SLAUGHTER AND MAY

Incentives Bulletin

July 2020

Welcome to the July edition of our Incentives Bulletin, updating you on the latest developments in remuneration and share schemes. The effect of the **COVID-19** pandemic on employees and their incentive arrangements continues to be a significant focus, and you will have seen our separate briefings on this topic. In this Bulletin, we look at the growing trend of **restricted share plans** in executive remuneration, **HMRC's latest guidance focusing on the impact on COVID-19 on tax-advantaged plans** and **three new share scheme-related court judgments**.

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Restricted share plans

Should companies follow the model of Lloyds Banking Group and others?

At the Lloyds Banking Group 2020 AGM on 21 May, the company's new Long Term Share Plan was approved by 63.69% of shareholders. The Lloyds Long Term Share Plan is the latest example of a growing trend: companies opting for share schemes that offer more certain outcomes but lower overall quantum than typical long-term incentive arrangements.

However, the significant number of shareholders voting against the Lloyds plan means that there remains some scepticism about the appropriateness of these types of arrangements for PLC executive directors in certain quarters.

Background

Share plans that offer more certain outcomes but lower overall quantum have been given various names, but the umbrella term often used is "restricted share plan".

These plans should not be confused with arrangements under which executives are actually issued with shares at the time their incentive awards are granted and those shares are subject to forfeiture or clawback in "bad leaver" scenarios (which are referred to as "restricted shares" in the relevant tax legislation). The use of "restricted shares" in long-term incentive arrangements can be administratively burdensome, compared to conditional share awards or nil-cost options, and such arrangements have declined in popularity in the UK over a number of years.

Instead, this briefing is focussed on restricted share plans under which executives receive conditional share awards or nil-cost options in the same manner as they would under a typical performance share plan (**PSP**). Although they are structurally similar, the key differences between a restricted share plan of this kind and a PSP are the applicable performance conditions (or lack thereof) and the maximum value of the pay-out.

Why opt for a restricted share plan?

Restricted share plans can be a useful option when market uncertainty or specific business conditions mean that setting effective performance conditions is challenging. For example, a corporate group with multiple businesses at different stages of development (e.g. one business division which is mature and profitable and another division which is young and in a growth phase) might opt for a restricted share plan due to the difficulty of setting appropriate performance metrics to meet the different objectives of different divisions.

The anticipated downturn in the wake of COVID-19 may provide a broader rationale for companies to consider implementing restricted share plans. This is because Remuneration Committees may find themselves struggling to assess what performance conditions should apply at a time when we are still waiting to see what the "new normal" looks like.

Recent history of restricted share plans

At its 2016 AGM, Weir Group proposed a resolution to amend its LTIP to allow "restricted share awards" to be granted to executives. Weir explained that the proposal "*would have offered senior management greater stability… in return for a substantial reduction in the maximum award available*".

72.24% of shareholders voted against the plan. The principal issue that investors had was the lack of any performance metric on the proposed restricted share awards. Hermes Investment Management were quoted in the press as saying "*To focus on creating long-term value, we believe the company should have performance targets and apply the test of common sense if these prove to be unrealistic due to unanticipated market conditions*".

Following this heavy defeat, Weir Group went back to the drawing board. They returned to shareholders at the 2018 AGM with a revised proposal called the "Share Reward Plan". Much like the 2016 offering, the new proposal broadly followed the "restricted share plan" model. However, key changes had been made to the terms, including a reduced cap of 125% of salary and a performance "underpin" which would allow the Board to adjust awards downwards to reflect poor business performance. In stark contrast to the vote at the 2016 AGM, this newly devised restricted share plan received 93.77% support from Weir's shareholders.

More recently, FTSE 100 companies such as Hargreaves Lansdown and Whitbread have received shareholder approval for new arrangements following the restricted share plan model.

The approval of the new Lloyds plan last week is further evidence that shareholders see restricted share plans as an acceptable alternative to the PSP in appropriate circumstances. However Institutional Shareholder Services had advised Lloyds shareholders to vote against the plan, noting concerns about "*the alignment of pay and relative performance*", and 36.31% of them did. This shareholder scepticism reaffirms the fact that caution should be exercised by companies thinking of implementing a restricted share plan. The specific terms of the plan, as well as the business case presented to shareholders, may be the difference between success and failure at the AGM.

