

*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

PAYE implications

Chapter 9: Enterprise management incentives

Overview

- 2143. This Chapter contains the information that an employee needs in order to be able to establish the tax consequences of receiving or exercising a share option that is within the enterprise management incentives (“EMI”) rules.
- 2144. A code has been introduced for EMI options as for SAYE, CSOP and SIPs as explained in the notes on the introduction to this Part.
- 2145. Those parts of the EMI code that determine which options are within the scope of the scheme are separated out and appear in Schedule 5. Schedule 5 refers to “share options”, where appropriate, so as to align this phraseology with SAYE and CSOP. There is a definition of “share option” in section 527.
- 2146. The requirements for a qualifying option, deriving from Schedule 14 to FA 2000, are now contained in Schedule 5 to this Act. There are transitional provisions in Schedule 7 to ensure that where a share option was a qualifying option under Schedule 14 to FA 2000, it is treated as a qualifying option for the purposes of the EMI code.

Section 527: Enterprise management incentives: qualifying options

- 2147. This section sets out what is contained in this Chapter and in Schedule 5. As well as being a new scene-setting section, it includes material drawn from paragraph 1(1) of Schedule 14 to FA 2000 about what is a qualifying option.
- 2148. In *subsection (3)(c)* there is a cross-reference to Part 4 of Schedule 7D to TCGA 1992 which covers the capital gains tax angle, (see Schedule 7 to this Act).

Section 528: No charge on receipt of qualifying option

- 2149. This section prevents tax being chargeable on receipt of a qualifying option. It derives from paragraphs 42(1) and 43 of Schedule 14 to FA 2000.

Section 529: Scope of tax advantages: option must be exercised within 10 years

2150. This section explains that the tax advantages described in the following sections only apply if the option is exercised within ten years of it being granted. If the option being exercised is a replacement for a previous option, it must be exercised within ten years from when the original option was granted in order to qualify for the tax advantages. This derives from paragraph 42 of Schedule 14 to FA 2000.
2151. The words “the date of the” have been added before “grant” in subsection (2)(b) to clarify the effect of the rule in paragraph 42 which provides for a ten year period exclusive of the date of the grant.

Section 530: No charge on exercise of option to acquire shares at market value

2152. This section, which derives from paragraph 44 of Schedule 14 to FA 2000, deals with the situation where an employee is granted an option with an exercise price not less than the market value of the shares at the time the original option is granted. In this situation, there is no charge on the exercise of the option (or a replacement option) under section 476. This provision is subject to section 532 which outlines what happens if a disqualifying event takes place.

Section 531: Limitation of charge on exercise of option to acquire shares below market value

2153. This section sets out how to calculate the amount chargeable under section 476 when a qualifying option (or replacement option) is exercised to acquire shares for less than their market value when the option was originally granted. It derives from paragraph 45 of Schedule 14 to FA 2000.
2154. This provision is subject to section 532 which outlines what happens if a disqualifying event takes place.
2155. There are formulae to aid understanding of the text in this and in the succeeding section, which provide the basis for the calculation of the charges.
2156. There is no successor to paragraph 46 of Schedule 14 to FA 2000 (exercise of option to acquire shares at nil cost). This is redundant in that it is a variation of the situation in this section. Small changes have been made to sections 531 and 532 to ensure that the whole picture is preserved. In subsection (1) of section 531 there is a new “(or at nil cost)” and in both subsection (2) of this section and subsection (4) of section 532, a reference to “if any” in the definition of “ACS”.
2157. There is a further point affecting both this and the next section. The source legislation includes a provision that stating that if the section 476 gain was nil there is no liability to income tax. Sections 531 and 532 now use a formulaic approach and a more general solution has been found to deal with negative results. Section 420 provides for the position where a formula in Part 7 would produce a negative result. The result is to be taken to be nil.

