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Client Alert Commentary

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UK Employment Law and Share Incentive Developments Spring 2014

Changes to LLP member taxation and employee incentive schemes could have wide ranging implications for UK employers.

Background

As always 6 April means a new UK tax year and a raft of employment and employee-tax related legislative developments. This *Client Alert* summarises the key changes which came into effect on 6 April 2014 and certain other key developments on the horizon. Employers of UK-based employees, particularly those operating or considering implementing share-based incentives, should ensure they understand the changes.

Taxation of LLP Members

The UK government introduced new tax legislation on 6 April 2014 which governs how members of a limited liability partnership (LLP) are taxed on the income they derive from the LLP. Our earlier Client Alert *UK Tax Shake Up for Partnerships* summarised the three conditions that Her Majesty's Revenue & Customs (HMRC) will apply to determine whether a member of an LLP should be taxed as an employee (and therefore subject to employee and employer National Insurance contributions (NICs) via pay-as-you-earn or PAYE) rather than taxed as a "true" partner, or on a self-employed basis. Broadly, if a partner fails any one of these conditions, the partner's income should not become subject to these withholding taxes under PAYE.

The three conditions:

- *Condition A* – the member performs services for the LLP and it is reasonable to expect that at least 80 per cent of the total amount payable by the LLP for the member's services will be fixed, or variable other than by reason of the profits or losses of the LLP.

- *Condition B* – the member does not have significant influence over the affairs of the LLP.

- *Condition C* – the member's capital contribution to the LLP is less than 25 per cent of the amount which it is reasonable to expect will be payable to the member as "disguised salary" during the relevant tax year.

When the draft legislation was published in December 2013, it was met with considerable confusion from banks and professional service firms. On 21 February 2014, HMRC issued new clarifying guidance. The new guidance (and legislation) states that, if it is reasonable to expect that at least 80 per cent of the amounts payable to the member for services to the LLP will be fixed, that member will be taxed as an employee. Accordingly, if variable pay comprises at least 80 per cent of the member's income from the LLP and is linked to the LLP's performance, the member will "fail" this employment test and can continue to be taxed as a partner. This distinction could cause difficult consequences for lateral hires who are guaranteed a fixed amount for the first year of service.

Most members of LLPs seem inclined to fall outside of this new legislation by attempting to "fail" Condition C. A member who makes a capital contribution to the LLP of at least 25 per cent of the member's likely annual draw will not be deemed an "employee" for tax purposes. HMRC has extended the deadline for making this capital contribution so that a commitment in place before 6 April 2014 to make the contribution within three months will count, meaning the member remains outside of the new rules and can be taxed as a "true" partner.

Early Conciliation

Perhaps the most headline-grabbing development for UK HR managers is the introduction of new rules requiring employees to attempt mandatory early conciliation with the Advisory Conciliation and Arbitration Service (ACAS).[1] Before an employee (or prospective or former employee) can file a claim in the employment tribunal they must now attempt to resolve the dispute through ACAS. Provided both parties agree to try conciliation, a one-month conciliation period (which can be extended by 14 days) will follow. The various time limits in which employees can bring employment-related claims will be extended to accommodate this early conciliation. The requirement to attempt conciliation before filing a tribunal claim only applies to claims presented on or after 6 May 2014 — although the process is available for claimants presenting claims from 6 April 2014.

Whether this new mandatory process will reduce the number of claims which are filed with the tribunal or whether this will simply become a new box-ticking exercise remains to be seen. Although the government has tried to keep the new process simple to avoid "satellite litigation" around compliance with the early conciliation rules, the new procedure impacts the various litigation time limits in complex ways likely to confuse both employees and employers.

Other employment law changes

The following employment law changes also came into effect on 6 April 2014:

- *Employer fines* – employers defeated in employment tribunal claims potentially face fines of up to £5000 if the case has "aggravating features". Fines will be payable in addition to any compensatory awards made by the tribunal.

- *Discrimination questionnaires* – employees filing discrimination claims can no longer submit statutory discrimination questionnaires. Employee claimants can still ask questions informally of their employer in connection with any discrimination claim. The tribunal can draw adverse inferences if an employer refuses to respond or provides an evasive answer, but hopefully abolishing the questionnaire process will reduce the number of excessive questions asked in the context of discrimination litigation.

