

Bonus deferral: pitfalls for the unwary

Background

The additional rate of tax, which applies to taxable income above £150,000, has stood at 50% since it was introduced in April 2010. However, it has been announced that the additional rate will be reduced to 45% with effect from 6 April 2013. As yet, the Government has not announced or indicated that any anti-forestalling measures will be introduced. Therefore, some employers and their employees (who are within the additional rate tax band) are considering deferring bonuses that may otherwise be paid before the decrease in tax rate until on or after 6 April 2013. This could be beneficial to employers as it may incentivise key employees, who could potentially make a big saving. In deciding to defer bonuses, several tax and employment law issues must be borne in mind. In addition to this, some wider reputational issues should be considered.

Deferral of bonuses – timing and consent

Where payment of a bonus is discretionary¹, it can be “deferred” by deferring internal decision-making processes until on or after 6 April 2013, and employee consent will not be legally required. Where, however, the payment provisions of a bonus plan are contractual, employers will need to seek employee consent to any proposed deferral. Employers may decide to offer all additional rate taxpayers the chance to elect to defer the payment of their bonus or to universally defer payment and seek consent to do so.

Note that in relation to discretionary bonuses, it is possible that past practice may lead to bonuses being “expected” by employees on or about a certain date. As such, it would be advisable to inform employees about any deferral plans, being careful not to use any language which suggests there is a contractual right to the bonus. Even without such past practice or expectations, there may be value in consulting with employees, or at least informing them of any intended changes, to reduce the risk of employees complaining about the deferral.

¹ Note: the relevant discretionary elements must be truly discretionary – determining this will require careful consideration of the plan’s terms, any implications arising from the history of payments made under the plan, any communications made with employees, etc.

For a discretionary bonus, any consultation should be carried out, and consent obtained, in writing before the date on which the bonuses are habitually paid. For a contractual bonus, consultation should be carried out and consent should be obtained in writing in advance of the time when the employees would otherwise be taxed in respect of the bonus (see next section).

Timing of taxation of bonuses

Bonuses are taxable as employment income so are subject to income tax and national insurance contributions (“NICs”) when the payment of the bonus is treated as made, usually the earliest of the time the payment is actually made and the time the person becomes entitled to the payment² (this is distinct from the time when entitlement to the bonus arises, e.g. when a performance target is met).

Making deferral of a bonus effective for tax purposes

To make deferral of a bonus effective for tax purposes, it is essential to defer not only the actual payment of the bonus but also the time at which the intended recipient becomes entitled to payment of the bonus.

Deferral of a bonus will not defer the accompanying income tax and NICs liability where either: (a) an employee is entitled to payment of a bonus on a specified date in the current tax year and the employer simply delays payment until on or after 6 April 2013; or (b) an employee is entitled to payment of a bonus on a specified date in the current tax year and the employee agrees with the employer on or after that date that the payment need not be made until on or after 6 April 2013.

However, deferral of a bonus will succeed in deferring the accompanying income tax and NICs liability where either: (a) an employee is entitled to payment of a bonus on a specified date in the current tax year and a deferral

² Note: slightly different rules apply to income arising to a director.

of this payment to on or after 6 April 2013 is agreed between employee and employer in advance of that date; or (b) where the payment date of a bonus is discretionary and the employer determines (and, where necessary consults with employees) prior to any habitual payment date that the bonus will be paid on or after 6 April 2013.

Key additional considerations

Third parties: It is important to be aware that, where a bonus is to be paid by a third party (i.e. any entity other than the employee's employer, although group companies may not be regarded as third parties), such as an employee benefit trust, the disguised remuneration rules may apply. A wider discussion of these rules is beyond the scope of this alert, but note that the disguised remuneration rules could give rise to an income tax charge and liability for NICs earlier than the time when the recipient becomes entitled to the payment. In particular, where a sum of money is earmarked with a view to later payment to the employee, that can give rise to an income tax charge at the time at which the sum is earmarked for the employee, even if the employee is not yet entitled to receive payment of that sum.

Anti-avoidance: Any bonus deferral must, of course, be genuine to be effective for tax purposes. Furthermore, although there are (as yet) no express anti-forestalling provisions that would prevent a bonus deferral being effective for tax purposes, employers should be aware of the planned general anti-abuse rule ("GAAR"). The exact scope of the GAAR is still to be finalised. That said, where any bonus deferral is genuine, and in particular where the bonus is "at risk" until the entitlement date or the date of payment, if earlier (for example in the event that the employee leaves before its payment due date, the bonus is forfeit), it could be argued that the deferral of the bonus constitutes a reasonable course of action, in which case the GAAR should not apply. In any event, as at today's date, the GAAR is expected to apply from the time when royal assent is given to Finance Bill 2013 (which will probably be in June or July 2013), in which case

arrangements completed prior to June/July 2013 ought not to be caught by the GAAR. However, this is something to keep under review over the coming months.

Reputational issues: Even if bonus deferral arrangements are not caught by the GAAR or any specific anti-avoidance provision, employers may wish to bear in mind the current atmosphere of hostility towards those who are seen as not paying their "fair share" of tax. In addition, although bonus deferral arrangements carried out in accordance with the above principles should be a legitimate means of reducing the income tax payable by high earning employees, and in particular where the bonus remains "at risk" until the entitlement date or the date of payment, it is possible that use of such arrangements could encourage HMRC to take a closer look at an employer's tax affairs.

Effect on company: A bonus deferral that is effective for tax purposes will also defer the time at which a bonus may be treated as a deduction for the employer company for corporation tax purposes.

Conclusion

Deferring bonuses is by all means possible and could be beneficial to employees. However, the employment and tax implications and issues outlined above should be considered carefully before deciding to offer a deferral to highly-paid employees. Although legally permissible, there could be reputational issues if a significant tax saving is involved, and if employers and employees are not careful they may think that a bonus has been deferred when the tax point has already occurred.

James Hill

Partner, Tax

T: +44 20 3130 3227

E: jhill@mayerbrown.com

Bernadette Daley

Partner, Employment

T: +44 20 3130 3667

E: bdaley@mayerbrown.com

Mayer Brown is a global legal services organisation advising many of the world's largest companies, including a significant portion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. Our legal services include banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory & enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

OFFICE LOCATIONS AMERICAS: Charlotte, Chicago, Houston, Los Angeles, New York, Palo Alto, Washington DC

ASIA: Bangkok, Beijing, Guangzhou, Hanoi, Ho Chi Minh City, Hong Kong, Shanghai, Singapore

EUROPE: Brussels, Düsseldorf, Frankfurt, London, Paris

TAUIL & CHEQUER ADOGADOS in association with Mayer Brown LLP: São Paulo, Rio de Janeiro

ALLIANCE LAW FIRM: Spain (Ramón y Cajal Abogados)

Please visit our website for comprehensive contact information for all Mayer Brown offices. www.mayerbrown.com

Mayer Brown is a global legal services provider comprising legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe-Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorised and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown JSM, a Hong Kong partnership and its associated entities in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. "Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.

© 2012. The Mayer Brown Practices. All rights reserved.

0608cor
January 2013