Section 532: Modified tax consequences following disqualifying events

2158. This section sets out what happens where there has been a disqualifying event and the option had not been exercised within 40 days of that event. The 40-day period of grace is in recognition of the fact that the option-holder may have no control over a disqualifying event.
2159. This provision derives from paragraph 53 of Schedule 14 to FA 2000. The section now has a more comprehensive heading and is in a more prominent position before the sections describing the various types of disqualifying event. This draws out the impact of such an event on income tax relief.

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

2160. The broad effect of an amendment in paragraph 11 of Schedule 14 to FA 2001 was that this set of rules wholly replaces those included in paragraphs 44 and 45 of Schedule 14 to FA 2000 (rewritten in sections 530 and 531), if a disqualifying event occurs. There is a slight change in the wording to reflect this, referring to the option being “within”, for example, section 530, rather than section 530 applying.
2161. The effect of the provision is to separate out and relieve the gain in the value of the share option accruing over the period up to the disqualifying event, leaving any gain accruing between the disqualifying event and the date of exercise fully chargeable. There is of course the usual deduction for anything paid for the grant of the option.
2162. As noted in relation to the preceding section there is no successor to paragraph 46 of Schedule 14 to FA 2000. Another small change has been made to this section to ensure that the whole picture is preserved. In *subsection (4)* there is an added reference to “if any” in the definition of “ACS”.
2163. The provision in sub-paragraph (2D) of paragraph 53 of Schedule 14 to FA 2000, has not been reproduced. This was a provision that stated that if the section 476 gain was nil there is no liability to income tax. This and the preceding section now use a formulaic approach and a more general solution has been found to deal with negative results. Section 420 provides for the position where a formula in Part 7 would produce a negative result. The result is to be taken to be nil.
2164. *Subsection (6)* contains a clearer exposition of the rule in paragraph 53(3) of Schedule 14 to FA 2000 from which it derives. This ensures that the operation of this section does not result in a higher taxable amount than would be charged under section 476, if the EMI provisions did not apply. In this situation no part of either this section or of sections 530 and 531 apply (and so the amount is counted as income under section 476).

Section 533: Disqualifying events

2165. This is a new provision, which provides the reader with a list of the possible disqualifying events and notes where they are described in full.

Section 534: Disqualifying events relating to relevant company

2166. This section sets out those events that can happen to the company whose shares are the subject of a qualifying option that would lead to that share option ceasing to qualify under EMI. These are “disqualifying events”. It derives from paragraph 47(1) and (2) and paragraph 48 of Schedule 14 to FA 2000.
2167. The word “being” has been changed to “becoming” in *subsection (1)(b)* to better match the wording and meaning of *subsection (1)(a)*.
2168. The definition of “control” is covered by section 840 of ICTA, see *Note 51* in Annex 2.
2169. In *subsection (4)*, which derives from paragraph 47(2) of Schedule 14 to FA 2000, the reference to the “original” option has been dropped from the phrase “when the option was granted”. There is no scope in paragraph 47(2)(b)(ii) of Schedule 14 to FA 2000 to refer to any option other than the qualifying option, mentioned in paragraph 47(2) (a) (in subsections (3) and (4)(a) of this section). This could be either an original or a replacement option. Also the words “of a group” no longer follow “parent company” in *subsection (4)(b)*.
2170. To clarify the position if there has been a replacement option, there is a cross-reference to paragraph 41(5) (b) of Schedule 5.
2171. The words “from the grant” in the source legislation have been changed to “the period of two years after the date” of the grant in *subsection (5)* to clarify the rule. This new wording provides for a period exclusive of the date of the grant.

