



The Law Society

## **Disguised remuneration**

*Comments of the Income Tax Sub-Committee*

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supporting  
solicitors

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# Disguised remuneration

## *Comments of the Income Tax Sub-Committee of the Law Society of England and Wales*

### Introduction

1. The Law Society is the representative body for over 140,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others.
2. We are pleased to have the opportunity to comment on the draft legislation dealing with disguised remuneration published on 9 December 2010.
3. This response has been prepared on behalf of the Law Society by members of the Income Tax Sub-Committee. The Sub-Committee is made up of senior and specialist tax lawyers from across the country.

### General comments

4. The summary to the explanatory notes to these provisions states that the schedule introduces rules that will apply in certain circumstances where employees and their employers enter into arrangements which result in a payment of money or the provision of an asset by a third party rather than the employer. The new rules create a tax charge which will apply to certain loans of money or assets by third parties to the employee; the earmarking of money or assets for the employee by a third party; and to the outright payments of money or transfers of assets to the employee by a third party where these are not otherwise charged to tax as earnings from the employment.
5. We understand that the principal areas which the legislation is designed to address (and counteract) are:-
  - 5.1 family benefit trusts which often, for example, make loans to employee beneficiaries or members of their family;
  - 5.2 employer financed retirement benefit schemes (EFRBS) which sidestep the constraints within the existing tax regime which apply to registered pension schemes; and
  - 5.3 the case of PA Holdings, where an interest in shares was conferred upon employees by a trust and shortly afterwards, and as part of a "Ramsay" type scheme, dividends were paid on the shares to employees who only suffered tax at the dividend rate rather than at the rates applying to income tax on employment. The reason that the dividends were taxed as such was because the "boundary" provisions within the UK tax code (formerly the scheduler system), prevented the payments from being treated as arising by reason of employment.
6. We would note that these objectives are quite diverse. This has two effects:-
  - 6.1 It is difficult to construct a set of rules which adequately counteract these arrangements and which at the same time leave untouched ordinary commercial arrangements which are taxed under the well trodden terms of the employee benefits code or the provisions

of Part 7 of ITEPA (the "ERS Provisions"). The effect of the draft legislation is potentially to bring into charge a considerable number of innocent arrangements and also arrangements where it was considered, pursuant to settled practice, that a particular tax treatment applied. The proposed legislation disrupts these settled treatments and the exceptions and reliefs are inadequate and puzzling and do not provide any form of satisfactory safe harbours from the legislation as currently proposed.

6.2 There is a lack of clarity and fairness. The effect of the comprehensive nature of the drafting is that it is extremely unclear when the arrangements cease to apply. However anxious HMRC may be to stamp out avoidance in this area, the difficulty for the employer is applying the rules to ascertain for the purposes of PAYE how, in particular, a dividend or a payment made by a third party to one of his employees should be treated.

7 The caveats regarding the policy are as follows:-

7.1 the FSA remuneration code requires remuneration to be partly in shares and partly deferred. It seems to us that the upfront tax charges arising from "relevant steps" as proposed by the new part 7A are incompatible with this proposal (see below);

7.2 where a relevant step is reversed or cancelled, or where a loan is repaid the tax charged should be repaid. The provisions do not allow for this and in our view are defective as a result. We believe this to be in breach of human rights.

7.3 the legislation to charge dividends in certain circumstances should be included in Part 7.

### **Main comments on the proposed rules and areas where change is needed**

8 We have made a number of detailed comments in this paper. Our concerns relating to the proposed Part 7A can perhaps be gauged by the length of this response. In brief we consider that the current version of these rules needs considerable revision before they could be said to be fit for purpose. At the very least the following fundamental issues need to be addressed in order for the proposed legislation to be properly targeted.

8.1 There should be an exclusion from the scope of the proposed rules for compensation arrangements covered by the FSA Remuneration Code and also for bona fide deferred compensation arrangements. The reason for this latter conclusion is that it is not only financial institutions covered by the FSA Remuneration Code which establish deferred compensation arrangements for their employees. Obviously such an exclusion would require careful drafting. We would suggest that the following components might be taken into account and which might represent the "hallmarks" of an excluded deferred compensation arrangement:-

- (a) Obtaining a "tax advantage" is not the purpose or one of the main purposes of the deferred compensation arrangements ("arrangements"). The "tax advantage" could be defined in a variety of ways, but in the context of this legislation the tax advantage might be the ability to have the use, as if owned, of the cash or securities without suffering a tax charge at the point that the use commenced.
- (b) Structuring the arrangements in such a way that there is an alignment between any income tax charge with the receipt of benefit by the employee or an

associated person (and not beforehand) would not of itself be regarded as an indicator of a "tax advantage" purpose.

