These notes refer to the Income Tax (Earnings and Pensions) Act 2003 (c.1) which received Royal Assent on 6th March 2003

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 5: Share options

Overview

1948. This Chapter is concerned with the income tax charges which may arise in respect of a share option granted to any person by reason of an individual's office or employment.

1949. The case of Abbott v Philbin (1960) 39 TC 82 (HL), [1960] 2 All ER 763, established that under general Schedule E rules, the only occasion of charge is on the grant (or assignment) of the option. The source of any gain arising on the later exercise of the option is the option itself, not the employment.

1950. The effect of this decision was largely reversed by legislation introduced in 1966 and now in sections 135 to 140 of ICTA. The underlying purpose of that legislation is to replace the charge on grant with one on exercise. Indeed that was what the original legislation achieved. However in 1972 the charge on grant was reintroduced for longer-term options to prevent liabilities being pushed too far into the future. At the same time the value of the grant was defined and provision made for any tax paid on grant to be deducted from the tax payable on exercise.

1951. The charging provision, section 135 of ICTA, does three main things.

- It provides that the gain on exercise (or on assignment, release or otherwise turning to account) is chargeable to tax under Schedule E provided the employee is in an employment within Case I of Schedule E.
- If any gain on exercise would be chargeable then it removes the charge on grant, except where the option can be exercised more than ten years after grant.
- It provides rules regarding the computation of charges that arise on grant and on exercise.

1952. The charges on grant and on exercise are removed where the options are issued under one of the schemes approved by the Inland Revenue. The legislation regarding these

schemes has been rewritten in Chapters 7, 8 and 9 of this Part. Those provisions do impose charges to tax in certain circumstances.

1953. The rewritten legislation sets out the scope of the Chapter in the opening sections. It then adopts a logical order by first considering the taxation issues that arise in respect of the receipt and then the issues that arise on exercise, assignment or release. The rules in section 187A of ICTA and in section 4 of the Social Security Contributions (Share Options) Act 2001 which give a deduction to the employee when under an agreement or election he meets some or all of the employer's secondary or special national insurance contribution have been incorporated.

1954. Two provisions in the source legislation have not been rewritten.

- Section 136(4) of ICTA excludes from the charge that part of any gain that arises before 3 May 1966. It only applies to options granted before that date. The provision is regarded as spent and it is not being preserved.
- Section 137 of ICTA allows for payment of tax under section 135 by instalments. It only applies to options granted before 6 April 1984. The provision is regarded as spent and it is not being preserved.

Section 471: Share options to which this Chapter applies

1955. This section sets out which share options come within the scope of the Chapter. It introduces the term "share option" in place of the cumbersome "right to acquire shares". In fact, although the title of section 135 of ICTA includes the words "share options", that term is not used at all in the source legislation.

1956. *Subsection (1)* makes it clear at the outset that the options concerned are those granted by reason of a person's office or employment. It derives from parts of section 135(1) and (6) and section 140(1) of ICTA.

1957. *Subsection (2)* makes it clear that the shares over which the option is granted can be shares in any body corporate. The normal case, of course, will be the grant of options over shares in the employing company, but the legislation can apply even if the body corporate is totally unconnected with the employment.

1958. *Subsection (3)* makes it clear that the option may be granted to someone other than the director or employee. It derives from section 140(1) of ICTA.

1959. *Subsection (4)* sets out two definitions which help to make the legislation easier to read. For example, the term "the employee" is used instead of "the director or employee of the company". Also, the fact that this Chapter applies to prospective and former employees is made clear by the reference to the extended definition in section 487(1).

Section 472: Introduction to taxation of share options

1960. This is a new introductory section. *Subsection (1)* derives from the Abbott v Philbin decision. It makes clear that unless a charge is imposed by this Chapter on exercise, then the only possible charge is when the option is received. If there is a charge on grant or assignment then it arises by virtue of Chapter 1 of Part 3 as earnings or under Chapter 10 of Part 3 as a taxable benefit.

1961. *Subsection (2)* acts as a signpost to the major exemption from the charge in respect of receipt, ie where the options expire within ten years of being obtained.

1962. *Subsections (3)* and *(4)* draw attention to charges that may arise when the option is exercised, assigned or released and *subsection (5)* to the different rules that apply for options received under an approved scheme or under the EMI code.

