Legal Insight
K&L GATES
www.klgates.com

March 2012
Employee Benefits
Executive Compensation

Pensions and Employee Incentives Newsletter: Spring 2012

By Ian Fraser, Danny Tsang, Louise Waldron & Victoria Green

Budget 2012

The March 2012 budget contained few surprises and no nasty shocks for pensions and employee incentives. The big news for personal pensions was that there were no further changes to pension tax relief for higher rate taxpayers. There will be some welcome changes to the Enterprise Management Incentives (EMI) legislation, subject to State aid approval. The Government is proposing to increase the personal limit on the value of shares that can be subject to qualifying EMI options from £120,000 to £250,000 which is a very welcome uplift, and will also consult on ways to extend EMI to academics employed by start ups. In addition, gains made on shares acquired through exercising EMI options on or after 6 April 2012 will be eligible for capital gains tax entrepreneurs' relief even if the employee does not hold 5% of the company's shares, although all other conditions for entrepreneurs' relief will still apply, including the requirement that the shares be held for 1 year before being sold. The increase in the personal EMI grant limit will be implemented as soon as possible, subject to State aid approval.

In other news, the Government has announced that there will shortly be consultations on reform and integration of income tax and NICs, changes to PAYE late payment and filing penalties in the light of the introduction of Real Time Information, and the introduction of a legislative General Anti-Abuse Rule (GAAR) to be introduced in the Finance Bill 2013. The Government has also announced that it will be taking action to reform the IR35 (personal service company) legislation so that it is easier to understand and administer, and harder to avoid income tax. There will also be a consultation on requiring office holders or controlling persons who are integral to the running of an organisation to have PAYE and NICs deducted at source. Again we await the draft legislation before we can assess the extent of this.

Termination Payments - change in treatment for share options

In our Spring 2011 newsletter we reported on a change to the PAYE Regulations which requires payments made to former employees after issue of Form P45 to be taxed using code "0T" (zero allowances) on a non-cumulative basis. Following lobbying, this requirement was then reversed for share-related payments.

The position will be changed again with effect from 6 April 2012 so that all payments in the form of shares, options or other securities paid to former employees after issue of Form P45 that are subject to income tax will be taxed using code 0T in the same way as other payments.

In many ways a standard approach to taxing all payments made after issue of Form P45 is to be welcomed. However, the change is likely to result in more tax being deducted than if the BR (basic rate) code had been applied as was previously the case. Where employees sell shares to cover their tax liability, they may now have to sell a greater number of shares upfront to cover the tax. This dilutes the employee's shareholding going forward and therefore means that the award has less of a retention or incentive impact.

Smartphones/mobile phones

HMRC has now accepted that smartphones can qualify as mobile phones for UK income tax purposes. This means that employers will be able to provide one smart/mobile phone to an employee without any income tax or NICs charges regardless of whether the phone is then used for business or private use.

Previously, HMRC's view was that blackberries and other smartphones were personal digital assistants (PDAs) and not treated in the same way as other "mobile telephones". Most employers therefore provided these under a separate income tax exemption that exempts supplies and services provided to employees to enable them to carry out the duties of employment, where any private use is not significant. This meant that companies had to decide what "significant" meant and monitor private usage. Where a smartphone is the only mobile phone provided, this will no longer be necessary.

This change of approach only applies to smartphones that are designed primarily for transmitting and receiving spoken messages and used in connection with a public electronic communications system. It does not therefore cover devices that are solely PDAs, tablets or laptop computers or, in general, any devices that use Voice over Internet Protocol (such as Skype).

If employers have treated smartphones as a taxable benefit in tax years back to 2007/08, they may be able to reclaim the Class 1A NICs, and employees may be able to claim back the income tax paid.

Fixed Protection and Life Cover

An HMRC communication has recently been drawn to our attention which affects individuals who apply or have applied before 6 April 2012 for fixed protection of pension benefits accrued to them during their lifetime. These individuals could lose such fixed protection in circumstances where, broadly: (i) they are provided by their employer with death benefits, (ii) the death benefits are insured with an insurer and (iii) there are restrictions in the insurance policy which may result in the insurance proceeds being less than the level of benefits which are calculated by reference to a multiple of salary. Companies which have pension scheme members who have applied or are considering applying for fixed protection should urgently review the rules of their life assurance scheme to see if these restrictions are contained in the rules. If so, companies may wish to consider either excluding the individual from membership of the life assurance scheme, or amending the rules of the scheme.

