Qualifying Bonus Schemes for Employee Trust-Owned Companies

A Fieldfisher LLP / Cwmpas article

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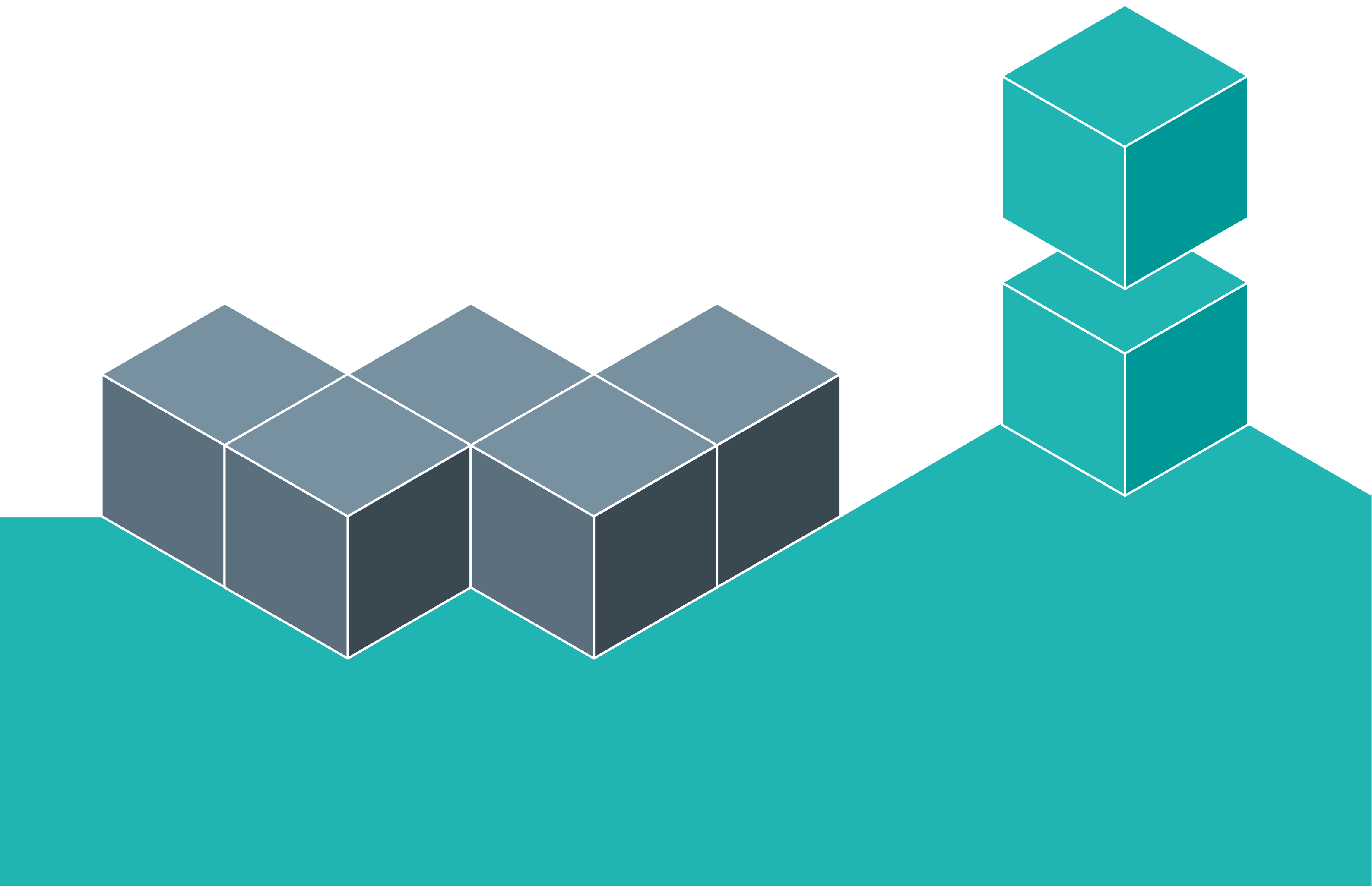

About Us

Fieldfisher LLP

Fieldfisher is a law firm with extensive experience in supporting organisations, and their owners and stakeholders, as they seek genuine alternatives to traditional business structures. Our work has focused particularly on creating and sustaining employee ownership solutions, and our employee ownership specialists have been at the forefront of the drive to make employee ownership mainstream in the UK and elsewhere for over 30 years.

Cwmpas

Cwmpas is a development agency working for positive change, in Wales and across the UK. Our economy and society could – and should – work in the interests of people and the planet. Established in 1982 as the Wales Co-operative Centre, at Cwmpas we've made it our mission to change the way our economy and society works. We have been supporting employee ownership in Wales for over 25 years.