- *Whistleblowing* – the "whistleblowing" legislation has been amended to clarify that an employee can make a "protected disclosure" to a UK Member of Parliament potentially triggering whistleblower protection against dismissal or detriment.

- *On-shore intermediary reforms* – new rules have been introduced requiring income tax and NICs to be withheld from payments to “workers” who provide services to end users via UK based “intermediaries”. The new rules are designed to tackle so-called “false self-employment”. Workers who are not under the “direction, supervision or control” of another person (and therefore are genuinely self-employed) are exempted. From October 2014, companies which engage workers and do not withhold income tax and NICs from the workers’ earnings will be required to disclose the workers’ details to HMRC. This disclosure will likely lead to increased HMRC scrutiny of self-employed arrangements.

Other employment law changes coming soon

- The UK government is currently consulting on how to incorporate “caste” discrimination into the existing race discrimination rules.

- Effective from 1 May 2014, the amendment to the *Transfer of Undertakings (Protection of Employment) Regulations 2006* (TUPE) will require transferors to provide employee liability information 28 days prior to the relevant TUPE transfer. The current 14-day time limit is widely seen to be impractical. See our earlier Client Alert *TUPE Developments: February 2014 Changes to UK TUPE Regulations* for further information on the recent changes to TUPE.

- On 30 June 2014, the right to request flexible working will be extended to apply to all employees, not just those with parental or care-giving responsibilities. The current, prescriptive procedure which employers must follow when responding to requests will also be replaced with a simpler code of practice requiring employers to consider requests in a “reasonable” manner.

New Statutory Rates and Limits effective from 6 April 2014	
Limit of a week’s pay for calculating statutory redundancy pay	£464
Maximum basic award for unfair dismissal/ statutory redundancy pay	£13,920
Maximum compensatory award for unfair dismissal	£76,574
Statutory maternity, paternity and adoption pay weekly rate (after the first six weeks’ at 90 per cent of pay)	£138.18
Statutory sick-pay (per week)	£87.55

Changes to Share Incentives

New self-certification process of tax-approved plans

A number of reforms came into effect on 6 April 2014 which form part of the UK government’s initiative to simplify and promote employee share ownership (see our earlier Client Alert *A Stake in the Business — Simplifying Employee Share Ownerships* for more information). Perhaps most strikingly, one reform introduces a new “self-certification” system which now applies to tax-approved share plans. Employers looking to implement tax-efficient Company Share Option Plans (CSOPs, which are similar to incentive stock option (ISO) plans in the US), Save-As-You-Earn Plans (SAYEs, which are similar to employee stock purchase plans (ESPPs) in the US) and Share Incentive Plans (SIPs) no longer must apply to HMRC for prior approval of the schemes. Instead employers can use a new online system to "self-certify" that the schemes comply with the relevant UK laws. HMRC can enquire into the operation of any approved share plan if HMRC believes that the scheme is not operating in accordance with the applicable requirements of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). If appropriate, HMRC can impose penalties for failure to comply.

Companies currently operating any of these tax-approved plans are required to notify HMRC online of their existing plans by 6 July 2015 and declare that the plan meets the applicable ITEPA requirements. Note that Enterprise Management Incentive (EMI) plans, although tax-efficient, have never been subject to the requirement for HMRC prior approval. However, from 6 April 2014 employers must file online the Form EMI 1 notifying HMRC of the grant of an EMI option.

The simplified process for implementing tax-efficient share plans is good news for employers. Although a number of strict qualifying criteria still apply to these plans, removing the administrative burden of the approval process should encourage more companies to adopt these plans — which in turn allows employers to incentivise employees tax efficiently.

Tax-approved plans – other developments

The following amendments to the operation of UK tax-approved share plans also took effect on 6 April:

- *CSOP and SAYE change in control provisions* – SAYE and CSOP plans can now include rules allowing for options to be exercised up to 20 days before or after a change in control and upon a "non-UK company reorganisation" without forfeiting the relevant tax reliefs. These new rules should allow employers more flexibility to operate SAYE and CSOP plans in the context of corporate transactions, particularly if the parent company whose shares are under option is a non-UK entity.