UK Tax Residency

Statutory Residence Test

In our Summer 2011 newsletter we reported on the proposal for a new statutory definition of residence, which was expected to be introduced from April 2012. The Government has now confirmed that the legislation will be included in the Finance Bill 2013 and take effect from 6 April 2013. Draft legislation is expected to be released for consultation shortly. While the year's delay will be welcomed if it means that the eventual legislation is properly thought out and well drafted, the lack of certainty for an extra year will not be welcomed by internationally mobile individuals and their employers.

Ordinary Residence

The Government has announced that ordinary residence will be abolished for tax purposes with effect from 6 April 2013. Overseas workday relief which can currently be claimed by individuals who are resident but not ordinarily resident will however be retained in some form. This will also go some way to providing greater clarity on residency issues for taxpayers.

Non-UK domiciled individuals - remittance basis charge from 6 April 2012

From 6 April 2012 non-doms who have been UK resident for 12 out of the previous 14 tax years and want to claim the remittance basis of taxation will be required to pay an increased annual charge. The current annual charge of £30,000 will remain for non-doms wanting to claim the remittance basis who have been UK resident for 7 out of the previous 9 tax years but individuals who meet the 12 year residence test will be required to pay £50,000 per year.

However, the US IRS has announced that the remittance basis charge can in certain circumstances be credited against US income tax (Revenue Ruling 2011-19), which means that US citizens who are also long-term UK residents and claiming the remittance basis of taxation may get some relief in respect of payment of the annual charges.

Approved Share Schemes - OTS proposes changes

The Office of Tax Simplification (OTS) has published its report on tax advantaged employee share schemes following a six-month review into whether these schemes can be simplified. The OTS has made a number of recommendations, some general and some technical. The main recommendations are:

1. Self-Assessment - abolish the requirement to seek advance approval from HMRC for SAYE, SIP and CSOP schemes and put them on the same self-certification basis as EMI schemes.
2. CSOP - further work should be undertaken to determine whether CSOPs remain relevant or should be abolished altogether. If CSOPs are retained, the legislation should be merged with EMI to create a single regime for tax-advantaged discretionary share option plans. The merged scheme would still distinguish between smaller and larger companies and retain the higher personal grant limits for smaller companies that currently qualify under the EMI rules.
3. Simplification - simplifying a number of provisions in the legislation and standardising definitions across the different schemes.
4. Single annual return - creating a single annual return for all grants and awards pursuant to tax advantaged schemes in place of the current separate returns for each regime, and abolishing the requirement to notify grants of EMI options to HMRC within 92 days of the date of grant. The return should be capable of being filed online. In the long term, OTS recommends real time reporting for tax advantaged schemes.

The Government confirmed in the March 2012 Budget that it would be consulting on how to take these proposals forward. Any legislation will be in future finance bills.

Solvency II - a further threat to UK pension schemes?

The consultation has recently closed on the proposal of the European Insurance and Occupational Pensions Authority (EIOPA) that defined benefit (DB) pension schemes be subject to the same or similar funding requirements as apply to insurance companies.

The intentions behind the proposal are essentially twofold: (i) to afford greater security for members in the event of another financial crisis; and (ii) to harmonise pension scheme funding

requirements across Europe in order to facilitate and promote the implementation of cross-border pension arrangements.

However, the proposal is likely to affect disproportionately the UK because it has more DB pension schemes than any other European country. Not surprisingly, the UK pension industry has severely criticised the proposal with concerns being raised that if implemented the requirements could drive companies into bankruptcy and add yet another layer of complexity into the already overly-complicated and over-regulated administration of DB pension schemes.

There is no stated timeframe for the implementation of these proposals yet. Given the way in which the institutions of the EU work implementation could still be years away. However, the impact for the UK DB pension schemes that are left and their sponsoring employers could be devastating.

