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INTERNATIONAL PENSION LAWYER

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INTERNATIONAL
PENSION LAWYER

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From the Editor…

Dear Members,

I am very excited and pleased to be entrusted by the Steering Committee with the editorship of the Journal. Of course our sincere thanks to Leanne van Wyk for her 6 years of tenure as Editor. Despite a very busy work schedule Leanne has consistently churned out 3-4 volumes every year. Added to this we have seen the development of a new hard copy format of the Journal, the development of a standarised policy on journal contributions, and the latest development – the new electronic edition of the Journal. So our many thanks to Leanne for her commitment and dedication to the Journal.

I would also like to thank the Journal Country Representatives for all their hard work in sourcing articles and communicating with authors in the various regions around the world. Thank you for your dedication in keeping articles flowing for the benefit of the Journal and our membership.

This edition of the Journal takes on special significance for two reasons. This is the first edition that is fully electronic. As foreshadowed in the email communication that accompanied the last volume of the Journal, apart from a limited print run (for the benefit of libraries and authors), the International Pension Lawyer will now operate as a fully electronic edition. You will see that there have also been a few design changes to reflect this new electronic style.

The second significant feature of this volume is the theme – "Employee Benefits". This volume is intended by the Steering Committee to focus on the "EB" part of the IPEBLA name. In the past IPEBLA has traditionally focused on the "pension" side of the law. As part of an effort to focus on the broader aspect of international employee benefits, this volume of the Journal has been dedicated as a "special" employee benefits edition.

The EB focus has the added advantage of generating contributions from jurisdictions not traditionally covered in the Journal. In this respect I draw your attention to the article from Argentina, which focuses on the nature and definition of salary and how that in turn impacts upon the structure of benefit and compensation arrangements. See also the Singapore article which examines how the Singapore model (the

Central Provident Fund) has evolved past its pension origins to provide a holistic system that covers other employee benefits like health, risk, education, housing, savings, and investments.

Concentrating on life and health insurance benefits, the Canadian article examines recent legislation implementing a new vehicle called a "employee life and health trust" (ELHT), and offers practical insights into the advantages that a properly structured ELHT can provide to all stakeholders in the employment (and post employment) relationship, namely employers, employees and retirees.

Continuing the theme of the provision of health insurance through the employment relationship, the first US article examines the topical (and not to mention controversial) subject matter of US health reform, which is sure to be a continuing policy issue with a US election looming in the not too distant future.

Addressing the broader theme of the notion of a "fiduciary" for investment advice purposes, the second US article examines potential reform that, although continuing to be debated, anticipates a re-defining of traditional advisory relationships with the intent that many more service providers will be caught within the "fiduciary" net.

The authors of our final article examine the ever important issue of structuring incentive arrangements in a way that seeks to minimise the tax burden for employers and employees. In particular the use of diagrams and practical examples guides us through the potential minefield of complex UK tax regulation.

Our many thanks to the authors (and country representatives who sourced the articles) for providing such interesting and insightful contributions in the EB arena, and for certainly making this volume a "special" edition.

Our next volume of the Journal will focus on the 2011 Berlin Conference with articles updating and summarising the content and discussions in the workshops (so a general reminder to all workshop coordinators to send your articles in).

With best wishes until next time,

Lisa

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From the Chair…

Hello

The new Steering Committee elected me as chair, Wijnanda Rutten to continue her great work as Treasurer, and Brian Buggy (fresh from his Berlin success!) as Secretary. The full committee, with portfolios, is on page 7 – two longer than usual as members agreed our expansion proposal.

For those who weren't at the conference I repeat here our huge thanks to Randy Bauslaugh for his creative drive over the two-year session, and for his continuing work as the IPEBLA joint chair (with Caribbean Actuaries Association) of next year's Jamaica conference (Montego Bay, April 22 to 24).

Lisa Butler Beatty also continues, and is our new editor of the Journal (see her pic on page 2).

George Bostick is very busy at the US Treasury, and has not stood again for committee, but we are great friends and hope to see him at next year's conference. Jens and Mitch (who continues on the committee), are also great friends, and respectively on our new teleconference committee and Rome 2013 chair. Jonathan Mort also did not stand again for the committee, but will be one of the Rome vice-chairs, and continues as co-editor of the Survey. Our thanks to them all, and to the continuing members for their great work in the last session.

2011 – 2013 focus

For richer, for poorer…our focus will be on:

- **EB lawyers** – the compensation guys who may glance at our IPEBLA name and be disappointed at the lack of EB content. Berlin made a start, with a plenary session and several workshops. In the USA particularly the pensions lawyers have always been practicing in wider areas, and in Latin America you will find 'benefits' lawyers but very few pensions lawyers – but a great need for pensions law! This issue of the IPEBLA journal is an opportunity for them, and we intend to build on it.
- **Developing countries** – the challenge of looking ahead at the demographics of 2050 while meeting the needs of the present elderly, often abandoned by families moving to towns far from their rural origins. Karla Small Dwyer of the Jamaica Financial Services Commission holds the newly created portfolio for developing countries, and at Berlin we had delegates from three of the smaller African nations.

Both these areas will feature in our 2012 joint conference, in future issues of the journal, and in teleconferences. Our website discussion forum will kickstart some of the discussions.

Young members

Last fall we introduced a range of incentives to widen our membership. The one I want to focus on here is:

- **Young Leaders** - Pension law practitioners with less than 5 years experience pay half the membership fee.
- 1st year FREE for associates or trainees nominated by an IPEBLA full member in their firm, up to three per firm.

If our association is to play a significant educational role, it has to reach down, below partner level, to the associates whose interest may be fired by our breadth and ideas. We are planning to give young members special opportunities for writing in the journal, but the starting point is to get them into membership.

The 2nd bullet above is the free category. We created it so that there should be no budgetary implications in enrolling your young associates. You can even do it on a sequential basis, whether or not they subsequently become half-price members.

Please action this in your own firms.

Academics; Government Officials

Academics and government officials also qualify for the half membership fee in the new system, and I dare say that if they think they're young we'll join them up for a free first year – research students and Professors, roll up!

Berlin

The May conference was fun, and brilliantly attended – 141 members and 33 accompanying partners, from 22 countries. Our Q3 journal will report fully.

Meanwhile, the photos are on the IPEBLA website.

Thanks to Brian and all the committee, and to Katherine at Managing Matters for 18 months' hard work and huge support at the conference.

The conference was dedicated to the memory of our dear member, Gary Nachshen, who passed away so unexpectedly shortly before. A full appreciation of Gary as a family man and lawyer will appear in the Q3 conference edition.

Journal

Our first electronic issue was a great success, reaching members over two months ahead of the mailed print. Lisa (on page 2) tells us about the Berlin conference edition which will reach you in December.

Comparative Law Survey – 25 countries

Our survey, free to members, now covers 25 countries – up from 18 in the first edition. The overview, and consistent headings, are invaluable for a quick glance at how a country organises (and taxes) pension provision. Being written for lawyers, the nature of the pension entity, and responsibilities of governance, are both covered.

The brainchild of Jonathan Mort (South Africa), and co-edited by him and Lisa Butler Beatty (Australia), their aim is to publish biennial editions, to coincide with our members' conference – next due Rome 2013. The current edition was distributed at Berlin, and mailed out in June to members who were not at the conference. If you have not received your copy, please email contact@managingmatters.com.

Best regards,

Jonathan Seres

on behalf of the 20011/2013 IPEBLA Steering Committee

Production Schedule

	3rd Quarter 2011	1st Quarter 2012
	IPEBLA Conference	**What's New**
Deadline for articles to country representatives	14 November 2011	16 January 2012
Deadline for articles to editor	14 November 2011	20 January 2012
Publishing date	8 December 2011	27 January 2012

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Employee Benefits in Argentina

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Argentine legislation provides a definition of salary that has been subject to different interpretations over the years. With abrogated laws, contradictory jurisprudence and twisted interpretations or the legal regime in force, the scenario of benefits and compensation structures is not only complex but risky. This article will explain the Argentine regulations on salary and benefits, the evolution of case law, and the answers that this puzzling context demands.

The legal nature of employee benefits other than salary, which in general terms are those allowances or compensation aimed to improve the employee's quality of life, have been object of long and controversial debate over the last fifteen years in Argentina. The current position adopted by the law and labor case law provides a criterion that is clearly detrimental both for employers as well as for employees.

1. Legal framework

Employment Contract Act Nº 20,744; and *Social Security Act* Nº 24,241.

These regulations provide the legal definition of salary and establish its requirements and specific legal characteristics.

The *Employment Contract Act* (**ECA**) defines "remuneration" as:

> "…the compensation that the employee **must** receive as a consequence of the employment contract…", (emphasis added)

and on the other hand, the *Social Security Act* defines it as:

> "…all income received by the affiliate, be it in money or in kind, capable of pecuniary appreciation, **as retribution or compensation or due to his personal activity**". (emphasis added)

It may be concluded from these two legal definitions that, according to their strict and literal terms, remuneration is any payment (in money or in kind) that the employer must make to the employee as a consequence of an obligation imposed by law or the applicable collective bargaining agreement.

Thus it is undoubted that the minimum amount of money established by law (the minimum wage) and/or by the applicable collective bargaining agreement will have remunerative nature for the purposes of calculating the thirteenth salary, vacation and other leaves (i.e. sick leave, pregnancy leave and indemnifications derived from the termination of the employment relationship, as well as for the determination of the base salary to be considered for the payment of social security contributions.

Therefore, the minimum amount established by law or collective agreement that the employer "must" pay the employee "as compensation … for his personal activity" will certainly constitute "salary".

It may also be quickly concluded that any payment in money or in kind made by the employer to the employee within the employment relationship that does not meet the defining conditions of salary would exceed the aforementioned legal framework and, consequently, said payment would not have a remunerative intent; but rather it would be a fringe benefit lacking remunerative nature, and motivated by the employer's desire to improve the employee's quality of life.

Nonetheless, it would be an error to conclude that any payment that exceeds the baseline set by the law or collective agreement would be excluded from the legal concept of salary. Although this would be a simple solution given the complex nature of salary, part of the academic opinion rejects the restrictive definition of salary provided by law and reasonably argues that it should be presumed that:

> "any economic compensation received by the employee within the employment contract that **may not be imputed to a different cause** is motivated by the performance of work and must therefore be considered as remuneration, **as long as it is not proved to stem from another cause or title**".[1] (emphasis added)

The preceding definition points out that the employee's individual performance constitutes the cause of the payment of salary. Therefore, any economic allowance granted by the employer in order to compensate the employee's effective rendering of services will have salary nature, whereas any additional compensation that is not generated by the employee's activity will lack salary nature.

In this sense, it is essential to determine which payments are meant to compensate the performance of services and which are not.

As I have mentioned, it is clear that the minimum mandatory baselines established by law or by collective agreement are salary. It is also irrefutable that the amount agreed as salary by the parties to the employment relationship also represents compensation due for personal work.

Now, above the minimum levels and specific contractual conditions, the legal nature (remunerative or non-remunerative) of the other allowances that the employer may grant its employees may give rise to doubts and different interpretations.

The best way to clarify the scenario avoiding contradictory interpretations that may generate controversy and lawsuits is through the law.

In those cases in which legislation clearly establishes the legal nature of a certain amount of money or, in general, of any allowance in money or in kind granted within the employment contract, the

[1] López, Justo, "El Salario", Ediciones Jurídicas, Buenos Aires, 1988.

possibility of controversy is reduced, if not eliminated.

On the contrary, when the laws are ambiguous and give rise to different interpretations, or in the absence of legal regulations, the discussion regarding the remunerative or non-remunerative nature of the allowances that exceed the legal salary – whether they are a liberality of the employer or imposed by collective agreements or contracts – may become ever more complex.

This controversy involves costly consequences, because Argentine laws establish that any compensation in money or in kind that is not registered as salary may give rise to a very high economic contingency derived from possible administrative sanctions, social security debts, indemnifications for deficient registration, and salary and indemnification differences.

In September 1996, Act Nº 24,700 clearly and precisely defined the benefits aimed to improve the employees´ quality of life that, due to said purposes would not have remunerative nature, thus providing legal certainty over this controversy. However, throughout its evolution, case law gradually drifted away from the most important concepts established in said act, challenging its constitutionality.

The grounds used by labor courts to challenge the legality of the dispositions of Act Nº 24,700 have prevailed in most case law and have recently extended to almost all fringe benefits that companies grant mostly to executives and hierarchical personnel. In this way, the concept of compensation has been extended to such broad limits that they disregard the essential definition of salary.

2. Legal treatment of benefits

Even though, as mentioned in the introduction, the legal treatment of employee benefits has been greatly developed over the past fifteen years, this article will focus on the legislative and jurisprudential changes that have occurred during the recent past.

Most case law of the last years holds true the criterion that fringe benefits have a remunerative nature. The legal grounds of said position are found in the provisions of Article 1 of Convention Nº 95 of the International Labor Organization (**ILO**), which in Argentina is hierarchically superior to the law, and that defines "salary" as:

> "remuneration or earnings, however designated or calculated, capable of being expressed in terms of money and fixed by mutual agreement or by national laws or regulations, which are payable in virtue of a written or unwritten contract of employment by an employer to an employed person for work done or to be done or for services rendered or to be rendered".