- (c) The exemption should apply to any relevant step that flows from such an arrangement (eg the use of an EBT to hold an award of deferred compensation).
- 8.2 As a policy matter, we believe that employment-related securities should be excluded from the scope of these rules. There is an existing regime for the taxation of employment related securities in Part 7 of ITEPA. To the extent that this regime is felt to be defective in its application, then changes should be made to that regime, following consultation, rather than by imposing additional tax charges under the disguised remuneration legislation. If the employment related securities regime is not felt to be defective in its application (which is the view that, on balance, we hold), then any inclusion of employment-related securities within the disguised remuneration legislation is entirely unnecessary, and only gives rise to uncertainty, the prospect of double taxation given the unsatisfactory way in which the relieving provisions are currently drafted, and additional administrative burdens for both HMRC and taxpayer alike.
- 8.3 We consider the definition of relevant third person should be amended. As can be seen from our comments below we consider that this amendment should be twofold:-
- (a) Save where a company is actually acting as a trustee, it should be absolutely clear that a relevant third party cannot include a company in the same group as the employer. We believe that "group" for this purpose should be defined in accordance with the Companies Act definition;
  - (b) we believe that as a general matter it should be clear that a relevant third person can only include persons acting as a trustee. If a group company acted as a trustee it would become a relevant third person for the purposes of this definition. However, the extended definition of "trustee" in Clause 554A(8) needs to be cut back so that it does not cover entities who merely procure payments to be made or are responsible for administration of payments without actually having discretionary power over the underlying amounts. (Someone who administers the making of a payment to a person who is entitled to it should not be a relevant third person).
- 8.4 If market value consideration is given for an asset (whether by the relevant third person or by the employee) then this transaction should not be within Part 7A. This exemption would not apply to loans which would, however, be outside Part 7A if another exemption applied to them (see below).
- 8.5 A loan would not be within Part 7A if the benefit of the loan is within the charge to income tax, (or would be unless interest was paid on the loan or the loan benefitted from an exclusion from the benefits charge), the loan was made for a specified purpose (for example the payment of tax or the acquisition of shares or payment for a season ticket), the funds were applied for that purpose, and the loan was repayable within a reasonable period, for example 10 years.
- 8.6 If a relevant step occurs which gives rise to a tax liability but that step is reversed any tax paid should be repaid. So if an asset is earmarked for an employee (subject to our comments on earmarking below) and the earmarking is reversed because, for example it is subject to performance conditions which are never satisfied, tax should be repaid.

Similarly if a loan is made which gives rise to a charge but is then repaid, any tax should be repaid.

- 8.7 The tax charge on investment returns arising from investments held within arrangements covered by Part 7A should not be subject to income tax at employment rates. If an employee receives remuneration from his employer and invests the net of tax amount the return is subject to savings rates not employment rates. If an amount is earmarked for an employee he will suffer a tax charge at that point. Any increase in value in the sum earmarked through investment returns should be taxed as investment returns. There is no justification for taking investment returns and treating these as employment income. The PA Holdings case is different from this principle as the returns in that case represent the bonus that the employee was intending to get and were pre-determined.
- 8.8 Earmarking – We believe that the earmarking of money or assets should not give rise to a tax charge. No employee (or related person) has any tangible benefit at the point where such earmarking occurs – at best it may create some sort of positive emotion in the employee, which seems an inappropriate trigger for taxation. If it is felt that offshore investment growth in relation to sums or assets held by non-resident third parties should be subject to UK taxation as employment income (and we disagree), it seems fairer and clearer to tax such sums when an employee has some form of tangible benefit from that third party (including by way of a loan) rather than taxing the mere expectation of future benefit. To tax mere earmarking is a fundamental departure from the traditional basis of taxation of employment income, which is the receipts basis.

**Exclusion for FSA compliant remuneration arrangements (and other deferred compensation arrangements which have no tax avoidance or deferral motive)**

- 9 A new exclusion should be added to the disguised remuneration legislation which makes it clear that where the “relevant step” is part of an arrangement which is being implemented to comply with FSA requirements on remuneration, the legislation should not apply. It is unacceptable for the Government on the one hand to require deferral (which would normally be structured in such a way that the employee would not be taxed on his deferred remuneration until he actually received it, particularly given that such remuneration may ultimately be forfeited), and on the other to impose an upfront tax charge on such deferred remuneration based on how it is structured.
- 10 In addition, some employers go further than the FSA requires in their deferred remuneration policies. There is no tax motivation to such arrangements – indeed the vast majority of employees would rather their employers did not have such policies – but the employer wants to be seen to be doing more than the minimum it is obliged to do by the FSA (or has been obliged to do so by the views of its shareholders).
- 11 In these circumstances, i.e. where there are genuine deferred compensation arrangements which are not motivated by tax, the legislation should not apply. Structuring such arrangements in such a way that the employee is not taxed until he actually receives a benefit (e.g. no tax before the award actually vests) should not be objectionable, and has nothing to do with the underlying rationale for the arrangements.

## Principles-based approach

- 12 We would like to know whether or not HMRC considered the use of principles-based drafting to achieve its policy objectives in respect of disguised remuneration (and if it rejected the idea, the reason for the objection). As is clear from the rest of our paper, we have considerable doubts about the clarity of the drafting and it seems to us that HMRC has adopted the approach of generic or principles-based drafting without actually setting out the principle underpinning the desired tax treatment and the outcome that the legislation is therefore designed to achieve. In the absence of a clearly stated principle, there will be great reliance on guidance from HMRC. Guidance cannot be relied upon by the taxpayer in the absence of specific confirmation given on the basis of full disclosure (*Gray's Timber*, *MFK Underwriting Agencies*). We would also point out that the raw material for formulating such a principle can, at least in part, be found in the introductory paragraphs of the technical note.
- 13 Given that the Government have legislated the group mismatch rules (which are the latest example of principles-based drafting), we assume that, despite the change in the making of tax policy, they are still in support of the approach. Nor presumably have HMRC changed their attitude to it since the publication of the March 2010 consultation document on group mismatches in which they stated that "although it is possibly too soon to assess their effectiveness fully, the early signs [of the introduction of the disguised interest and income transfer rules] are encouraging. Its successful introduction not only comprehensively responds to the underlying avoidance but permits the repeal of significant amounts of traditional anti-avoidance legislation thus promoting simplification." A principles-based approach would assist practitioners and the courts in developing a "feel" for the ambit of the legislation without excessive reliance on guidance from HMRC.

## Specific comments

- 14 We have set out below particular comments on the draft legislation followed by a number of specific situations where we believe the legislation is not intended to apply but apparently does, even though these are not within the intended policy.
- 15 Chapter 2 applies if:
- (a) there is an individual ("A") who is a current, former or prospective employee of another person ("B");
  - (b) there is an arrangement to which A is a party or which covers or relates to "A" (this is described as a "relevant arrangement");
  - (c) it is reasonable to suppose that in essence, the relevant arrangement is wholly or partly a means of providing rewards or recognition or loans in connection with A's employment with B;
  - (d) a relevant step (within Clause 554B, 554C or 554D) is taken by a relevant third person;
  - (e) it is reasonable to suppose that:-
    - the relevant step is taken wholly or partly pursuant of the relevant arrangement or

- "there is some other connection (direct or indirect) between the relevant step and the relevant arrangement".

