

REGULATORY IMPACT ASSESSMENT

NICs ON UNAPPROVED SHARE OPTIONS GRANTED DURING 6 APRIL 1999 – 19 MAY 2000

INTRODUCTION

1. Since 6 April 1999 National Insurance Contributions are charged on gains arising when share options are exercised, assigned or released outside an Inland Revenue approved scheme if the shares are readily convertible into cash. While employers can plan for NICs on regular pay, it is not as easy for them to plan for NICs on share options, particularly where the share price is volatile.
2. Under accountancy rules companies are required to make a provision in their accounts for the anticipated NIC liability on share options based on the market price of the shares on the date that they prepare the accounts. Employers have expressed concern that their exposure to an unpredictable NIC liability could put at risk their investment strategies and even make some technically insolvent.
3. Legislation was introduced in July 2000 to allow employees to bear the employer's NIC when they make a gain on their share options. However, some companies have said that they cannot make such agreements with their employees if an option has already been awarded. Many employers have said therefore that the uncertainty and unpredictability of the options granted between 6 April 1999 and 19 May 2000 continue to affect their businesses.
4. Ministers have decided to help companies that awarded options between the 6 April and the 19 May 2000. Employers will be able to limit their exposure to NIC by opting to pay NIC by reference to the gain attributable to the growth in company share price up to 7 November 2000. Under this arrangement the NICs will be payable within 60 days of the new legislation being introduced.

PURPOSE AND INTENDED EFFECT OF THE MEASURES

5. The intention is to introduce new legislation specifically to cover share options granted from 6 April 1999 to the 19 May 2000 inclusive. This period is commonly referred to as the “gap period”.
6. This new measure is to enable the employer to opt to calculate the employer’s NIC due on the options granted during the gap period and remit a payment of the NIC due within 60 days of Royal Assent of the legislation.

RISKS

7. In absence of this measure, the risk to business is that they can become technically insolvent or seriously prejudice their borrowing capacity and credit worthiness.
8. The risk to the (National Insurance Fund) NIF is that the likely number of businesses who take advantage of the measure could be higher than the proportion estimated (see paragraph 23) and therefore the cost to the NIF would increase.

BENEFITS

9. The benefits to the employer of this measure is that overall it will reduce financial risk:
 - They will effectively be able to cap their NIC liability by reference to the share price on 7 November 2000. No further NIC will be due if the share price subsequently rises.
 - This will remove uncertainty for the employer. The value of this cannot be quantified readily, but in principle it is reflected in the increase in credit worthiness which is seen as the increased borrowing limits available to the business because of crystallisation of liability.

- Upon payment and notification to the Revenue they will be able to remove the corresponding NIC provision from their accounts.
- They will not need to add to the provision in their accounts further in subsequent reporting periods, thus avoiding further charges against their profits.
- Companies have reported that where a NIC provision causes them to miss a performance target, the response of the market would have been damaging in the short to medium term.

10. The measure provides an option for the employer to effectively cap the NIC liability on the gap options by reference to the share price on the 7 November 2000. If the share price subsequently rises, falls or indeed if the option is not exercised there is to be no refund or recalculation. Employers will therefore need to consider whether settlement would be right for them.

11. Employees who have been granted options in the period covered by this measure will benefit because once their employer opts to pay the NIC charge no further employee or employer NIC will be due on exercise of the option.

12. Those employees who have agreed or elected to pay the employer's NIC in respect of these options will also be able to benefit if their employer opts to take advantage of the measure and pay the NIC himself. And, the employee will be able to similarly cap the liability that they have agreed to take on.

CONSULTATION

13. There has been informal consultation on the subject of options granted during the gap period between May and October 2000 where the views of over 50 companies have been expressed. Those companies, both large and small, have approached the Government and the Inland Revenue

asking for help in resolving the difficulties arising from NIC liability on the gap options.

COMPLIANCE COSTS FOR BUSINESS

14. Since the measure only provides a single opportunity for the employer to make a payment of NICs in respect of specific options the compliance costs will be minimal. Any work produced will not be recurring and will be limited to the returns received in the period provided for in the legislation.
15. The intended measure only affects those options granted during the gap period that remained unexercised on the 7 November 2000.
16. This is a voluntary measure. Employers will need to consider whether settling the NIC in this manner is right for them. For some this decision will be easy:
 - Where the share price on the 7 November 2000 is below that of the exercise price the employer can effectively opt to pay no NIC provided that the appropriate notification is sent to the Inland Revenue within the required period.
 - Where the shares under option are not readily convertible assets on the 7 November 2000 the employer will again effectively be able to opt to pay no NIC. This will help some companies who are unlisted on the 7 November 2000.
17. Employers (who do not fall into the preceding paragraph) who have granted options during the gap period will need to consider whether they expect their share price to rise or fall from that on the 7 November 2000. They will need to make a judgement as to whether the benefits that early settlement will offer will outweigh any risk that the share price might fall. Employers will have from the 8 November 2000 to 60 days after the legislation comes into force to decide whether this is right for them. Any costs, involved in following the provision, should be limited to the information requirement and be one-off. Notification would consist of a list

of the options from the employer for which they wish to settle with determination of market price following normal Revenue practice.