According to judicial interpretation, the terms of this article give grounds to the criterion that holds the remunerative nature of *"all earnings derived from the employment contract"*. In this sense, in the precedent *Perez Anibal v Disco S.A* (September 2009), the National Supreme Court of Justice held a broad criterion in connection with the definition of salary, and stated that remuneration should be defined as *"all earnings of the employee stemming from the employment contract…"*.

Based on this interpretation, the National Supreme Court of Justice held the unconstitutionality of subsections b) and c) of Article 103 bis of the ECA by stating that:

> "The improvement of the quality of life of the employee and his family, which is the purpose of the challenged regulations, is not a valid argument to modify the title corresponding to a compensation according to the Constitution. Social justice is the spirit that has continuously guided the ILO since its incorporation up to these days in its multiple institutional statements defending and protecting the rights of the employees from the many challenges that have arisen throughout the evolution of the employment market, which is subject to the superior demands of protection of the dignity of the individual and common good".

The position of the Supreme Court of Justice was aligned with the rules of Act Nº 26,345 (O.G. 12/24/2007) that two years before the aforementioned precedent had ordered the progressive inclusion of the sums that employers were paying as lunch and supermarket tickets into the salary of the employees (subsections b) and c) of article 103 bis of the ECA).

As from said precedent onwards, the rulings issued by the National Labor Court of Appeals in connection with benefits gradually began establishing their remunerative nature. In this sense, most of current case law does not hesitate in establishing the salary nature of the benefits granted within an employment relationship that are of personal use of the employee exceeding work-only purposes.

In this context, the use of a car provided by the employer, cell phone, parking space at the establishment, internet connection at the employee's home, are tools that – if habitually destined to personal use in addition to work purposes – reflect an economic benefit obtained within the employment relationship and consequently, in the terms held by the Supreme Court of Justice, constitute unregistered salary.

3. Case law evolution

As from the enactment of Act Nº 26,341 and the ruling of the National Supreme Court of Justice in *Perez v Disco*, a great controversy arose and all economic benefits granted to the employees within the employment contract began to be challenged.

In this sense, case law began to hold the remunerative nature of many of the benefits that employers granted without remunerative nature, mostly to hierarchical employees. In this context, the salary nature of fringe benefits held by case law was based mainly on the following arguments:

- article 103 of the ECA and article 1 of the Convention Nº 95 of the ILO define salary as any earning in money or in kind derived from the employment contract;
- whenever an employer takes on expenses that are proper of the employee, this involves a salary in kind;
- whenever an employee is free to dispose of a sum of money granted by the employer, even with specific imputation, the employee obtains a remunerative income;
- if the benefit covers an expense that the employee would have borne anyway according to his lifestyle, it constitutes a saving that has remunerative nature.

Academic opinion has attempted to explain this phenomenon by pointing out that:

> "when according to article 103 of the ECA the compensation that must be granted to

> the employee is considered a consequence of the employment contract, even if it is an economic benefit received as a payment by a third party, such an interpretation implies that the salary, according to our legal framework, is not only the compensation for the performance of acts, execution of works or rendering of services for the employer, but also **something else**".
>
> According to this interpretation, the concept of salary would include all the benefits derived from a position, all income obtained by the employee, irrespective of its origin, as long as they are directly or indirectly motivated by said condition of employee". (emphasis added)

Such a broad criterion has, however, an opposing interpretation that distinguishes salary as compensation for the work of an employee from other earnings, compensation of benefits that, although motivated in the condition of being an employee, exceed the exchange scheme proper of the employment contract and aim to face social contingencies or improve the quality of life of the employee and his family.

> "This line of thought coincides in relating the concept of remuneration with the compensation of the service performed or offered by the employee, and excludes from the concept of salary the benefits that, although granted within the employment contract, are not provided as compensation for the performance of service, but with the spirit of satisfying certain needs or covering certain social contingencies, in order to improve the quality of life of the employee and his family."[2]

[2] Labor Law Treatise, Volume III, page 170. Director Mario E. Ackerman.

4. Not all is lost: Pension plans

As it may be concluded from the precedent explanations, the broad position that currently prevails in the jurisprudential and legal field hinders the drafting of a general policy of compensation and benefits. In order to provide the employee with not only a fair compensation for his performance but also with an allowance independent from the salary aimed to the direct satisfaction of needs aside from work and to the improvement of the quality of life of the employee and his family, no doubt that an extremely creative structure must be in place.

As mentioned, the provision of a car, cell phone, access to better education than the employee may aspire to according to his salary level, the use of a parking space within the employer's establishment, and the provision of internet service, constitute benefits that have not succeeded in overcoming the high barrier of salary. In this way, the companies that grant such benefits are forced to face the risks that would arise in a specific case from their judicial appreciation as salary.

In these conditions, in addition to the few non-remunerative benefits that still exist according to the restrictive enumeration of article 103 bis of the ECA (lunch service at the establishment, reimbursement of medical and dental expenses, provision of work clothes, reimbursement of documented expenses of daycare or kindergarten, provision of school supplies and public school uniforms for the employee's children, payment of training courses, burial expenses for family members financially supported by the employee) pension or private retirement plans are one of the scarce benefits that may be successfully implemented without the risk of being the object of legal

challenge regarding their non-remunerative nature.

This statement is not based on the legislation in force or the current criterion of our courts, but is solidly supported as an interpretation of the contrary sense of case law and academic opinion that has established the remunerative nature of the benefits that were not treated as such.

Indeed, a pension plan would strongly resist the arguments that have been used to hold the unconstitutionality of lunch and supermarket tickets and to claim the salary nature of benefits such as car, cell phone, parking, and etc.

In this sense, pension plans:

- are not compensation;
- are not accrued monthly;
- are subject to and conditioned by a future and uncertain event;
- cannot be disposed of until the condition occurs;
- are not earnings derived from the performance of work;
- are related to the employment contract but not with the individual performance;
- are not an income or economic benefit that the employee may use on a benefit of his own choice;
- do not imply a saving in connection with an expense that the employee would have had anyway.

Argentina began to extend this practice as of 1994 and currently applies this tool in around 45% of the 200 companies of highest turnover, even despite the absence of legal regulations or fiscal incentives.

The frailty of the national social security system (which I will not address here since it would exceed the main focus of this paper) demands the analysis of alternative tools in order to accomplish the desired well-being at the time of retirement.

This may be achieved through a benefit such as the pension plan, because it is an effective alternative to benefit the personnel at the time of retirement, and because it represents a good choice for a policy of compensation and benefits designed to avoid legal risks.

Canadian Employee Life and Health Trusts

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This article provides an overview of a new arrangement available under the Income Tax Act (Canada) (the "Act"), called an "Employee Life and Health Trust" (ELHT), through which an employer (or group of employers) can fund certain group health and life insurance benefits for employees and retirees. In December 2010, the Act was amended to introduce rules for ELHTs retroactive to 2009.

The article is divided into two parts. Part I summarises the most salient aspects of the new ELHT rules. These include the criteria that an arrangement must meet in order to be considered an ELHT, restrictions on the participation in an ELHT by high-earning employees, and the tax consequences of contributions made by employers as well as payouts to employees and retirees.

Part II describes some of the advantages that a properly structured ELHT can provide to employers (from a financial statements perspective) and employees and retirees (from a benefit security perspective). In particular, Part II focuses on large employers with significant unionisation and large, unfunded "other post-employment benefit" (OPEB) obligations. This part also discusses the practical considerations that will have to be taken into account when settling an ELHT, including strategies for negotiating with unions and retirees, how best to bind retirees and how to "paper" the deal. While framed generally, much of the authors' analysis is based on their experiences with Canada's first ELHT.

On December 15, 2010 legislation[3] came into force amending the *Income Tax Act* (Canada) (the "**Act**")[4] to introduce a new vehicle to fund employee group life and health insurance benefits called an "employee life and health trust" (**ELHT**), retroactive to 2009. Although the amendments were introduced mainly to reorganise the group insurance benefits provided by General Motors of Canada Limited and Chrysler Canada Inc. to unionised employees and retirees during their respective restructurings, the new rules have general application.

The ELHT rules are largely contained in a new section 144.1 of the Act. Together, the amendments codify many of the less formal rules that have historically governed "Health and Welfare Trusts" (**HWTs**), a somewhat similar vehicle whose design and taxation have been based on the policy pronouncements of the Canada Revenue Agency (**CRA**).[5] The ELHT rules do, however, provide some new twists.

The purpose of this article is twofold. In Part I, we summarise the most salient aspects of the new ELHT rules. In Part II, we describe some of the advantages that a properly structured ELHT can provide to employers (from a financial statements perspective) and employees and retirees (from a benefit security perspective). We also discuss in Part II the practical considerations that will have to be taken into account when settling an ELHT trust. Through framed generally, much of our analysis is based on our experiences with Canada's first ELHT.[6]

Part I.

Overview of ELHTs

An ELHT is an independent, taxable *inter vivos* trust to which an employer, or group of participating employers, contributes in order to fund "designated employee benefits" (**DEBs**), which are defined as benefits under a group sickness or accident insurance plan, a private health services plan or group term life insurance.[7] An ELHT can either provide DEBs directly (like a self-insured plan) or indirectly by paying premiums toward a policy with a licensed insurer.

ELHTs are unregistered arrangements. Instead, any trust that meets nine criteria enumerated in subsection 144.1(2) of the Act will be considered an ELHT. Taken together, these criteria can be summarised as follows:

- The ELHT's only purpose must be to provide DEBs to employees (defined to include active and former employees), their eligible spouses and their beneficiaries.
- On the wind up or reorganisation of the ELHT, trust property may only be

[3] Bill C-47, *Sustaining Canada's Economic Recovery Act*, S.C. 2010, c. 25.

[4] R.S.C. 1985, c. 1 (5th Supp.), as amended.

[5] In particular, HWTs have been and continue to be governed by CRA Interpretation Bulletin IT-85R2, "Health and Welfare Trusts for Employees" (31 July 1986), online: http://www.cra-arc.gc.ca/E/pub/tp/it85r2/it85r2-e.html
The government has confirmed that the informal HWT rules will remain in place for now, and there is no indication that it will eventually abolish the rules governing HWTs now that the ELHT rules are in force.

[6] The ELHT established by the Canadian Auto Workers' Union for the benefit of retired automobile industry workers (specifically, employees and retirees of General Motors of Canada Limited and Chrysler Canada Inc.).

[7] To the extent DEBs relate to health benefits, they usually supplement the basic public healthcare provided by federal and provincial governments. For example, since the costs of shared hospital rooms are generally covered publicly, DEBs may cover the additional costs of private hospital rooms.

distributed to: (i) employees and their beneficiaries; or (ii) another ELHT.[8]

- The ELHT must be resident in Canada.
- The level of participation and rights of "key employees" must be limited. This requirement ensures that ELHTs do not provide a tax-deferral vehicle for high earners or owner-employees. The concept of "key employees" is described in more detail below.
- No participating employer may have any rights under the trust, except for a right to receive DEBs (if the employer is an individual); rights to enforce covenants that the ELHT status of a particular arrangement will be maintained; and rights to receive prescribed payments.[9] The ELHT may also not lend to or invest in a participating employer or any person who does not deal at arm's length with the employer.
- Representatives of one or more participating employers may not form the majority of trustees or otherwise control the trust.

Key Employees

The Act defines a key employee as an employee who owns at least 10% of any class of his or her employer's issued shares (or shares of a related corporation), any person who does not deal at arm's length with the employer, or any employee whose employment income in at least two of the five preceding years exceeded *five times* the relevant, statutorily-defined "Year's Maximum Pensionable Earnings" (**YMPE**) under the Canada Pension Plan (Canada's public occupational pension scheme). The YMPE generally increases each year. It is C$48,300 (US$49,200) for 2011, for a total key employee threshold of C$241,500 (US$245,900).

Key employees cannot have rights under an ELHT that are greater than the rights of non-key employees. In addition, the ELHT may not be maintained "primarily" for the benefit of one or more key employees or their family members.

Tax Treatment for Employees

Employees and/or retirees may, but need not, be required to contribute to an ELHT. If required, employee/retiree contributions will not be deductible from the individual's income.

The Act will look through the ELHT so that benefits received by an employee or retiree will be included or excluded from the employee's income pursuant to other provisions in the Act as if provided by the employer directly. There is no withholding on payments of DEBs to non-residents.[10]

Tax Treatment for Employers

Generally, employer contributions to an ELHT are only deductible for a year in the proportion that they bear to amounts paid from the ELHT to provide DEBs in that year to the employees and former employees of the employer. As a simple example, if an employer contributes C$500,000 in Year One to an ELHT in which it is the only participating employer and the ELHT spends only C$250,000 to

[8] Property must be distributed to the federal or a provincial government if the last individual beneficiary of the ELHT has died and there is no other ELHT to which to distribute it.

[9] Currently, the only payments prescribed are payments to reimburse General Motors Canada Limited and Chrysler Canada Inc. for services they rendered to help transition to an ELHT arrangement. *Income Tax Regulations*, C.R.C., c. 945, Reg. 9500.

[10] Paragraph 212(1)(w).

provide DEBs that year, the employer would only be able to deduct C$250,000 in Year One. Any undeducted amount is carried forward to be deducted in a later year (up to amounts paid out in that later year to provide DEBs).