16. For the purposes of Clause 554A:-

- a relevant third person means any person other than A and B and includes A and B if either is acting in the capacity of a trustee;
- the meaning of "trustee" is extended to include any person who holds any sum of money or asset or on whose behalf any sum of money or asset is held under the arrangement or who is responsible for the management of any sum of money or any asset;
- to get to the essence of any particular matter any relevant circumstances are to be taken into account.

17. Many of the uncertainties caused by the rules stem from the construction of Clause 554A(1). In particular:-

- Clause 554A(1)(c) only requires that it is reasonable to suppose that in essence the relevant arrangement is wholly or partly concerned with providing rewards or recognition in connection with A's employment. It is not necessary for any payments or provision of rewards to be made to A by reason of his employment but simply that the relevant arrangement provides rewards, etc "in connection with" A's employment.
- The concept of an arrangement being a means of providing some "recognition" "in connection with" employment is particularly wide. This means that a huge number of transactions or structures entered into by employers for perfectly commercial purposes with perfectly normal tax outcomes will be within Clause 554A(1)(c). Once this provision applies the rest of the rules follow. In our view the central provision is Clause 554A(1)(c) and how this provision is approached is of critical importance. We believe that the phrase "or recognition" should be removed in Clause 554 A(1)(c) and we would question whether the phrase "in connection with" is appropriate or whether this should instead read "by reason of".
- the breadth of the rules becomes apparent when the definition of relevant third person is considered, because this simply covers *any person* other than A or B acting in any capacity.

## Linked Persons

18. Clauses 554I(9) and (10) extend the definition of family members beyond the definition that applies for the purposes of ITEPA. This drafting is not consistent with employment tax legislation and it is unclear why this departure is required or justifiable.

## Relevant Third Person

19. The relevant third person definition includes anyone other than A or B. This seems to us to be not what was intended by the policy of the legislation. We think the policy of the legislation is that it should cover anyone acting as a *trustee* other than A or B. The definition of trustee is extended by Clause 554A(8) and this extension in itself makes



the provision, even if limited to trustees, extremely wide and again capable of attacking completely innocent arrangements. Nevertheless we feel that limiting this definition to persons acting as trustees would go some way to bringing the draft within what we believe is the scope of the policy.

20. In relation to Clause 554A(8) we do not believe that even an extended definition of trustee should include any person "on whose behalf any sum of money or asset is held" as this is the beneficiary rather than the trustee, nor is the concept of "management" particularly correct as the management of funds could cover purely administrative actions. For example if an employee is also a partner in a partnership which owns the group for which he works and that employee has an entitlement to a share of the profits of the partnership by reason of being such a partner, the fact that the general partner of that partnership pays him a sum to which he is entitled appears to bring that general partner (in the absence of being treated as a relevant third person in any event by being someone other than A or B) within the concept of "trustee" as he "manages" funds – whereas in fact he is only paying to the partner what the partner is entitled to in the first place. Similarly, as noted below, a group company may manage group benefit arrangements and come within the definition. Similarly as noted below, a group company may manage group benefit arrangements and come within the definition. This seems to us to be an unjustifiable extension of what we believe to be the policy behind the legislation.

## Relevant Steps

21. Clause 554A(1)(e) requires for Chapter 2 to apply that it is reasonable to suppose that the relevant step is taken in pursuance of the relevant arrangement or that there is some "other connection" between the relevant step and the relevant arrangement. We consider that sub-paragraph (ii) of this sub-Clause goes too far. If there is a relevant arrangement of the type envisaged and funds are earmarked or a sum is paid or another relevant step is taken, there is likely in practically all circumstances to be some "other connection" between the arrangement and the relevant step. The question is surely, whether the relevant step was made pursuant to the arrangement. For example in the PA Holdings case the interest in the shares was conferred upon the employees with a view to the declaration of a dividend by the company concerned in favour of the employees. The Upper Tribunal in that case noted there was an unbroken link between the award of the interest in the shares and the payment of the dividend, there being an expectation that the dividend would be declared shortly after the trustee awarded the shares to the employees. The Upper Tribunal found this to be within the principle in *Hochstrasser v Mayes*. We accept the fact that HMRC might wish to step away from the constraints of the causation test imposed by income tax case law. However, in order to do this a great deal of thought needs to be given to the boundaries and limits which are to be imposed on the legislation if this is to occur. A relevant third person confers shares on an employee pursuant to a relevant arrangement. A charge arises under proposed Part 7A. The employee is free to deal with the shares as he wishes. Are all the dividends to be taxed as employment income. Is the payment of a dividend still a relevant step "in pursuance of" the original arrangement? How can an employer possibly know or judge this issue?
22. Those boundaries could either be imposed by a tightening of the language in Clause 554A(1)(e) (we would suggest the removal of sub-paragraph (ii) would be one way of achieving this) or by substantial bolstering of the exceptions and exclusions from the legislation. Merely to offer comfort through guidance is insufficient particularly as the effect of this legislation is to not only radically to alter the tax treatment of what would

appear to be ordinary transactions but also to require additional sets of computations on bases which are different from those used for existing income tax and savings provisions.

