

PART 7A ITEPA: TRAPS AND HOW TO AVOID THEM

Ian Shaw, Partner, EP&G Group

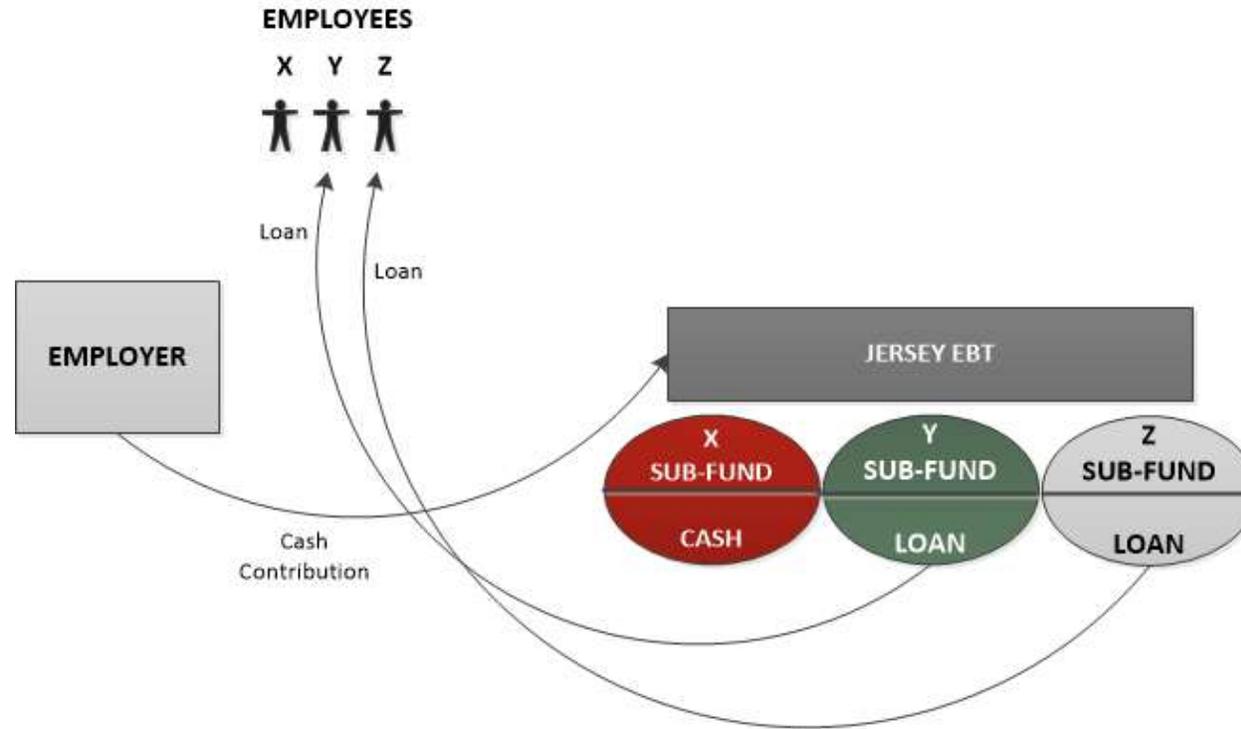
11 October 2023



KORN FERRY
BE MORE THAN

Recap: Why was this legislation introduced?

Before Part 7A...certain earnings out of HMRC's reach



No earnings charge on X, as EBT is discretionary

No earnings charge on Y or Z, as a loan is not earnings

Part 7A ITEPA 2003

Overview

- Rules took effect from 6 April 2011
- Where a 'relevant third person' takes a 'relevant step' pursuant to certain arrangements, such as earmarking (X in the above diagram) or making a payment (eg by way of a loan) (Y and Z in the above diagram), income tax and NICs will arise on the value of the relevant step
- The rules have been drafted so widely that they impact on 'regular' incentive arrangements, particularly those involving EBTs
- Exclusions are narrowly drafted and not always straightforward to apply

The Disguised Remuneration gateway

Is there an arrangement?

- A is an employee or director of B
- There is an arrangement concerning A
- The arrangement provides reward, recognition or loans in connection with A's employment with B (including former and prospective employment)

Once through the DR gateway...

Is there a relevant step?

- Payment of a sum of money (including by way of loan) – such as a bonus
- Transfer of an asset
- Taking a step by virtue of which a person acquires a relevant asset (includes grant of options) (554C)
- Making an asset available in a way substantially similar to ownership (554D)
- Continuing to make an asset available to benefit a relevant person two years or more after termination of employment, if the asset was made available to benefit that person before the date falling two years after termination of employment or office
- Must be '*reasonable to suppose that, in essence*' the relevant step is taken in pursuance of/in connection (direct or indirect) with the arrangement

Once through the DR gateway... (continued)

Is the relevant step by a relevant third person?