Section 473: Share options to which this Chapter does not apply

1963. This section explains which offices and employments come within the scope of these provisions. *Subsection (1)* brings to the fore the idea that the Chapter is only concerned with options granted in respect of an office or employment the earnings from which fall within sections 15 or 21. This is derived from the restriction in section 140(1) of ICTA, that the legislation only applies to Case I offices and employments, although the exact scope of that restriction was not clear. Clarifying the scope of the restriction is a minor change to the law. See *Change 118* in Annex 1.

1964. *Subsection (2)* derives from section 140(1) of ICTA and makes it clear that the legislation applies to options granted after the employment has ceased if the employment is within sections 15 or 21 in the last tax year in which the employment was held. This section makes it clear that a charge can arise where an option is granted to another person after the employment has ceased. See *Note 49* in Annex 2.

Section 474: No charge in respect of receipt of shorter-term option

1965. This section derives from section 135(2) of ICTA which gives an exemption in respect of receipt of options which expire within ten years provided that any gain on exercise of the option would be chargeable. The proviso is not expressly stated in this section. It follows from the fact the reference to “share option” imports the conditions in sections 471 and 473 and therefore limits the scope of the exemption to options within the Chapter and potentially chargeable on exercise.

1966. *Subsection (2)* also highlights the point, referred to rather obliquely by the opening words of section 135(2) of ICTA, that charges can arise on grant under an approved CSOP scheme in certain circumstances. Other than this instance, it follows that a charge in respect of the receipt can only arise where:

- the award is of a longer-term option; or
- the circumstances are such that a charge could not arise on exercise. Examples of this would be that the employment (considered at the time of grant) is not within sections 15 or 21, or the holder of the option is an office-holder who is not a director or employee.

Section 475: Value of longer-term option for purposes of liability to tax in respect of receipt

1967. This section derives from the rule in section 135(5)(b) of ICTA regarding the valuation of a longer-term option for the purposes of a charge to tax in respect of the receipt of the option. Section 135(5)(b) says that the value of the option is not less than the current market value of the option shares reduced by whatever the employee has to pay for the shares. In practice, a higher value is never used. Accordingly, the “not less than” part of the rule has been left out. This is a minor change to the law. See *Change 119* in Annex 1.

1968. *Subsection (2)* derives from section 135(5)(b) of ICTA and resolves an ambiguity if the option shares carry conversion rights. It is not clear in the source legislation in such a case whether the value of the option shares or the value of the shares obtained on their conversion should be the basis of the charge. This section resolves the ambiguity by taking the higher value. This is a minor change in the law. See *Change 120* in Annex 1.

1969. The definition of “market value” in *subsection (3)* derives from section 140(3) of ICTA. It is reasonably plain from the wording of section 140(3) that the intention is to have the same rules about market values as apply in TCGA 1992 although only section 272 is mentioned. The new definition refers to Part 8 of TCGA 1992 rather than just section 272 and is now the same as in Schedules 2, 3, 4 and 5 to this Act. This change in approach is explained in more detail in *Note 23* in Annex 2.

Section 476: Charge on exercise, assignment or release of option by employee

1970. In ICTA, the rules that apply in situations where another person (rather than the employee) realises the gain are in the middle of section 135 surrounded by other material dealing with the more common case in which the gain is realised by the employee personally. In this Act the rules have been separated, this section being concerned with gains realised by the employee and section 477 with gains realised by other persons.

1971. *Subsection (2)* provides that an amount is to count as employment income of the employee. It derives from section 135(1) of ICTA. Such an amount is specific employment income (see section 7(4) of this Act) which replaces the free-standing Schedule E charge. It does not depend on the residence status of the employee at the time of exercise. The charge applies whether the option was originally granted to the employee or to another person and then assigned to the employee; see section 471(3) of this Act. The amount that is to count as employment income (the taxable amount) is determined under section 478.

1972. *Subsection (3)* is new and simply specifies the year for which the taxable amount counts as employment income. It is Inland Revenue practice to apply section 135 of ICTA to charge the gain in the year of exercise etc. See *Note 3* in Annex 2.

1973. *Subsection (4)* refers to the exceptions that apply if the options were granted under an approved scheme or under the EMI code.