One important exception to the general rule above allows an employer to claim a deduction in a year (so long as its contributions support it) based on the reasonably estimated annual payment from the ELHT to provide DEBs disclosed in a report prepared by an independent actuary. This exception applies so long as the employer's contribution postdates the actuarial report and so long as no contrary evidence exists to call the actuary's projections into question.

In all cases, the total of the employer's deductions cannot exceed the total of its contributions made to the trust. This rule prevents an employer from claiming a disproportionate deduction based on payments from the ELHT that are partly funded by (i) employees' or other participating employers' contributions; or (ii) the investment return on the trust assets.

Finally, the Act allows employers to issue promissory notes to the trustees of an ELHT in respect of future contributions. In this case, the Act deems payments on account of the notes (whether principal or interest) to be contributions to the ELHT (interest on the notes will therefore not be treated as investment income of the trust).

Part II.

Advantages and Practical Considerations of Implementing an ELHT

Broadly speaking, ELHTs can be structured in two ways, each achieving different goals. First, an ELHT could be funded through ongoing employer (and perhaps employee and retiree) contributions over the long term. Second, however, an ELHT could be settled by an employer through a lump sum contribution (or series of discrete contributions) to fully and finally shift its so-called "other post-employment benefit" (**OPEB**) obligations for retirees to an independent vehicle. The latter structure can be advantageous for both employers and retirees (including active employees with a view to retirement). In this part, we discuss these advantages and the practical steps involved in settling an ELHT in this way.

Advantages of a Full and Final Settlement

Employers typically must account for unfunded benefit and OPEB liabilities in their financial statements. In certain unionised industries (including the automotive, steel and manufacturing sectors), these liabilities are often quite significant. The sizeable obligation arises out of a number of factors, including a combination of (i) historically generous OPEBs; and (ii) high ratios of retirees to active employees.[11] The liability is also affected by experience-related volatility and the high inflation rate of healthcare costs.

ELHTs have the potential to eliminate OPEB liabilities from financial statements through what is called "settlement accounting" – a sufficiently final and irrevocable settlement of existing benefit obligations through an ELHT such that the employer's benefit obligations can be considered "defeased". As mentioned

[11] In the case of General Motors, for example, the ratio of retirees to active workers was about two to one in 2009. Greg Keenan & Karen Howlett, "GM seeks government pension aid" *Globe & Mail* (19 June 2009), online: http://www.theglobeandmail.com/report-on-business/article11257.ece

above, this result can be achieved through a lump sum or discrete series of lump sum employer contributions to the ELHT and legal documentation, such as a court-approved settlement, demonstrating irrevocability and binding beneficiaries to the arrangement. Removing these liabilities from the financial statements could have positive effects on an employer's ability to borrow and the terms of such loans as well as its and share price.

Irrevocably settling an ELHT is, however, easier said than done. Settling OPEBs through an ELHT will require a number of practical considerations. The remainder of this article aims to provide a high level outline of the key steps in defeasing these liabilities.

Approaches to Negotiation

In the unionised context, in which the defeasance of unfunded OPEBs will generally have the most impact, an employer will first have to engage in discussions with the union in respect of benefits for active employees and, only once these have been successfully concluded, proceed to address retirees.

A strong theme in the employer and union's negotiations ought to be that defeasance of OPEBs for active employees (many of whom will expect to retire in the future), and, ultimately, for retirees formerly represented by the union, is mutually beneficial. We have already discussed the financial statements advantage for the employer. Advantages will, however, inure to the employees as well.

For one thing, given that OPEBs are not typically pre-funded,[12] pre-funding benefits which become obligations of an independent trust will better protect employees, retirees and their beneficiaries from the employer's solvency risk. In particular, and in those industries in which finally-settled ELHTs may be most beneficial, there is a real risk that employees and retirees entitled to unsecured benefits would lose virtually all of their coverage in a bankruptcy or insolvency.

Another key element in the negotiations will be the amount of money which the parties agree is a fair estimate of the cost of the relevant benefits. The starting point will probably be the employer's current benefit program and its projected OPEB obligations. In this regard, we anticipate that employers seeking to defease their OPEB obligations will commission an actuarial report (as described above) on a timely basis in order to ensure the desirable tax treatment of contributions. As well, if the employer is looking to settle its benefit obligations to improve its financial prospects, it may wish, in addition to moving to an ELHT in the first place, to negotiate reduced coverage, increased employee and retiree premiums or co-payments (or the introduction of such premiums or co-payments for the first time) or some mix of these so that its lump sum contribution obligation is kept as financially manageable as possible.

Retirees

Although the union will not be able to formally bind retirees to a new ELHT arrangement, its involvement in negotiations with retirees will be essential. In this regard, the simplest way to bind retirees will be through a court order

[12] This is a result of a number of factors, including an employer's historic preference for a "pay-as-you-go" arrangement which aligns timing of pay outs and tax deductions along with the CRA's administrative position that HWTs cannot be pre-funded.

granted under the class proceedings legislation of an appropriate Canadian jurisdiction and sought with the union's support.[13] Through its involvement, the union will generally make it easier to identify a small group of retirees who can form a "retiree committee", who will negotiate with the employer, retain counsel on behalf of all eligible retirees and act as the class representatives in the class proceeding.

The retiree representatives, union and employer will need to manage a complex employee-relations project whereby retirees are sent sufficient correspondence about the move to an ELHT arrangement that the final proposal does not catch them off guard. To pre-emptively combat retiree murmurs that their benefits are being "cut" or that they are being "sold out", especially if retiree premiums or co-payments are being introduced for the first time, the communications will have to be clear and emphasise the increased benefit security that the ELHT is intended to provide.

Class Proceedings

A class proceeding culminating in a court-approved settlement represents the easiest and most cost-effective way to bind retirees. Procedurally, the class proceeding has two goals:

- Court-certification of a class comprising all retirees, their surviving spouses or related beneficiaries, as applicable; and
- Court-approval of a settlement agreement containing the terms of the new ELHT arrangement, including the employer's agreed-on up-front funding obligations.

As might be expected, the employer, union and retiree representatives will have to agree on the terms of the settlement, including the ELHT documentation, conditions precedent for settlement and monetary amounts involved, in advance.

Under class proceedings legislation, "class members" (*i.e.* eligible retirees and beneficiaries) will also have statutory rights to opt-out of the settlement and to make submissions as to the appropriateness of the proposed class representatives and settlement terms.[14] The goal of the comprehensive retiree communications strategy discussed above is to prevent as many of these opt-outs and objections as possible.

Once the court approves the settlement as fair and reasonable, retirees who do not opt-out will be bound and the ELHT arrangement can be finalised.

"Papering" the Settlement

It will be necessary to "paper" the ELHT settlement through more than just a simple settlement agreement to be approved by a court. Trust infrastructure will have to be prepared or modified in advance of the settlement, and the always crucial terms of the employer's contributions, both the amounts and their frequency, will have to be fully committed to writing in advance.

Generally, the settlement will involve the preparation of the following documents:

1. A preliminary Term Sheet that outlines the proposal's financial and other elements;
2. The Declaration of Trust;
3. The Plan Document;
4. Promissory notes, if any; and

[13] See e.g. *Class Proceedings Act, 1992*, S.O. 1992, c. 6, s. 29(3).

[14] See e.g. *ibid.* s. 9.

5. The Settlement Agreement.

Each agreement is briefly discussed in turn. In addition, in order to justify its deductions and as suggested above, the employer will need to commission an actuarial valuation that validates the expected benefit payments to be made by the ELHT in connection with the employer's contributions to the ELHT.

1. Term Sheet

The parties will likely need to agree to a preliminary agreement which could be given any variety of names. The preliminary agreement(s) will summarise the key terms of the settlement and underpin future negotiations and proceedings.

This "Term Sheet" should build on the commitments made in negotiations with the union. At a minimum, the Term Sheet should set out the employer's and the union's basic responsibilities. The employer will want to ensure that the Term Sheet confirms its maximum liability to contribute to the ELHT and disclaims its liability for OPEBs post-settlement. Finally, the Term Sheet should set out a timeline establishing, among other things, the target effective date for the settlement of benefit liabilities in the ELHT.

2. Declaration of Trust

If the union has agreed to a new ELHT, it will be necessary to prepare a Declaration of Trust appointing the trustees and describing the trust's terms and the trustees' obligations.

The trustees will likely be individual union officers or representatives, but may also include retiree representatives or independent trustees. Although the Act contemplates employer-appointed trustees, it is expected that, in cases in which employers wish to achieve settlement accounting, they will not wish to retain ongoing rights in connection with the administration of the ELHT, just in case such rights could be interpreted as the employer exercising *de facto* control.

The Declaration of Trust will address the establishment, maintenance and termination of the ELHT. In particular, the declaration would address:

- The employer's contribution obligations.
- Employee and/or retiree contribution obligations, if any.
- Other administrative matters related to the transition from the employer to the ELHT (see also the discussion under the heading "Settlement Agreement" below).
- Separate accounting for multiple participating employers to ensure that contributions made in respect of one participating employer's employees or retirees are not used to provide benefits for another's.
- The trust's compliance with tax requirements.
- The trustees' ongoing disclosure obligations to participating employers to ensure that employers are promptly informed of benefits paid out of the ELHT in a year so that they are able to claim a corresponding deduction in respect of the year or a past year's contribution.
- The trustees' right to amend the ELHT, including reserving the right to reduce coverages based on the trust's finances, if such a right is desired.

3. Plan Document

The Plan Document will set out the benefit coverages. Initially, the terms of the Plan Document as it will be administered by the

ELHT will likely mirror the terms of the former benefit plan provided by the employer, subject to any changes to coverage levels that the employer has negotiated as part of the Term Sheet or otherwise.

4. Promissory Notes

The parties will have to agree on the terms of any notes, including the interest rate, if any, pre-payment rights, if any, and events of default.

5. Settlement Agreement

The Settlement Agreement will be the principal document outlining the terms of the ELHT settlement to be approved by the court in order to bind retirees. As such, it will build on the earlier agreements necessary to effect the settlement: the Term Sheet; the Declaration of Trust (or the form of Declaration of Trust if not yet signed); the Plan Document; and the form of any promissory notes.

The Settlement Agreement will also append the form of the litigation documents necessary to certify and bind the class of eligible retirees and beneficiaries, including the forms of the statutorily-required notices to class members. The Settlement Agreement will likely also append the form of court orders necessary to give effect to the settlement and release the parties.

In addition, the Settlement Agreement should generally be expected to address:

- The acceptable number of opt-outs, including what happens to the economics of the deal if any specified opt-out thresholds are exceeded (including, for example, the chance of full cessation of benefit coverage for class members who opt out).
- A final release in favour of the employer, which will assist in establishing irrevocability of the settlement for purposes of settlement accounting. The union will likely seek a corresponding release in favour of its officers.
- The employer's contribution obligations and the terms of any promissory notes, the form of which will likely be appended to the agreement, and the employer's right to withhold any taxes from employer and employee/retiree contributions as required by law.
- If retirees will be required to pay a periodic premium, the mechanism for withholding their contributions directly from their pension payments. This type of withholding is the easiest, and perhaps the only logistically feasible means to collect retiree contributions from a large and disparate retiree population.[15]
- The payment of benefits during any transition period, assuming that the ELHT has not been settled by its target effective date. One solution is to have the employer pay for benefits past the target effective date and then be reimbursed from the trust. So far, the Act permits such reimbursement only for General Motors of Canada Limited and Chrysler Canada Inc., so an employer may have to approach the federal government to broaden this existing restriction.
- Data sharing and disclosure obligations governing the employer's

[15] It may also be feasible to allow retirees to elect to have premiums automatically withdrawn from their bank accounts; however, it is unlikely that this option would have a 100% take-up rate, since some may be reticent of enrolling in an automatic withdrawal program.

and the trustees' initial and ongoing disclosure rights and obligations. Not only will the employer have to provide the trustees with an initial "data dump", but it may also need to provide the trustees with ongoing documentation and support in order to allow them to set up their systems and, if necessary, switch carriers and service providers. To this end, the union may wish to consider employing staff to set up trust infrastructure in advance of settlement.

Other Considerations

Although the Act primarily governs the taxation of ELHT contributions and payments, a number of other statutes will come into play during and after the settlement of the ELHT. In brief, this legislation would generally include: (i) pension standards legislation if contributions are to be withheld directly from retirees' pension payments (generally this legislation prohibits "assignment" of pension benefits, so a revocable consent to withhold premiums would have to be obtained from each retiree); and (ii) provincial tax legislation, which may create administrative trouble if provincial tax regimes levy taxes (for example, sales taxes) on contributions to and payments from an ELHT that differ from the manner taxes are levied under the Act.

Employers, unions and trustees will therefore need to be mindful of the interaction of other statutes with the basic ELHT regime, which can lead both to delays and administrative headaches.

Conclusion

ELHTs represent an innovative new mechanism through which to provide group life and health insurance benefits to employees, retirees and their beneficiaries. For employers that intend to maintain an obligation to fund employee and retiree benefits through periodic contributions over the long term, the ELHT rules basically represent a codification of the existing policies governing HWTs, albeit with a few new rules and features.

