# Out with the Old, In with the New

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2004 saw a flurry of Government activity in the field of employee benefits in the UK. This alert addresses three topics:

- the 366-page Pensions Act 2004 (or rather a few selected aspects);
- a loosening of certain tax rules which were restricting entrepreneurial activity in the University sector; and
- impact of new guidance on transfer pricing and share incentive arrangements.

The Pensions Act and the proposed tax changes in the University sector illustrate an interesting development in the Government's approach to business. On the one hand, the Government clearly believes that, faced with a wealth of cheap labour in the Far East, the UK must invest in hi-tech, value added manufacturing and services. This view has led to a number of measures intended to help technology-based companies. Such measures have included the creation of tax efficient enterprise management incentive (EMI) options and the extension of the scope of R&D tax credits, which allow certain companies actually to receive cash from the Treasury. This focus on hi-tech has, in turn, allowed the Universities to lobby successfully for an easing of the tax burden on academics who found spin-out companies. In contrast, the UK still has large companies (many in traditional manufacturing) with older style defined benefit or final salary pension schemes, many of which are in deficit. Such companies, certainly in the pensions area, are subject to an increasing level of regulation and expensive protective measures. The areas covered by this briefing note illustrate this well—a helpful tax relief for small technology-based University spin-outs and measures which are likely to increase costs for those companies running defined benefit pension schemes which, these days, are usually only offered by large, well established companies or the public sector.

**Pensions Act 2004**

The Government, in response to high-profile examples of pension scheme insolvency (the situation in relation to the Turner & Newell and Allied Steel & Wire funds being relatively well-known) and continuing deficits within ongoing pension schemes, has introduced legislation designed to improve members' security. The legislation, generally speaking, focuses on occupational pension schemes which provide defined benefits. The Pensions Act contains a wealth of measures, including the creation of a new pensions regulator and the pension protection fund. The latter is intended to meet, at least partially, the liabilities of pension funds which are not able to provide the promised level of benefits. Most elements of the Pensions Act will, we are told, come into force in April 2005. However, retrospection cannot be discounted completely!

As well as seeking to underpin pension scheme failures, the Pensions Act introduces a number of measures to try to ensure that full contributions are paid by employers to the scheme. Of course, given that the new pension protection fund will be at least partially funded by the Treasury, the Government is anxious to ensure that schemes are well funded. To this end, for example, the Act requires scheme trustees to prepare a statement of contributions based on a scheme specific funding basis (rather than the current prescribed minimum funding requirement). However, this briefing note focuses on some of the potential liabilities arising on the sale of a company which has up to that point participated in the seller's pension scheme. The impact of this new legislation must be taken into account in all merger and acquisition activity. Not doing so may result in purchasers overpaying for the business and leaving themselves open to significant liabilities.

For a number of years the UK has had legislation imposing potential "exit" penalties on companies which cease to participate in occupational defined benefit pension schemes. A common reason for ceasing to participate in such a scheme is the sale of a subsidiary company. Under the current law the existing subsidiary is liable (and remains liable) for its share of any deficit within the pension scheme. Any such "debt" is then owed to the trustees of the relevant pension scheme. Up until now, this legislation has not caused too much difficulty since the deficit in question was calculated on a generous actuarial basis laid down by legislation. However, this is about to change under the provisions introduced by the Pensions Act.

Under the Act, the Government can now introduce regulations to amend the basis on which this debt is calculated. The Government intends to impose a stricter (read more expensive) actuarial basis. The Government's announcement that new legislation in this area was to be introduced suggests that an insurance company buy-out basis will be used to calculate the debt. Given that virtually all UK pension schemes will be significantly under-funded on a buy-out basis, this approach would trigger large debts when companies are sold which, in turn, is likely to impact purchase prices significantly and may even affect the viability on the whole transaction.

Fortunately, the Act makes provision for the application of alternative bases of calculation where "prescribed requirements" are met. The nature of the prescribed requirements is not made at all clear in the Act. However, the explanatory notes published with the Act list possibilities such as making the top company of a group liable for the debt or obtaining a bank guarantee. All such arrangements are likely to require the approval of the new pension regulator. The advantage of entering into these arrangements is that the debt is likely to be assessed on a scheme specific basis and not the buy-out basis. Depending on the circumstances, this is likely to eliminate or drastically reduce any debt owed to the trustees.

Given the dramatic impact this legislation will have, it is important to be clear when it is coming into force. Unfortunately, this is not at all clear although the indications are that it will apply from April 2005. However, this cannot be guaranteed—it could come in earlier!

This area is but a small part of the Pensions Act, but it is of crucial importance when subsidiaries are being bought and sold. Not to take full legal and actuarial advice could destroy the value of an acquisition. In contrast, potential sellers with issues in this area should consider forcing sales through before April 2005. Otherwise, they may find that the sale price of the business is severely reduced.

