SLAUGHTER AND MAY

Incentives Bulletin

March 2019

Welcome to the March edition of our Incentives Bulletin, updating you on the latest developments in remuneration and share schemes. This month, we look at **HMRC's new spotlight on the 2019 disguised remuneration loan charge**, the EAT's decision that a **bad leaver provision in an SPA was not unconscionable or a penalty**, HMRC's ERS Bulletin 31 with **updates on EMI options**, the ECJ's decision that an **employer's loan to an employee was in scope for the *Unfair Contract Terms Directive***, and the upcoming **off-payroll working consultation**. We conclude with a timeline of **key dates in employee incentives** coming up in the near future.

Contents

- HMRC's new spotlight on the 2019 disguised remuneration loan charge
- Bad leaver provision in an SPA was not unconscionable
- Updates to EMI Options
- Employer's loan to employee was in scope of *Unfair Contract Terms Directive*
- Upcoming off-payroll working consultation.
- Horizon scanning

HMRC's new spotlight on the 2019 disguised remuneration loan charge

Summary and key practice point: Further to the upcoming introduction of the disguised remuneration charge under the Finance (No. 2) Act 2017 applicable to certain loans outstanding on 5 April 2019 where such loan was made by a third party to an employee, Spotlight 49 warns people from entering into certain arrangements where they receive money in a "fiduciary capacity".

More detailed analysis/commentary: This spotlight builds on Spotlights 36 and 39, and warns people off using schemes where they receive money in a "fiduciary capacity". In this spotlight, HMRC have said that arrangements, which may have professional marketing material and which may be marketed from an off-shore location such as Cyprus, Malta or Isle of Man, that claim to avoid the 5 April 2019 loan charge legislation, and which may claim that by entering the scheme, disguised remuneration loans are paid off and that the scheme is not disclosable under the Disclosure Of Tax Avoidance Schemes regime (and which may have a QC's opinion) should be avoided. HMRC's view is that these will be caught by the legislation, especially as the legislation excludes repayments which are non-monetary, and repayments connected to tax avoidance. HMRC's advice is to withdraw from such schemes and settle the relevant tax affairs with them.

The disguised remuneration loan charge, which affects certain loans made after 5 April 1999 which are outstanding at 5 April 2019, has been the subject of some criticism from MPs due to its arguably retroactive nature, and the potential to charge taxpayers who have previously disclosed such schemes and not been challenged. However, HMRC shows little sign of changing its stance and so those who used such schemes should consider carefully whether to settle with HMRC by the 5 April 2019 deadline.

Bad leaver provision in an SPA was not unconscionable

Summary and key practice point: In Nosworthy v Instinctif Partners Ltd [2019] 2 WLUK 469, the EAT held that a provision in a share purchase agreement that required an employee to forfeit certain deferred shares and loan notes if she left employment was neither unconscionable nor void as a penalty clause nor a failure to exercise discretion in good faith.

Facts: The Claimant joined Communications Operations Limited ("**COL**") in 2011. Approximately two years later, the company was sold to the Respondent. As part of such sale, the former owner of COL was required to issue shares in COL to the Claimant and another employee. These shares were then sold to the Respondent under a Share Purchase Agreement in return for initial consideration, and deferred consideration in the form of shares and loan notes that were subject to an earn-out. The agreement specified that the earn-out payments ceased to be payable if the Claimant was a "Bad Leaver", which included someone who voluntarily resigned. In addition, under a separate agreement (the "**Principal Agreement**"), the Claimant agreed that if she became a "Bad Leaver", the Respondent was able to reclaim an amount equal to the amount payable to her under the loan notes at the time the loan notes were redeemed (to be set off against the amount owed to her under such loan notes). Finally, the Articles of Association required that if she became a Bad Leaver, the loan notes would be forfeit in whichever way the Remuneration Committee determined in good faith, and she would be required to transfer her shares at the lower of cost and market value.

The Claimant voluntarily resigned. The Respondent required her to transfer her shares at cost and to forfeit her loan notes, in accordance with the Articles of Association. The Claimant brought a claim in the Employment Tribunal, maintaining that the provisions requiring her to forfeit her shares were unconscionable; that they amounted to a penalty; and that the requirement not to become a Bad Leaver breached the Modern Slavery Act 2015. She also claimed there had been a breach of the Articles of Association. This was rejected by the Employment Tribunal. The Claimant appealed against the findings on unconscionability, penalty and breach of the Articles of Association; the Respondent argued that the Employment Tribunal had no jurisdiction to hear a claim in relation to shares and loan notes. The EAT upheld the Employment Tribunal's decision.

More detailed analysis/commentary: In respect of jurisdiction, the EAT held that the Claimant's claim could not be heard as an unauthorised deduction from wages claim, as the payments were not made to her in her capacity as a worker but as a seller of shares; however, the Share Purchase Agreement was a contract related to her employment and so fell within their jurisdiction.