For other employers, however, ELHTs represent more than just a particular way of providing ongoing group insurance benefits. Employers with significantly unionised workforces and large retiree populations have the ability to settle their OPEB obligations in an independent trust that will remove hitherto unfunded benefit obligations from the financial statements once and for all. And, to be sure, final settlement of OPEBs through an ELHT benefits employees and retirees too, since it provides benefit security though a prefunded, independently-administered vehicle largely independent of its originating employer's subsequent financial health.

Our intention has been to describe not only the new ELHT rules themselves, but also their main advantages and the practical considerations that will be necessary to achieve those advantages. Simply put, the complexities of implementing an ELHT can be overcome. Our comments are only to say that, as with all new things, "some assembly is required".

Singapore's Central Provident Fund – A Model Employee Benefit Solution for other Jurisdictions?

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Singapore has created a national pension scheme, the Central Provident Fund, whose purpose and function has expanded far past utilization for retirement income. As demands on the country have changed so has the scope of the Central Provident Fund. Currently, in addition to providing an income upon retirement the Central Provident Fund will assist members with other benefits such as home ownership, healthcare, various forms of insurance, education and savings and investment enhancement.

This comprehensive system illustrates increasing convergences of employee benefits and permits some measure of flexibility and tailoring of benefits depending on the needs of the individual. This unique system offers many advantages that the larger and more cumbersome systems of other nations may aspire to. The Singaporean system merits review and consideration for other nations seeking to refine their systems relating to healthcare, risk benefits, home ownership, education and pensions.

Note:

- All monetary figures expressed in Singaporean dollars unless otherwise indicated
- Exchange Rate (April 20, 2011 www.xe.com)
- Singaporean (SGD) (SGD) dollar = .80 USD/.56 EUR/.49 GBP

Introduction

The Singaporean mandatory Central Provident Fund (**CPF**) provides multiple benefits to Singaporean citizens and permanent residents. For these members the CPF is a constantly changing mechanism that meets the needs of both the members and overall government policy in directing economic resources in an efficient manner and is a model which merits close examination by other countries and jurisdictions.

History of the Central Provident Fund

The Central Provident Fund was established by legislation in Singapore in 1955 initially as a retirement scheme. Over time the scheme adapted to the changing needs of society and its coverage included other aspects of financial security.

At present the scheme permits its members to utilise the available funds within the scheme for other benefits in addition to retirement such as home ownership, housing insurance, medical expenses, disability and life insurance, and post secondary education.

Since 1955 the Singaporean scheme has adapted to the altering needs of society and become a flexible and holistic pension, home ownership and medical solution. Originally the scheme was designed as a compulsory savings scheme so that the United Kingdom did not have a legal or moral responsibility to the residents of Singapore while Singapore was a colony of the United Kingdom. The CPF continues to a primary savings vehicle in Singapore.

After Singaporean independence in 1965 the government made changes in the CPF in 1968 to permit members of the scheme to finance housing purchases with their funds. The result was a sharp increase in population via home ownership. This gave expatriate employees an economic incentive to remain in Singapore and the rapidly expanding country was in need of a larger population.

Initially, residents could use a portion of their CPF account to finance the purchase of government built properties. Over time the entire cost of a flat could be financed by one account within the CPF and public or residential properties could be purchased or financed from the CPF.

Likely as a result of the ability to finance housing purchases via the CPF the homeownership percentage in Singapore is 87.2% as of 2010. In addition, 74.4% of homeowners own a 4-bedroom or larger house or unit.[16]

By comparison the average percentage of homeownership within OECD member countries is 67%.[17]

The CPF has continued to adapt to the changing political and economic realities permitting a range of benefits under the scheme.

The Current Central Provident Fund

The *Central Provident Act* (the "**Act**") established a mandatory social security savings program for all citizens and permanent residents of Singapore. The CPF is the fund into which all contributions are to be paid under the Act.

As of March 1, 2011 employers and employees in the private sector with salaries between $1,500 and $4,500 are required to contribute based on the following table:

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[16] Department of Statistics Singapore Key Annual Indicators 2010: http://www.singstat.gov.sg/stats/keyind.html

[17] OECD News Releases – Housing and the Economy: Policies for Renovation – US fact sheet: http://www.oecd.org/document/1/0,3746,en_21571361_44315115_46935681_1_1_1_1,00.html

Employee Age (Years)	Contribution Rate *(for monthly wages exceeding $1,500)*			Credited into		
	Contribution by Employer (% of wage)	Contribution by Employee (% of wage)	Total Contribution (% of wage)	Ordinary Account (% of wage)	Special Account (% of wage)	Medisave Account (% of wage)
35 & below	15.5	20	35.5	23	5.5	7
Above 35-45	15.5	20	35.5	21	6.5	8
Above 45-50	15.5	20	35.5	19	7.5	9
Above 50-55	11.5	18	29.5	13	7.5	9
Above 55-60	8.5	12.5	21	11.5	0.5	9
Above 60-65	6	7.5	13.5	3.5	0.5	9.5
Above 65	6	5	11	1	0.5	9.5

Source: CPF Contribution and Allocation rates from 1 March 2011. (http://mycpf.cpf.gov.sg/Members/Gen-Info/Con-Rates/ContriRa.htm)

The contributions are paid into subsidiary accounts pursuant to section 13 of the Act which established three different accounts known as the Ordinary Account, The Medisave Account, and the Special Account. The amount of contributions, interest and the conditions of withdrawals are subject to the Act and associated regulations.

The Central Provident Fund Board, which administers the CPF, advises that CPF savings should be utilized to provide:

- Sufficient savings throughout the lifetime of the member, commencing on retirement;
- A property which is fully unencumbered upon retirement; and
- Sufficient savings to meet medical needs in old age.

Members are also encouraged to supplement retirement income with their own savings and to purchase private medical insurance in order to meet health care expenses.[18]

The Ordinary Account

One significant use of the Ordinary Account for most members is for home ownership. Immovable property may be purchased including a leasehold interest with sufficient time on the lease to last for the member's lifetime. Members are able to purchase either a public housing flat or private property. The savings in the Ordinary Account may be used for partial or full payment of property and also to service monthly mortgage obligations. In addition, contributions remitted to the Ordinary Account from employment may be used to service the mortgage. For private property a minimum payment of 5% of the purchase price of the property is required.

[18] http://mycpf.cpf.gov.sg/CPF/About-Us/Intro/Intro

For any public housing purchased insurance must be taken out under the Home Protection Scheme. This insurance scheme is mortgage protection in the event of death or disability before the mortgage is paid.

The Home Protection Scheme (**HPS**) requires medical evidence of good health and is payable to the member or his beneficiaries. The Home Protection Scheme premium is payable from the Ordinary Account on an annual basis.

The Dependant Protection Scheme (**DPS**) may also be provided under the Ordinary Account. The DPS is a term insurance scheme which insures members' lives for the sum of $46,000 up to age 60. Annual premiums which are based on age, but not gender, are deducted annually from the Ordinary Account or if funds are not available in the Ordinary Account then from the Special Account. Annual premiums range from $36 for members under age 34 up to $260 for members aged 55-59. The premiums are purchased in the open marketplace from private insurers at agreed upon premium rates with the Central Provident Fund Board.[19]

Members may use their CPF funds from the Ordinary Account to pay for the member's own or their child's eligible education expenses. The Education Scheme is intended for full-time students with no income or from low income families whom may have difficulty paying tuition fees from their own savings. The Singaporean tuition rates are subsidised by the government; overseas courses are not eligible.

The student must repay the full amount and interest commencing the first year of full time studies and over a maximum period of twelve years. The student will be required to pay the loan back into the applicable account - either his or her own account, or the account of one of his or her parents (whose savings from the Ordinary Account were responsible for the loan).

Members with over $20,000 in their Ordinary Account are able transfer the excess over $20,000 into a sub-account of the Ordinary Account knows as the CPF Investment Scheme Ordinary Account (**CPFIS-OA**). Under the CPFIS-OA members may own a variety of investments including shares, unit trusts, government bonds, bank deposits, investment linked insurance policies exchange traded funds and gold. The intention of this account is to provide members with a larger amount on retirement assuming greater long-term capital appreciation and income.

Shares, real estate investment trusts and corporate bonds within the CPFIS-OA are subject to a limit of 35% of investable assets and gold is subjected to a 10% limit. The total amount invested under the Ordinary Accounts as at 31 December 2010 in excess of 77 billion and over 25 billion of that amount was invested in the CPFIS-OA.[20]

The Medisave Account

Between 7% and 9.5% of a member's annual earnings are earmarked for his or her Medisave Account during the employees working life. The Medisave Account was established in 1984 and its initial objective was the payment of members or families hospital expenses at private hospitals. Medical insurance may

[19] CPFA Dependents' Protection Scheme: http://ask-us.cpf.gov.sg/explorefaq.asp?category=23023

[20] CPF Statistics – Members Accounts: http://mycpf.cpf.gov.sg/CPF/About-Us/CPF-Stats/CPF_Stats2010q4.htm

also be purchased. The Medisave Account covers hospital charges, fees of medical practitioners and operating procedures and charges.

The funds in the Medisave Account earn a statutory compound interest rate. The interest rate (2011) is currently 4% compound per annum but expected to fall to 2.5% in 2012. Certain hospitalisation expenses may be covered directly or the members may purchase medical insurance for themselves or their dependents.

MediShield was introduced in 1990 as basic medical insurance to help Singaporeans deal with hospital expenses and catastrophic illness, excluding pre-existing conditions. Premiums range from $33 – per annum for those under age 31 up to $1123 for those members ages 84-85. The yearly claimable limit is $50,000 and a lifetime limit is $200,000.[21] The MediShield premiums are deducted annually from the Medisave Account. Approved private medical insurance may also be purchased from the Medisave Account.

Currently, (2011) the Medisave Contribution Ceiling is $39,500. Once this Medisave Contribution Ceiling is reached all excess amounts for member under age 55 will be transferred to the Special Account. For members over age 55 all excess amounts over the Medisave Contribution Ceiling will be transferred to the members Retirement Account.[22]

The Special Account

The Special Account is for old age and retirement related financial products. The intention of the Special Account is the accumulation of assets and investments to be utilised during retirement.

Special Accounts may accept transfers from Ordinary Account from the same member. There are more restrictions on the Special Account with respect to accessing funds prior to retirement and a transfer from the Ordinary Account cannot be reversed. However, members normally earn a bonus interest rate (currently 1.5% annual interest) in the Special Account compared with the Ordinary Account.

The Central Provident Fund Investment Scheme – Special Account (**CPFIS-SA**) is a sub-account of the Special Account open to members with a Special Account balance of over $40,000. The members may transfer their excess balance to this sub-account of the Special Account and invest in shares, unit trusts, government bonds, statutory board bonds, fixed deposits, annuities, investment linked insurance policies exchange traded funds and gold.[23]

The investment account CPFIS-SA and CPFIS-OA with exposure to equities bonds and alternative investments such as gold should be able to generate higher returns over the long term for those members who have excess or high balances.

There is over $40.3 billion invested in the Special Account of that amount over $7.1 million invested in the Central Provident Fund Investment Scheme Special Account.[24]

Thus members who are seeking a return higher than cash-based investments are also able to invest in more risky, but

[21] Axco- Insurance Market Reports, Singapore Life & Benefits, 2011.

[22] Axco – Insurance Market Reports, Singapore Life & Benefits, 2011.

[23] http://ask-us.cpf.gov.sg/Home/Hybrid/themes/CPF/Uploads/Investment/INV_Annex%20A.pdf

[24] http://mycpf.cpf.gov.sg/CPF/About-Us/CPF-Stats/CPF_Stats2010q4.htm

potentially higher, returning vehicles such as equities.

Minimum Amounts and the Retirement Account

Upon reaching age 55 a Retirement Account is created and members may, but are not required to, withdraw their funds from the CPF. Members may only withdraw funds from the Retirement Account in excess of a balance of $123,000 (defined as the "**Minimum Sum**"). Members must also leave a minimal amount of $27,500 in the Medical Account.[25]

The intention of the preserved amounts is to provide sufficient funds for both retirement and medical needs.

The Retirement Account also permits members to purchase life annuities. CPF Life provides an income stream for life for retirees and commences, depending on the member's date of birth, between ages 62 and 65. Life annuities vary by the type selected and other factors such as contingent beneficiaries.

For members without the Medisave Required Amount (i.e. $27,500) members must transfer amounts from the Ordinary Account or Special Account Savings to the Medical Account. The Medisave Minimum Sum, which is currently $34,500 and any amount in excess, may be withdrawn from age 55.

For members who continue in employment after age 55 CPF contributions are still required from both employers and employees. The amount contributed to the Ordinary Account and Special Account decreases at age 55 and after age 65 there is only a minimal contribution of 1% of annual wages to the Ordinary Account and 0.5% of annual wages to the Special Account. However, the contributions to the Medisave Account remains at 9.5% of annual wages after age 60.

The Lifecycle Benefits of the Central Provident Fund

The current Singaporean Central Provident Fund seems to anticipate and provide protection for all aspects during an individual's lifecycle.

For example, a Singaporean could be attending an educational institution in Singapore with tuition assistance from her parent's Ordinary Account. As she enters the workforce the loans for tuition will be paid back from her Ordinary Account into her parents Ordinary Account. Also, her Ordinary Account will accumulate the largest amount of funds and be able to assist with the purchase of a residence. The Ordinary Account can be used to service the mortgage and if the mortgage payment is less than the amount of income being transferred into the Ordinary Account every month then as her income increases she will be both paying off her mortgage and accumulating a surplus in her account. Additionally, she may take out term insurance on her own life with payments coming out of the Ordinary Account and must take out additional insurance on the Home Protection Scheme should she purchase a public residence. This insurance will pay off the loan in the event of death or disability. As these premiums are paid out of the funds they are less noticeable than a monthly or annual invoice.

