

PARTIAL REGULATORY IMPACT ASSESSMENT (RIA)

Corporation Tax Relief and Employee Share Schemes

Introduction

1. The Government wants to encourage growth in productivity, and believes that employee share award and share option schemes have a role in this by linking employees' interests with those of the company and its other shareholders. Research has found a clear link between widespread employee share ownership and company performance.
2. Employee share option and share award schemes are commonplace in remuneration packages of larger companies but, unlike cash remuneration, there is no automatic corporation tax (CT) deduction for the costs of many of these schemes. Despite this, many large companies obtain CT deductions by using arrangements involving trusts.
3. The cost and complexity of such arrangements act as a bar to smaller companies making them less likely to secure a CT deduction. Even larger companies find the arrangements burdensome and they do not necessarily provide tax certainty.

Purpose and intended effect

4. The proposed statutory deduction is designed to encourage and enable companies to set-up or expand employee share schemes by removing the need for complex arrangements solely to obtain a CT deduction. It levels the playing field between the use of cash and equity as remuneration and provides:
 - greater clarity
 - fairness between all companies, and
 - reduced bureaucracy

Risks

5. The proposals address the issue that if action were not taken smaller companies in particular would not benefit from the productivity gains that can accrue from offering employees share award and share option schemes. Currently, smaller companies either do not obtain a CT deduction or are deterred from setting up schemes because of the need to enter into complex and expensive arrangements in order to get a deduction. These proposals ensure appropriate relief to all companies, irrespective of size.

Options

a) No Change

6. It could be argued that change is not required because companies already offering employee share schemes will do so regardless of whether changes are made to the CT deduction rules. While many companies already achieve a CT deduction the processes involved can be complex, expensive and open to challenge by the Inland Revenue. These factors deter smaller companies from adopting them.
7. The no change option does not address the risks, continues to disadvantage smaller companies and retains uncertainty surrounding eligibility to a CT deduction.

b) Statutory Relief

8. The legislative option levels the playing field between remuneration in the form of cash and shares and enables all companies to obtain comparable CT deductions, irrespective of size or structure. A CT deduction would be available where the employee is chargeable to UK income tax as a result of receiving shares or exercising share options, or would be but for relief under an Inland Revenue “approved” scheme or Enterprise Management Incentives (EMI). This ensures that companies operating “approved” schemes also benefit from the new rules. The Share Incentive Plan (SIP) already has a CT deduction. It is not proposed to amend the SIP rules.
9. The introduction of a modern, simple and fair system underpinned by legislation provides certainty to companies in terms both of timing and amount, reduces administration and reduces compliance costs. The proposals are in some instances more generous than the treatment currently available elsewhere.

Benefits

10. Companies will not have to use complex arrangements specifically to gain a deduction, particularly in respect of newly issued shares. It should also reduce administrative costs of those currently using trust arrangements. Typical cost for the set up of the current arrangements are estimated to range from £5,000 to £25,000 depending on the size of the company and complexity of arrangements. Similarly, typical annual running costs for these arrangements are estimated to range from £2,000 to £10,000. For the largest companies the set up cost could rise to £100,000 with annual running costs of £10,000 to £30,000 plus internal staff costs of about one day per month.

We would welcome views on the above costs and the likely savings for companies with the provision of a statutory CT relief.

11. Approximately 5,000 companies that currently operate employee share schemes will potentially benefit, as will other companies which set-up employee share schemes in the future.
12. Allowing a CT deduction for the cost of awarding shares or satisfying share options instead of paying cash will level the playing field between cash and shares as forms of employee remuneration.
13. The employing company will be eligible to obtain the CT relief. The amount of the new deduction is '*market value less employee contribution*' which also forms the starting point of the Schedule E and National Insurance contributions (NICs) charges. Employers maintain records to enable them to make returns of share acquisitions by employees and they should be able to enhance those systems to provide data relating to the timing and amount of the new deduction without creating additional administrative burdens.
14. Accountancy treatment of share based payments is currently under review. Neither the IASB proposals nor FRED 31 change the principles applicable to the tax treatment of share schemes. A statutory framework provides companies with certainty without the need for complex structures and makes a clear link with taxation of the shares in the employees' hands.