### **Clause 554B: Earmarking**

- 23.1 This provision applies if P earmarks any sum of money or asset held by or on behalf of P "with a view to a later relevant step being taken in relation to a relevant sum or asset". Generally employment income is charged on a receipts basis (see for example section 15(2) ITEPA. Earmarking brings forward the time of charging and is a radical departure. The mere indication to a trustee that a person is desired to benefit from the particular portion of a fund would constitute earmarking. We do not believe that mere earmarking should give rise to a tax charge for the employee unless, at the very least, it is combined with some other circumstances which indicate that the employee has the exclusive use and control of the funds or assets so earmarked (and always will have that use and control).
- 23.2 Clause 554B(2) states what "does not matter" when considering whether a sum of money or asset has been earmarked. It is considered that, if earmarking is to be retained, Clause 554B should also state what *does* matter. In our view earmarking should represent an intention to allocate funds to a particular individual such that any profits or losses from those funds or assets should accrue to that individual and ultimately that individual should be entitled to deal with those funds or assets as if they were his own.
24. As the legislation is currently drafted, an income tax charge will arise when a sum of money or an asset is earmarked for an individual. The fact that the award of the money or asset is conditional upon performance conditions or some future event does not prevent a tax charge arising by reference to when the "earmarking" occurs and there is nothing in the legislation to provide for any tax paid to be repaid if the employee never becomes entitled to the award. We consider that a repayment of tax should be available in these circumstances to the extent that the award does not become unconditional as it is unjust for an employee to be taxed on something that they never receive. The tax position of the employer will be complex. On earmarking the employer will have to account for PAYE. If the employee does not reimburse the employer within 90 days, tax on the amount of PAYE is due under section 222. How can this approach be justified where the award when made was only conditional?

### **Clause 554C: Payments, transfer of assets, etc**

25. Clause 554C is the most wide ranging Clause within the provisions. As mentioned above Clause 554A is extremely broad and capable of covering a wide range of arrangements. Tax arises under Clause 554J on the value of the relevant step. Clause 554C introduces as a relevant step a payment of a sum of money to a relevant person (basically A and people nominated by A) by a relevant third person. From the various categories set out in Clause 554C(1) we do not think that the payment of a sum of money within Clause 554C(1)(a) is meant to cover the circumstance where P enters into an arm's length transaction. This is because the other sub-paragraphs refer to what appear to be actions which involve an element of bounty, and we believe Clause 554C(1)(a) should be read in this context as otherwise there is no sensible limit to the breadth of the provision. However, this is not clearly stated on the face of the legislation.

26. Payment of a sum of money could be one part of a bilateral arrangement under which the payee transfers an asset to the payer. Given that relevant third person is anyone other than the employer and the employee this brings within the scope of the rules an enormous number of transactions (some of which are referred to below, but for example the sale of shares by an employee where a section 431 election had been entered into on acquisition). We would suggest that Clause 554C is tailored to deal with the circumstance which we think it is directed at, namely payments or transactions involving an element of bounty taken by a person exercising a discretion. If this is not made clear there will be no tax certainty in relation to a number of common place transactions.

#### **Clause 554D: Making assets available**

27. There seems to be quite a difference between making an asset available prior to the end of the relevant period and making the asset available after the end of the relevant period. Prior to the end of the relevant period the asset has to be made available in such a way that the person receiving it could have dealt with it as his own; after the end of the relevant period any passing over of possession or use appears to be sufficient. So if a trustee makes a yacht available to a beneficiary for a week this does not appear to be caught on the proposed Part 7A (that is the charge is under the benefits code). But if the asset is made available after the end of the relevant period for even a short while (a week for example) the charge appears to be on the open market value of the yacht (see Clause 554K(2)). Is this intended? How is this justified?

#### **Exclusions**

##### ***Clause 554E***

28. This exclusion is to be welcomed but is hardly surprising. We believe that the word "under" should be replaced with "in connection with" to reflect the breadth of the charging provisions.

##### ***Clause 554F Exclusions, commercial transactions***

29. These exclusions are rather narrow.
- 29.1 Clause 554F excludes loans on commercial terms within section 176, but section 176 only applies where the loan is made in the ordinary course of a business carried on by the lender which includes the lending of money. In other words Clause 554F(1) only appears to be relevant to banks and other financial institutions.
- 29.2 Clause 554F(2) gives an exemption for a transaction which is essentially the same transaction as is entered into by P in the course of a business with members of the public. It is hard to see how such a transaction would be caught by the provisions of Part 7A anyway unless the provisions are designed to have such a wide import that this type of an exclusion is needed.
- 29.3 Clause 554G is supposed to exclude transactions under employee benefit packages. Where loans are involved it is again a requirement that the lender has to be in the

business of making loans to the public. So this exemption would cover the case where an employer arranges for a bank to make season ticket loans to its employees but again this is hardly the type of arrangement which the provisions ought to catch. The conditions attaching to Clause 554G are particularly onerous, not least those contained in Clause 554G(5) which appears to say if the arrangements are more likely to apply to higher paid employees (which could be construed as meaning those employees who are not on the lowest wages of the organisation concerned because of the use of the word "higher"), then the safe harbour does not apply.

### ***Clause 554H exclusions, employment related securities***

30. The relationship between the proposed Part 7A and the employment relating securities provisions is puzzling. There is no clear dividing line between the two sets of provisions.

The relationship with the ERS Provisions appears to work as follows:-

- (a) Chapter 2 does not apply on the acquisition of ERS where the ERS will cease to be restricted within five years (section 425(2)) nor to share options within section 475, but this only applies to acquisitions. So if there is an earmarking of an ERS Chapter 2 does apply.
- (b) Certain chargeable events under the ERS provisions prevent Part 7A coming into play provided that these give rise to an amount which "counts as employment income of A". So the disposal of a restricted security would prevent Part 7A applying but only if an amount has to be entered on a return which would not be the case if a section 431 election had been made. If Part 7 and Part 7A are both capable of applying there may not be a set off of any tax liability arising under Part 7A because of the restrictions in the relief contained in Clause 554O and 554S. The latter does not give any credit for charges under Part 7. Much depends on the circumstances. The intended ambit of the reliefs is extremely unclear, particularly when Part 7A applies to acquisitions and the ERS Provisions are triggered in a variety of other circumstances.
- (c) An example would be as follows:-
  - (i) a restricted ERS is earmarked for an employee by a relevant third person: a charge arises under Clause 554J;
  - (ii) the ERS is transferred to the employee. If the ERS is within Clause 425(2) Part 7A does not apply. If this is not the case Part 7A does apply. The general earnings income tax charge which might arise would be reduced by the original Part 7A charge under Clause 554S. If Clause 554M applies any initial Part 7A charge is reduced. This does not affect the Clause 554S relief. (Relief under Clause 554N is reduced where Clause 554M applies).
  - (iii) a restriction on the ERS is lifted. Part 7A does not apply because of the relief in Clause 554H (and in any event does not appear to apply to the lifting of a restriction). However there will be a charge under Chapter 2 of Part 7. There is no relief for this charge under Part 7A, but the amount of this Part 7 charge is reduced by the Part 7A charge arising either on or prior to acquisition (see paragraph (f) inserted by paragraph 14(b) which inserts a new head of