As her assets and fund balance increase she may accumulate more investment excess amounts in the Ordinary Account may be transferred to the Special Account which would earn an additional rate of return if kept in interest bearing accounts. Both the Ordinary Account and the Special

[25] Reaching 55 – A CPF Publication, S. Heng, Central Provident Fund Board, March 2011.

Account permit her to invest in equities and other higher risk but higher returning investments. This could significantly enhance her retirement income.

Should she have elderly parents she is also able to top up their account on a tax efficient basis up to certain limits.

The Medisave Account will permit the member to purchase health related services or insurance for herself and her dependants. This can be done throughout her lifetime and as medical costs increase, as the member ages, a larger amount as a percentage of annual income will be contributed to the Member's account.

After age 55 she may continue working and continue to contribute to her CPF. If she has accumulated a large amount she may withdraw much of the balance and on retirement (or the minimum age of 62) may also take a monthly income for life in the form of an annuity.

Lastly, the CPF account balance may be left to her beneficiary or beneficiaries according to her election.

Tax free status

Contributions to the CPF are tax deductable as a business expense and also tax deductible for employees. There is a limit on personal tax relief equivalent to the maximum CPF contribution ceiling. The account balance and gains accrue tax free and on retirement income from an annuity or monthly income is not taxed.[26]

Summary

Singapore has established a pension, homeownership and benefits regime, which provides for members thorough out their lifetimes. The government is able to reduce members' demands on governmental services, such as healthcare, by mandating that its citizens allocate part of their income to healthcare. By incentivising member to buy housing the government has successfully increased homeownership. In events such as an economic downturn the government is able to decrease the employers required contributions (as it did during the Asian Financial Crisis) for short term periods.

The small nation of Singapore currently has member account balances in excess of $185 billion in the CPF. The convergence of pensions, insurance, investments and health is only likely increase over time and the 'pension pot' is available for social programs directed at the individual members as required. The large percentage of retirement assets within the CPF has transferred risk from the government to the employees and employers.

As in all pension systems the CPF can still be criticised, for example, it only provides for those citizens who are employed or self-employed and not the more needy members of society. Conversely, wealthier members may purport that they can gain higher rates of return in the private sector.

However, on the balance, the system is a commendable model for other jurisdictions to ponder when developing or modifying their own pension, employee benefit, health, risk and investment programs.

[26] Axco – Insurance Market Reports, Singapore Life & Benefits, 2011.

U.S. Health Care Reform: One Year Later

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In March 2010, the Patient Protection and Affordable Care Act ("health care reform") was signed into law by President Obama. Employer sponsored group health plans in the U.S. will be significantly impacted by various provisions of health care reform. The article provides a summary of some of the significant health care reforms applicable to U.S. employers with group health plans. Many health insurance reforms became effective beginning January 1, 2011 (for calendar year plans). Additionally, employers and individuals will be subject to significant penalties for failure to offer or maintain health coverage beginning in January 1, 2014. However, recent court decisions have raised doubt about the constitutionality and future of health care reform. If health care reform remains intact, industry analysts predict that it will cost $940 billion over the next 10 years.

In March 2010, the *Patient Protection and Affordable Care Act* (referred to herein as "**health care reform**") was signed into law by President Obama. Employer sponsored group health plans in the U.S. will be significantly impacted by various provision of health care reform. Some of these provisions were effective immediately upon enactment while others become effective on later dates. Many reforms do

not become effective until 2014. This article provides a summary of some of the significant health care reforms applicable to U.S. employers with group health plans. It also includes a summary of recent court decisions that may impact health care reform, and the estimated cost of health care reform on U.S. employers by industry analysts.

Expansion of the Definition of "Dependent"

One of the most significant and immediate (effective March 30, 2010) changes under health care reform was the expansion of the definition of "dependent' for purposes of tax free health coverage to include a "child" who will not turn age 27 during the year, regardless of whether the child otherwise qualifies as a tax dependent.[27] A "child" for this purpose includes children, stepchildren, adopted children and eligible foster children.[28] This provision had an immediate impact on plans such as flexible spending arrangements (**FSAs**) or health reimbursement arrangements (**HRAs**) that condition eligibility on a child qualifying as a tax dependent for health coverage purposes.[29] However, it is important to note that health care reform changed the definition of "dependent" for purposes of tax free health coverage only. Health care reform did not change the definition of "tax dependent" for purposes of the individual income tax rules.

Health Insurance Reforms Applicable to Group Health Plans

In addition to the immediate expansion of tax-free health coverage to adult children, health care reform also made changes effective January 1, 2011 (for calendar year plans), that broaden health coverage for all participants in group health plans. However, "grandfathered" health plans are exempt from some of the changes. Generally, a grandfathered health plan includes group health plans in effect on the date of enactment of health care reform (March 23, 2010). However, there are significant constraints on the changes that may be made to a plan without loss of grandfather status.

The following health insurance reforms affect all (grandfathered and non-grandfathered) group health plans effective for plan years beginning on or after September 23, 2010:

- **Annual and lifetime limits on the value of benefits.** Plans are prohibited from imposing lifetime limits and may impose only restricted annual limits on the dollar value of "essential benefits" for any participant or beneficiary. Essential benefits generally include a broad range of items and services (e.g. emergency services, maternity and newborn care, preventive and wellness services and chronic disease management, etc.)
- **Prohibition on rescissions.** Plans may not retroactively terminate (rescind) group health plan coverage except in cases of fraud or intentional misrepresentation. However, the prohibition on rescissions does not prohibit employers from prospectively terminating group health plans.
- **Preexisting condition exclusions.** Plans may not impose preexisting condition exclusions or limitations with respect to enrollees under age 19.

[27] IRS Notice 2010-38.

[28] IRC § 152(f)(1)

[29] IRC §105(b).

- **Coverage of adult children.** Plans that cover dependent children must provide for coverage of children until age 26. This requirement applies regardless of the child's marital, tax dependency or residency status. For grandfathered plans, coverage is required before 2014 only if the child is not eligible for other employer coverage (other than under the plan of a parent).

The following reforms do not apply to grandfathered plans:

- **Coverage of preventive care.** Plans must provide first dollar coverage (i.e. no cost sharing) for certain evidence-based preventive care, including well child care and immunizations.
- **Nondiscrimination rules for insured plans.** The nondiscrimination rules under *Internal Revenue Code* (**IRC**) Section 105(h) previously applicable only to self-insured plans are extended to fully insured group health plans.[30]
- **Patient Protections.** Plans that provide for a designation of a primary care provider must allow each participant to designate any participating primary care provider who is available to accept such individual. Health care reform also requires plans to comply with requirements regarding access to emergency services and obstetrical and gynecological care, and to allow designation of a pediatrician as a primary care provider for children.
- **Transparency Requirements.** Plans must provide to the Secretary of Health and Human Services (the "**Secretary**"), the applicable state insurance commissioner and the public the information regarding claims payment policies and data, financial disclosures, enrollment, information on cost sharing and payments and information on participant rights and other information as determined by the Secretary.
- **Ensuring quality of care.** Plans must annually report to the Secretary and to enrollees (during each open enrollment period) regarding benefits under the plan that improves health, such as disease management and wellness and health promotion activities.
- **Uniform Explanation of Coverage.** The plan administrator (in the case of a self-insured plan) or the insurer (in the case of a fully insured plan) must prepare and distribute a paper or electronic summary of coverage to all applicants and all enrollees, both at the time of initial and annual enrollment.[31]

A second set of health care insurance reforms go into effect for plan years beginning on or after January 1, 2014. Such health insurance reforms include (but are not limited to) a prohibition on exclusions based on preexisting conditions for all enrollees, cost sharing limitations and guaranteed renewability of coverage.

Employer Responsibility

In addition to ensuring compliance with the new requirements for group health plans,

[30] The IRS has deferred the enforcement of these rules until after the issuance of regulations or other administrative guidance. IRS Notice 2011-1.

[31] §1101 of the *Patient Protection and Affordable Care Act* (**PPACA**).

employers must begin to report the value (i.e. the COBRA[32] cost) of employer provided health coverage on each employee's IRS Form W-2 (Wage and Tax Statement) beginning with the 2012 calendar year (i.e. the first W-2 affected will be the W-2 sent no later than January 1, 2013). Beginning January 1, 2014, employers become subject to the automatic enrollment requirement and employer penalties. Under the automatic enrollment requirement, large employers with 200 or more full-time employees that offer at least one health plan benefit option must automatically enroll all new full-time employees in one of the plans offered and continue the enrollment of current employees in a health plan offered by the employer. The automatic enrollment program must include adequate notice and the opportunity for an employee to opt out of the "auto" coverage and elect another option or opt out altogether. The automatic enrollment requirement will be effective as of the date set forth in the regulations (to be issued at a future date) and applies to employers subject to the *Fair Labor Standards Act* (**FLSA**).[33]

In addition to the obligation to comply with the health insurance reform requirements above, "applicable large employers" are subject to penalties related to coverage that they offer or fail to offer to full-time employees (and their dependents). An applicable large employer is defined as an employer (and any other employer within the same controlled group[34]) who employed at least 50 employees for more than 120 business days during the preceding year. A "full-time employee" is defined as an employee who is employed on average at least 30 hours of service per week. Seasonal employees (employees who work fewer than 120 days) are not included for purposes of determining who is considered to be an applicable large employer.[35]

Employer Penalties

Applicable large employers who fail to offer any full-time employees "minimum essential coverage" must pay a penalty with respect to each full-time employee in any month in which any employee enrolls in and receives a subsidy for an exchange. Generally, any group health plan coverage offered by an employer that complies with the applicable health insurance reforms mentioned above will qualify as minimum essential coverage for purposes of the employer penalties. The penalty is determined on a monthly basis and is the product of the total number of full-time employees of the employer for that month (including those employees who did not receive a subsidy for the state health insurance exchange) and 1/12 of $2000. The first 30 employees are disregarded for purposes of calculating the penalty.[36]

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[32] **COBRA** stands for the *Consolidated Omnibus Budget Reconciliation Act*. COBRA generally gives enrollees the right to choose to keep group health insurance benefits that they would otherwise lose after a reduction in hours or job loss. COBRA continuation coverage cannot exceed 102 percent of the cost to the plan for similarly situated individuals who have not experienced a COBRA qualifying event.

[33] §1511 of PPACA.

[34] Generally, all employers related though common ownership (directly or indirectly) of at least 80%.

[35] §1513 of PPACA.

[36] §1513 of PPACA.

For example:

ABC Company does not offer health coverage and has 61 employees in 2014. For 2014, ABC Company will be subject to the following penalty:

- 1/12 x $2,000 x 31 (number of full-time employees minus the first 30) = $5167/month or $62,000/year.

Applicable large employers who offer unaffordable coverage to employees are also subject to a penalty. Applicable large employers who offer "minimum essential coverage" for any month to a full-time employee who is enrolled in the state health insurance exchange and received a tax subsidy are subject to a penalty equal to the product of the total number of employees enrolled in subsidized coverage and 1/12 of $3,000. The amount of the tax for applicable large employers who offer minimum essential coverage is limited to 1/12 of $2,000 multiplied by the total number of the employer's full-time employees.[37]

For example:

Suppose instead, ABC Company offers health coverage but 31 of its 61 employees enroll in subsidized health insurance exchange coverage in 2014. For 2014, ABC Company will be subject to the following penalty:

- 1/12 x $3,000 x 31= $7750/month or $93,000/year

However, the penalty is capped at the amount ABC Company would have paid if it had offered no health coverage ($5167/month or $62,000/year).

[37] *Ibid.*

Individual Mandate and Recent Court Decisions

Effective 1 January 2014, most individuals are required to maintain "minimum essential coverage" (through an employer or the state health insurance exchange) or pay a monthly penalty equal to greater of:

- For 2014, $95 per uninsured person or 1% of household income
- For 2015, $325 per uninsured person or 2% of household income
- For 2016, $695 per uninsured person or 2.5% of household income

Judicial and Legislative Challenges to Health Care Reform

Recent court decisions have raised doubt about the constitutionality of the individual mandate and health care reform in general. In a ruling entered in December 2010, a United States Court District Judge in Virginia held that the individual mandate included in health care reform is unconstitutional. However, the Virginia court severed the individual mandate from the health care reform bill and left the remainder of the bill intact.[38]

In January 2011, a district court in Florida issued a decision with a broader revocation of health care reform.[39] The court reasoned that the entire health care reform bill should be declared void because the individual mandate was unconstitutional and inextricably linked to the rest of the health care reform bill. In *State of Florida v United States Department of Health and Human Services, et al.,* a lawsuit filed by the State of Florida and 25 other states, 2 private

[38] *Cucinelli v Sebelius*, No. 3:10-CV188-HEH (December 13, 2010).

[39] No. 3:10-cv-91-RV/EMT (January 31, 2011) (order granting summary judgment).

citizens and the National Federation of Independent Business (**NFIB**), the plaintiffs acknowledged that the Commerce Clause permitted Congress to regulate certain "activities." However, the plaintiffs argued that failure to purchase insurance is an "inactivity"[40] and therefore regulation is outside the scope of the Commerce Clause.