- DR not confined to EBTs!
- Any person (including, but by no means limited to, an EBT) **other than**:
 - A (unless acting as a trustee)
 - B (unless acting as a trustee)
 - Any other member of B's 51% group (unless acting as a trustee or there is tax avoidance)

If caught (and no exemption is available)

The charge

- Charge arises at the time the relevant step is taken on the value of the step
- Value of relevant step is treated as earnings
- Value can be reduced where there is consideration given or a double tax charge
- Tax is payable through PAYE based on a 'best estimate' of value
- Section 554Z4(5) of ITEPA 2003 states that the question of whether or not the value of a relevant step is in respect of UK duties is to be determined on a 'just and reasonable' basis
- There is no refund of a DR charge on a loan, even if it is repaid

Is there an available exclusion?

Main exclusions relevant to share incentive arrangements

- Steps taken under certain tax-advantaged incentive plans
- Earmarking in respect of share-based awards (or cash based on the value of shares) on a conditional deferred basis provided they vest within ten years and there is a 'reasonable chance' that the award will be revoked/not become exercisable (s554J/L)
- Earmarking in respect of conditional deferred awards dependent on 'exit events' (554K/M).
- 'Blind hedging' (employer obtains EBT trustee's agreement to satisfy awards over an aggregate number of shares (or cash value) in respect of an aggregate number of unnamed beneficiaries)
 - But deliberate concealment (calling two employees X and Y) does not work
 - Actual knowledge issues where trustee directors are also company directors
- No earmarking charge on earmarking immediately preceding a relevant step (hence earmarking applied to X in the first slide but not to Y or Z)
- Relief for 'un-earmarking' (eg failure to vest in a case outside the exemptions)

Is there an available exclusion? (continued)

Other employment-related exclusions

- Deferred Remuneration (554H)
- Employee car ownership schemes (s554O)
- Certain loans made on commercial terms – limited to where making loans is in the ordinary course of the lender's business

Certain transactions under employee benefit packages (s554G)

- Step not taken under a pension scheme
- Step taken for the sole purpose of a transaction which the third party has with the employee and which is entered into in the ordinary course of the third party's business

If the transaction **is not** a loan:

- Must be part of a benefits package available to a substantial proportion of the employer's employees, or
- A substantial proportion of the employee's peers

Terms generous enough that offerees can generally afford to accept.

Majority of employees do not have material interest in the employing company.

No connection with tax avoidance.

Elephant Trap 1

Third party makes loans to employees

- Charge arises on making of loan by the third party (eg an EBT, a bank or someone else)
- Charge (if not subject to exclusion or relief) is on value of loan
- No credit if the loan is repaid
- Finance Act 2017 - transfers of employment related loans to new employers and (now historic) tax charge on outstanding DR loans - originally applied to all loans made since 6 April 1999 which remained outstanding on 5 April 2019, but changed to 9 December 2010 (when Part 7A was first announced) after protests

Elephant Trap 1 (continued)

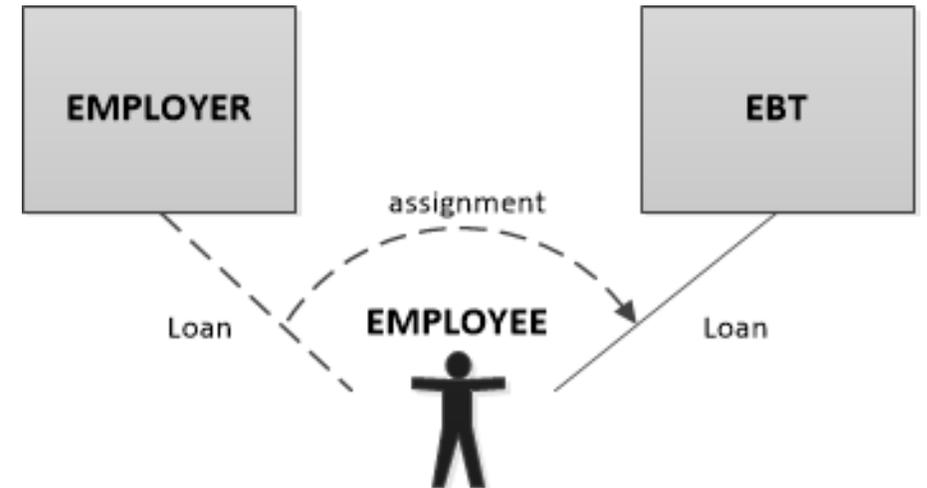
Solutions

- Normal commercial transaction
- Employee benefit packages
 - A substantial proportion of the third party's business must be making loans to the public
 - Must be part of a benefits package available to a substantial proportion of the employer's employees
 - Not mainly conferred on senior employees
- Loans provided to assist with option exercises are exempt - provided they are repaid within 40 days
- Domestic, family or personal relationships – not explicit as per Part 7, but see EIM45030

What does not work any more

Shortcoming in the 'payment' relevant step

- Originally, the main relevant step was the payment of an amount (including by way of loan) to A by a relevant third person
- This was avoided by a loan from B which B then assigned to the EBT
- This was rectified in FA 2017 following DOTAS disclosures



Elephant Trap 2

One employee grants options to another over their shares

- Not uncommon question from start up founders
- They are a third party and they aren't the employer
- Not a DR point, but...potential CGT despite no actual gain under the market value deeming rule