deductible amount in Section 428(7)). Is it necessary to have overlapping regimes in this way?

31. What is the amount of the charge which would arise? On the allocation of the ERS the value of the relevant step is the market value of the asset. This would presumably take into account any restrictions affecting the securities if these were inherent. If the cost of the securities was higher (say the trustees bought them at the top of the market) that amount would be substituted. If the security is an ERS this cost would not be relevant because it would appear that Chapter 2 to 4A of Part 7 would apply "by virtue of the acquisition" even though a charge might not itself arise on the acquisition. This is somewhat torturous and a taxpayer could conceivably be obliged to use different basis' of valuation in the light of the rather special meaning of "market value" for the purposes of the restricted securities provisions.

#### **Clause 554K – value of the relevant step**

32. The provisions of Clause 554K did not give credit for the value paid or given by A. As mentioned above, the higher cost does not apply if Chapter 2 to 4A of Part 7 applies to the acquisition, but this should extend to circumstances where there is no charge such as where a section 431 election was made. Perhaps the provision should instead refer to those chapters being "capable of applying".

#### **Clause 554L – residence issues, categorisation of earnings etc.**

33. Paragraphs 5 and 6 of the schedule containing the draft legislation make it clear that income taxable under the legislation is to be regarded as specific employment income. However, Clause 554L(1) and (2) effectively treat the income as general earnings. Clause 554J(1)(b) also seems to contradict Clause 554L(1) and (2), all of which should be irrelevant anyway if the income is taxable as specific employment income.
34. The interaction of these provisions needs to be clarified. The legislation should be entirely clear as to the type of income categorisation which it is requiring (general earnings vs specific employment income), and Clauses 554J and L should be revisited and amended to ensure that they work with whichever type of categorisation is chosen.
35. The basis of taxation is particularly important in the context of pension arrangements. If a non-domiciled employee has worked in the UK, contributed to an international pension plan and then retired outside the UK, he is likely to be taxed on his pension in his country of residence. It would be double taxation to tax him on the same pension under these rules. There is no guarantee that a double taxation treaty would operate to relieve such double taxation – whilst under the standard OECD model, the taxation of pensions is allocated to the country of residence, and it is unclear from the draft legislation that HMRC would view such payment as a pension payment rather than a payment of employment income. In addition, the UK's double tax treaties with a number of countries, such as the USA, do not contain the standard OECD model pensions article. Furthermore, such double taxation treaties do not override domestic law – i.e. the employer would not be able to rely on them in relation to any PAYE obligation (without prior HMRC clearance in any event) – they simply allow employees to claim relief from any double taxation they have suffered.

### **Clause 554N – overlap with certain earnings**

36. Clause 554N (1) limits the application of Clause 554N (2) to those within (a) and (b). Who is not intended to benefit from Clause 554N (2) who is within Part 7A?
37. Clause 554N provides for a reduction of any charge under the disguised remuneration legislation if the “relevant step” also gives rise to earnings within Chapter 1 of Part 3 of ITEPA. However, the reduction should also apply to the extent that ITEPA specifically exempts particular payments from being taxable (e.g. the first £30,000 of payments made in connection with the termination of employment pursuant to s.401 ITEPA). The breadth of the drafting of the legislation is such that it could apply to such payments, which is presumably not the intention of the draftsman.

### **Clause 554O – consideration given before relevant step taken**

38. We assume this provision is designed to prevent a tax charge arising to the extent that an employee gives consideration for the transfer of an asset. However the provision is drafted in a way that is too restrictive. For example it only applies where consideration is given before the transfer of an asset. So as drafted it would not apply if the payment is made at the same time as the transfer of an asset. If payment is made after the transfer of the asset, this does not prevent the tax charge arising (which is understandable if HMRC are concerned the exemption could be manipulated), but there appears to be no mechanism to adjust the tax liability if full consideration is subsequently given. This seems unfair, particularly as you could fall foul of the exemption simply by making payment a few days late.
39. The wording of Clause 554O(1)(a) is also unduly restrictive. If the relevant step was the transfer of an asset, with the employee paying market value for the asset, this would arguably not be within the section because although there would be a relevant step within Clause 554C(1)(b), Clause 554O(a) requires that the relevant step “does not also involve a sum of money”. The word “involves” is so wide that this could catch the payment by the employee, which would make the provision meaningless.
40. Clause 554O is also too restrictive in that it only applies to a transfer of an asset from the third party (P) to the employee (A) and not the transfer of an asset from the employee to the third party. For example in the situation where a departing employee of a private company transfers shares to an employee trust (assuming that it could be argued that the arrangement fell within Clause 554A(1)(c) as being in recognition of employment) there would appear to be nothing to stop the payment of the consideration by the trust being treated as a relevant step, even though the employee has given full consideration in the form of the shares. It is also not clear why Clause 554O only applies to transfers when the charging provision applies to acquisitions.
41. Why does this provision not simply provide an exemption from Part 7A where the asset is acquired either at market value or pursuant to a bargain at arm's length?