Pension Auto-Enrolment - Starts October 2012

The new rules on auto-enrolment for pensions start to be phased in from October 2012, and the larger the employer (or more employees in their PAYE scheme), the earlier they will have to start providing benefits. The current proposal is that employers with 120,000 or more employees in their PAYE scheme as at 1 April 2012 will need to comply with auto-enrolment from 1 October 2012, with the rules being phased in for bands of smaller employers. Employers with fewer than 250 employees will not be bought into scope until 1 April 2014 at the earliest and 1 August 2015 for employers with fewer than 50 employees.

Auto-enrolment means that employers will have to enrol qualifying employees into a pension scheme automatically and to make contributions to the pension on their behalf. There will also be additional administrative burdens on these employers. All employers with qualifying employees will need to register with the Pension Regulator and choose a pension scheme in which to enrol employees. Employees are entitled to opt out of auto-enrolment, but must be able to opt back in at any time and are automatically re-enrolled after three years.

Auto-enrolment will apply to employees aged between 22 and the state pension age, who are working or ordinarily working in Great Britain and are paid earnings in excess of a statutory minimum (£8,105 in 2012/13). Earnings here includes salary, bonus, commission and overtime as well as statutory payments such as maternity and sick pay. In principle an employer must auto-enrol each qualifying employee from the date on which they meet the qualifying requirements, although employers will now be able to delay auto-enrolment for up to 3 months by giving notice to the employee.

The mandatory contribution levels will also be phased in over time. The current proposed levels are 2% (with at least 1% from the employer) until 30 September 2017, increasing to 5% (with at least 2% from the employer) to 30 September 2018 and finally increasing to 8% (with at least 3% from the employer) from 1 October 2018.

Auto-enrolment has been talked about for some years now, and has broad cross-party support in Parliament. The Government has confirmed that phasing in for the largest companies will start in October 2012 and it is not likely that this will change at this stage, even though the legislation and guidance in the area is still evolving. We anticipate that most large employers will be using their existing pension schemes as the automatic enrolment scheme and many will already meet the minimum contribution requirements, but clearly employers should seek advice at the earliest opportunity. Employers should be ready to circulate employee communications and opt-out forms in October. Companies who do not currently use arrangements to mitigate the costs of pension contributions (such as salary sacrifice arrangements) may wish to consider implementing them in connection with auto-enrolment.

Pensions and Employee Incentives Newsletter: Spring 2012

GMP equalisation

The UK Government is currently consulting on GMP equalisation.

Following the decision of the European Court of Justice on 17th May 1990 in ***Barber v. Guardian Royal Exchange Assurance Group***, pension schemes were required to equalise the overall benefits payable to male and female members. However, it was not clear from the ECJ's decision whether guaranteed minimum pension (GMPs) also had to be equalised. Given this uncertainty, schemes have tended not to equalise GMPs.

The Government is now proposing to amend legislation to require pension schemes to equalise GMPs which accrued between 17 May 1990 (the date of the *Barber* decision) and 5 April 1997 (the date on which GMPs stopped accruing). This means that men will be able to take payment of GMP benefits from 60 instead of having to wait until 65 as they do now. Significantly, pension schemes will be required to equalise GMPs whether or not there is an opposite sex comparator with the higher benefit in that particular scheme.

As part of the consultation, the Government has also put forward a methodology for equalising GMPs, although it does not appear that schemes will be required under legislation to follow it; they will be able to use alternative methods.

Critics of the proposal have agreed that the legislative change may be imposing obligations beyond those imposed by the *Barber* decision and that it would be better for the Government to sponsor a test case before the ECJ to establish if the original *Barber* decision does extend to GMPs. Concerns have also been raised that the Government's proposals are going to impose another significant administrative burden on pension schemes. It is also not clear from the consultation whether pension schemes will be obliged to equalise the GMPs of those members who have already retired.

The consultation closes on 12 April 2012.

