TAXREP 2/2000

A NEW ALL-EMPLOYEE SHARE PLAN

A Memorandum submitted to the Inland Revenue in January 2000 in response to a Technical Note and consultation issued in November 1999.

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Introduction

1. We welcome this opportunity to comment on the Inland Revenue's Technical Note issued in November 1999 setting out the draft legislation for a new All-Employee Share Plan.

Summary Response

2. We believe that it is a great pity that a major piece of new legislation of this type was not drafted in accordance with the style established by the Tax Law Rewrite Project. We believe an adaptation of the new style would have been beneficial to all users of the proposed plan.

3. We are still very concerned about how this proposed new plan will work in relation to existing schemes. We believe the proposed plan is an improvement over many of the existing similar schemes and it would be sensible to take stock of these and to consider whether they could be brought within the new proposals. However, there is currently in existence the Save-As-You-Earn (SAYE) scheme, which is not similar to the proposed plan but has many advantages. It has been proven to work, has a high level of take-up and is relatively easy to administer. It is unclear whether the intention is to keep SAYE or not. Our preference would be for the SAYE scheme to be maintained and run in parallel with the new plan.

4. We remain concerned that the administrative burdens of the new plan may be a substantial disincentive to those considering taking-up the scheme. We are also concerned that the tax legislation is becoming exceeding complex and that the new plan does little to clarify or simplify the legislation in this area.

Comments on the draft legislation

5. The following are specific comments on the draft legislation included in the Technical Note. Paragraph references are to that Note.

Paragraph A1

6. Paragraph A1(1) would appear not to be worded as intended. It takes the form of a definition of the phrase 'employee share ownership plan', such that any plan which provides for free shares and/or partnership shares (as defined) is an employee share ownership plan. This is regardless of whether it meets the other requirements of the draft legislative Schedule or has any intention of seeking tax-favoured status. We do not think that this was intended, since the phrase is clearly being used elsewhere in the Schedule to mean a plan which satisfies all the conditions for tax-favoured status, subject only to the requirement for approval by the Revenue. The various subsequent paragraphs to the effect that a plan may, or must, contain such and such a provision can only make sense on that basis. We believe this would be clarified by adding at the end of paragraph A1(1) the words 'and which meets the requirements of this Schedule'.

7. This lack of clarity is found in other parts of the draft. For instance, it is not clear whether some of the conditions set out in the Schedule, for example, those in paragraphs E4 and G3, are required to be incorporated in the terms of the plan (or in the trust deed) or merely have to be complied with in practice on pain of approval being withdrawn. The fact that some of the conditions are expressly identified as things which must be provided for in the plan, while others are not, might be taken to imply that the latter do not have to be so provided for. Alternatively, the fact that compliance with (presumably all) the requirements of the Schedule is a precondition for approval under paragraph A3 might suggest that the Schedule (apart from paragraph M3) is actually concerned wholly with the terms of the plan rather than with its actual operation. We believe it would be useful to clarify this point at the beginning of the Schedule.

8. We believe that it would also be helpful if it were explained in paragraph A1(1) that partnership shares can be 'acquired' by appropriating shares already held, rather than relying on the unsignposted definition in paragraph E7(2) - particularly as paragraph A1(1)(b) does not actually contain a reference '*the trustees* acquiring partnership shares on behalf of an employee' (emphasis added) as paragraph E7(2) requires.

9. In the third line of paragraph A1(3), it appears that the word 'when' should be 'whether'; however the whole of this subparagraph after the comma seems to be redundant in any event. We believe it adds nothing to what has gone before, even by way of clarification and therefore we suggest it is removed.

Paragraph A2

10. In paragraph A2(1) and (2), it is not clear what shade of meaning is intended to be given by saying that the plan may be 'expressed' to extend to the other companies, rather than simply that it may extend to them. If no actual distinction is intended, the superfluous words would be better removed.

Paragraph B2

11. The reference to 'a continuing stake in the company' is arguably not wide enough to cover the case where the shares used for the plan are actually those of a different company, as permitted by paragraph H2(b) and (c), and the 'stake' is therefore only an indirect interest. We, therefore, suggest that the wording is suitably broadened.

Paragraph B3

12. In relation to paragraph B3(2), it appears that the requirement for a holding period may well discourage some employees from participating in the plan, particularly if they are not expecting to stay with the company that long. There may well be other examples of particular provisions which the Schedule actually requires to be included in the plan but which may discourage at least some categories of employee. We suggest that there should be a much wider exclusion than the existing second sentence of this paragraph, to cover any features which the legislation either requires or expressly permits to be included in the plan.

Paragraph C5

13. We believe the closing words of paragraph C5(2) would be better expressed as '… or which is owned by a consortium of which the company is a member', to tie in more closely with the relevant definition in paragraph M13(3).

