



THE TIME IS RIGHT TO OFFER SHARE INCENTIVES TO EMPLOYEES

In recent years, share incentives have become a common component of an employee's remuneration package, and, for many companies, tailored arrangements designed for key employees can be critical to their recruitment and retention.

However, over the last 12 months, the value of many companies has fallen significantly, and as a result many share incentive schemes are "under water" and have no value. Many companies are therefore currently looking to take advantage of the low share values to offer new share incentive schemes to their key employees.

Due to tax changes introduced by the current Government, the profits accruing to employees from share incentives can easily fall to be taxed at marginal income tax rates of 40%. Furthermore, National Insurance Contributions ("NIC") can increase the overall tax cost to an effective rate of 48%.

Nevertheless, with careful planning, certain share incentive schemes can benefit from being outside the scope of income tax, and instead be subject to the more favourable capital gains tax ("CGT") rate of 18%.

Indeed, there are two common types of flexible "unapproved" Share Incentive Schemes that benefit from the 18% CGT rate, and these schemes are frequently used by public and private companies. These are Enterprise Management Incentives ("EMI") options, and "Restricted" Shares, and these are detailed below.

EMI Options

Share options are a very flexible way of providing incentives to employees, but options that are unapproved by HMRC are not tax efficient because the whole of the profit is liable to income tax and NIC when the options are exercised, generating an overall tax cost of up to 48%.

Unapproved options can, however, qualify for favourable treatment if they are EMI options. EMI treatment is afforded where the following principal requirements are met:

- The employee works full time for the company (generally at least 25 hours per week),
- The company's gross assets must not exceed £30m when options are granted,

- The company must be a trading company and must not be controlled by another company,
- An individual can only be granted an EMI option over shares of up to £120,000,
- The company can only grant EMI options over shares worth up to £3m in total, and
- The company can only issue EMI options if it has fewer than 250 employees.

There is no exposure to income tax or NIC if the EMI options are granted at an exercise price of not less than the market value of the shares at the date of grant. Future growth in share value is then subject to the 18% CGT rate, and this CGT only arises when the shares are sold, not when the options are exercised.

Restricted Shares

Where EMI status is not available or not suitable, then a similar type of commercial arrangement can be achieved by issuing "restricted" shares that are subject to forfeiture in certain circumstances.

For instance, an option might be granted that vests only after the individual has served three years of employment. The profit realised on such an unapproved option, where it does not qualify for EMI status, is potentially fully liable to income tax and NIC at an effective rate of 48%.

However, if instead of being issued with an option, the employee is issued with "restricted" shares (that are forfeited if three years of employment are not achieved), then the commercial relationship is the same, but any future profit on the shares will be subject to only 18% CGT.

This favourable tax treatment is achieved by the employee and employer entering into a tax election within 14 days of the "restricted" shares being issued. The effect of the election is to apply income tax and NIC to the unrestricted value of the shares at the date of share issue (giving an upfront tax charge), but any future growth in value of the shares will then only be subject to CGT.

Summary

Many companies are currently taking advantage of low share values to offer new share incentive schemes to their key employees. With careful planning, share incentive schemes can be designed to benefit from the 18% CGT rate rather than the 48% income tax and NIC rate.

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DON'T GET CAUGHT OUT IF YOU ARE PAYING NON-EXECUTIVE DIRECTORS

Recently, we have seen a significant rise in HMRC's enquiries into payments made to non-executive directors where they have not been subject to the PAYE regulations. Payments to non-executive directors are often made on the basis that the non-executive is self-employed. This is based on the misconception that non-executive directors can be treated as consultants without the need to deduct PAYE. However, HMRC take the view that payments to a non-executive director for services as a director are remuneration, and therefore the PAYE rules apply even if that individual has significant other self-employment income.

Care should therefore be taken, and companies should review payments to non-executive directors, to determine whether the payments are for services performing the functions of director, or for consultancy. If payments are a combination of both, then a separate consultancy agreement should be drawn up with the individual to ensure that, at a later date, it can be argued that there is a distinction between the two payments made, especially if one is made without the deduction of PAYE.