18. Those employers who wish to settle the NICs will need to identify the employees who received options during the gap period information, which in most cases will be already captured for other purposes. The measure gives employers the flexibility to choose which options they wish to include in the settlement or of course they can include all options granted during that period.
19. Once the employer has decided which options he wishes to include in the settlement, he must prepare a notification, calculate the NIC due and send these to the Inland Revenue within 60 days of the legislation coming into force. A central point of collection of payments and returns specific to this measure will be used to ease administration for employers.
20. The employer will not be required to obtain Inland Revenue approval or make complicated returns so there should be minimum impact on their business in terms of time and resources.
21. The cost to employers of seeking professional guidance to consider this measure, and if they wish to settle, to prepare and make the additional return is estimated to be equivalent to a one-off cost in the region of £5 to £10 million, net of future discounted savings from not having to adjust their provisions. These costs will be outweighed by the benefits of certainty over future liability and the savings companies will make by not paying NICs on the actual share option gains that they have included in the settlement.
22. In future years those companies that settle the liability will make administrative savings after settlement because they will no longer need to accrue for and report on the NIC provision in their balance sheets and profit and loss accounts.

OTHER COSTS AND EFFECTS

23. It is estimated that around 2,000 companies may have offered share options in the gap period to some 50,000 employees. The following costs assume that 2/3rds of the companies will take advantage of the measure.

24. It is estimated that the employers who opt to settle their NIC will save an estimated £160m in employers NIC over the next 5 years. As settlement of the NIC is required within 60 days of Royal Assent the NIC received is estimated to be higher in the first year but with lower NIC receipts in later years.

25. This measure is anticipated to effect receipts to the National Insurance Fund as follows:

2001/2	2002/3	2003/4	2004/5	2005/6
£200m	-£230m	-£80m	-£30m	-£15m

EFFECT ON EMPLOYEE

26. Those opting to settle their NIC will be opting to pay a Class 1A charge, which is an employer only contribution. There is the potential therefore, that some employees may pay less employee's NIC as a result. However, it is considered that only a small number of employees who received unapproved share options during the gap period are earning under the Upper Earnings Level (and consequently eligible to pay any employee NIC) and may therefore be affected. Share options are paid in addition to regular salary on which the employee will pay employee's NIC. Therefore, the likelihood that entitlement to basic pension entitlement will be lost is minimal. The number of employees likely to be adversely affected by this measure is expected to be very small and it is not possible to make reliable estimates.

IMPACT ON SMALL BUSINESS

27. Ministers and the Inland Revenue have had a period of informal consultation where they have met with small businesses and trade organisations. Representations to Ministers and officials strongly indicated a need for a specific measure to deal with the gap issue where the impact on small companies of the NIC provision was causing particular difficulties.
28. The intention of this measure is to help all businesses that are having difficulty with the unpredictable NIC charge that will follow a share option gain. It is likely that those businesses involved in the high-tech industry, where there are many small, but growing companies, where equity remuneration is favoured will benefit significantly from this measure.
29. Small businesses not involved in equity remuneration will be unaffected by the measure, but in a few cases it may be argued that start-up business without share options may have to consider their remuneration practices to retain staff.

MONITORING AND EVALUATION

30. Due to the time limitation of the measure it is perceived there will be no need for ongoing monitoring of the effects of the measure. A central point, to which the employer will submit a return will capture the data showing how many employers have taken advantage of the measure, NIC collected and the number of employees affected.

SUMMARY AND RECOMMENDATION

31. This measure will allow the employer to elect to pay the NICs on the share options granted in the gap period but not exercised before 8 November 2000 by reference to the share price on the 7 November 2000. The measure is in response to requests from employers and will help them to remove the NIC provision and uncertainty from their balance sheet once the NIC has been paid. It will also save NIC costs in relation to any further upward movement of share prices.

CONTACT POINTS

Hasmukh Dodia

Capital & Savings 3

Inland Revenue

New Wing, Room 138

Somerset House

Strand

London WC2R 1LB

Tel No: 020 7438 7504

E-Mail: Hasmukh.Dodia@ir.gsi.gov.uk