Introduction

Since the introduction of "employee ownership trusts" (EOTs) to the UK in 2014, the employee ownership (EO) sector has seen exponential growth with many more company owners choosing to transfer their businesses into employee trust-ownership. As advisers to the EO community, Fieldfisher and Cwmpas have seen this growth first hand as an ever increasing number of companies approach us to support their transitions.

The increased awareness of EOTs has been fuelled by the two tax incentives associated with this type of employee trust. The first is a capital gains tax exemption on qualifying sales of shares to an EOT and the second is an income tax exemption for qualifying bonuses paid to employees of EOT-owned companies.

In this article, we focus on the second tax incentive for payments of "qualifying bonuses" by EOT-owned companies. Under Chapter 10A of Part 4 to the Income Tax (Earnings and Pensions) Act 2003 (ITEPA), EOT-owned companies can make bonus payments of up to £3,600 per employee in any tax year which are free from UK income tax (but are still subject to national insurance contributions).

As with any tax relief, a number of strict requirements must be met in order for bonus payments to be "qualifying bonus payments" (QBPs) for the purposes of ITEPA. To start with, the employer company ("E") (or, if relevant, the top company in the employer company's group) must meet the relevant qualifying requirements throughout the "qualifying period" and these are:

(a) the trading requirement; and
(b) the indirect employee-ownership requirement which is that:
  (i) E is owned by a "settlement" (trust) which meets the "controlling interest requirement"; and
  (ii) that such settlement meets the "all-employee benefit requirement".

If E has recently transitioned to EOT-ownership these requirements will have already been considered as part of that sale process.

In this article, we focus on some of the qualifying requirements which relate to the payments of QBPs themselves, rather than on the requirements which relate to E or to the ownership of E. Inevitably, the "devil is in the detail" and from our experience of assisting clients with both the practical and technical aspects of implementing "qualifying bonus plans" since 2014, we have come across a number of potential pitfalls which have highlighted the need for companies to consider the qualifying requirements carefully each time they make QBPs– this should include taking professional advice where appropriate.

We have set out below eleven (11) considerations and potential risk areas to watch out for. Unfortunately, the consequences of failing to meet all of the qualifying requirements are severe in that none of the bonus payments made by E will be eligible for the income tax relief.

1. **A QBP must be awarded under a "scheme" (section 312B(b) of ITEPA)**: although not a specific statutory requirement for QBPs, in our view the best way to demonstrate that there is a "scheme", is to adopt a specific set of rules for the "scheme" or "plan". This helps to demonstrate that there is a "scheme" and also sets out the terms of each bonus payment so it is clear that all relevant qualifying conditions are met.

2. **The scheme must meet the "participation requirement" (section 312B(b) and section 312C of ITEPA)**: the participation requirement is that all persons in (current) relevant employment when the QBP is "determined" must be eligible to participate so, subject to limited exceptions and the opportunity to apply a minimum period of continuous service, all employees who are employed by E (or the group of companies of which E is part) must receive a bonus payment. This includes overseas employees although they will not benefit from the income tax exemption. The scheme rules should refer to a "determination date" in order that E can be sure that all individuals employed on that particular date have been included in the scheme (the "determination date" will usually be the date on which the directors of E determine the amount available to make bonus payments and also the exact terms/allocations of the QBPs). It is not possible to exclude employees who are in a notice or probationary period, although moving the determination date or imposing a qualifying period of employment may assist with

these aspects. If there is a gap between the determination date and the payment date, it is not possible to exclude any employee who leaves employment with E after the determination date but before the payment date.

3. **The scheme must meet the "equality requirement" (section 312B(b) and section 312C of ITEPA)**: the equality requirement is that every employee who participates in a QBP award under the scheme must do so on the "same terms" and the equality requirement is infringed if the amount of an award to an employee under the scheme is determined by reference to factors other than: (i) remuneration; (ii) length of service; and/or (iii) hours worked. The simplest bonus structure is for all eligible employees to receive the same QBP amount. However, in our experience, companies often want to make different allocations among employees. This is fine provided that the acceptable factors are used to determine the allocations (i.e. remuneration, length of service and/or hours worked) in a way which is also acceptable. Perhaps the most common differentiating factor is "remuneration". If E wishes to use this method for calculating QBPs, it must first ascertain what "remuneration" is - there is no statutory definition of this so the term must be construed in accordance with its ordinary meaning and there is some flexibility here – there may be a choice between using contractual salary on a particular date, or actual pay/earnings over a particular period. Either way, E is likely to want/need to make adjustments to cater for various different practical scenarios and to mitigate the risk of discrimination when calculating QBPs– including (for example): excluding discretionary bonuses, including salary sacrifice amounts, adding back notional earnings for certain types of protected leave such as parental leave or sick leave. There may be other relevant considerations such as whether any employees are engaged on "zero hours" contracts such that they may not have any contractual salary or actual pay for a particular period. In our experience HMRC seem generally content to accept a calculation methodology which is seeking to be fair and reasonable, and there is also a need to take into account the relevant employment law aspects.