Section 477: Charge on employee where option exercised, assigned or released by another person

1974. This section derives from section 135(6) and (7) of ICTA which imposes a charge on the employee where the gain is realised by another person. *Subsection (1)* sets out clearly the three circumstances where an amount is to count as employment income of the employee. The amount that is to count as employment income (the taxable amount) is calculated under section 478.

1975. *Subsection (3)* is new and specifies the year for which the taxable amount counts as employment income. See *Note 3* in Annex 2.

1976. *Subsection (4)* is new. It legislates the present practice of not charging the personal representatives or beneficiaries when the option is exercised following the death of the person to whom the option was granted. See *Change 121* in Annex 1.

1977. *Subsection (5)* derives from section 135(7) of ICTA and contains an exemption where the employee was divested of the share option by operation of law. The reference in section 135(7) of ICTA to "on his bankruptcy or otherwise" has been left out as it adds nothing.

1978. *Subsection (6)* provides that where subsection (5) applies, the gain is chargeable under Schedule D, Case VI. The subsection also removes ambiguity by making it clear that any person charged under Case VI is entitled to the reduction derived from the closing words of section 135(6) of ICTA. This is a minor change to the law. See *Change 122* in Annex 1.

Section 478: Amount of charges

1979. This section identifies those deductions which are made from the amount of the gain (calculated under section 479 or 480) in arriving at the taxable amount.

1980. *Subsection (2)(a)* and *(b)* reflects the amendments made to section 135 of ICTA by paragraph 1 of Schedule 6 to FA 2002. That changed the rule about giving relief where there had been an earlier charge in respect of the receipt of the option. The amount that is charged to tax in respect of the receipt is now deducted in calculating the taxable amount

instead of giving relief in terms of tax. In strictness, a deduction is only due where the option is exercised, assigned or released by the employee. However, in practice it is appropriate to give the deduction where the option is exercised by another person, so long as the same amount is not deducted twice. The section makes any amount charged to tax in respect of the receipt of an option a deductible amount in calculating the taxable amount for the purposes of section 477 (charge where option exercised by another person), but *subsection (3)* prevents double deductions. This is a minor change to the law. See *Change 123* in Annex 1.

1981. *Subsection (2)(c)* allows a deduction in calculating the taxable amount for the amount of any allowable national insurance contributions met by the employee. It derives from section 187A(4) of ICTA.

Section 479: Amount of gain realised by exercising option

1982. This section brings together the parts of section 135(3) and (6) of ICTA which provide the rules regarding the computation of the gain on exercise and a further rule in section 185(8) of ICTA. That rule allows a deduction in calculating the amount of the gain for any charge to tax under section 185(6) of ICTA in respect of the grant at a discount of a share option under an approved CSOP scheme. Those parts of section 135(3) of ICTA which relate solely to the gain on an assignment or release appear in a separate section. The method adopted leads to some repetition between this section and section 480, in order to assist the reader.

1983. *Subsection (1)* introduces a formula for calculating the gain.

1984. *Subsection (2)* specifies the items which are deductible costs in calculating the gain.

1985. *Subsection (3)* derives from the closing words of section 135(4) of ICTA and ensures that the amount paid for the option is deducted only once. It should be noted that section 135(9) of ICTA replicates the effect of section 135(4) of ICTA and has not been separately rewritten. This removes unnecessary material.

1986. *Subsection (4)* provides a signpost to the EMI provisions which modify the calculation of the amount of the gain.

Section 480: Amount of gain realised by assigning or releasing option

1987. This section mirrors section 479 and sets out the rules which apply to the computation of the gain when the option is assigned or released. As the EMI provisions do not apply when an option is assigned or released no signpost is required here.

Section 481: Deductible amount in respect of secondary Class 1 contributions met by employee

1988. Section 187A of ICTA, introduced by section 56(1) of FA 2000, provides relief against a gain chargeable under section 135 of ICTA for amounts of employer's Class 1 National Insurance contributions payable in respect of the gain and met by the employee under arrangements set out in social security legislation. The relief has now been written as a deduction in calculating the taxable amount and does not affect the amount of the gain. It is the amount of the gain (rather than the taxable amount) that is relevant for the purposes of section 120(4) of TCGA 1992 and national insurance provisions. It is therefore not necessary to reproduce the rule in section 187A(5) of ICTA which prevented relief under section 187A from being taken into account for those purposes.