Exchequer Costs

15. Due to the variety of share award and share option schemes, coupled with the current requirements of UK Generally Accepted Accounting Principles (UK GAAP), it is difficult to establish precisely, the number of companies using equity to remunerate their employees or the amounts involved. Data can be easily extracted for Inland Revenue tax advantaged schemes but not so easily for other schemes.
16. The table below shows how much a statutory CT deduction will cost the Exchequer. It makes assumptions about how companies currently operate schemes and how this might change if a statutory deduction is introduced. Those assumptions take into account factors like company structure and size, volume of share awards and the effect of accounting principles and are based on deductions being available for accounting periods starting on or after 1 January 2003.

Tax Year	2003-04	2004-05	2005-06	2006-07	2007-08
CT (£ million)	+5	-45	-75	-85	-95

Implementation costs

17. The timing and amount of the CT deduction is matched as far as possible with the Schedule E charge on the employee. Therefore although the rules depart from the accountancy treatment they should not give rise to significant extra work for companies.
18. Some unquoted companies may require additional valuation work in relation to their shares where there is no Schedule E charge (usually as a result of operating a tax advantaged scheme) but that should be outweighed by them getting a CT deduction they may previously have forgone.
19. Companies will need to track share options and share awards during the transitional period to avoid double deductions in respect of the same shares under the old and new regimes. They already have to track shares for accounting purposes so this proposal requires only that this data is used to quantify accounting adjustments and CT deductions.

Competition Assessment

20. We have undertaken a competition assessment and the competition filter indicated that the proposed statutory CT deduction should not have any adverse effects on the competitive process in the markets affected. Rather, any impact on competition is likely to be positive because the reduction in costs will be most acute for smaller companies. This will encourage more use of existing schemes. It will also encourage more small companies to offer shares or options to their employees. The competitive process should benefit through the improved ability of smaller companies to recruit and retain the skilled workers they need to become more competitive.

Securing Compliance

21. No new compliance regime is required to enable the Inland Revenue to deal with company accounts or CT Self-Assessment returns. The proposals provide a deduction in computing profits for CT purposes.

Implementation Guidance

22. Initial guidance will be in the form of explanatory notes to accompany the publication of the draft legislation. This will be followed with updates on the Inland Revenue website in the form of Questions and Answers. After Royal Assent of Finance Bill 2003 an article in Tax Bulletin will be published. Guidance will be included with the Revenue's internal guidance material relating to the computation of Corporation Tax profits that is used by both Inspectors and customers.

23. Most companies will follow their current established practice of preparing and submitting CT computations of profits. The proposed new CT relief will not alter that practice in principle but will impact more on the timing and amount of the CT deduction in respect of employee share schemes.

Impact on Small Business

24. A key objective is to encourage small and medium sized companies to set-up employee share option and share award schemes by making the CT deduction rules simpler. Although this should help improve companies' performance, it is difficult to predict how many small companies will set-up schemes. Despite this, the proposals can be seen as part of the Government's wider aim of creating the right environment for small companies to grow and prosper.

25. Smaller companies spoken to consider the proposals an incentive that will encourage them to use equity remuneration more widely.

Consultation

26. Informal consultation was undertaken between May and September 2002 by talking directly to companies to establish:

- how they currently achieve CT deductions for employee share schemes
- their views on whether the tax should follow accountancy treatment, either current whatever the future standard might be
- their views on the resulting deferral of relief in a limited number of cases
- whether they supported the proposals in full or in part
- their views on whether S67 FA 1989 relief should be retained or abolished as part of these proposals

27. 70 companies were selected at random to include large multinationals, medium sized plc's and small private companies covering trades such as banking, IT, manufacturing and pharmaceuticals. 19 accepted the invitation to meet with Inland Revenue officials. In addition we met with a number of share scheme advisers to discuss the same issues.

28. The overwhelming view is that companies welcome the proposed changes but emphasised that they would like a system that is easy to understand and apply. Companies are not unduly concerned about the timing issues, favouring certainty above all else.

Monitoring and Evaluation

29. The main effect of the legislation will be to provide certainty of a CT deduction in terms of timing and amount. It will be monitored on the same basis as currently adopted for the review of company self-assessment tax returns. We should observe declining use of trusts in operating share schemes. In addition we will undertake a review of a sample of companies to establish the effects of the new legislation on how they operate their employee share schemes. This review will be conducted informally through the Inland Revenue network and large business offices as well as contact with representative groups once companies have had a reasonable period of time to apply and benefit from the new legislation.

Contact Point

Hasmukh Dodia
Share Schemes Team
Capital & Savings
Room 138, New Wing
Somerset House
Strand
London WC2R 1LB
Tel No: 020 7438 7504
Email: Hasmukh.dodia@ir.gsi.gov.uk