Executive remuneration and shareholder voting rights in listed companies

As executive pay and corporate governance issues have become a major focus for institutional investors, stakeholders, regulators, the media and the general public, the Department for Business, Innovation and Skills (BIS) has been consulting in relation to executive pay and corporate governance in UK listed companies. In January, the Secretary of State, Vince Cable, announced proposals for new regulations as a result of the consultation which focus on four areas:

1. Greater transparency in disclosure;
2. Shareholder powers and in particular binding votes on pay;
3. Opening up remuneration committees; and
4. Sector-led reform.

BIS subsequently, in March, published a consultation document looking at the proposals for shareholders voting rights.

<u>Greater transparency.</u> BIS is proposing that the Directors' Remuneration Report in the Annual Report of all UK listed companies should be split into two sections:

1. A "future pay" section would give details of (i) pay policy for the year ahead including the composition and potential level of pay for each director, (ii) how benchmarking exercises, employee pay differentials and employee views have been taken into account in assessing pay for the forthcoming year, (iii) how the proposed pay structures reflect and support company strategy, (iv) how performance will be measured, and (v) how that performance measurement affects awards. Particular emphasis will be placed on how performance criteria for annual

bonuses work. However, importantly, the report will not include disclosure of actual pay ratios.

2. A report on previous year's pay would include a single figure for each director's total pay, a description of how pay awards relate to the company's performance, and a description of how executive pay compares with dividends, business re-investment, tax and general staffing costs. It is unclear how stock awards would be valued for these purposes.

Shareholder powers. BIS is keen to ensure that shareholders have a binding vote on executive pay, rather than the current advisory vote and is consulting on the following proposals:

1. An annual binding shareholder vote to approve the future pay policy for the board as a whole, including details of how performance will be judged and examples of potential pay-outs;
2. a 75% threshold for all binding shareholder votes on pay;
3. maintaining the existing annual advisory vote on the preceding year's pay, but if the company does not receive 75% votes in favour, the company will be required to issue a statement to the market detailing the issues that shareholders have raised and how the company will address these;
4. a requirement for shareholder advance approval of any exit payment following termination of a director's service that exceeds one year's basic salary. This would be by way of ordinary (50%) resolution; and
5. directors recruited mid-way through a year could only be paid in a way that is consistent with the policy that has prior shareholder approval, unless the shareholders have agreed to give the company greater flexibility. Poor planning in this regard could have a serious impact on recruitment and the ability to attract key talent.

Opening up Remuneration Committees. The consultation process in Autumn 2011 considered requiring that an employee representative participates on each remuneration committee or that there is a formal employee vote on remuneration, but these proposals have now been dropped. However, BIS are proposing two changes:

1. preventing serving executives from sitting on the remuneration committees of other large companies; and
2. requiring greater transparency around the role of remuneration consultants including their appointment, accountability and fees.

Sector-led Reform. BIS intends to work with businesses, remuneration committees and institutional investors to encourage changes in executive remuneration policies and practices and it is likely that further initiatives will be introduced to encourage this.

Large companies will be relieved that some of the more draconian proposals have been dropped but significant changes have been proposed and it will be important to monitor developments in this area closely. Detailed proposals and draft legislation are expected to be issued in the Autumn with legislation on shareholder voting rights and revised reporting requirements expected to come into force in Spring 2013. The Government is proposing that the provisions should take effect from 1 October 2013. The consultation period for the proposals on shareholder voting will end on Friday 27 April 2012.

Corporate governance is now of fundamental importance to companies, both listed and unlisted. We have worked with numerous companies on establishing and operating governance policies and procedures in relation to executive compensation and all forms of employee benefits. Please speak to your usual K&L Gates contact if you would like to discuss this with one of our lawyers.

Pensions and Employee Incentives Newsletter: Spring 2012

Salary Sacrifice - Reed Employment plc

Salary sacrifice schemes have become more popular as UK income tax and NICs rates have increased and pensions relief has been restricted. A recent case has highlighted the importance of ensuring that these schemes are correctly implemented.