Any payment which is made to a non-executive director for performing the functions of a director (such as attending Board Meetings) will therefore be subject to PAYE. The only exception is payments that are made to a company or LLP that is providing the services of the non-executive director. HMRC by concession allow these payments to be made gross without the deduction of PAYE. The company should however ensure that it has valid invoices from the limited company or LLP in respect of these payments.

ONE MAN'S MARKETING IS ANOTHER MAN'S ENTERTAINING

Almost all businesses need to undertake some form of entertaining or marketing to promote their goods and services. The problem comes when the costs are charged to marketing when they would be considered by HMRC to be entertaining. The reason for the distinction is that VAT cannot be reclaimed on entertaining and the business would not get a tax deduction for entertaining costs.

Valid marketing costs such as mail shots and advertising, are a deductible expense of the business. However, entertainment is not. This makes the cost of entertaining significantly higher for a business than the actual cost of the expenditure.

When reviewing these expenses, businesses need to look behind the expenditure to determine the actual physical activity that took place that incurred the expenditure. One simple test is to determine whether food and drink were involved. This usually indicates that the nature of the activities were more in line with entertaining than marketing, although these can be blurred. Taking a customer to Ascot would clearly be deemed to be entertainment, and the whole cost would therefore be disallowable, as would the VAT incurred.

Another example, which is more blurred, is where a business promotes its services by a seminar, which is followed by drinks and canapés. The expenditure incurred on the drinks and canapés would not be allowable, and the VAT could not be recovered, but the other costs of putting on the seminar could be deemed to be marketing and therefore deductible.

HMRC are increasing their interest in marketing expenditure and reviewing closely the levels that businesses are claiming under this heading. Particular sectors have been targeted, including the pharmaceutical industry, where examples include marketing to doctors by way of expensive conferences in ski resorts. These have been attacked and deemed to be entertainment rather than marketing.

As a result, if you are unsure as to whether an event will be deemed to be marketing or entertainment, then advice should be sought before the expenditure is incurred. This is because the actual cost could be significantly higher to the business if it is deemed to be entertainment at a later date.

NOW IS THE TIME TO FILE FORM 42

The filing deadline for Employment-Related Security Returns (Form 42) for 2007/08 is 6 July 2008. The Form 42 asks for details of reportable events in relation to securities and options that are obtained by reason of employment. Reportable events include the acquisition of securities (including by the exercise of an option), or the acquisition of an interest in securities by a person by reason of their employment.

If a Form 42 was completed last year, then HMRC will have automatically issued a notice to the taxpayer to complete a form for 2007/08. Even if there have been no reportable events in 2007/08, a declaration to that effect still needs to be made on the Form, and this must be submitted by the filing deadline of 6 July.

HMRC can impose an initial penalty of up to £300 for failure to submit the Form 42 by the deadline, plus penalties of up to £300 for each reportable event. Further penalties of up to £60 per day can be imposed if the Form remains outstanding.

WATCH OUT FOR THE NEW VAT PENALTIES

For VAT periods starting on or after 1 April 2008 there is a new penalty regime. Previously the serious mis-declaration VAT penalty was set at a 15% rate, but the penalty rates are now much higher.

Penalty percentages will now be applied to additional VAT due as a result of correcting an error, as follows:-

- The penalty is up to 30% of the potential lost revenue if the error is "careless",
- The penalty is up to 70% of the potential lost revenue if the error is "deliberate", and
- The penalty is up to 100% of the potential lost revenue if the error is "deliberate" and the taxpayer "conceals" it.

It will therefore be important for businesses to show that reasonable care has been taken in preparing their VAT Returns. Not only will HMRC look at the preparation of the VAT Returns, they will also review the underlying accounting systems. In addition, obtaining expert advice on complex VAT issues will be evidence of reasonable care being taken by the taxpayer.

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