Avoiding the wrath of shareholders

As well as clearly explaining the rationale for the changed approach to investors, companies thinking of moving from a PSP to a restricted share plan should ensure that the plan that they put up for approval complies with the following principles:

- **Reduced quantum -** Investors will expect to see a reduction in overall quantum to reflect the greater certainty of awards paying out. The Investment Association has suggested that the "*discount rate for moving from the LTIP to restricted share awards should be at least 50% and grant levels should be held at this level in future and not gradually increase over time*".

- **Performance underpin and discretion to adjust** – Although restricted share plans will not have "stretching" performance conditions in the way that a PSP would, shareholders will expect to see some form of performance underpin to guard against the risk of "payments for failure". The Investment Association also considers it vital, in line with UK Corporate Governance Code, for Remuneration Committees to retain discretion to reduce vesting where the formulaic application of the plan rules would provide pay-outs that are inappropriate.

- **Vesting period -** Investors generally expect restricted share plans to have a vesting period of at least five years. This is to align with the requirements of the new UK Corporate Governance Code as applied to traditional PSPs, which require that the aggregate vesting and holding periods to be at least five years.

- **Consistency in approach to remuneration** – Companies should only implement a restricted share plan if they believe it to offer the best form of executive incentive for the medium to long term. Short term decisions to switch model – for example, because PSP awards haven't been paying out – are likely to be received by shareholders with scepticism. For the same reason, if a restricted share plan is introduced to replace a PSP during the downturn, it may be difficult to switch back to a performance-driven model when the good times return.

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HMRC publishes latest bulletin focusing on COVID-19

HMRC's latest bulletin, published in June, provides helpful guidance on a number of COVID-19 related issues for tax-advantaged share plans. The key points are:

- Payment holidays have been extended for SAYE participants who are unable to make contributions due to the impact of COVID-19.

- Participants may make contributions by standing order if they are unable to make contributions from their salary.

- Payments made to furloughed employees under the Coronavirus Job Retention Scheme can count as salary and SIP contributions can be deducted from them.

- CSOP options that were previously granted to full-time employees and directors will not cease to be qualifying as a result of participants being furloughed.

- The period for granting EMI options where a valuation has been agreed with HMRC has been extended.

- Although companies should try to meet their obligations as soon as they can, HMRC will consider COVID-19 to be a "reasonable excuse" for failing to comply with certain tax obligations on time (e.g. registering new schemes and filing returns).

Full details can be found on the HMRC website by following this link:
https://www.gov.uk/guidance/employment-related-securities-bulletin-35-june-2020

"Employment-related securities options"

HMRC wins appeal in the Upper Tribunal

The Upper Tribunal has overturned the decision of the First-tier Tribunal in *HMRC v Vermilion Holdings Limited*.

In the case, the company had granted an individual consultant a share option in 2006 (the **2006 Option**). At the time of grant, the individual was not at that time an employee or director of the company and so the 2006 Option was not an "employment-related securities option". Subsequently, as part of a restructuring of the company in 2007, the individual gave up the 2006 Option (which had ceased to have any value) and was granted a new option (the **2007 Option**). Crucially, he also became a director of the company as part of the same restructuring.

The UT found that the FTT was wrong to conclude that the 2007 Option was not an "employment-related securities option". The statutory test set out in section 471(1) of ITEPA 2004 turns on whether the option was granted "by reason of employment". This is to be given its ordinary meaning and the employment need not be the sole reason for the grant – it is enough that the employment was a condition of the option being granted.

On the facts of the case, there were multiple reasons for the grant of the 2007 Option. These included the fact that the 2007 Option was granted partly to replace the 2006 Option. However, the grant of the 2007 Option was also conditional upon the individual becoming a director of the company. The UT found that, for this reason, the employment of the individual as a director was an operative cause (although not the sole cause) of the grant of the 2007 Option and, therefore, the option was granted "by reason of employment". Accordingly, the 2007 Option fell within the tax regime for employment-related securities options in Chapter 5 of Part 7 of ITEPA.

