

INCOME TAX (EARNINGS AND PENSIONS) ACT 2003

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Example 3

Ne = £5,000; Da = 183; De = 183; Smg = 0

Part 7: Employment income: share-related income and exemptions

Arrangement of material for share schemes

Chapter 2: Conditional interests in shares

Overview

1832. Where shares are awarded to employees by reason of their employment, their value (less anything paid for them) will generally be taxable as an emolument. If the shares have restrictions attached to them so that they are subject to risk of forfeiture (typically in the event of performance criteria not being met), the Inland Revenue view until 1998 was that there was not an emolument at the time of award and that liability only arose when the risk of forfeiture was lifted. Legal advice in 1998 showed that this view was wrong. Liability arose in the normal way at the time of the award on the value of the shares taking into account the risk of forfeiture. No liability as an emolument arose at the time that the risk was lifted. Nor would the legislation in sections 77 to 88 of FA 1988 generally bite as there was no event giving rise to an immediate increase in value.
1833. The legislation introduced by sections 140A to 140C of ICTA (together with supplementary provisions in sections 140G and 140H) is intended broadly to restore the position as it existed under the earlier practice. It applies to shares acquired on or after 17 March 1998. In essence the normal income tax emoluments charge on award is removed by section 140A unless the shares can still be subject to forfeiture more than five years after acquisition. The same section then imposes a charge (whether or not there is an emoluments charge) when the employee's interest ceases to be "only conditional", a term which is defined by section 140C. A number of situations are specifically excluded from counting as "only conditional" so that in those circumstances the normal rules of a charge on acquisition apply.
1834. Sections 140G and 140H of ICTA contain supplementary provisions some of which apply solely to the provisions concerning conditional shares (sections 140A to 140C of ICTA), some of which apply solely to the provisions concerning convertible shares (sections 140D to 140F of ICTA) which were introduced at the same time and some which apply to both. In this Act the provisions on convertible shares appear in Chapter 3. This does mean that those supplementary provisions which apply to both types of share have been duplicated, but the overall result is intended to be much easier to follow.

Section 422: Application of this Chapter

1835. *Subsection (1)* of this introductory section derives from section 140A of ICTA and gives the two basic conditions for the provisions to apply. First, the shares must be acquired “as a director or employee” and that term is defined in section 423. The second condition is that the employee’s interest in the shares is “only conditional” as defined in section 424. The fact that these provisions only apply to shares acquired on or after 17 March 1998 is made clear in Part 7 of Schedule 7 to this Act, to which there is also a signpost in section 418(1).
1836. *Subsection (2)* is new and sets out a number of useful labels which make for less cumbersome drafting. The fact that this Chapter applies to prospective and former directors and employees is made clear by the reference to the extended definition in section 434(1).

Section 423: Interests in shares acquired “as a director or employee”

1837. *Subsection (1)* explains the circumstances in which shares are regarded as being acquired by a person (“E”) “as a director or employee”. They are broadly equivalent to the circumstances in which a normal earnings charge would arise. The provision derives from section 140H(1) of ICTA. *Subsection (1)(c)* no longer says an assignment “to him” because if the assignment was to anyone else the shares would not have been acquired by E.
1838. *Subsection (2)* qualifies subsection (1) and derives from section 140H(2) of ICTA with only minor modifications.
1839. *Subsections (3) and (4)* are based on section 140H(4) of ICTA and explain the treatment when one conditional or convertible interest is exchanged for another.
1840. *Subsection (5)* derives from the opening words of section 140H(4) of ICTA.
1841. *Subsection (6)* contains the definition of “convertible shares”.

Section 424: Meaning of interest being “only conditional”

1842. *Subsection (1)*, which derives mainly from section 140C(1) of ICTA, defines when an interest in shares is “only conditional”. While section 140C of ICTA says “for the purposes of sections 140A and 140B”, the definition is applied more widely by section 140H(5) of ICTA. Hence the definition is now applied “for the purposes of this Chapter”.
1843. *Subsection (2)* summarises the exceptions from subsection (1) which prevent the interest being only conditional so that the normal charge as earnings applies on acquisition. The exceptions derive from section 140C (1A), (2), (3), (3A) and (4) of ICTA.
1844. *Subsection (3)* derives from section 140C(5) of ICTA and expands on the circumstances falling within subsection (1)(a). They are not regarded as including cases where the terms on which the employee is entitled to the interest allow the employee to require a person to acquire the interest at undervalue.
1845. *Subsection (4)* relates back to subsection (1)(b) and derives from the closing words of section 140C(1) of ICTA.
1846. *Subsection (5)* is new and reflects the latest legal advice that the term “articles of association” includes foreign equivalents, thus widening the circumstances in which an interest is not “only conditional”. See *Note 44* in Annex 2.
1847. *Subsection (6)* is supplementary to subsections (2)(b) and (c) and derives from parts of section 140C(3) and 140C(3A) of ICTA.

1848. *Subsection (7)* derives from section 140(6) of ICTA.