Nevertheless, in February 2011, a district court fended off a challenge to Congress's authority to enact the individual mandate of health care reform.[41] In *Mead v Holder*, the U.S. District Court for the District of Columbia, the court dismissed a lawsuit brought by several individual plaintiffs who claimed that health care reform's individual mandate is unconstitutional. The court declared that the Commerce Clause gives Congress the authority to enact the provision because it regulates an activity that substantially affects interstate commerce. The Department of Justice issued a statement indicating that it welcomed the decision "which marks the third time a court has reviewed the Affordable Care Act on the merits and upheld it as constitutional."[42] The DOJ further indicated that it will continue to vigorously defend health care reform in ongoing litigation.

While two federal district courts have found the individual mandate unconstitutional, one of these two courts struck the individual mandate only.[43] The *State of Florida* court is the only court that has ruled that the individual mandate provision cannot be decoupled from the rest of the health reform law and invalidated the entire statute. Notwithstanding these two unfavorable court decisions, two federal district courts upheld health care reform in the face of lawsuits challenging the individual mandate.[44] Consequently, the implications of these recent court cases are unclear. The court in *State of Florida* refused to issue an injunction to implementation and enforcement of health care reform and it has been asked to clarify the impact of the ruling on future implementation activities in the states involved. Furthermore, the U.S. House of Representatives recently approved a budget bill that would bar the use of any Federal funds for implementing or enforcing health care reform. However, this provision is unlikely to survive in the U.S. Senate, which must approve the bill. The ultimate outcome of these judicial and legislative challenges will determine whether health care reform is here to stay and, if so, what form it will take.

Estimated Costs

It is still early to determine the full cost of health care reform on employers in the U.S. Moreover, it will be years before many provisions in the legislation will go into effect. Health care reform is projected to extend coverage to 32 million uninsured U.S. residents.[45] However, 20 percent of employers have indicated that they are considering dropping health coverage

[40] EMT Document at 3.

[41] *Mead v Holder* No. 1:10-cv-00950 (February 22, 2011).

[42] Russo, Tracy, *The District Court in Washington, DC's Affordable Care Act Ruling,* THE JUSTICE BLOG, February 23, 2011: http://www.dailykos.com/story/2011/02/22/948589/-Federal-judge-in-DC-upholds-Affordable-Care-Act

[43] *Cucinelli v Sebelius*, No. 3:10-CV188-HEH (December 13, 2010).

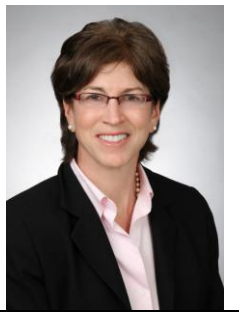
[44] *See* e.g. *Liberty University, Inc. v Timothy Geithner* No. 6:10-cv-00015-nkm (March 23, 2010); *see also, Thomas More Law Center v Obama*, No. 10-CV-11156 (October 7, 2010).

[45] Humo, Terry, *Health Care Reform Fails to Align Goals with Consequences, Costs*, Employer's Guide to Self-Insuring Health Benefits Newsletter (September 2010).

entirely. The Congressional Budget Office estimates that health care reform will cost $940 billion over 10 years. Analysts predict that employers whose workforces are comprised primarily of lower-wage workers paying premiums that exceed what the health care reform defines as affordable are most likely to be affected by health reform changes. Others believe that the effect of health care reform on employers will vary depending on the employer's situation and that the impact will be very company-specific.[46]

[46] Geisel, Jerry, *Employer Impact of Reforms Weighed*, 2010 WLNR 6326238 (Business Insurance 1, March 22, 2010, Volume 44, Issue 12).

A Hot Issue in Employee Benefits in America – The DOL Proposes an Expanded Definition of Fiduciary



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US labor law known as ERISA imposes significant duties upon fiduciaries of employee benefit plans. Since its inception, the definition of who is a fiduciary or not for purposes of that law has excluded certain types of investment advisors, appraisers, and other entities and persons. Some concern has been raised that those rules allow for certain conflicts of interest and should be changed. A new proposal by the US Department of Labor would significantly expand the definition of fiduciary and eliminate many of those exclusions. The impact on the investment industry could be significant.

This article explains the proposal and its implications.

Introduction

There has been a flurry of activity by the US Department of Labor (**DOL**) of late attempting to increase transparency regarding pension plan fees and investment-related activities. The DOL, which along with the IRS is one of the principal regulators of pension plans, issued regulations requiring enhanced disclosure to plan fiduciaries by service providers,[47] new disclosure rules for

[47] ERISA Reg. §2550.408b-2, also known as the "408(b)(2) regulations". Requires registered representatives, investment advisers and others working with 401(k) plan sponsors to provide detailed overviews of their services and compensation, as well as declare whether they are acting as fiduciaries. This interim final rule represents a significant step toward ensuring that pension plan fiduciaries are provided the information they need to assess both the

participant-directed retirement plans,[48] and the expansion of the definition of "fiduciary" for investment advice purposes. This article will discuss the proposed definition of "fiduciary" for investment advice purposes. The expansion of the definition, if finalized as anticipated, will extend duties to many service providers to US plans who currently are not subject to fiduciary duties. As may be expected, the change is very controversial.

On October 22, 2010, the DOL proposed an important regulation[49] defining when a person or entity offering investment advice becomes a "fiduciary" under the *Employee Retirement Income Security Act* of 1974, as amended (**ERISA**). The proposed regulation would replace an earlier regulation that limited the meaning of fiduciary and as a result permitted what has been perceived as serious conflicts of interest. If the proposed regulation is made final in its current form, brokers and brokerage houses, appraisers and valuation firms, and various types of financial advisors face a changing regulatory landscape and may soon become exposed to new liabilities. Also, unless the DOL provides additional prohibited transaction exemptions (administrative exemptions to the prohibitions imposed by the proposed regulation), they may have to radically change the way they do business.

In March and April of this year, the DOL held hearings and collected comments on the roles and duties of fiduciaries in order to better understand the implications of their proposed changes to the definition. The comments came from industry and participant representatives, plaintiff law firms and public interest representatives that urged the DOL to take different positions on the same issue. The DOL is trying to issue a final fiduciary definition regulation by the end of the year.

Update on the Status of this Regulation since this Article was Scheduled to be Published

The U. S. Department of Labor announced on September 19, 2011 that it was going to withdraw this proposed regulation and re-propose it. The Department of Labor is targeting to re-propose the proposed regulation early in 2012. This action was in response to extensive criticism that the proposed extension of the definition of a "fiduciary" was too intrusive in the ordinary course of business. The Department of Labor said that it would re-examine the rule in light of new information that it received and also simultaneously issue prohibited transaction class exemptions where necessary. We believe that this article is still relevant because it explores the background and issues involving who is a fiduciary and it explores some of the places where change may be made to the proposed regulation.

Background

Under ERISA, there is overlapping jurisdiction with regard to many rules governing pension plans between the DOL and the Internal Revenue Service (**IRS**). From an early date, the regulatory agencies decided between themselves on certain allocations of responsibilities. Under that allocation, the DOL has the responsibility to determine who is a fiduciary and when a fiduciary's actions are prohibited (the "prohibited transaction" rules – ERISA does not merely enforce

reasonableness of the compensation to be paid for plan services and potential conflicts of interest that may affect the performance of those services. This rule is effective April 1, 2012.

[48] ERISA Reg. §2550.404c. This rule is effective no earlier than May 31, 2012.

[49] ERISA Reg. §2510.3-21(c).

fiduciary standards of behavior but prohibits *per se* certain related party transactions). The DOL by going to court or by requesting voluntary compliance can enforce those determinations and have damages assessed. There also is the ability to exempt certain actions statutorily and administratively from the prohibited transaction rules. The administrative exemption process can be on an individual or class basis and is controlled by the DOL. In addition, the IRS has the authority to assess substantial fines on prohibited transactions.

ERISA was enacted by Congress in 1974 to protect employee benefits plan participants and beneficiaries against the loss of benefits promised to them by their employers. A person is an ERISA "fiduciary" with respect to a plan to the extent he (1) has discretion over plan assets or plan management and administration, or (2) renders investment advice for a fee, direct or indirect.[50] ERISA both establishes affirmative obligations on fiduciaries[51] and prohibits particular transactions with respect to a plan and its assets.[52] Personal liability is imposed on fiduciaries for failing to live up to the affirmative standards or violating the prohibitions.[53] This article will focus only on fiduciaries offering investment advice.

In 1975, shortly after ERISA was passed, the DOL issued a regulation that narrowed the definition of a fiduciary, by providing that investment advisers would not be considered fiduciaries unless their (1) advice was provided, (2) on a regular basis, (3) pursuant to a mutual agreement, (4) that serves as the primary basis for investment decisions, and (5) the advice is individualized to the particular needs of the plan.[54] If the adviser does not meet any of these criteria, it is not a fiduciary. Thus, providing investment advice to a plan on isolated occasions may not suffice to confer fiduciary status.[55] The importance or effect of the advice to the plan is irrelevant under this regulation.

The DOL further provided in a 1976 advisory opinion that "investment advice" does not include providing a valuation of employer securities to an employee stock ownership plan (**ESOP** – generally, a plan that invests participant's accounts in employer securities, and is subject to certain special tax benefits and rules) in connection with the plan's purchase of those securities.[56] Such valuations are required at least annually for employer securities that are not publicly traded.

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[50] ERISA §3(21)(A).

[51] Under ERISA, fiduciaries are required to act for the exclusive purpose of the plan, act prudently, diversify plan investments, and act in accordance with the terms of the plan. ERISA §404.

[52] ERISA prohibits transactions between a plan and a fiduciary that involve self-dealing (i.e. a fiduciary dealing in plan assets for his own account or acting on behalf of someone with interests averse to the plan or its participants and beneficiaries) and prohibits transactions between plans and parties-in-interest to the plan unless specifically exempted by statute or DOL rulemaking. ERISA §406. Jurisdiction over prohibited transactions is shared by the DOL and the IRS. Engagement in a prohibited transaction for which there is no exemption thus also results in the imposition of an excise tax on the disqualified person.

[53] ERISA §409.

[54] ERISA Reg §2510.3-21(c)(1)(ii)(B).

[55] See, e.g. *Mid-Atl. Perfusion Assoc., Inc. v Prof'l Ass'n Consulting Servs., Inc.*, No. CIV. A. 93-3027, 1994 WL 418990, at *6 (E. D. Pa. 1994) (absent evidence that adviser would provide investment advice regularly, adviser was not a fiduciary), *aff'd*, 60 F.3d 816 (3d Cir. 1995) (table); *Brown v Roth*, 729 F. Supp 391, 397 (D.N.J. 1990) ("provision of advice on two occasions is too infrequent to raise the inference that advice was provided on a regular basis").

[56] DOL Advisory Opinion 76-65A (June 7, 1976).

At the time the regulations were issued, the most common retirement plan was a defined benefit plan over which the employer exercised investment control; investment professionals were primarily advising sophisticated fiduciaries who were more capable of synthesizing market information and better able to identify and evaluate potential conflicts of interest. Since that time, there have been dramatic shifts in the retirement plan marketplace; most employees are in 401(k) plans and have to make their own investment decisions, despite their lack of investment experience or knowledge. There has been an increase in the types and complexities of investment products and services available to plans and to IRA investors in the financial marketplace. Thus, the plan participants are highly dependent on the advice offered to them by the investment industry, but the advice they receive may be subject to conflicts of interest. Indeed, some investment advisers receive undisclosed payments from the vendors of the products they recommend. This would be prohibited under ERISA if the investment advisers are ERISA fiduciaries, but a significant part of the investment advice industry claims that the 1975 regulation shields them from fiduciary status and allows them to accept these third-party payments. Currently, advisers who are not fiduciaries under ERISA may operate with conflicts of interest that they need not disclose and for which there is limited liability; the Department must prove each element of the five-part test at great expense, even if investment advice is abusive. A common problem identified in the DOL's recent ESOP national enforcement project involves the incorrect valuation of employer securities that are not publicly traded. Furthermore, the Government Accountability Office noted an association between pension consultants with undisclosed conflicts of interest and lower returns for their client plans.[57]

DOL Proposes Expanding Definition of "Fiduciary"

The DOL believes that redefining the types of advisory relationships that give rise to fiduciary duties will discourage harmful conflicts, improve rates of return, and enhance the Department's ability to redress abuses and more effectively and efficiently allocate its enforcement resources.

With regard to the five-part fiduciary test, the new regulation:

- eliminates the requirement that the investment advice be provided on a regular basis;
- provides that any advice that may be considered in connection with investment or management decisions is now covered (i.e. removes the individualized investment advice requirement); and
- provides that the advice no longer needs to be provided pursuant to a mutual agreement, just an agreement or understanding.

In addition, providing advice, appraisals or fairness opinions as to the value of investments, recommendations as to buying, selling or holding assets, or recommendations as to the management of securities or other property will result in fiduciary status. The DOL stated that the intent is to establish fiduciary responsibility on parties who provide valuations of

[57] *Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, GAO 09-503T (Mar. 24, 2009).

closely held employer securities and other hard to value plan assets.

