restriction would have a negative impact on private companies, in many of which, the majority of directors do not hold equity and do not have control over the company. Provided that the nature of the benefits that may be provided by such a vehicle are adequately circumscribed, the risk of exploitation under these arrangements should be minimal.

Question 15: What would be the effect of establishing these criteria to define "qualifying purposes" for property held within the vehicle? Should any others be considered?

40. In our view, limiting the type of benefits that can be provided using the new vehicle should act as an effective safeguard for the Exchequer against abuse of the vehicle.

41. Our recommendation is that these sorts of awards will meet the requirements of most employers, provided that it is possible for the vehicle to transfer shares to employees for consideration, as well as for nil consideration.

Question 16: What would be the effect of allowing the vehicle to deal only in the "qualifying securities" recommended by the OTS? Please explain why. The breach of any of these conditions would mean the exemptions would no longer apply and which could, potentially, be backdated for several years unless the breach is proven to be trivial or accidental

42. As the objective is to facilitate transactions in ERS with employees, it is, in our view, sensible and proportionate to restrict the asset classes that may be held by the vehicle to shares in the companies grouped with the sponsoring company, cash and securities acquired pursuant to a wider company transaction.

Question 17: What would be the effect of introducing safeguards that would ensure the exemptions would no longer apply and allowing this to be backdated several years if the vehicle is purposely abused by a company?

43. Provided that penalties cannot be triggered by inadvertent actions of the sponsoring company our view is that it would be proportionate to impose punitive penalties where the vehicle is purposely abused by a company. Our preference would be for the penalties to be levied in the year that the default is committed, rather than backdated, so that the position of taxpayers who have acted in good faith and subsequently left the business is unaffected.

Question 18: What would be the effect of potentially introducing maximum and minimum holding periods for employees? What periods would be appropriate to prevent avoidance risks?

44. In most private company contexts there is unlikely to be any liquidity in shares acquired by employees in advance of a whole company exit. In addition, plans are often tailored to incentivise employees to generate value in the company and retain employees until the exit happens.

45. For public companies, monitoring share transactions undertaken by employees can lead to difficulties and would impose an additional administrative burden on the company.

46. In our view, minimum and maximum holding periods have a place in share incentive design, but the intention behind the new vehicle is to facilitate transactions pursuant to those incentives. For this reason our view is that the imposition of holding periods would greatly reduce the attractiveness of the new vehicle and restrict take up significantly.

Question 19: What would be the effect of potentially restricting the vehicle from borrowing cash to loan to beneficiaries, or to set up sub-funds?

47. Our understanding is that the purpose behind the new vehicle is to enable companies to facilitate employee shareholding; the provision of loans or other benefits would not advance these objectives.

Question 20: What would be the effect of restricting the ability of the trustees to waive voting and dividend rights?

48. Restricting the ability of trustees to waive dividend and, crucially, voting rights would act as a significant disincentive for many companies to adopt the new vehicle and also, in our opinion, conflates the purpose of the vehicle, namely to facilitate transactions in employees' shares, and the purpose of the share plans that the vehicle is intended to support.

49. There are a number of practical objections to preventing trustees from waiving dividends and voting rights:

    - Many companies will have limited liquidity in their shares and transactions to acquire shares may be one-off or very infrequent - in such situations the vehicle would have limited opportunities to use cash received on the payment of a dividend to acquire shares for use in a share scheme - the payment of a dividend would represent an additional cash cost for the company, a tax cost for the trustees without conferring any material benefit on the employees;

    - Any voting rights on shares held by the vehicle would be exercisable by the trustees (assuming that the vehicle is constituted as a trust), this creates a corporate governance issue if, as commonly occurs with UK situs trusts, the trustee is a 100% subsidiary of the sponsoring company; where the trustees are professional trustees, their information about the company will be comparatively limited, in which case the likelihood is that they will either decline to exercise their voting rights or seek additional fees to cover their costs of becoming adequately acquainted with the running of the company in order to allow them to effectively exercise their voting rights;

    - In a public company context, shares are often purchased in the market to fund employee share schemes where companies wish to manage the dilution effect of their share schemes; in such a context, the exercise of voting rights by the trustees is unlikely to have a material impact on the governance of the company, but is likely to be regarded negatively by institutional shareholders.

50. From the point of view of looking at the incentive effect of the share arrangements, employees are interested to know what rights shares will have when they ultimately receive them, the rights of the shares while they are held by another shareholder or by the new vehicle are unlikely to be taken into consideration by employees in evaluating the shares that they stand to receive under a share scheme.