**University Spin-outs**

The Government has actively encouraged so-called University spin-out activity. This is a process whereby academics who have developed technology whilst employed at a University commercialise that technology by forming a company (the spin-out company). The relevant University will transfer intellectual property to the spin-out in return for a shareholding. The academic founders will also take shares in the company. Unfortunately, the revamp of the taxation of share-based benefits under the Finance Act 2003 has had a severely detrimental effect on spin-out activity.

Prior to the Finance Act 2003, academic founders expected to pay tax if and when the shares they received (normally for virtually no payment) were sold and under the more favourable capital gains tax regime, not income tax. This was important since capital gains tax relief was likely to reduce the tax rate from 40% to 10%.

The Finance Act 2003 attempted to close perceived loopholes which permitted large bonuses to be provided to employees in shares rather than cash with significantly better tax and national insurance treatment. A side effect of this new legislation was to impose potentially significant income tax charges on academic founders around the time the shares were first purchased—that is when the shares could not be sold. This dramatic change led to many spin-outs being shelved.

After a year of debate with University representatives, the Government in the Chancellor's pre-budget report in December 2004 announced certain measures to help spin-outs and re-introduce the prospect of a 10% tax rate for academics. The changes envisaged will be part of the Finance Bill of 2005 and likely to become law in July or August 2005. However, the Government has said that the legislation will be backdated to December 2004.

The Government's proposals address the potential income tax and national insurance contributions in relation to academic founder shareholdings which might arise as the intellectual property (IP) on which the spin-out is based is transferred to the spin-out, typically by the sponsoring University. In short, the proposed tax relief consists of ignoring, for the purposes of the tax position of the founders, the value of the IP.

Draft legislation is due to be published shortly and a consultation exercise is underway. However, what is clear from the announcement is that this is a limited measure and is unlikely to be able to be utilised by those outside of the University spin-out sector. The press release warns of anti-avoidance provisions applying " *… where commercial organisations attempt to abuse the provisions for their employees."*

The announcement is an important shot in the arm for the spin-out sector. However, the exact ambit of the relief needs the clarification which will only come when the draft legislation is published. This will also enable a clearer assessment of whether the relief is available on any given spin-out. The exact spin-out structure varies between universities as does the exact role and input of the academic founders—all of which are important.

In addition, there must be some residual doubt as to whether the necessary legislation will be enacted given that 2005 is an election year. We suspect, however, that this measure will receive cross-party support.

**Transfer Pricing**

Transfer pricing describes the Inland Revenue’s ability to adjust the tax bills for group companies on the basis that goods and services provided between group companies have not been properly charged on an arm’s length basis. Recently there have been a number of developments on the interaction between share schemes and transfer pricing.

Historically, there was some debate as to whether the transfer pricing rules applied to share schemes. In 2001, it was decided in the *Waterloo* case that the transfer pricing rules did apply to share schemes, essentially that the provision of shares to a subsidiary was a “business facility”—a requirement of the tax legislation then in force. Since the case declared the law as it should have been interpreted all along, there was a significant issue as to how far the Inland Revenue might go back and seek tax adjustments. The Revenue have now confirmed that they will “only” go back to 1997. In addition, the Revenue have confirmed that no transfer pricing issues will arise if the shares provided to employees were new issue shares. The *Waterloo* case itself concerned trustees purchasing shares. Thus, for many international groups, the UK transfer pricing rules may not be too onerous. It should be remembered that other countries have transfer pricing rules which may not be so beneficial.

The 2004 Finance Act recently revised the transfer pricing rules. Firstly, transfer pricing now applies to all groups, even those comprising solely UK companies. Secondly, the transfer pricing rules will not apply to small and medium size enterprises (known as SMEs). SMEs are defined as groups with less than 250 employees (worldwide) with a turnover of less than €50m (again on a worldwide basis) or balance sheet worldwide net assets less than €43m. So far as share schemes are concerned, for those groups which are not SMEs, further help is provided since the Finance Act 2003 introduced a statutory tax deduction in relation to shares provided to employees. It would be nonsense for the Revenue to make a transfer pricing adjustment only for the charge to be relieved due to the corporation tax deduction. Accordingly, the Revenue accept that, where corporation tax relief is available, no transfer pricing adjustment will be made. Of course, these are UK rules and so the transfer pricing legislation of other jurisdictions may apply.

**Conclusions**

The Government has yet again shown its willingness to legislate in the employee benefits area. One result of this is that it is ever more important to take specialised advice early. In the pension area for example, this is obviously important for buyers who do not wish to take on significant liabilities. It is also important for sellers prior to a sale since pensions may well become a major issue in negotiations and it will be best to conduct those negotiations after a full appraisal of these issues. Similarly, in the University spin-out context an early analysis of the current tax rules and the Government's proposals will be needed since the outcome of that analysis may impact the structure adopted. This is especially the case since circumstances between spin-out projects will differ and so the tax relief offered up by the Chancellor may apply to some spin-outs but not others. Likewise in the transfer pricing area, a group with subsidiaries in different jurisdictions will need to assess the impact of the UK rules and those in other relevant jurisdictions.

**Further Information**

For further information on this alert or any other aspects of employee benefits, please speak to your usual WilmerHale contact or any of the following members of the UK and US tax group listed above.

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