## **The application of the provisions in the context of particular transactions or circumstances**

### **Group Companies**

42. It seems clear that employer for the purposes of the provisions only covers the actual employer of A. Very often the group company will provide a benefit to an employee. In many circumstances there will be no benefit because the transaction is at market value, but as indicated above it is not clear whether this type of transaction will still constitute a "relevant step" by a "relevant third person".
43. So what happens for example if an employee of a subsidiary is allowed to subscribe for shares at market value in the holding company of the group? The issue of the securities would appear to be caught by Clause 554 C (1) (c). If this is the case it would appear that the relief in Clause 554O is not available unless the concept of the transfer of the property in the asset is sufficiently wide to cover the creation of an asset.
44. In our view a company in the same group as the employer should not be treated as a relevant third person. In addition any relief for the transfer of an asset should also apply to the creation of an asset, which is most doubtful.

### **Application of the draft "disguised remuneration" legislation to unapproved share option arrangements**

45. Clause 554H contains an exemption from the disguised remuneration rules in relation to grants and exercises of options which fall within section 475 and 476 ITEPA. These provisions only apply to employees who are both resident and ordinarily resident on the grant of options.
46. However, other types of employees (e.g. those that are UK resident but not ordinarily resident, and those that are subject to tax by reference to duties performed in the UK) should also benefit from an equivalent exemption in relation to unapproved options.
47. The exemption should be based on the acquisition and exercise of "securities options" as defined in section 420(8), which does not import any additional residence requirements.
48. In addition, any exclusion should also be widened to cover "earmarking" that takes place as part of such option arrangements. In the context of private limited companies, it is perfectly common to use employee benefit trusts to facilitate liquidity in the shares of that company. Where share options over shares in such private companies are granted to employees, it is common for the trust to purchase shares which it will hold to meet the exercise of options by employees. It should be made clear that, to the extent a trustee is holding shares to meet the exercise of employment-related securities options, the trustee will either not be regarded as "earmarking" such shares. Alternatively, the exclusion in Clause 554H should apply to any "earmarking" of shares which are held to satisfy the exercise of such securities options.

## **Shares Acquired by Management in a Private Equity Context**

49. Where a senior manager is offered an opportunity to subscribe for shares alongside a private equity house on completion of an acquisition, there appears to be a risk that this could be caught by Part 7A, even where no EBT or similar arrangement is used and despite the fact that this situation is already covered by Part 7. This is a consequence of two key features of the draft legislation, both of which have been referred to above but which are also relevant here.
50. Firstly, in such arrangements the shares are often issued by a different group company from that which employs the relevant members of management. However, the draft legislation makes no provision for a company in the same group as the employer to be excluded from the definition of "relevant third party" where that company issues shares to management as part of such an arrangement. We would suggest that Clause 554A(7) be amended so as to treat such group companies in the same way as the employer.
51. Secondly, under Clause 554A(1)(c), the draft legislation applies where it is reasonable to suppose that the relevant arrangement is concerned with the provision of "rewards or recognition...in connection with" employment. As noted above, the precise meaning of "recognition" in this context is unclear. However, there appears to be a significant risk that it could even cover circumstances where management pay market value for the shares which they acquire. This again suggests that "recognition" should be taken out of the draft legislation.
52. If it is intended that Clause 554A(1)(c) should apply in these circumstances, then any agreement between the private equity house and management as to the shares to be issued may constitute an "earmarking" (Clause 554B(1)) and the subsequent issue of shares itself may constitute either a transfer of an asset (Clause 554C(1)(b)) or a taking of a step by virtue of which a relevant person acquires a security (Clause 554C(1)(c)).
53. Under Clause 554H(1)(a), Chapter 2 does not apply by reason of an acquisition of any employment related securities if section 425(2) applies to that acquisition. Whilst this may serve to exempt share issues to management under certain circumstances, it by no means alleviates all of the above concerns. For example, the exemption does not appear to catch anything beyond the actual acquisition of the shares and so would seem not to apply to any prior earmarking. Moreover, it only applies to acquisitions of shares within section 425(2) and therefore only to restricted securities where the restrictions will cease within five years. Most shares in private equity backed companies will not satisfy this condition.
54. Clause 554O provides relief in circumstances where the relevant step is one under Clause 554(1)(b) and the transfer is for consideration given by the employee, which is paid before the relevant step is taken. However, this exemption does not extend to steps by virtue of which a relevant person acquires a security (under Clause 554C(1)(c)), which is arguably the applicable step in the case of a share issue. Moreover, it clearly will not apply to prevent any charge which may arise on an earmarking. We would suggest that 554O be amended so as to ensure that it covers all circumstances where market value is paid for an acquisition of shares by employees, including an earmarking where the ultimate intention is for shares to be acquired at market value.



55. Clause 554N provides relief from double taxation by reducing the value of any relevant step by any amount which counts as relevant earnings. However, this appears to require that the acquisition of shares "gives rise to" relevant earnings and so will be of no assistance in circumstances where market value has been paid for the shares and hence no charge arises under Part 7.

### **Sale of Shares for Market Value**

56. Where shares are acquired by management as described above, a subsequent sale of such shares to a third party (for example, on an exit) could potentially give rise to a further liability to income tax under Part 7A. By virtue of the combined effect of Clauses 554A(1)(e)(ii) and 554A(9), very little in the way of a connection appears to be required between the relevant step and relevant arrangement in order for Part 7A to apply. Since the payment of sale proceeds to the employee shareholders seems likely to constitute a relevant step under Clause 554C(1)(a) and there is little to indicate that it does not apply (save as referred to above) the amount of the payment would appear to be subject to PAYE. This would appear to be the case notwithstanding that, for example, an election had been made under section 431 ITEPA. There is no exclusion of Part 7A in the circumstances as Clause 554H does not apply. Instead, by virtue of the alteration to the definition of deductible amounts introduced by paragraph 14 any charge and the disposal of ERS would be reduced – however no such charge will arise. Nor will Clause 554O provide any relief because the relevant step involves a sum of money paid by the relevant third person for the shares.