51. The potential tax advantage that is highlighted in the consultation document, that the holding of shares in an

employee share ownership vehicle increases the rights of existing shareholders is already potential subject to tax under the rules in chapter 3B of Part 7 ITEPA.

Question 21: What would be the effect of imposing a charge if shares have not been applied by the vehicle within, say, two years of acquisition? What currently drives decisions about the length of holding periods?

52. In our view, the imposition of such a condition could be seen as a disincentive to make use of the new vehicle, as it would impose an administrative burden on companies to monitor the acquisitions of shares and grants of options to employees (this could be particularly onerous in a public company context).

53. The main driver behind decisions on holding periods will be the structure of any share plan adopted by a company, for example:

    - awards may be made to reward performance over a period of time, instead of making awards that vest subject to meeting performance conditions - awards are typically structured this way where there is a concern about the accounting cost of making share awards; or

    - the share award may be targeted at the holder of a specific role within the business who may not have been recruited or may not have completed a probationary period.

54. It is entirely possible for companies to make share purchases in good faith, with a clear plan for the use of those shares, but to be unable to fully execute that plan by reason of circumstances beyond its own control.

Question 22: Would the treatment of existing liabilities associated with EBTs, as described above, affect the likelihood of transferring into the new scheme?

55. In our view, the proposed treatment of existing liabilities is unlikely to impact on transfers into the new vehicle - companies have tended to use separate trust vehicles to provide benefits such as sub funds and loans to those used for the provision of shares to employees.

Question 23: Do you agree with the recommendations from the OTS on legislation? What, if any, supporting guidance would HMRC need to produce?

56. We would welcome the publication of model rules to govern the new vehicle and simply stated legislation to exempt the new vehicle from the existing tax charges.

57. Clear guidance would be needed if it is decided to place time limits on the usage of shares as set out at 3.2 of the consultation document.

Question 24: What would be the nature and size of company most likely to use this vehicle if it is introduced?

58. Our expectation is that this vehicle would prove to be attractive to companies of all sizes. We would anticipate a high uptake among public companies and among small close companies, which are currently discouraged from using employee share trusts by the prohibitive costs of offshore trusts.

Question 25: Would this be the default vehicle for companies seeking to make arrangements for genuine equity based rewards and remuneration for employees? Would there be incentive to switch from use of existing schemes? Please explain why.

59. We anticipate that this arrangement, could become the default vehicle for companies, provided that the proposed tax reliefs are present, accessible and the associated administrative and compliance burdens are not excessive. This is because the existing alternatives can be expensive to administer, require complex advice and management to prevent unexpected tax costs from arising.

60. For the same reasons, we would expect companies to seek to move their existing arrangements into the new vehicle.

Question 26: Would companies not currently incentivising and rewarding employees through such schemes now

be attracted to do so if this vehicle is introduced?

61. In our view, any simplification of the systems for companies to award employee share will lead to further take-up of share incentives. Our experience is that the complexity of the existing structures is regarded as a significant disincentive for many companies.

Question 27: Would the vehicle encourage companies to increase the proportion of employee ownership compared to external shareholder ownership? What are the driving factors behind the allocation between the two?

62. The driving factor behind external shareholder ownership is a company's capital requirements and its prior acquisition activities. Where a company has a positive requirement for capital, it is highly unlikely to be met through employee share ownership.

Question 28: To what extent would such a vehicle reduce the administrative costs for those currently running and operating employee share ownership schemes? Please provide examples.

63. Many off-shore trustee providers charge in excess of £5,000 per annum to act as trustee of an employee share trust for a private company, if the new vehicle is sufficiently attractive to allow companies to on-shore their share trusts and sufficiently simple to allow administration to be carried on in-house, we would anticipate that companies of all sizes would be attracted by the potential cost savings.

Question 29: Would this simpler vehicle allow companies to able to set up an employee share scheme by seeking advice from a general tax practitioner rather than a share scheme specialist? What more could be done to support that ambition?

64. In our view, the new vehicle is unlikely to reduce the need for companies to seek specialist advice. The legislation governing the taxation of employee shares is very complex and the law governing the operation of even the statutory share plans (SAYE, SIP, CSOP & EMI) requires detailed knowledge that would not normally be available to a general tax practitioner.

65. The interaction between the rules governing income tax, corporation tax, inheritance tax, capital gains tax, stamp duty, company law and employment law is complex and needs to be compassed in any advice given to a company wishing to establish a share plan.

66. Only a radical simplification and codification of the tax rules affecting employee shares and employee share schemes would make the tax element of employee share schemes open to general advisers and they would still need to have recourse to specialists to deal with the wider commercial and legal issues that arise in connection with share schemes.

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