Section 425: Cases where this Chapter does not apply

1849. The two rules in this section derive from section 140H(3) of ICTA.

1850. The source legislation specifies that these provisions only apply to Case I employments. *Subsection (1)* rewrites this rule by applying the equivalent test that the earnings must be within section 15 or 21.

1851. *Subsection (2)* explains that the test in subsection (1) is to be applied to the final year of employment in cases where the right or opportunity to acquire the shares is conferred or offered after the employment has ceased.

Section 426: No charge in respect of acquisition of employee's interest in certain circumstances

1852. This section concerns the five year rule and derives from section 140A(3) of ICTA. In the typical case the conditions apply for less than five years at which point the employee has an indefeasible interest in the shares. In those circumstances no charge as an emolument arises on acquisition but this does not affect any charges that may arise under section 135 of ICTA (where the shares are acquired by exercising an option) or section 162 of ICTA (where the shares are acquired at undervalue). In this Act those provisions are in section 476 and Chapter 8 of Part 3 respectively.

Section 427: Charge on interest in shares ceasing to be only conditional or on disposal

1853. *Subsections (1) to (3)* derive from section 140A(4) of ICTA which imposes a tax charge when the risk of forfeiture is lifted or on the earlier disposal of the shares.

1854. *Subsection (4)* is new and acts as a signpost to a provision removing the charge for shares awarded under an approved SIP.

Section 428: Amount of charge

1855. This section concerns the calculation of the taxable charge under section 427. It derives from section 140(5), (7), and (9) of ICTA. A formula has been introduced in *subsection (1)* to make the provisions more user-friendly.

1856. The deductible amount provided by section 140A(7)(b) of ICTA is any amount chargeable in respect of the acquisition of the interest. It is not immediately clear what is meant by that phrase and the approach adopted here is to specify what is allowable. The three charges that are relevant are detailed in paragraphs (b), (c) and (d) of *subsection (2)*. See *Note 45* in Annex 2.

1857. *Subsection (3)* provides that charges under sections 449 and 453 are deductible. It derives from section 140A(7)(c) of ICTA. The opportunity has been taken to make it clear that a charge taken under these provisions is not a deductible amount if it is generated by the same event which gives rise to the charge under this Chapter. This is because the FA 1988 provisions, from which sections 449 and 453 derive, are subject to section 140A of ICTA so that the latter takes priority.

Section 429: Amount or value of consideration given for employee's interest

1858. This section derives from section 140B(1) to (6) of ICTA. Section 140B(7) has been taken to a separate section. This section determines, for the purposes of section 428, the amount allowable as the cost of the shares.

Section 430: Amount or value of consideration given for right to acquire shares

1859. This section derives from section 140B(7) of ICTA which is concerned with calculating the allowable cost where an original option has been exchanged for a replacement option. Section 140B(7) simply refers to the workings of section 136 of ICTA which are not easy to follow. This section spells out what the allowable cost is and the wording follows section 485 which derives from section 136. See *Change 125* in Annex 1.

Section 431: Application of this Chapter where employee dies

1860. This section derives from section 140A(8) of ICTA which gives rules which apply when the employee dies holding the conditional shares. There is a deemed disposal immediately before death and a special market value rule applies.

Section 432: Duty to notify provision of conditional interests in shares

1861. This section derives from those parts of section 140G of ICTA concerning information requirements on the initial award of the conditional shares. Section 140G(1)(b)(i) has been omitted as unnecessary because the original award of the shares cannot itself result in any charge under section 140A of ICTA. Accordingly this section simply focuses on the possibility of there being subsequent events that may result in a charge.

1862. The time limits for providing information throughout Chapters 2 to 5 of Part 7 have been standardised at 92 days after the end of the year in which the matter arose or after the event concerned. In the source legislation for this section the time limit was 30 days after the end of the tax year in which the interest is provided. In addition where a time limit runs from the end of the tax year it is now expressed as “before 7th July” to give greater clarity. See *Change 111* in Annex 1.

Section 433: Duty to notify events resulting in charges under section 427

1863. This section derives from those parts of section 140G of ICTA concerning information requirements on the occurrence of any of the three events (death, disposal of shares, lifting of restrictions) which may result in a charge under section 140A of ICTA. The time limit for providing information has been extended from 30 to 92 days after the end of the tax year in which the event occurred and expressed differently. See *Change 111* in Annex 1.

Section 434: Minor definitions

1864. This section brings together the definitions in section 140H of ICTA and elsewhere in the provisions and adds some new labels for terms used in section 422. In the definition of “terms” the word “include” in section 140H(6) of ICTA has been replaced by “means” to make better sense of the additional words “or in any other way”.

1865. The definition of shares (which comes from section 136(5)(d) of ICTA, as applied with modifications by section 140H(8) of ICTA) includes stock “in so far as the context permits”. This rider has been omitted as unnecessary since there does not appear to be anywhere in this Chapter where the context would not so permit.