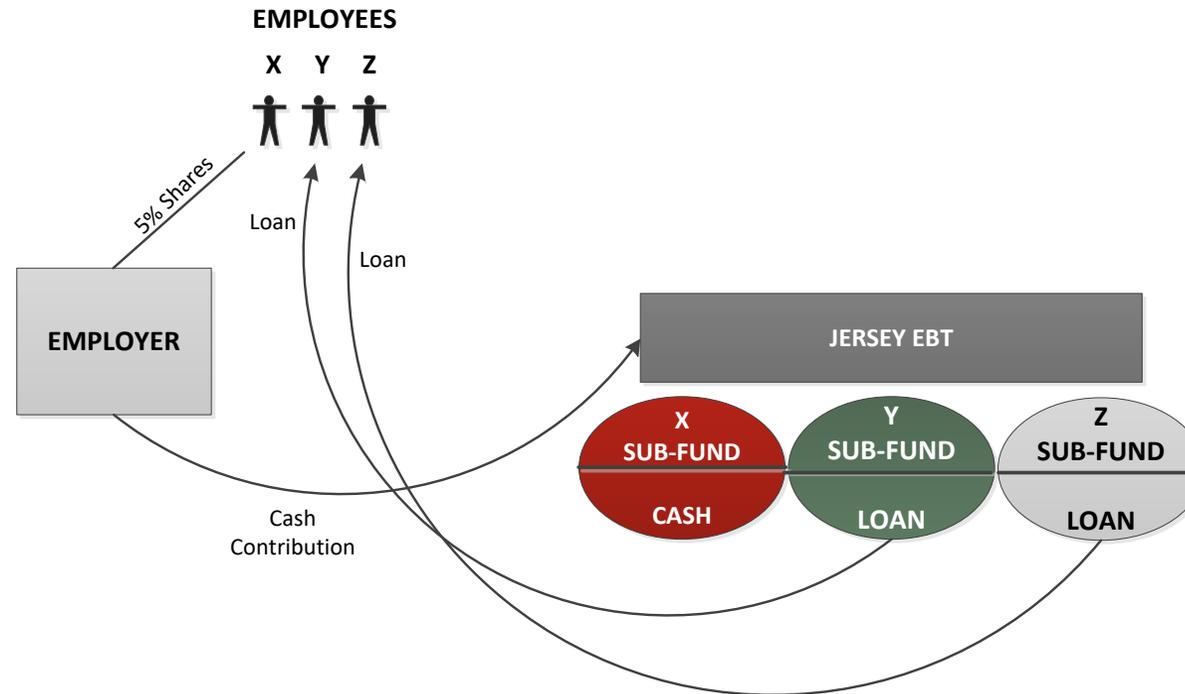
Elephant Trap 2 (continued)

Solutions

- Company grants the option and the founder enters into a share supply agreement
- But founders generally have actual knowledge...so could still be an earmarking
- Transfer shares to an EBT?

What does not work any more

Reward by reason of Shareholding - Shortcoming in the basic gateway



X argues that the arrangement concerning him provides reward, recognition or loans in his capacity as a shareholder in the Employer.

What does not work anymore (continued)

The Close Company Gateway - Shareholder benefits via third party

- A is an employee or director of B (a close company) and has a 5% material interest in B as a shareholder
- B enters into a 'relevant transaction' (typically, a payment to a 'relevant third person')
- A 'relevant third person' makes a payment (eg by way of loan) or confers some other benefit on A which derives from the money or asset which is the subject of B's relevant transaction
- There is a main purpose of tax avoidance
- Income tax and NICs are payable on the value of the payment or other benefit to A

Elephant Trap 3

Part 7A has a special definition of group

- A group of companies comprises a principal company and all its 51% subsidiaries, other than any which are **not** effective 51% subsidiaries of the principal company
- A 51% subsidiary means a company of which the principal company owns (directly or indirectly) more than 50% of the ordinary share capital
- A company is an effective 51% subsidiary of the principal company, if the principal company is beneficially entitled to:
 - more than 50% of any profits of the subsidiary available for distribution to 'equity holders' and
 - more than 50% of any assets of the subsidiary available for distribution to equity holders on a winding-up

Elephant Trap 4

EBT pays bonuses to employees

- EBT holds surplus cash/shares and wishes to pay bonuses to employees
- Selection of recipients will be earmarking and trigger a Part 7A charge
- If no gap...‘simultaneous step’ concession
- If gap...later relevant step on the transfer of cash overlaps with earlier relevant step and therefore relief should be available
- To avoid having to account for PAYE/NICs early, ensure that both relevant steps take place within the same income tax month

Elephant Trap 5

Termination Payments

- The first £30,000 of payments that fall within s401 ITEPA are exempt from tax and any excess will be subject to income tax (but not NICs) in the normal way.
- Warning - payments (or non-cash benefits) provided by a third party (such as an EBT) to a departing employee, or to a member of the departing employee's family or other related person, could be fully taxable under Part 7A.