Finally, acknowledgement of fiduciary status for purposes of providing advice will result in fiduciary status. This provision is significant because under the old test, a party could acknowledge fiduciary status in writing, but the rule controlled – they could still fail to be liable for a breach if they did not meet all five parts of the old test in fact.

The proposed regulations also clarify that providing the advice for a fee includes any direct or indirect fees received by the advisor or an affiliate from any source including transaction-based fees such as brokerage, mutual fund or insurance sales commissions.

Exclusions from Fiduciary Status

The proposed regulation provides the following exceptions from fiduciary status:

1. **Sales exception / disclaimer:** Persons providing advice or recommendations in their capacity as a purchaser or seller of a security or other property and whose interests are adverse to the plan or its participants or beneficiaries and who are not undertaking to provide impartial investment advice.
2. **Investment education:** Persons providing investment education in connection with an individual account plan.
3. **Platform providers:** Persons marketing or making available an investment platform without regard to the individualized needs of the plan or its participants or beneficiaries if the person making the platform available discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.
4. **General financial information:** Persons providing general financial information to assist a plan fiduciary's selection or monitoring of the investment options on an investment platform if the person making available the financial information discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.
5. **Valuations for compliances with plan reporting (e.g. Form 5500):** Under the proposal, "advice, appraisal or fairness opinion" does not include the preparation of a general report or statement setting forth the value of an investment of a plan or its participants or beneficiaries that is provided to comply with the reporting and disclosure requirements of ERISA, "unless such report involves assets for which there is not a generally recognized market and serves as a basis on which a plan may make distributions to plan participants and beneficiaries".

Impact of the Definition Expansion

Some claim that the proposed regulations would prohibit broker-dealers from giving investment advice, based on the notion that the only permissible form of compensation paid to an investment adviser would be on a fee basis. Because the nature of IRA investments generally are different than employer based retirement plans and IRAs are often through custodial arrangements with services being provided through related parties, it is unclear how these rules would

impact IRA investments. However, the DOL has indicated its willingness to issue prohibited transaction exemptions in addition to those that permit fiduciaries to receive commission-based compensation for the sale of mutual funds, insurance, and annuity contracts. In addition, the statute includes a prohibited transaction exemption for investment advice if fees are leveled or if the investment advice is determined through objective computer programs. Whether parts of the industry will try to make use of the "sales exception" is also in question.

Under the current regulations, many consultants that provide recommendations regarding the selection of investment advisers or other persons to manage plan assets took the position that they were not fiduciaries under ERISA. The proposed regulations change this result and make consultants fiduciaries.

The valuation of employer securities of an ESOP that are not publicly traded will now be considered the provision of investment advice and the DOL has made it clear that appraisals and fairness opinions concerning the value of securities or other property is not limited to employer securities. For example, valuing an interest in an alternative investment like private equity would make the evaluator a fiduciary.

Finally, the new status of investment advisors will, among other things, compel them to procure fiduciary liability insurance, expose them to litigation for potential breach of fiduciary duties and require greater disclosure. These new costs may drive some of these firms out of the marketplace.

Conclusion

The new regulation would apply the statutory rule that a person providing investment advice for a fee is a fiduciary but would continue to allow investment advisers with certain conflicting interests to offer advice under applicable prohibited transaction exemptions yet to be issued. On the one hand, this would prohibit advisors from offering investment advice when they face serious conflicts of interest, which would supposedly result in better investment advice, lower fees, and substantial additional retirement savings for employees. On the other hand, the proposed definition change will likely lead to greater exposure to liability for brokers, appraisers, financial advisors and others who provide services to employee benefit plans because they will likely find that they are fiduciaries as a result of the expansion of what constitutes "investment advice" in the new rules. And this may lead to greater compliance costs.

As one can imagine, the state of affairs has led to concern from and uncertainty for industry insiders. The next step in this process will be to review and analyze future guidance that is issued by the Department of Labor and to evaluate its impact on the industry.

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Tax-efficient UK Share Incentive Arrangements

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Since April 2010 the effective rate of income tax for high earners has risen sharply. From April 2011, employee and employer national insurance contribution (NIC) rates have increased as well. As a result of these tax and NIC rises, employers are looking more and more to structure, where possible, their employee incentive arrangements in the most tax efficient manner in order to provide maximum benefit to their employees. This article sets out some of the ways in which companies may structure incentive arrangements to minimise the tax burden for both employees and themselves, where possible by seeking to take advantage of the lower rates of capital gains tax.

UK tax legislation provides for a number of tax-efficient employee share arrangements under which shares, or the growth in value of shares, can be delivered to employees tax-free or as capital rather than income. Companies may be able to finesse these arrangements to maximise the benefits available to employees by considering using an approved Share Incentive Plan as part of a flexible benefit arrangement or in conjunction with a self-invested pension plan. For those executives whose wealth is tied up with existing share plan arrangements which are unapproved for tax purposes, it may be possible to defer the tax burden so as to see what happens to tax rates in the future. Companies that don't already take advantage of approved Company Share Option Plans tax reliefs could operate such plans in tandem with a Long Term Incentive Plan to deliver at least some part of a free share award in a tax-efficient manner. In addition, "Joint Ownership Plans" and "Growth Shares" offer companies the ability to deliver more substantial benefits to employees in a tax-efficient manner.

Note: This article is current as at July 2011 (please refer to note at the end of the article)

Introduction

Since April 2010 the effective rate of income tax for those earning in excess of £100,000 has risen sharply. Employees now lose £1 of their personal tax-free income allowance for every £2 they earn over £100,000; as a result, those earning over £114,950 are no longer entitled to any personal allowance: they suffer an effective rate of tax of 60% on income between £100,000 and £114,950. The top rate of income tax has increased from 40% to 50%, for those earning in excess of £150,000.

From April 2011, the rate of employees' national insurance contribution (**NIC**) has increased for all employees, from 11% to 12% on earnings of between £139 per week to £817 per week and from 1% to 2% on earnings above £817 per week.

Employers too are impacted with employers' NIC now levied at 13.8% (up from 12.8%) without limit on earnings above £136 per week.

As a result of these tax and NIC rises, employers are looking more and more to structure, where possible, their employee incentive arrangements in the most tax efficient manner in order to provide maximum benefit to their employees.

This article sets out some of the ways in which companies may structure incentive arrangements to minimise the tax burden for both employees and themselves by seeking to take advantage of the lower rates of capital gains tax (**CGT**). CGT applies at 18% for basic rate tax payers and 28% for higher and additional rate tax payers (with an annual exemption, for 2011/12, of £10,600).

The "approved" arrangements

UK tax legislation provides for a number of tax-efficient employee share arrangements under which shares, or the growth in value of shares, can be delivered to employees tax-free or as capital rather than income.

Such arrangements are extremely popular due to their simplicity, their relatively low set-up and on-going costs and the certainty of tax treatment afforded to employees and employers.

The arrangements are Share Incentive Plans (**SIP**), Save As You Earn (**SAYE**) schemes, Company Share Option Plans (**CSOPs**) and Enterprise Management Incentives (**EMIs**). SIPs and SAYE schemes must be offered to all employees whereas CSOPs and EMIs options can be granted on a discretionary basis.

There are, however, two key draw-backs to the implementation of HMRC-approved employee share arrangements:

- the arrangements must comply with strict legislative provisions which, if breached, may result in the loss of the beneficial tax treatment; and
- the aggregate value of shares over which HMRC-approved options/awards may be granted is quite limited and frequently lower than the aggregate value of the incentives packages typically offered to employees. However, HMRC-approved options/awards can be "topped up" with unapproved options/awards.

The individual limits under each HMRC-approved arrangement are as follows:

- **SIP**: up to £7,500 of shares can be awarded in any tax year as "free", "partnership" and "matching" shares. After 5 years, SIP shares may be sold free of tax;
- **SAYE**: savings of between £5 and £250 per month can be used to purchase shares (at up to a 20% discount to the market value at the date of grant) after a 3, 5 or 7-year savings period;
- **CSOP**: market value options can be granted over up to £30,000 of shares (valued at the date of grant); and
- **EMIs**: EMI options can be granted over up to £120,000 of shares (valued at the date of grant).

For SAYE, CSOP and EMI options, the growth in value is available income tax free, with gains on sale subject to the more favourable CGT rates.

Listed companies (and many unlisted companies) will normally satisfy the conditions for establishing SIPs, SAYE schemes and CSOPs. Particular care must be taken with EMIs as there are several specific tests that need to be satisfied relating to the size of the company, the number of employees and the type of business involved.

HMRC approved plans have been and continue to be an important part of the employee reward landscape and are the starting point for a company seeking to minimise the tax burden for employees.

But can a company finesse these arrangements to maximise the benefits available to employees? Two structures which may be worth considering are using a SIP as part of a flexible benefit arrangement or in conjunction with a self-invested pension plan.

(i) Flexible benefits, salary sacrifice and SIPs

Flexible benefits programmes usually operate by providing each employee with a "benefits pot" of a certain value from which those employees are able to purchase their annual benefits. It is possible to provide employees with the ability to request up to £3,000 worth of shares from this benefits pot, in addition to £1,500 of "partnership shares" which those employees may purchase from their pre-tax pay, allowing employers to provide up to £4,500 worth of shares each year on which there is no income tax or NICs payable provided that the shares are held in trust for five years.

The flexible benefits programme may already be in place. Alternatively, the benefits pot could be introduced in place of a future pay rise or could be achieved by a salary sacrifice arrangement i.e. the employee agrees to give up a portion of their gross salary in return for a benefit that is free of tax and NIC (and free of NIC for the employer).

Some companies offer employees the opportunity to receive free shares under their SIP as part of a "salary sacrifice" scheme. This can be structured in a tax efficient manner as employees will not be subject to income tax or employee's NIC on either (a) the amount of the salary sacrificed or (b) the acquisition of the free shares.

Example:

If a basic rate taxpayer acquired £3,000 of free shares under a SIP via salary sacrifice, he would save £600 in income tax (i.e. 20% x £3,000) and £360 in employee's NIC (12% x £3,000), resulting in an overall saving to the employee of £960. The employer would save £414 in employer's NIC (£3,000 x 13.8%). For companies with a large workforce the savings could be significant.

Some companies offer to share the employer's NIC savings with employees as further encouragement to participate in salary sacrifice arrangements.

It is important that any salary sacrifice arrangement involving a SIP be available to all employees (even though not all employees may actually participate).

(ii) SIPs and self-invested pension plans ("SIPPs")

Shares can be transferred out of a SIP trust free of income tax, NIC and CGT provided they have been held for at least five years. After leaving the SIP, if the shares are transferred into a SIPP within 90 days, the value of the shares is treated as a net pension contribution and grossed up for income tax relief. The SIPP administrator will claim the basic rate income tax relief on the share contribution (and employees can claim back any higher rate tax relief via their self-assessment tax return).

This means that if an employee transferred free shares acquired at the end of the five year holding period at a time when they were worth, say, £6,000, his SIPP fund would be entitled to a tax credit of £1,200, resulting in a gross contribution of £7,200. The employee has therefore not paid any tax on either the acquisition or disposal of the free SIP shares, but has managed to secure a tax advantage when the shares are transferred into the SIPP fund (although the same tax benefit would be received if the employee made a cash contribution to the SIPP).

The employee can then either continue to hold the same shares within the tax-free environment of the SIPP or request that the shares be sold so that the proceeds can be used to diversify the SIPP fund.

Once shares have been moved from a SIP to a SIPP, they follow the same rules as other pension assets: they can be sold and the proceeds used to buy alternative pension assets, but they cannot be moved out of the pension before age 55.

Deferring the tax charge

It is clear that HMRC-approved arrangements may be very useful in minimising tax liabilities. For many executives, however, much of their "employee wealth" will be tied up with existing share plan arrangements which are unapproved for tax purposes, giving rise to income tax and NIC consequences. Can anything be done in respect of these?

One suggestion is to defer the tax burden so as to see what happens to tax rates in the future.

Some companies grant "provisional allocations" under their long-term incentive plans (**LTIPs**). A "provisional allocation" is an unsecured promise of free shares which are automatically transferred to an employee upon vesting provided service and/or performance conditions have been met. By contrast, a "nil cost" option is a right for the employee to call for the shares without payment (again provided service and/or performance conditions are achieved): the advantage is that the employee is able to decide when to acquire the shares and thus crystallise the tax charge.

Companies may wish to consider granting future LTIP awards as nil cost options (or even convert existing LTIP awards into nil cost options although the tax consequences of doing so need to be considered).

As the tax charge on receiving shares under a provisional allocation is the prevailing rate upon receipt of the shares, switching to nil cost options may delay crystallisation of the tax charge, either until the employee falls into a lower tax bracket (e.g. following cessation of employment) or following a possible reduction in the current 50% additional tax rate.

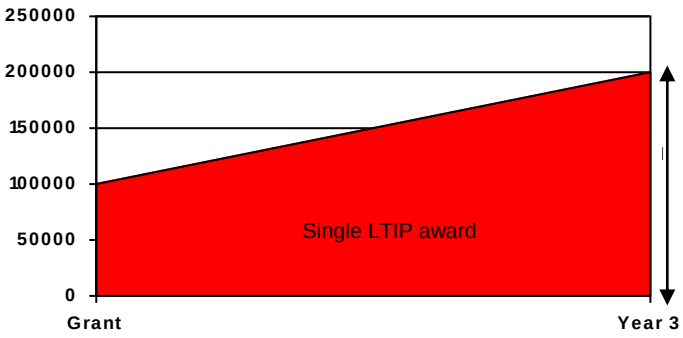
One word of caution: tax rates may rise as well as fall!