In respect of unconscionability, the EAT set out the three-part test for setting aside an unconscionable bargain: one party must have been at a serious disadvantage; the other party must have exploited that disadvantage in some morally culpable manner; and the resulting transaction must be overreaching and oppressive. However, there was no evidence that the Claimant had not been able to take legal advice (i.e. that she was at a disadvantage) and had, in fact, warranted that she had taken such

advice. They also noted that the remedy for an unconscionability claim was to put aside the agreement, which would mean she would not be entitled to the shares.

In respect of the Articles of Association, the Claimant argued that although the Articles stated that someone who voluntarily resigned would be a Bad Leaver, the Remuneration Committee could use its discretion to determine someone was a good leaver if dismissed other than summarily for cause. This was rejected – the definition of a Bad Leaver was clear, and there were no exceptional circumstances to suggest the Remuneration Committee should have reclassified her.

In respect of whether there had been a penalty for a breach of contract, the EAT noted that the Respondent had not sought to rely on a breach of the Principal Agreement nor attempted to enforce it – as that would have required reclaiming an amount of money from the Claimant, and did not refer to shares. Instead, they had relied on the Articles of Association. As there was no attempt to rely on a breach of contract, there could not be a penalty clause.

This case highlights the limits of the penalty doctrine – in particular, that while it can apply in an employment context, it must relate to a breach of contract. Similarly, it is a reminder that where the drafting is clear that someone is a bad leaver and no exceptional circumstances exist, it is not a misuse of discretion not to reclassify someone as a good leaver (even if they arguably could do so).

HMRC ERS Bulletin 31: updates to EMI Options

Summary and key practice point: HMRC has published ERS Bulletin 31 and provided the following key updates relevant to EMI options:

(1) where a company uses IFRS for accounting purposes, HMRC will update its guidance to reflect that IFRS16 will apply for the purposes of the gross assets test;

(2) certain instruments often issued in Switzerland, France, Germany and Austria which do not carry an interest in company capital cannot constitute ordinary share capital for the purposes of various parts of the employment-related securities legislation;

(3) if a mistake is made when notifying HMRC of EMI option grants, the course of action you should take depends on when the mistake was made; and

(4) it is not possible to bypass the requirement to make a statement as to working time at grant of the option.

More detailed analysis/commentary: ERS bulletin 31 contains a number of points of note. Of particular importance to non-UK based companies will be the declaration that jouissance shares (‘*actions de jouissance*’ in French and ‘*Genußscheine*’ in German) do not constitute ordinary share capital because while they carry an interest in dividends and winding-up as to unpaid dividends, they do not carry an interest in company capital. HMRC has also determined that building society permanent interest bearing shares are not ordinary share capital, but Swiss Participation Certificates with par value will meet the relevant criteria. HMRC has confirmed they will honour existing advantageous tax treatment for options over such instruments that currently subsist, but options granted on or after 6 April 2019 over such instruments will not benefit from such treatment. In addition, such instruments will not, with effect from 21 March 2019, be treated as meeting the ordinary share requirement for Corporation Tax relief under Part 12 of the Corporation Tax Act 2009.

In respect of notifying HMRC of mistakes with respect to notification (not to the underlying grant), ERS Bulletin 31 builds on the guidance offered in ERS Bulletin 30 and notes that a mistake that is spotted

within 92 days of granting the option can be remedied by simply re-notifying HMRC. A mistake noticed after the 92 days but within nine months of grant, if there is a reasonable excuse, can be notified by obtaining a reasonable excuse code from HMRC (and the originally issued incorrect options should be cancelled when the ERS annual return is completed and filed). However, a mistake noticed after nine months or without a reasonable excuse for the mistake cannot be corrected and should be notified to HMRC so that they can assess whether the error was material.

HMRC has also published guidance on the notification of restrictions on shares to participants and notes that if they have not been notified, this should be remedied as swiftly as possible and in line with published guidance.

Finally, HMRC has updated its contact details, noting that the postal address is now: Charities, Savings and International 1, HMRC, BX9 1AU; and their email address will soon end with @hmrc.gov.uk rather than hmrc.gsi.gov.uk

Employer's loan to employee was in scope of *Unfair Contract Terms Directive*

Summary and key practice point: In Pouvain v Electricité de France (Case C-590/17) the ECJ held that a loan made by an employer to an employee can fall within the scope of the Unfair Contract Terms Directive.