It is also worth noting that the UT did not need to consider application of 471(3) of ITEPA in reaching its decision. This "deeming provision" effectively provides that, unless a very limited exception applies, a share option or award will always be regarded as "employment-related" if it is made available to a person by their employer. The FTT had applied non-standard principles of statutory interpretation to find that this provision did not apply in the "anomalous" circumstances of the *Vermilion* case. As the UT held that the 2007 Option fell within section 471(1) of ITEPA in any event without HMRC needing to rely on the "deeming provision", it did not deal with this separate question in its judgment. However, in our view, it is unlikely that the FTT's reasoning in this respect would be applied by the courts in future cases.

This case provides further evidence that share options or awards granted to employees or directors will almost invariably fall to be taxed under ITEPA as "employment-related securities options". The one statutory exception to this – where the option or award is made available to an individual in the "normal course of the domestic, family or personal relationships" – will rarely apply. The UT's approach in this case suggests that the courts are unlikely to interpret section 471 more liberally in favour of taxpayers to offer exemption from the ITEPA regime in other circumstances.

Tax deductibility of share plan payments

HMRC loses appeal in the Court of Appeal

The Court of Appeal has dismissed an appeal by HMRC against Upper Tribunal's decision in the case of *NCL Investments v Smith & Williamson*.

It was held that the employers in the case were entitled to a corporation tax deduction as a trading expense in respect of the IFRS2 accounting debits recognised in their respective accounts on the grant of share options to their employees by an employee benefit trust.

The Court dismissed all of HMRC's arguments concluding that (among other things):

- The accounting treatment was a proper accounting treatment.
- The debits were wholly and exclusively for the purposes of the employers' trades as they were required to be made in the employers' profit and loss accounts as they represented the consumption of services provided by the employee to the taxpayers for the purposes of their trades. They were revenue, not capital, items.

This will be of primary interest for those companies who claimed "lapsed option relief" in respect of accounting charges incurred in connection with their share awards. The case relates to the law as it was before amendments made by Finance Act 2013 came into force, which prohibits such claims. However, it makes clear that share plan expenses constitute revenue expenditure for the purposes of a company's trade. This should assist companies in claiming corporation tax deductions in respect of their employee incentive arrangements under general principles where a statutory corporation tax deduction is not available.

We understand that no notice of appeal has yet been submitted. However, we anticipate that HMRC may appeal this decision to the Supreme Court.

Accelerated Payment Notices (APNs)

Upper Tribunal decides APNs may be issued against employers where PAYE amounts are "disputed tax"

The Upper Tribunal has dismissed an appeal by the taxpayer in the case of *Sheiling Properties v HMRC*.

Sheiling had entered into share-based remuneration arrangements with two directors which were notifiable to HMRC under the Disclosure of Tax Avoidance Schemes (DOTAS) rules. HMRC issued determinations under regulation 80 of the PAYE Regulations in relation to the arrangements, which Sheiling appealed against. HMRC initially agreed to postpone the PAYE that was in dispute but subsequently issued two APNs to Sheiling in connection with the arrangements. The APNs required Sheiling to pay account to HMRC for the PAYE upfront.

The Upper Tribunal found that the appealed PAYE determinations were "disputed tax" and therefore HMRC was entitled to issue the APNs. Sheiling's belief that the APNs were invalid was not a "reasonable excuse" for not complying with them.

The risk of being subject to an APN provides another reason to be cautious about implementing employee remuneration schemes that will be DOTAS-able. We expect schemes of this kind to continue to be unattractive for most companies due to the tax risks inherent in them.

Horizon scanning

What key dates and developments in employee incentives should be on your radar?

6 July 2020	HMRC deadline for filing annual share schemes returns for 2019-2020
31 December 2020	Transitional arrangements under the UK-EU withdrawal agreement expected to end unless extended
6 April 2021	Off-payroll working rules (IR35) come into force for the private sector

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