"Approved LTIPs"

Is it possible to make unapproved LTIPs more tax-efficient? Many companies that don't already take advantage of the CSOP tax reliefs could operate a CSOP in tandem with their LTIP to deliver at least some part of a free share award in a tax-efficient manner.

Consider a standard LTIP where an employee receives a single free share award over a fixed number of shares. On vesting, the full value of the shares is subject to income tax and NIC (see illustration 1 below).

Illustration 1: Single Free Share Award



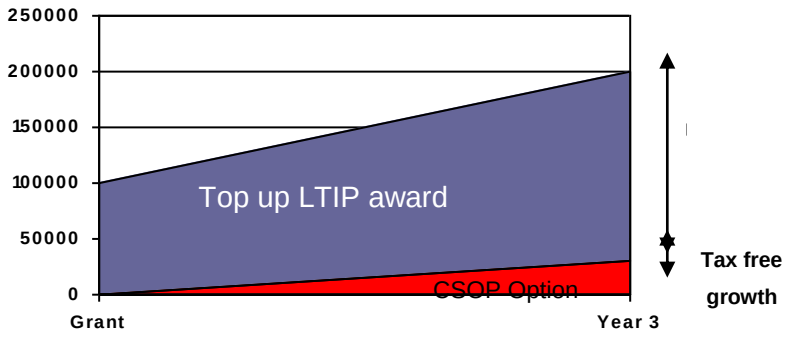
Tax efficiency could be improved by granting the employee an award in two parts, with one part comprising an approved CSOP option with the aim that gains on this option will be subject to CGT, rather than income tax and NIC.

Under this arrangement (see illustration 2 below):

- an approved CSOP option is granted up to a maximum of £30,000 as at the date of grant;

- the LTIP award is granted as normal as an unapproved award but subject to a reduction in value equal to any gain on the CSOP option. This part of the award is subject to income tax and NICs.

Illustration 2: "Approved LTIP"



How does it work in practice?

Assume that a company would ordinarily grant an employee a single free share award over 20,000 shares worth £5 each as at the date of grant (i.e. worth £100,000).

Instead of granting a single free share award over 20,000 shares, the company instead could grant:

- an approved CSOP option over 6,000 shares (i.e. worth £30,000); and
- a side-by-side LTIP award over the same number of shares as would have been subject to the single free share award (i.e. a further 20,000 free shares) but subject to a reduction for the value of any gains on the CSOP option.

The employee will need to pay £30,000 to exercise the approved CSOP option. This can be covered, however, through a cashless exercise where shares are sold to cover the exercise cost.

What happens on exercise/vesting?

At exercise/vesting, the employee receives the same equivalent net value of shares as would have been received under a single free share award.

…if the share price has risen?

For example, if the share price has risen to £10 at the date of exercise/vesting, the employee:

- will exercise his approved CSOP option in full over 6,000 shares (now worth £60,000) (tax free); and
- will receive 17,000 shares under the LTIP award (worth £170,000 (taxable)). 3,000 shares, worth £30,000, are sold to fund the exercise price of the approved CSOP option.

He has therefore received 20,000 net shares with a value of £200,000 (compared to a single free share award over 20,000 shares of equivalent value). The company has, however, had

to issue, or arrange for the transfer of, 3,000 additional shares (when compared with the single free share award) to enable him to be compensated for the exercise price of the approved option[58].

He will be taxed on £170,000 (under the LTIP award), rather than on £200,000 under the single free share award.

…if the share price has fallen?

For example, if the share price has fallen to £2 at the date of exercise/vesting, the employee:

- will not exercise his approved CSOP option as it will be underwater; and
- will receive 20,000 shares under the LTIP award (worth £40,000) (taxable).

He has therefore received 20,000 shares with a gross value of £40,000 (i.e. the normal single free share award). He will be taxed on the £40,000 which is the same as under the single free share award without a side-by-side CSOP.

Shifting to capital gains tax

The arrangements outlined above might be seen as useful parts of a well-thought out remuneration policy. But they are limited in the tax-efficient benefits that they can deliver. Is there anything more fundamental that can provide CGT treatment on a substantial share award? Two suggestions are "Joint Ownership Plans" and "Growth Shares".

(i) Joint Ownership Plans ("JOP")

A JOP is tax-efficient share plan which may provide "net growth" returns similar to those seen under HMRC-approved plans but without two key limitations: (i) there is no requirement to comply with approved share plan legislation in order to obtain the beneficial tax treatment; and (ii) there are no limits on the value that can be delivered to the employees.

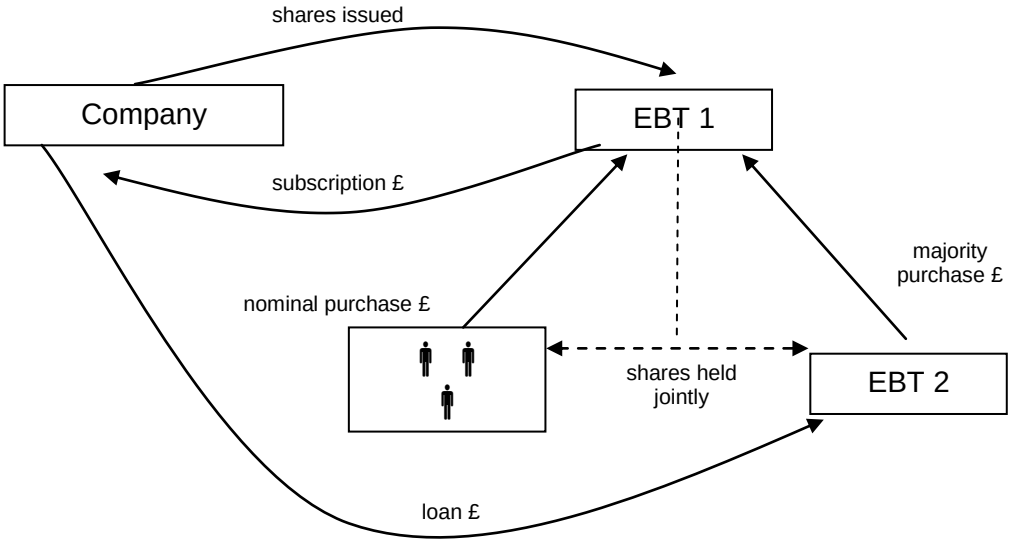
Implementing and operating a JOP could allow companies to deliver share "growth" to employees in a far more tax-efficient manner than under a unapproved share scheme. Whereas, under a standard unapproved share option scheme, employees receive market value share options, the "option gains" of which are subject to income tax and employer's and employee's NICs (i.e. on the growth in value of the shares from the date of grant), the way in which a JOP works is that employees acquire shares jointly with a third party (usually a trustee of an employee benefit trust ("**EBT**")) with the aim that the share growth accruing to the employee on the sale of the shares will be subject to CGT, rather than income tax and NIC (see Illustration 3 below).

Instead of granting the employee an unapproved share option, the employee is invited to purchase an interest in the underlying shares which will entitle him to any growth in the value of the shares from the date of acquisition (referred to as the "growth right"). The trustee of the EBT will be the legal owner of the shares and will

[58] For companies that have dilution concerns arising from the number of new shares that may be issued, the company could pay a cash bonus to fund the exercise price rather than issue shares which are then immediately sold.

own the right to the intrinsic value of the shares at the date they are acquired. Illustration 3 shows a typical structure. Other structures may use a single EBT holding the shares on behalf of itself and employees jointly.

Illustration 3:



The employee must either pay the full value of the "growth right" or will be subject to income tax and NIC on any shortfall compared to the price paid. It should, however, be possible to establish a relatively low market value for the growth right by imposing a requirement on the employee to sell his interest in the shares to the trustee of the EBT (for the employee's acquisition cost or, if less, the current market value) if performance conditions and/or service conditions are not met or the employee ceases employment (except in specified "good leaver" circumstances). In addition, the taxable value of the employee's growth right can be reduced by imposing an annual growth hurdle (or "carry cost") representing the cost of operating the arrangements. It is therefore important for the company to obtain a professional valuation of the growth right before the interest is acquired by the employee.

What are the benefits for the employee?

The table below compares the tax treatment of an additional rate taxpayer holding an unapproved share option with participation in a JOP.

	Exercise of Unapproved Share Option			Sale of JOP Shares			
	Gain	Employee Income Tax/NIC at 52%	Employer NIC at 13.8%	Gain	Employee Tax/NIC at 52%	Employee CGT at 28%[1]	Employer NIC at 13.8%
	£200,000	£104,000	£27,600	£200,000	-	£53,032	-
Employee tax/NIC saving						**£50,968**[2]	
Employer NIC saving							**£27,600**[2]

1 after personal allowance of £10,600 for 2011/12

2 assuming that the employee pays the full value of the growth right at the time of acquisition, representing a nominal additional cost to the employee

In order for the cost and effort of structuring of the JOP shares to be worthwhile, there must be a realistic prospect that the company will achieve sufficient growth in the value of its shares in the short to medium term (i.e. two to five years).

Are there any benefits or issues for the employer?

Any gain under a JOP will be subject to CGT, rather than income tax and NIC, which means that the employer would make a saving of 13.8% of the gain made by its employee by not having to account for any employer's NIC liability. However, this saving must be balanced against the fact that the employer will not be entitled to a UK statutory corporation tax deduction (whereas the exercise of an unapproved option gives rise, subject to statutory requirements being met, to a UK statutory corporation tax deduction equal to the amount on which the employee pays income tax). However, this may not be a concern for a loss-making entity or one with substantial historical losses.

If the above structure is used, a company operating a JOP would be required to fund the trustee of EBT 2 (by way of loan) to enable the trustee to pay the balance of the market value of the shares at the time of acquisition. There is a risk that where there is a share price decline the loan may not be repaid. However, this is essentially no different to standard share hedging arrangements and can be avoided if the company is prepared to issue new shares rather than market purchase. If only one EBT is used, the EBT could subscribe at nominal value and then sell the growth right to the employee.

What rights does the employee have?

The employee will have the right, at the end of the "vesting period", and possibly during a period equivalent to an option exercise period, to request that the jointly owned shares are sold in order to realise the gain for the employee and allow the trustee to recover the initial investment (plus the "carry cost", if applicable).

As the employee is a joint owner in the shares it is also possible for the arrangements to provide a proportionate right to vote the shares and a proportionate right to receive dividends during the vesting/holding period.

On an "exit", the JOP may provide the trustee with the ability to require the employee to convert his gain into shares of an equivalent value out of the EBT, thus enabling the employee to retain shares rather than having to sell all of the jointly owned shares.

It is also possible to extend this structure to mirror an LTIP by granting an option to the employee over the EBT's residual interest, although this value would be subject to income tax and NIC on receipt.

(ii) Growth shares

A "growth share" usually refers to a special class of share designed to allow the holder to benefit only from any growth in the value of the company from the time the shares are issued provided certain conditions have been met (such as exceeding a profit target, or a minimum exit price on a disposal of the company's business or the company itself).

As a growth share will be subject to special terms, the company will need to establish a separate class of share, which can result in time and expense on the part of the group company adopting the plan due to the amendments to the articles and the valuation of the shares. In addition, a new class of share may need to be established for each round of "growth share" awards. It is for these reasons that "growth shares" are unsuitable for most quoted public companies. However, a quoted company may be able to use growth shares in one or more trading subsidiaries, perhaps alongside arrangements for vested growth shares to be bought back, or exchanged for quoted parent shares, if shareholders will support this.

If growth shares are implemented correctly they can deliver the growth in the value of the shares to employees in an extremely tax-efficient manner similar to that of JOP shares (i.e. being subject to CGT rather than income tax) although the structure of the two arrangements are quite distinct.

As the name implies, a "growth share" only has an entitlement to share in any growth in the value of the company from the date of acquisition, which means that the shares will generally have a low market value on acquisition. Consequently, the amount the employees are required to pay to acquire the growth shares is generally quite low. As employees will normally enter into a section 431 restricted securities election on the acquisition of growth shares, any growth in the value of the shares should be subject only to CGT rather than income tax and NICs. CGT will not be payable until the shares are disposed of which is in contrast to share options when a tax charge arises on exercise.

If employees pay less than the unrestricted market value of the shares at the date of acquisition they will be subject to an income tax and employee's NIC charge on the amount by which the unrestricted market value of the shares exceeds the price paid to acquire them. Therefore, as for the JOP shares, it is essential that the growth shares are valued correctly.

As with JOPs, the employer would make a saving of 13.8% of the gain made by employees by not having to account for any employer's NIC liability, but again the lack of a UK statutory corporation tax deduction would need to be factored into the cost of operating the incentive.

Conclusion

None of the arrangements outlined above are themselves a complete solution to the very high tax burden currently borne by UK-resident taxpayers. Nor should the tax tail wag the commercial dog. There are very good non-tax reasons for companies to implement employee share incentive arrangements with a view to incentivising and retaining key staff. However, as part of an overall remuneration package, maximising the tax advantages available will be a welcome relief for both employees and employers.

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