4. **The participation requirement is not infringed if E imposes a minimum period of continuous service which does not exceed 12 months (section 312C(3) of ITEPA)**: this carve out from the "participation requirement" (discussed at point 2 above) can be helpful. Note that a qualifying period of employment need not necessarily run to the "determination date" (this may assist with, for example, including seasonal workers). Also note that where E takes on new staff through a transfer under the Transfer of Undertakings (Protection of Employment) (TUPE) Regulations 2006, their past employment should be counted for the purpose of determining their length of service with E.

5. **The equality requirement is infringed if an award is made on terms such that some (but not all) of the employees participating in the scheme receive nothing (section 312C(7) of ITEPA)**: this can be a trap for the unwary in certain circumstances. For example, E must ensure that the methodology used to calculate remuneration or hours

worked does not result in any employee having zero pay or zero hours worked for the relevant period. This could happen where, for example, E employs individuals on zero hours contracts.

6. **If two or more acceptable factors are used to determine a QBP award, the equality requirement is infringed unless: (a) each factor gives rise to a separate entitlement; and (b) the total entitlement is the sum of those separate entitlements (section 312C(8) of ITEPA)**: if factors are combined, a separate entitlement for each must be established and they must be added together (not multiplied). The scheme rules should make clear what factors are being used and that each gives rise to a separate entitlement. In practice this means that using contractual salary as at a particular date (remuneration) and pro-rated for part time workers (length of service) may infringe the equality requirement – there may be a different methodology which achieves the same (or nearly the same) result (e.g. using actual pay (remuneration) over a particular period).

7. **Former employees (section 312B(1)(h) of ITEPA)**: E has flexibility as to whether to include former employees in the QBP scheme, provided a payment is made to a former employee within 12 months of the date they left employment with E. The drafting of the legislation indicates there is an opportunity to be selective as amongst former employees – i.e. E can choose certain former employees to benefit from a QBP and not others (subject to employment law considerations).

8. **Excluded payments (section 312H of ITEPA)**: a payment is "excluded" (i.e. does not qualify as a QBP) if an employee is party to an arrangement under which the employee gives up the right to receive an amount of earnings or income in return for a QBP. This is because a QBP must be a bonus payment which is entirely discretionary and paid in addition to all normal contractual income. That said, it is possible to adjust the total amount available for distribution as QBPs to take into account E's total "remuneration" commitments.

9. **Treatment of office holders who are not generally considered employees:** according to HMRC, a non-executive director (NED) is an "employee" for the purposes of the QBP rules in ITEPA. This means that they must be eligible to receive a QBP payment in order for the participation requirement to be met. This can cause particular difficulties where companies wish to determine the QBP amount by reference to remuneration, if a NED does not receive any "remuneration" (which, we understand, does not include consultancy fees). In this case, the equality requirement cannot be met in relation to that factor because the NED would receive a bonus amount of zero – the requirement is therefore infringed if E engages NEDs who do not receive director's fees through E's payroll. Care is needed in order to ensure the equality requirement is not infringed – a possible work around is for a QBP award to be split in two so that one part is a fixed amount awarded to all eligible "employees" (including NEDs with no remuneration) and a second part which is calculated in relation to "remuneration". However, it is not certain this approach would satisfy HMRC and it may be necessary to

make a non-statutory clearance application to HMRC to clarify the position.

10. **"Excluded participators" cannot be excluded from a payment of QBPs**: the excluded participator concept applies to any distributions which are made from an EOT – the terms of an EOT must provide that, broadly speaking, any individual (or connected person) who has (or has had for a look back period) held 5% or more of the shares in E (or E's parent company) (or 5% or more of any class of share in E) cannot benefit from the EOT, even if they are employees of E. There is no equivalent concept for the payment of QBPs – this means that even if an individual employee is excluded from benefitting from the EOT itself because they are an "excluded participator", they must still be eligible to benefit from a QBP payment to ensure there is no breach of the participation requirement.

11. **Consider impact of QBPs on benefits**: it is possible that payment of a QBP could impact an employee's eligibility for certain benefits. In relation to Universal Credit (UC), our understanding is that QBPs are not treated as earnings and so will not affect the entitlement of an employee to UC. More information can be found in this article. This same principle may apply to other types of benefit but this would need to be checked.

These eleven points do not represent an exhaustive list of the sorts of issues that an employer company should consider before making QBPs. However, hopefully they do demonstrate the benefit of giving the statutory requirements careful consideration and applying them to the relevant factual position and of taking independent advice in respect of any areas of uncertainty.

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