EQUITY INCENTIVES LIMITED

News on share based rewards

Statutory corporation tax deduction announced

27 November 2002

Pre-Budget Report

New legislation announced in the 27 November 2002 Pre-Budget Report promises to make it easier to claim a tax deduction for the costs of an employee share scheme but anti-avoidance provisions threaten some employee trust based share schemes.

In particular, the legislation will not help companies that, because of their corporate structure, cannot operate Inland Revenue tax approved plans, and may adversely affect companies that have established employee benefit trusts (EBTs) for the indefinite retention of shares for employees.

Statutory corporation tax deduction

The Government has announced the:

> "introduction of a statutory corporation tax deduction for the cost of providing shares for employee share schemes, for accounting periods starting on or after 1 January 2003, to further encourage employee share ownership".

The draft legislation will be published on the Inland Revenue website. The full explanation provided in the Pre-Budget Report is as follows:

"Corporation tax (CT) and employee share schemes

Currently employers are not guaranteed a CT deduction for their employee share schemes. Instead there is a mixture of statutory and 'case-law' routes by which a deduction might be obtained. Following widespread support during informal consultation in summer 2002, the Government is introducing a statutory CT deduction for the cost of providing shares for employee share schemes. This will provide companies with the certainty of getting a CT deduction, and encourage more companies to set up employee share schemes.

The statutory CT deduction will be available for employee share schemes where the employees are subject to UK tax on award of shares, or would be but for the fact that the shares are obtained under an Inland Revenue approved scheme or Enterprise Management Incentives. This makes the UK regime more generous than the US, where the CT deduction is limited to the amount taxable on the employee.

Smaller companies in particular will benefit from the certainty of the CT deduction when offering share participation to their employees. They will not need to set up complex and expensive trust structures in order to generate a CT deduction for the cost of shares.

The rules relating to Qualifying Employee Share Ownership Trusts (QUESTs) are being changed at the same time to remove duplication and simplify the statutory rules for the CT treatment of share schemes. Companies using QUESTs for Save-As-You-Earn schemes will continue to receive a similar deduction under the new rules. In addition, CT benefits currently enjoyed by small family-owned companies using QUESTs will be preserved by the provisions of the Employee Share Schemes Act 2002 that made some changes to the CT provisions in the Share Incentive Plan legislation."

The prospect of getting a CT deduction without routing payments through EBTs is helpful but this is not the only reason EBTs are used. The Pre-Budget Report has more to say on EBTs.

New EBT law

The Government has also announced new legislation on EBTs. This new legislation:

> "will defer the contributor's corporation tax deduction until a payment is made out of the EBT in a form that gives rise to a liability to income tax and national insurance, and will apply for contributions made on or after [27 November 2002]. Changes to the national insurance regulations, which come into force [on 28 November 2002], will make clear who has ultimate responsibility for paying national insurance".

The new EBT legislation is anti-avoidance legislation. Many UK based businesses, particularly those who pay large cash bonuses, use offshore EBTs to mitigate income tax and national insurance contributions. The new legislation provides a comprehensive set of rules for determining when deductions can be made, in computing an employer's taxable profits for payments made to a third party (including the trustees of an EBT) to hold or use to provide benefits to employees. These provisions replace existing rules in Sections 43 and 44 Finance Act 1989 which dealt, to a limited extent, with the timing of deductions for potential emoluments held by an intermediary. The legislation does not apply to any deduction that is allowable in respect of contributions under a retirement benefits scheme or personal pension scheme. The Government states that the new EBT law will not adversely affect companies contributing to trusts that qualify for relief under the proposed statutory corporation tax deduction. However, this is not a comprehensive assurance and some employee trust based share schemes may be adversely affected.

The new EBT law together with explanatory notes are available on the Inland Revenue website (http://www.inlandrevenue.gov.uk/).

What now for case law?

Equity Incentives Limited will try to clarify with the Inland Revenue what happens, in particular, to those companies that cannot benefit from the new statutory corporation tax deduction.

The new CT deduction law will use a definition of "qualifying shares" which is broadly in line with the conditions for eligible shares in approved plans. Companies that cannot operate Inland Revenue approved share or share option plans (John Lewis Partnership, Scott Bader Commonwealth and others) will it seems, yet again, be discriminated against.

There are companies who wish to retain shares in an EBT. They may find the EBT anti-avoidance provisions block a tax deduction and prevent the use of case law as a fallback. Equity Incentives Limited has worked hard to promote the importance of sustaining employee share ownership through the indefinite retention of shares in an EBT. It is vital the Inland Revenue confirms that case law deductions in such cases will not be adversely affected by the new law.

Equity Incentives' news on share based rewards is distributed free of charge. For more information, contact Graeme Nuttall, Sarah Anderson or another member of the Equity Incentives team on 020 7861 4717 or by email on info@equityincentives.co.uk. Our website is www.equityincentives.co.uk. To unsubscribe from this newsletter please contact us either by email or by telephone.

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