The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 - Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

Personal Tax Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

8 October 2014

Dear Sirs

Revenue Law Committee response to HR Revenue & Customs Open Consultation on New Employee Shareholding Vehicle

We write in response to the consultation document "New Employee Shareholding Vehicle", published by HM Revenue & Customs on 17 July 2014.

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Revenue Law Committee.

We welcome the opportunity to comment on the proposed new employee shareholding vehicle. We set out below our responses to the specific questions raised in the consultation document.

If you have any questions in relation to our comments, or would like to discuss any of the points raised, please contact Darren Oswick (partner, Simmons & Simmons LLP) on tel: 020 7825 3546, darren.oswick@simmons-simmons.com.

Responses to questions

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.

Private companies that wish to encourage share ownership amongst their directors and employees need a mechanism to facilitate that share ownership. In an ideal world, the number of sellers and buyers of shares within the employee population would always match, but this is rarely the case in practice. Therefore a warehousing vehicle is needed to bridge the gaps between buyers and sellers. In addition, it is often necessary to establish a vehicle that enables a means of providing completely free shares to employees as well as a means of creating a pool of shares in issue from the outset of an employee share scheme (e.g. following a management buy-out) even if it isn't clear who should receive them. Given the purpose of such a vehicle is one of mechanics it is usually commercially unacceptable for that vehicle to give rise to any tax leakage. Hence it is usually preferable to establish a vehicle such as an employee benefit trust in an offshore jurisdiction (such as Guernsey or Jersey), and ensure that the relevant arrangements are structured in a way which eliminates or minimises any tax liabilities arising from the use of that vehicle. It follows that any new vehicle will need to avoid tax leakage in the same way as offshore EBTs avoid such leakage.

Of the issues identified by the OTS, those that create the greatest complexity and administrative cost for companies when deciding whether to set up and operate shareholding vehicles are the disguised remuneration rules, the risk of IHT, tax on loans to finance the EBT and the transaction in securities rules. CGT is a particular driving factor behind the establishment of offshore EBTs.

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

The inheritance tax treatment of EBTs has been uncertain in a number of aspects as regards the use of EBTs for bonus planning, but less so as regards the use of EBTs as a pure warehousing vehicle for employee share schemes. The scope of the protection offered by s.86 IHTA should either be made entirely clear in the context of any new vehicle (and it should be entirely clear that such a vehicle will fall within its protection), or it should be simplified with particular regard to the additional requirements for close companies (to exclude participators holding more than 5%) and the charges that can arise under s.72 IHTA when payments are made to s.86 trusts.

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?

Firstly, s.239ZA was originally an extra-statutory concession, and was only enacted in 2009. The majority of EBTs in the market will have been established before 2009, and relying on an extra-statutory concession to provide a safe harbour from capital gains tax was often felt to be unsatisfactory when there was the alternative of establishing an EBT offshore, which has been a well trodden path for the last 30 years.

Secondly, private companies are often close companies (there are a number of close companies which are international businesses with hundreds of employees). Section s.239ZA does not apply if the beneficiary is an "excluded person", which includes a

participator in a close company with a 5% or greater shareholding. No equivalent restrictions apply to an offshore EBT.

Thirdly, one condition of s.239ZA is that the entire market value of the assets transferred out of the trust must be subject to income tax – meaning the trustee cannot receive any consideration. Accordingly, the exemption isn't available where shares are transferred out on the exercise of an option and the trustee receives the exercise price. Relaxing this condition would negate an advantage of establishing such trusts offshore.

Lastly, a further advantage of establishing trusts offshore is that, were an offshore trust to make actual gains, these are exempt from tax.

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?

As stated above, there are significant numbers of private companies that are also close companies, and s.455 will therefore impact on them. S.455 is a frequent issue for close companies operating EBTs and would, we expect, similarly be an issue for any new vehicle.

Sometimes it is possible to structure around the impact of these rules, e.g. by lending "clean" funds from a non-UK subsidiary that has derived those funds from a business carried on outside the UK. The time and cost involved in ensuring that the arrangement is not impacted by the rules is not, however, desirable.

It is common for EBTs to be funded by loans as it is never entirely certain how much funding an EBT will ultimately need. Companies don't want large surpluses building up in EBTs (once the money is in there, they can't get it back) and it is rarely the case that it can be repaid in time to prevent a s.455 charge from arising.