Reed is an employment agency that sends employees on temporary assignments to clients. Reed took the view that its employees work at temporary workplaces when assigned to clients and that the employees were exempt from income tax and NICs where travel and subsistence costs were reimbursed to them. Reed and HMRC agreed dispensations for the expenses. The Reed employees then signed up to a salary sacrifice scheme whereby they agreed to reduce their salary by the amount of their travel and subsistence "expenses" and receive instead a (purportedly tax free) reimbursement. Reed argued that the employees made an effective salary sacrifice in exchange for the reimbursement, the effect of which was that the reimbursements were not earnings and were not taxable.

The First-Tier Tribunal agreed that the scheme formed a valid part of the employment contracts but considered that there was not a valid sacrifice of salary for a number of reasons.

Firstly, the Tribunal considered that the employees did not understand the implications of the scheme or that they were sacrificing salary, and in particular did not understand that their "salary" for the purposes of entitlement to contributory benefits was lower than the total cash they received. Companies need to ensure that schemes are fully explained to employees to ensure they are valid.

Secondly, the employees must not be free to opt in and out at anytime. This is consistent with current HMRC guidance that employees should only be able to opt in or out of the arrangements every 12 months or on a significant lifestyle event.

Finally, the employees received very little benefit under the scheme merely exchanging one cash sum for an equivalent cash sum. The Tribunal commented that a salary sacrifice required an employee to give up a portion of his earnings in exchange for an identified benefit, but in this case there was merely a reallocation of pay to a notional reimbursement of expenses. The Tribunal stopped short of saying that the benefit of saving employer NICs which arises from salary sacrifice should be shared with the employees, but companies should consider the benefits offered to employees and ensure that they can point to a clearly identified benefit to the employees of participating in the salary sacrifice scheme.

The case related to about 500,000 employees over an 8 year period involving unpaid tax and interest in the order of £158 million and shows how important it is to ensure that tax efficient schemes are properly implemented and operated.

Kuehne and Nagel Drinks Logistics Limited and others v. HMRC - DB termination payments are taxable as employment income

The Court of Appeal has found that payments made to employees to compensate them for the loss of defined benefit pension rights are taxable as employment income.

In 2006, Scottish & Newcastle UK Limited ("**S&N**") and Kuehne & Nagel established a joint venture company called Kuehne & Nagel Drinks Logistics Limited ("**KNDL**"), with each company having a 50% share. S&N transferred its drinks distribution business to KNDL, together with 2000 employees. The Transfer of Undertakings (Protection of Employment) Regulations 2006 ("**TUPE**") applied to the transfer.

The transferring employees raised concerns that the KNDL pension scheme was not as generous as the S&N pension scheme which was a defined benefit arrangement. Further, TUPE did not

Pensions and Employee Incentives Newsletter: Spring 2012

preserve or protect future pension rights. As a result of these concerns, the affected employees threatened industrial action.

Following negotiations, S&N agreed to fund payments to each transferring employee who was a member of the S&N pension scheme in an amount of £5,000, to be paid in two parts by KNDL on behalf of S&N: £3,000 in August 2006 and £2,000 in April 2007. The transfer then went ahead without further incident.

HMRC then deemed these payments to be taxable as employment income (and not tax-free termination payments). S&N and the employees challenged this decision.

Upholding the decision of both the First Tier Tribunal and the Upper Tribunal, the Court of Appeal held that the payments had been paid and received substantially as an incentive to work willingly for KNDL in the future and to avoid industrial action and were therefore taxable as employment income even if there were other ancillary reasons for such payments such as compensating for loss of pension rights which are unrelated to employment income.

Authors:

Ian Fraser
ian.fraser@klgates.com
+44.(0).20.7360.8268

Danny Tsang
danny.tsang@klgates.com
+44.(0).20.7360.8144

Louise Waldron
louise.waldron@klgates.com
+44.(0).20.7360.8250

Victoria Green
victoria.green@klgates.com
+44.(0).20.7360.8202

K&L GATES

Anchorage Austin Beijing Berlin Boston Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg Hong Kong London Los Angeles Miami Milan Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco São Paulo Seattle Shanghai Singapore Spokane Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of more than 40 fully integrated offices located in North America, Europe, Asia, South America, and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&L Gates or its locations and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2012 K&L Gates LLP. All Rights Reserved.