1989. *Subsection (4)* derives from section 4(3) of the Social Security Contributions (Share Options) Act 2001. Its effect is that one cannot get a deduction under both this section and under section 482 (special contributions).

Section 482: Deductible amount in respect of special contribution met by employee

1990. This section derives from section 4 of the Social Security Contributions (Share Options) Act 2001. That Act enabled the employer or employee as appropriate to cap exposure to employer's Class 1 National Insurance contributions by instead paying a special contribution calculated by reference to any increase in value of the shares subject to the option on 7 November 2000. Although any special contributions had to be paid by 11 August 2001 the relief is due when the gain is realised which may not be for several years.

1991. For the same reasons as explained above in the notes on section 481, the provisions of section 187A(5) of ICTA have not been reproduced in this section. It is not necessary to prohibit a deduction made in calculating the taxable amount and not in calculating the amount of the gain.

Section 483: Extended meaning of "assign" and "release"

1992. This section brings together the two rules regarding the extended meaning of "assign" and "release" to include other situations where options are turned to account. It derives from section 135(8) and section 136(5)(a) of ICTA.

Section 484: Amount or value of consideration given for grant of share option

1993. This section contains supplementary rules for determining the amount allowable as a deduction in respect of the cost of the option in calculating the amount of the gain.

1994. *Subsection (2)* derives from the rule at the end of section 135(3) of ICTA regarding the apportionment of a single sum paid for both the share option and something else. The wording in that subsection is a "just" apportionment. This has been amended to "just and reasonable" to align the wording with that used in sections 429 and 442. This is a minor change to the law. See *Change 124* in Annex 1.

1995. *Subsection (3)* derives from section 135(4) and provides that no account is taken of the value of the duties of the employment performed by the employee. As mentioned in the explanatory note to section 479, section 135(9) of ICTA has not been rewritten as it replicates the effect of the rule in the final part of section 135(4), that the cost of the option can only be deducted once. That rule is rewritten in sections 479(3) and 480(3).

Section 485: Application of this Chapter where share option exchanged for another

1996. This section derives from what is probably the most complex part of the source legislation. Section 136(1) to (3) of ICTA are concerned with creating a form of rollover treatment which applies when a right to acquire shares is effectively swapped for another such right. The effect is to ignore the swap for section 135 purposes and apply the Chapter to the replacement option. Any consideration received which is not represented by the new option is taken into account in calculating the gain in the normal way.

1997. The prevention of the early crystallisation of the charge in the case of a straightforward exchange also has an anti-avoidance effect. In the absence of the provision it could be arranged that a valuable option is exchanged for an option with an apparently lower value (thus generating an immediate, but low tax charge), and there would be no charge on exercise because the new option would not have been issued by reason of employment, but to the employee as option-holder.

1998. Section 136(1) of ICTA is not easy to follow partly because it says that the cost of the new option excludes some things, but includes others; and partly because those rules are in the same long sentence detailing other rules not concerned with working out the allowable cost of the new option. These ideas have been separated and in order to make the provision easier to use *subsection (4)* specifies what is in fact the consideration for the grant of the new option. *Subsections (5)* and *(6)* extend the rollover

treatment to cases where the swap is achieved indirectly under arrangements described in section 136(2) and (3) of ICTA.

1999. It may be noted that section 136(2)(b) of ICTA refers to tax "chargeable under this section". This makes no sense because tax is not chargeable under section 136, but under section 135 of ICTA. The problem stems from consolidation. Previously section 136(2) was part of the same section as section 135. When that section (section 186 of ICTA 1970) was split in two on consolidation the relevant amendment to section 136(2)(b) was missed. This error has been corrected in section 485(5)(b). See *Change 125* in Annex 1.

Section 486: Duty to notify matters relating to share options

2000. This section derives from section 136(6) to (8) of ICTA. The time limit of 92 days after the end of the year of assessment has been rewritten as "before 7th July" in line with the new practice in Chapters 2 to 5 of this Part. The particulars are now to be given to the Inland Revenue rather than to the inspector. See *Change 158* in Annex 1.

Section 487: Minor definitions

2001. This section brings together minor definitions from section 136(5) of ICTA and others from section 187A of ICTA in connection with the deductions for National Insurance contributions.

2002. The definition of shares in section 136(5)(d) 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.