Facts: The employer granted a loan to the Claimant and his spouse to assist in the purchase of their home. As part of the loan agreement, the Claimant agreed that if his employment were to be terminated, the loan would become repayable immediately. The Claimant resigned from his employment and the employer issued a summons for €5,023,837. The Claimant appealed to the Regional Court of Saint-Pierre, who ruled that the term requiring automatic repayment on termination of the loan was unfair. This was then overturned on appeal by the Court of Appeal of Saint-Denis on the basis that, as the employer had made the loan in its capacity as an employer, it could not be a *seller or supplier* for the purposes of the French consumer code and therefore the loan was not in scope for protection from unfair terms. The Claimant appealed to the Court of Cassation, who referred the question of whether the employer could be a *seller or supplier* to the ECJ.

More detailed analysis/commentary: The ECJ has confirmed AG Bobek's opinion and ruled that although the Unfair Contract Terms Directive does exclude contracts relating to employment from scope, a loan agreement made by an employer to an employee is not necessarily excluded from scope. Whether the Unfair Contract Terms Directive applies will depend on the capacity of the contracting parties and whether they were acting for purposes relating to their trade, business or profession - the fact that the parties are also parties to an employment relationship does not preclude the Unfair Contract Terms Directive applying. It also does not matter if a certain type of contract was reserved for certain groups of consumers nor does it matter if the main activity of the employer is not offering financial instruments: the fact the employer has technical information, expertise, and human and material resources that the other part does not have is relevant. A broad interpretation of *supplier* would help achieve the objective of the Unfair Contract Terms Directive, being protecting the consumer as the weaker party

In the world of share schemes, it is not uncommon for employers to offer a loan to their employees to assist in purchasing the shares. Although the *Unfair Contract Terms Act 1977* used to exclude contracts relating to the creation or transfer of securities, the *Consumer Rights Act 2015* does not contain such a provision. Whether the decision in this case will be upheld in English law after the UK leaves the

European Union remains to be seen, but it would be prudent to review the terms of any loan agreement an employer may wish to enter into with an employee, to ensure terms contained within are not too onerous.

Upcoming off-payroll working consultation

Summary and key practice point: HMRC has launched a consultation on the practicalities of the extension of the public sector off-payroll working rules to the private sector from 6 April 2020. If the legislation, which is expected to be contained in the Finance Bill in summer 2019, proceeds then with effect from 6 April 2020, it will be the client's responsibility to confirm whether the intermediaries legislation applies and therefore whether payments made to a personal service company should be subject to deductions for income tax and employee NICs.

More detailed analysis/commentary: At the moment, if a client contracts with an individual, the client must determine whether the individual is an employee or self-employed for tax purposes. However, if a client contracts with a service company, it is the service company's responsibility to determine whether they fall within IR35, which requires a determination as to whether any individual provided to do the work would, if not for the service company, be an employee/office holder of the client for tax purposes. It is now proposed that, with effect from 6 April 2020, this determination will be the client's responsibility. If the client decides that IR35 does not apply, the fee payer will (as now) continue to pay the intermediary gross.

Both private sector and public sector clients will have to inform both the entity with which they contract, and the worker, of their determination (and, if requested, the reasons for it). In addition, all recipients of the determination will be required to pass it to the person with whom they contract, before the first payment is made under the arrangements.

HMRC has confirmed that, in making the IR35 determination, clients should apply the normal employment status tests. To help public sector clients make the determination, HMRC launched Check Employment Status Tool (CEST). CEST has been criticised as being biased towards a finding that IR35 applies and HMRC says it will improve it.

Where a contractor disagrees with the determination, the only current recourse is an appeal to HMRC. HMRC is proposing to change this so that the client bears the burden of resolving disputes.

Under existing IR35 public sector rules, the liability to account for income tax and NICs can be transferred from the fee payer to another party in limited circumstances. HMRC is proposing to extend the rules in both sectors so that, in the event of non-compliance, the entity in the supply chain that fails to comply will be liable for PAYE, NICs and apprenticeship levy, unless and until it complies. In addition, if HMRC is unable to collect the liability from the relevant entity, the liability will transfer to the first agency in the supply chain and ultimately to the client.

Horizon scanning

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

12th April/22May 2019	European Union (Withdrawal) Act 2018 expected to take effect (subject to Parliamentary discussions)
4th April 2019	Gender pay gap reporting deadline
6th April 2019	Extension of holding period to qualify for entrepreneurs’ relief extended to two years from disposals made on or after this date
April 2019	Annual updates to employment rates and limits

Jonathan Fenn
T +44 (0)20 7090 5025
E Jonathan.Fenn@slaughterandmay.com

Padraig Cronin
T +44 (0)20 7090 3415
E Padraig.Cronin@slaughterandmay.com

Phil Linnard
T +44 (0)20 7090 3961
E Phil.Linnard@slaughterandmay.com

Ian Brown
T +44 (0)20 7090 3576
E Ian.Brown@slaughterandmay.com

© Slaughter and May 2019
This material is for general information only and is not intended to provide legal advice. For further information, please speak to your usual Slaughter and May contact.

Dated March 2019