If it is accepted that it is commercially legitimate for such vehicles to borrow – the consultation refers to the possibility of bank borrowing – it would be preferable to disapply the provisions of s.455 to the new vehicle to enable the new vehicle to be funded by the company setting up the vehicle and other group companies. This is likely to be a cheaper source of funding for the vehicle than bank borrowing.

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?

Generally, clear legislation for a complete exclusion is significantly preferable to guidance (which can be subject to change in interpretation or withdrawal at any time). The transactions in securities rules are so widely drafted that, absent a specific statutory exclusion, there would always be a residual concern that they might apply to any arrangements involving the new vehicle.

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?

There is no special stamp duty / SDRT exemption which EBTs rely on. Stamp duty / SDRT is either due or not due depending on the nature of the transaction which the EBT

undertakes (essentially, whether it is dealing with existing shares or new shares and whether or not there is any consideration given for the relevant transaction). The position of the EBT is no different to the position of any other person who undertakes those same transactions.

However, the fact that stamp duty / SDRT charges are triggered when an EBT sources shares but not when new shares are issued is problematic and raises costs for the EBT in cases where charges do arise. It would be preferable if shares were treated in the same way, whatever their source.

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?

We believe it would be relatively unlikely that an EBT or other employee shareholding vehicle would ever control the employing company (or its parent) but it would be helpful to change the law to make it clear that, if one were to be in this position (perhaps unintentionally or for a short period of time), this would not lead to any loss of eligibility for tax-advantaged share schemes.

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?

The disguised remuneration rules are the worst example of anti-avoidance legislation currently on the statute book. The rules are incredibly difficult to interpret and the legislative exclusions are extremely narrow (often to the extent that they cannot apply in practice), and certainly cannot be relied upon without the benefit of expert advice as to what they actually mean. The guidance is often meaningless in practice. The only satisfactory approach would be to carve out the new vehicle from the scope of the rules altogether, either completely or at least where they are used in conjunction with an approved plan/there is no tax avoidance motive.

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.

Offshore EBTs are a well understood commercial proposition. Their tax treatment is not straightforward, but the market has developed solutions to the potential tax issues which are inherent in their structure. The market is unlikely to change to another structure which has the same (or different) issues – it will only change if the proposed vehicle has fewer (preferably zero) issues. It is perfectly possible to achieve this – all that is required is some political will and to persuade certain elements within HMRC that the use of such vehicles should not automatically be regarded as tax avoidance. We note HMRC's concerns about the abuse of EBTs (especially in the context of sub-fund arrangements) but it is but it is important for them to realise that in the vast majority of cases, EBTs are used for entirely practical, commercial reasons – not for the avoidance of tax. The unpopularity of QUESTS (which were very limited in their scope) demonstrates that a very inflexible vehicle is unlikely to be used.

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

If all of the other tax issues are solved, then it is probably unnecessary to include any further exemptions. However, given that there seems to be no particularly good reason for the restrictions on returning funds to a sponsoring company on the winding up of the vehicle, or for limiting the tax relief for loans to purchase shares in a close company to those with a 5% holding or those spending time in the management of the company, the removal of these restrictions would be welcome.

In addition, as discussed at Question 6, the fact that stamp duty / SDRT charges are triggered when an EBT sources shares but not when new shares are issued is problematic and raises costs for the EBT in cases where charges do arise. It would be preferable if shares were treated in the same way, whatever their source.

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?

We do not believe that these are areas which give scope of avoidance.

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?

Companies will only establish the vehicle onshore if there is a clear and workable exemption in the legislation from capital gains tax on any gains made by the vehicle.

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?

We think this limitation is unnecessary and unworkable. Former employees often receive benefits from EBTs in practice. Although most plans will provide for awards to be lost on cessation of employment, this won't always be the case. Companies may have good leavers who have exit based options that are not exercisable early but do not lapse on cessation of employment. The exit may not happen for a number of years. If they were excluded as beneficiaries under the trust after 5 years then it might not be possible for them to have the options satisfied by transfers from the trust. If HMRC believe that it is necessary, any time limit should be relatively substantial, e.g. 10 years.

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?