### **Pensions**

57. When the "earnings cap" for tax exempt pensions contributions was introduced in 1989, provision was made for employers to "top up" employees' pensions through funded unapproved retirement benefit schemes ("FURBS"). Since A-Day, FURBS have been replaced by employer financed retirement benefit schemes ("EFRBS"). There are many FURBS still in existence as well as EFRBS which have been set up as genuine top up pension arrangements for those employees whose contributions to registered schemes are restricted.
58. In addition, many internationally mobile employees will participate in their employer's International Pension Plan which may be an EBT, a FURB or an EFRB and may be for employees generally or an individual arrangement for the particular employee.
59. New contributions such as unregistered pension arrangements will now trigger an immediate tax charge. There is likely to be a further tax charge when benefits are taken.
60. In relation to EFRBS, no relief is available under Clause 554N as the tax charge which arises under section 394 is not "relevant earnings" within Clause 554N(3). To the extent that the payment of benefit is a "relevant step" Clause 554M would prevent a second charge under Part 7A, but the second charge, under section 394, would have to be dealt with, if at all, under Clause 554S which is unsatisfactory as it is a discretionary relief, available only where HMRC considers it "just and reasonable".
61. Under the old FURBS rules, the employee was taxed on employer contributions when they were made but, under the grandfathering provisions, there is no tax charge when benefits are received from a pre-A day FURB as a lump sum. The receipt of a benefit

would now be a relevant step and would be taxable on the employee. None of the relieving provisions in Clauses 554M, 554N or 554S apply because the initial tax charge will have occurred before the relevant step and was not itself a relevant step.

62. Accordingly, there seems to be a double tax charge and there can be no rationale for this.
63. Companies may also establish unfunded, unregistered pension arrangements, where they promise to provide an employee or group of employees with pension or lump sum benefits on retirement and charge assets in favour of the employees to secure the promise.
64. If the security is given by someone other than the employer itself, eg by another group company or an EBT, there would seem to be an earmarking of the charged assets within Clause 554B triggering an immediate tax charge.
65. If the ultimate benefit is paid by the employer, this will not be a relevant step, but will be a taxable event under section 394 and the employee will have to rely on the unsatisfactory provisions of Clause 554S to prevent a double charge.
66. If the ultimate benefit is paid by a relevant third party, it would be both a relevant step and taxable under section 394 and our comments in paragraph 60 apply here also.
67. The legislation also appears to apply to investment growth and the payment of cash in respect of shares (such as dividends). As the ultimate payment of the pension benefits will be taxed is this intended policy?

### **Post Death Liabilities**

68. Clause 554I(9) states that a person is linked with the employee if that person “**is or has been** connected with A” within the definition in section 993 ITA (emphasis added).
69. This would seem to mean that a person remains linked with the employee, even after the section 993 connection has ceased, so that a divorced spouse would remain a linked person and linking continues after the death of the employee.
70. In this context, we are concerned by the draft amendments to section 13 which include a reference to Part 7A in subsection 13(3) and insert additional subsections (4B) and (4C).
71. Section 134(B) has the effect that if a relevant step is taken after the death of the employee, the employee’s personal representatives are liable for the tax.
72. As family members and others remain “linked” to the employee after death by virtue of Clause 554I(i)(a), an earmarking, payment or loan etc to a widow or widower or child or other linked person of the employee after his death, possibly long after his death, would trigger a tax liability on the personal representatives.
73. This would mean that personal representatives could never wind-up an estate where the deceased was covered by an “arrangement” within Clause 554A because the contingent liability could continue indefinitely. This is a serious concern for personal representatives.

74. Section 13 (as amended) also refers to the situation where employment income is remitted to the UK after the death of the employee (who must, presumably, have been a remittance basis user). There seems no reason why an employee (that is, his estate) or his heirs should be liable in relation to the individual's earnings after his death. Any remittance would have to be by a relevant person other than the individual himself. The definition of "relevant person" in section 809M of ITA 2007 includes the individual's husband, wife or civil partner. A widow, widower or surviving civil partner cannot therefore be a relevant person and the general framework of section 809M implies that to be a "relevant person" there must be a subsisting connection to the individual. It must be questionable whether persons within section 809M(2)(b) to (h) remain relevant persons after the death of the individual in which case, it is difficult to see how there can be a remittance after the individual's death.
75. If there is to be a continuing liability after death, then the liability should fall on the person who benefits from the relevant step or the remittance, not the personal representatives or it will seriously hamper the administration of estates.

### **Deferred Remuneration**

76. Bonuses paid by an EBT may be earmarked unconditionally or subject to performance/other conditions. If earmarked unconditionally but never received, there should be some mechanism for repayment. If earmarked subject to conditions, there should be no charge until the condition is satisfied (so an amendment to the charging provision is required).
77. On a related note, at what stage does the earmarking occur? Presumably there must be some element of allocation between employees and it is not possible to earmark a lump sum for a number of executives? Is provision in the accounts enough?

### **Carried Interest**

78. Will the proposed rules override the 2003 BVCA guidelines? The basic structure envisaged by the Memorandum of Understanding describes a limited partnership which has a corporate general partner often in the same group as another corporate entity which is the manager. The manager will employ the executives who will be responsible for the investment policy of the limited partnership. Third-party investors will become partners in the limited partnership. In addition the executives will, usually through a feeder partnership, acquire interests in the main limited partnership which becomes entitled to profits after the external third-party limited partners have received back the value of their investment together with a preferred return. This interest is called "carried interest" and is often subject to "good leaver/bad leaver" provisions which basically reduce the amount of carried interest available to an executive if he leaves the employment of the manager within a certain period and in certain circumstances. It seems hard to avoid the conclusion, if the recipient of the carried interest is an employee of a corporate manager, that the carried interest is not bestowed upon the executive "in connection with" an arrangement to "reward" the executive or at least "recognise" his efforts.
79. After a number of investments are sold the carried interest may cut in if the limited partners receive back their investment and the level of preferred return is reached. At this point part of the investment proceeds will become the entitlement of the carried

interest partners. The good leaver/bad leaver provisions may by this time have fallen away but this will depend on the terms which have been negotiated.