Paragraph C6

14. The provision of separate rules in paragraph C6(1) for close and non-close companies seems an unnecessary complication. We suggest that one set of rules should suffice.

Paragraph D4

15. Method one, in paragraph D4, is extremely hard to understand, even with the aid of the commentary. One needs an answer, firstly, to the question 'performance of what?', and this needs to be supplied in paragraph D4(1)(a) at the point where performance is first mentioned. At present one only discovers indirectly, by inference from paragraph D6, that what has to be measured is the performance of units of some sort, and not of the individual personally.

16. It is not clear without reference to the commentary that the references to 'the highest performance award' and 'the highest non-performance award' in paragraph D4(b) are to the amounts awarded to individuals rather than to the amounts awarded to all the employees in aggregate on each occasion, in a case where there are several awards during the period.

17. If the words 'in any period' in paragraphs D4(1)(a) and (b) mean anything different from 'on any occasion' one needs to know what periods are to be used for these tests, but the draft legislation is silent on the point.

18. One would expect that in practice, rather than there being separate performance awards and non-performance awards, there would on each occasion be a single award of shares calculated partly according to performance and partly not. The wording of paragraph D4(1)(b) does not fit comfortably with this situation, and in particular leaves it unclear whether where an employee receives a 'mixed' award of this kind the whole of it is regarded as a 'performance award' (since the aggregate amount is certainly dependent on performance), or only the element of it which is directly proportional to or conditional on some measure of performance.

19. It is presumably intended that for the purposes of the test in paragraph D4(1)(b) one is to aggregate the awards made to each individual during the period in question, but that also is not clearly stated. We would welcome clarification of this point.

20. Some explanation of the method one alternative for awarding shares is found in the commentary on the plan at Chapter Two of the Note. It is not clear what is meant by the words 'on the 'similar terms' basis' in the first bullet of paragraph 2.4 of the commentary, or how (if at all) they are reflected in the legislation. It might be logical, if the plan allows for discrimination between employees on the

basis of length of service etc, that the 'four times' test should be applied only as between employees who are in the same position as regards all such distinguishing factors. However, if this is intended, there seems to be nothing in the draft legislation which implements it, and we believe it must be very doubtful whether it could be applied in practice given the endless permutations of length of service, remuneration and hours worked which are likely to exist within the workforce.

21. Paragraph D4(3) seems to disapply the 'similar terms' requirement altogether when method one is used. One might have supposed that the intention is that all employees must still be treated similarly except to the extent that differences are justified by objective differences in performance or by the factors mentioned in paragraph B4(2). However, the effects of paragraph B4(3) and D4(3), and the interaction between the two, are generally unclear.

22. Related to the above, the commentary says that under method two (and by implication not under method one) the awards must be made to all employees in each performance unit on similar terms, but it is not clear how this is implemented in the legislation. Again clarification on this point would be of assistance.

Paragraph D5

23. It is also unclear what purpose is served by the requirement in paragraph D5 for the performance measures etc. to be notified to the Revenue, given that they appear to have no power to refuse or withdraw the approval of the scheme if they consider these measures to be inappropriate.

Paragraph D9

24. Paragraph D9(1)(a) does not seem quite to cover the normal case of a takeover bid. In that case the new holding is equated with the old holding by reason of the bid being accepted by the necessary number of shareholders to become unconditional, not just by reason of acceptance of the offer for the free shares of the plan participant in question.

Paragraph E4

25. In paragraph E4(1), we would welcome clarification as to whether the limit is supposed to be the greater of £1,500 per annum and £125 per annum, or the lesser? As a matter of construction, since neither is specified, the simple 'or' seems to mean that the limit is the lesser of the two amounts, but we believe that would impose an unreasonable restriction on employees who are paid at intervals of longer than a month.

Paragraph E8, E9 and G5

26. We assume that the 'price' referred to in step 2 of paragraphs E8(2) and G5(3) includes any associated dealing costs, but we recommend that this should be made explicit.

27. It is not clear what circumstances are intended to be covered by clauses E8(3) and E9(4). One situation which clearly is covered is the case where a small amount of money is left over, representing the price of less than one share. However the application of these paragraphs is presumably intended to be wider than that, otherwise more specific language would have been used, as in paragraph G8(1). But it is not obvious what other circumstances could be relevant: it seems to be implicit in paragraphs E8(1) and E9(2), and in the calculations in paragraphs E8(2) and E9(3), that whatever money is available is to be used in acquiring shares, so that the only variable is the number acquired and there should never be any surplus cash, apart from fractional amounts and cases of outright error. In one sense any partnership share money used to 'acquire' shares which the trustees are able to appropriate out of their existing holdings is 'surplus', since it is left in the hands of the trustees, but this surely cannot be what is meant. Some clarification would be welcome.