Any new vehicle will not be adopted if it contains these restrictions. Linking the identity of the potential participants to the use of the arrangements for tax avoidance is bizarre.

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?

These criteria seem fine, although we do not agree that participators should be excluded.

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

We agree that the vehicle should only be allowed to deal in "qualifying securities". However, we think that the list of "qualifying securities" is arguably limited and could lead to the issues experienced by QUESTS. For instance, loan notes could be included within the permitted securities. The rules should also make clear that the vehicle can pay fees and employers NICs.

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?

There should be limited effect provided it is clear what HMRC regard as accidental failure to fulfil the conditions, and that this would not lead to loss of exemption provided that it was remedied within a reasonable period of time.

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?

Any new vehicle is unlikely to be adopted if it contains these restrictions. Length of holding period should not be linked with avoidance.

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?

These restrictions would both be consistent with ensuring the vehicle is only used for its principal purpose, ie facilitating a market for employees to buy and sell shares in their employing company.

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

Trustees of offshore EBTs waive dividend rights to ensure that they do not receive taxable dividend income. An exemption should be introduced to exempt dividends received by the new vehicle (and instead tax them in the hands of beneficiaries as and when they are distributed).

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?

It would be very unusual to leave shares in the vehicle for that length of time. The only example which springs to mind would be where shares have been set aside for a particular role, e.g. a new chairman, and it proves difficult to find that person. We do not understand the need for a charge should shares be left in the trust for any particular period of time though and this could create practical difficulties.

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

It is likely that companies will only want to operate one employee shareholding vehicle, so if they have an existing offshore EBT, they will not move to a new vehicle without a compelling reason to do so. The government could encourage such a move by providing for an exemption from stamp duty / SDRT on the transfer of shares to the new employee shareholding vehicle.

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

We agree with the OTS's recommendations. HMRC should ensure that any changes are primarily dealt with in clear and concise legislation, and that guidance is not being used to provide exemptions that are not included in the legislation. The approach taken in the disguised remuneration legislation should be avoided at all costs.

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

The vehicle would potentially be used by any private company with employees that it wishes to make shareholders, where it expects there to be a market in those shares. Public companies that currently use EBTs as a source of shares for their employee share schemes may also move to the new vehicle provided they have a compelling reason to dispense with their existing EBTs.

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.

It will only be the default vehicle if (a) the tax treatment is either the same or better as existing offshore EBTs and (b) it is possible to switch from offshore EBTs to the new vehicle in a way that is tax neutral e.g. with an exemption from stamp duty / SDRT on transfer of shares 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?

This question is difficult to answer. It certainly wouldn't make them less likely to incentivise and reward employees through such schemes. Companies aren't put off from establishing EBTs under the current arrangements; it would simply make it easier and cheaper for them to set up an EBT if the tax framework was less complicated. The current situation involving multiple potential tax charges puts those companies that are unable to afford specialist advice at a disadvantage.

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?

We doubt that the new vehicle on its own would impact this. This is ultimately a commercial matter.

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.

It may not – it will depend whether UK service providers can provide the relevant services involved in the running of the vehicle more cheaply than offshore service providers do at the moment.

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?

Employee share schemes and shareholding vehicles do not just require tax advice – they require employment law advice, company law advice, trust law advice and regulatory advice. In order to be properly advised, clients need input on all of these areas and employee share scheme specialists are best placed to advise because they look at all of these issues on a regular basis.

Yours faithfully,

Simon Yates
Chair
The City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

Individuals and firms represented on this committee are as follows.

S. Yates (Travers Smith LLP) (Chairman)

H. Barclay (Macfarlanes LLP)

B. Coleman (Ropes & Gray International LLP)

C.N. Bates (Norton Rose Fulbright LLP)

D. Friel (Latham & Watkins LLP)

D. Oswick (Simmons & Simmons LLP)

D. Winter (Linklaters LLP)

C. Hargreaves (Freshfields Bruckhaus Deringer)

C. Yorke (Allen & Overy LLP)

K. Hughes (Hogan Lovells LLP)

G. Miles (Slaughter and May)

J. Scobie (Kirkland & Ellis LLP)

N. Mace (Clifford Chance LLP)

C.G. Vanderspar (Berwin Leighton Paisner LLP)

I. Zailer (Herbert Smith Freehills LLP)