80. The general partner of the carried interest partnership will be responsible for the calculation of the amount due to each of the carried interest partners (which will usually be by reference to a fixed partnership share) and will distribute the entitlement to those partners. The role is purely administrative but it would appear that such an activity could have the effect that the general partner of the carried interest partnership is a relevant third person, or the manager, to whom the functions of the general partner in this respect may have been delegated, may be such a relevant third person. In this case, once more, it seems possible that the rules will apply.
- 8.1 From a policy perspective the fact that the "connection" required between the relevant arrangements and a relevant step is so drafted so widely means that, potentially, returns arising from the underlying fund (in the form of dividend or interest income or sale proceeds on a disposal of an investment) could be potentially taxed as employment income. This is unsatisfactory for two reasons.
- 8.2 Firstly, the tax treatment of carried interest has been considered publicly in the last couple of years and while the rate of capital gains tax has been increased and capital gains tax reliefs (in particular, taper relief) has been withdrawn there has been no stated change of policy towards the tax treatment of carried interest in BVCA style partnerships. It seems wrong that this policy should be reversed by the back door through this legislation.
- 8.3 Secondly, as noted in the opening general comments, a code for the taxation of securities acquired by reason of employment already exists in Part 7 of ITEPA. It, combined with section 62 ITEPA, applies to tax the acquisition of carried interest if the employee pays less than (unrestricted) market value. Further income tax charges can apply during the period the employee owns the asset under widely drafted anti-avoidance provisions within Part 7 (most notably Chapter 4). This existing statutory code, together with the Memorandum of Understanding agreed between the BVCA and HMRC in 2003, should be sufficient to tax carried interest and, if HMRC believes it is not, Part 7 should be amended rather than introducing new overlapping provisions.

## **Loans**

81. Where loans are caught by the legislation but are subsequently repaid, there is no mechanism in the draft legislation for a credit to be provided. We believe this to be potentially in breach of human rights.
82. 554O does not assist as it does not apply if the relevant step involves a sum of money.
83. 554F will only help in very limited circumstances.
84. 554G appears only to apply to banks by virtue of 554G(1)(b). Should 554G be amended to remove (1)(b)? This seems right if 554G is intended to exempt benefits made universally available to employees.
85. Should there be a de minimis? £5,000 (see s.180 ITEPA)?
86. There appears, under ITEPA (section 175), to be a continuing cheap loan charge on the interest element of a loan made to an employee on less than market terms even

though there is a parallel charge under Part 7A on the amount lent. We would be grateful if HMRC could let us know whether it is taking advice from the solicitor's office on the human rights implications of intentionally taxing a loan as if it were an outright payment without any credit for any tax paid when the loan is repaid. This seems to be wholly unjustified and indefensible.

87. Tax or share loans (e.g. where employee incurs a liability to overseas taxation for which he must claim credit in the UK all where employees pay for shares out of salary over a period) would be similarly caught. 554F will not apply as amount/timing of repayment will depend on when/whether credit received so not on ordinary commercial terms.

### **Making Assets Available**

88. Clarification is needed that no tax charge arises on the full value of an asset where the asset is made available for limited period.

### **Employer PAYE Obligation**

89. PAYE operates despite the fact that it is not necessary for anyone to be aware that a relevant step has been taken for Chapter 2 to apply. We believe that it is inappropriate to make an employer liable to account for tax where the tax liabilities are triggered by the actions of a third party with whom the employer has no connection.
90. Whilst the employer may have been involved in setting up trust-based arrangements, there is no guarantee that such arrangements will provide for either the trustee to provide the employer with the appropriate information to allow the employer to meet any PAYE obligations imposed by this legislation, or, even more importantly, provide that the trustee will deduct amounts in respect of PAYE and pay those over to the employer, to allow a corresponding payment to HMRC. Following implementation of the legislation, employers may wish to ensure trust arrangements contain such provision going forwards, however it is not appropriate to change the law now in such a way that they are prejudiced as regards historic arrangements.
91. Furthermore, it is common for trusts established by the employer, for example as international pension plans, to make payments out to other trust arrangements (for example if the employee is no longer UK resident). The employer has no visibility in relation to such trust arrangements, and it is entirely inappropriate for the employer to have a PAYE liability as a result of the actions of the trustee of such arrangements (particularly as, by the time the trustee takes such actions, the beneficiary may no longer be an employee of the employer).
92. In circumstances other than those whether the employer itself takes the "relevant step", we would therefore propose that the tax due is collected from the individual taxpayer under income tax self-assessment. In such circumstances, no section 222 ITEPA charge would be applicable, because there would be no liability on the employer which could give rise to such a charge.

## **Credits against Capital Gains**

93. The legislation contains no amendment to the Taxation of Chargeable Gains Act 1992 to provide that where an asset is disposed of in circumstances where the acquisition of that asset gave rise to a liability under the disguised remuneration rules, the amount on which the income tax charge has arisen will be treated as consideration given for the acquisition of the asset and will therefore increase the base cost, reducing the capital gains tax liability on the disposal. Section 119A TCGA 1992 provides this in relation to certain charges arising under Part 7 ITEPA. We think such a provision should be included in respect of Part 7A charges as section 37 TCGA will not apply because the disguised remuneration charge will not necessarily have arisen on the acquisition of the asset.

### **Contact details:**

If you have any questions concerning these representations or would like to discuss anything contained in them, please contact the Chairman of the Income Tax Sub-committee Mr Richard Stratton (tel: 020 7295 3219, email: [richard.stratton@traverssmith.com](mailto:richard.stratton@traverssmith.com)).

9 February 2011