- *New "purpose" test* – CSOP, SAYE and SIP plans are now subject to a simplified "purpose" requirement. Now the plan must intend to provide benefits to employees in the form or share options or shares, the plan must not provide benefits otherwise than in accordance with the relevant ITEPA rules and, specifically, the plan cannot allow for cash payments (*i.e.* cash-cancellation of awards). This test is clearer than the previous test which prohibited provisions in any tax-approved plan which were not "essential or reasonably incidental" to the provision of benefits to employees. The old phrasing significantly confused employers seeking to add rules to their approved plans which were not envisaged in ITEPA. The new purpose test should allow more flexibility for employers to incorporate US top-plan rules into their UK sub-plans so that the plans dovetail better.

- *Amendment to limits* – the annual limits of SIP partnership shares and free shares increased from £1500 to £3000 and £1800 to £3600 respectively. The monthly saving limit applicable to SAYE plans increased from £250 to £500.

- *SIP forfeiture provisions* – companies can now apply forfeiture provisions to dividend and partnership shares which are awarded pursuant to a SIP, provided the shares are forfeited for the lower of cost or fair market value.

- *CSOP amendments* – additional rules relating to CSOP options include: restrictions on how options can be amended after grant, a requirement for certain prescribed information to be included in award agreements, and a requirement for options to be exercisable during the period between the third and tenth anniversary of the date of grant and for 12 months (as opposed to six) after a participant dies.

Employers with existing approved-option plans in place should consider updating their plan rules to take advantage of some of the new changes which will allow them to operate their approved plans more flexibly, particularly if the approved plan is a sub-plan to a US top-plan.

New tax reliefs when operating an employee benefit trust

Employee benefit trusts (EBTs) are often used in connection with operating share plans in the UK to "warehouse" company shares which are subject to options or other share awards. As part of the government's attempts to promote employee share ownership, two new tax reliefs became available on 6 April 2014 for transactions involving EBTs:

- Since 6 April 2014, a new capital gains tax (CGT) relief is available upon the sale of a controlling interest in a business to an EBT. This relief is intended to encourage business owners selling their interest in a company to divest value to employees, via an EBT.
- From 1 October 2014, a new relief from income tax (but not NICs) will be available for bonuses of up to £3,600 which an EBT pays to employees — provided the employees are employed by a qualifying "employee-owned" company (*i.e.* where a qualifying EBT holds a controlling interest in the company).

In practice, the criteria an EBT must meet to qualify for these new reliefs are stringent and may prevent their wide use. To address this concern, and to prevent companies needing to re-draft existing trust deeds, separate new rules will enable an EBT to meet the new criteria and qualify for the CGT relief. However, these restrictive "deeming" rules could easily trip up a number of employers looking to benefit from the new tax reliefs.

Other reforms affecting employee share-ownership arrangements

The following notable changes also took effect on 6 April 2014:

- *Corporation tax relief changes* – if an unlisted company (*e.g.* a company under private equity ownership) acquires a listed or independent company, the company is allowed a 90-day grace period in which a corporation tax deduction will be available in respect of shares acquired by employees in connection with the transaction. This means that a corporation tax deduction may now be available for employee options exercised over target shares within 90 days after a change of control. The corporation tax deduction has also been extended to cover shares acquired by certain overseas employees who are providing services (*e.g.* on secondment) to the relevant UK entity claiming the relief.
- *Rollover of restricted securities* – restricted shares can now be exchanged for other restricted shares without triggering income tax, provided the exchange meets certain criteria.
- *Deferred/partly-paid and nil-paid shares* – the relevant tax rules have been amended to limit the risk of employees paying income tax on deferred payment shares if the employee still has a loan outstanding on the shares.
- *Longer period for making good tax on notional payments* – employees now have 90 days from the end of the relevant tax year (not 90 days from the notional payment date) to reimburse their employer if income tax has not been withheld, before failing to pay the initial tax is treated as a taxable payment subject to an income tax charge under s.222 ITEPA.

Conclusion

UK employers should ensure they have reviewed relevant employee incentive plans as soon as possible to benefit from the new opportunities for tax relief.

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Endnotes

1 The Advisory Conciliation and Arbitration Service is a UK independent organisation mandated to liaise with both parties in an employment dispute with regard to possible settlement of the claim.