Paragraph F3

28. In paragraph F3(3), does the employee have to be informed only if the ratio changes before any shares are acquired under the agreement i.e. before the first such acquisition, or if it changes before any subsequent acquisition as well? The former seems to be the better reading of the words used, but we believe the latter is what one would expect.

Paragraph G2

29. In the second line of paragraph G2(1) 'participants' should be 'a participant', to agree with 'on his behalf'.

Paragraph G6

30. In the second line of paragraph G6, we believe notice should also be given to the participant of the particulars mentioned when dividend shares are actually acquired on his behalf, not just when existing shares are appropriated for that purpose.

31. Nothing is said explicitly about the consequences of shares already acquired or appropriated under a plan ceasing to satisfy the requirements of part H, for example where they are shares in a parent company which ceases to have control of the plan company. On the face of it these requirements only have to be satisfied at the time of the acquisition or appropriation, so the subsequent change of status should not affect the approved status of the plan although it would of course preclude any further acquisitions or appropriations of similar shares. However, confirmation of this would be welcome.

Paragraph H7

32. We believe in paragraph H7(3) the employer should have the option of setting a forfeiture period of less than three years, as he has in paragraph H7(2).

Paragraph H8

33. Paragraph H8(2)(c) is presumably intended to apply only to persons acquiring shares in the circumstances mentioned in subparagraph (1)(b). As it stands, it could be read as requiring the preemption condition to be extended to all shareholders, so that a non-employee shareholder who wishes to sell is required to offer the shares on the same terms as an employee who is leaving his employment.

Paragraph I9

34. Paragraph I9 could be construed as requiring the trustees to pay the proceeds to the participant, if shares which have been forfeited by him are subsequently sold or appropriated to another participant as partnership or dividend shares. This is presumably not intended. We would welcome clarification on this point.

35. More generally, the trustees may come to hold unappropriated shares and/or cash as a result of forfeitures. The trust deed will have to make some provision for the disposition of these if they have still not been used for the purposes of the plan when it comes to be wound up, and probably also if at any time they come to exceed the reasonably foreseeable requirements of the plan. They might, for example, be returned to the company, given to charity, or transferred to a separate trust for the benefit of employees. Are there intended to be any restrictions on the provisions which may be made in this regard, or any special tax consequences?

Paragraph J4

36. It seems at least arguable that the ending of a forfeiture period, as well as the ending of the holding period, could be a chargeable event for the purposes of section 78, FA 1988. It would therefore be better, if only for the avoidance of doubt, for paragraph J4(2) to exclude both.

Paragraph J5

37. Paragraph J5 seems to require an identification rule, corresponding to paragraph J9(4).

Paragraph J6

38. Since the two subparagraphs of paragraph J6 are contradictory, it would be better to express subparagraph (1) as being subject to subparagraph (2).

Paragraph J9

39. We believe that the amount in paragraph J9(3)(a) should be reduced by any capital receipts already taxed, as in paragraph J5(2)(a).

Paragraph J10

40. The word ‘are’ is missing in paragraph J10(1)(a).

Paragraph J11

41. Does paragraph J11(4) imply that the plan may, or must, contain a provision requiring employees to leave the plan at the specified 'retirement age' even if that is not their actual retirement date under the terms of their employment? Nothing seems to be said explicitly about the consequences of a retiring age being specified in the plan, and this needs clarification.

Paragraph L2

42. One effect of defining the deduction in paragraph L2(2) by reference to market value rather than cost seems to be that any associated dealing costs are excluded. We would welcome clarification on whether this is intended. It might be reasonable to deny relief for costs involved in issuing new shares to the trustees, on the grounds that they relate in part to the change in the capital structure of the company itself, but we believe it is contrary to the general spirit of the proposed legislation to refuse a deduction for the necessary costs involved in purchasing existing shares from third parties at arm's length.

Paragraph L8

43. Paragraph L8 is extraordinarily draconian, in denying tax relief altogether for any period in which the trustees fail to act in accordance with the trust deed, even if such failure is inadvertent and trivial in extent. It should, at the least, be subject to mitigation to such extent as is just and reasonable in all the circumstances.

Paragraph L9

44. Paragraph L9 should be refined to show that it is referring only to deductions arising after the time with effect from which the approval is withdrawn.

Paragraph M3

45. Is 'the company' in paragraph M3(2)(c) the company which created the plan (the usual meaning of the phrase in this Schedule) or, if different, the one whose shares are used for the plan? Clarification is required here.

46. Paragraph M3(4) needs also to exclude differences in treatment which result from the key features of the plan, such as plan shares being subject to forfeiture while other shares are not.

Conclusion

47. We would be happy to meet with you and discuss the issues raised above further if that would be of assistance.

48. We would also welcome any feedback from you relating to this consultation process.

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