Section 535: Disqualifying events relating to employee

2172. This section sets out the disqualifying events that can occur in relation to an employee. These result in the share option held by that employee ceasing to qualify under EMI. It derives from paragraphs 47(1) (part), (3), and 52(1), (2) and (6) of Schedule 14 to FA 2000 and relates to provisions in Schedule 5 to this Act. It picks up on some new expressions introduced in paragraph 26 of that Schedule to set out more clearly the requirement on working time.
2173. First there is the employment requirement in *subsection (1)(a)*. Next, under *subsection (1)(b)*, there is a disqualifying event if, on the facts of the arrangement between employer and employee (usually the contract), the employee ceases to meet the requirement as to commitment of working time, contained in paragraph 26 of Schedule 5 to this Act.
2174. Finally, and the different nature of this test is emphasised by the words “in addition” in *subsections (2) to (5)*, there is what is known as the “working time rule”. This takes into account the time actually spent by the employee on work in the relevant employment.
2175. The provisions in paragraphs 47 and 52 of Schedule 14 to FA 2000 are cumbersome to operate, do not work satisfactorily in all circumstances and could impact harshly on employees working flexi-time. Under *subsections (2) to (5)* there is a much simpler “working time rule”. See *Change 130(A)* in Annex 1.
2176. There is another minor change to the law in *subsection (3)*. This corrects an omission in the source legislation, by providing a cross-reference to paragraph 26(3) of Schedule 5 to this Act. See *Change 130(B)* in Annex 1.

Section 536: Other disqualifying events

2177. This section lists the other events that can result in a share option ceasing to qualify under EMI. It derives from paragraphs 47(1) and 51 of Schedule 14 to FA 2000.

Section 537: Alterations of share capital for purposes of section 536

2178. Among the disqualifying events in section 536 are certain kinds of alteration of the company’s share capital. Section 537 sets out what kind of alteration comes into play for the purposes of section 536(1)(b) and (c). It derives from paragraphs 47(1) and 49 of Schedule 14 to FA 2000.
2179. There is a change in the wording in *subsection (4)* compared to the final paragraph of paragraph 49(1). “References to restrictions ... or to rights ... *include*”, followed by an interpretation, is replaced by “any reference to a restriction ... or a right ... *is a reference to such a restriction ... or right*”, followed by the same interpretation. This rephrasing makes better sense of the final words in the sentence, “or in any other way”.

Section 538: Share conversions excluded for purposes of section 536

2180. Among the disqualifying events in section 536 is a conversion of the shares, to which the option relates, into a different class. Section 538 prevents a share conversion being a disqualifying event if it meets certain conditions as set out in subsections (2) and (3). This section derives from paragraph 50 of Schedule 14 to FA 2000.

Section 539: CSOP and other options relevant for purposes of section 536

2181. Among the disqualifying events in section 536 is the grant of a CSOP option if, after this grant, the total value of the shares for which the employee holds unexercised employee options under EMI or CSOP exceeds £100,000. This section explains the meaning of CSOP options and employee options for those purposes. It derives from paragraph 51(1) to (4) of Schedule 14 to FA 2000.

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

2182. There is a new definition of a group of companies, in contexts where there is no reference to the parent company, in paragraph 58 of Schedule 5 to this Act.

Section 540: No charge on acquisition of shares as taxable benefit

2183. This section prevents there being a charge to tax under Chapter 8 of Part 3 in respect of shares acquired by the exercise of a qualifying option, if the employee is resident and ordinarily resident in the United Kingdom. This derives from paragraph 54 (1) of Schedule 14 to FA 2000.
2184. The wording of the source legislation suggests that the residence tests apply at the time the option is exercised. In practice the Inland Revenue applies the test at the time of the grant of the option. In this section it has been made clear that the tests can be applied at the time of the grant or at the time of the exercise of a qualifying option. See *Change 131* in Annex 1.
2185. The content of paragraph 54(2) of Schedule 14 to FA 2000 is in section 541, rather than in this section, since it relates to a charge under Chapter 9 of Part 3 which is not affected by the EMI provisions.

Section 541: Effects on other income tax charges

2186. The fact that a share option may be a qualifying share option under EMI does not prevent the ordinary operation of certain other income tax provisions. This section sets out what those provisions are. This includes a reference to the possibility of a charge under section 453 in *subsection (1)(c)*. This last subsection derives from section 79 of FA 1988 and, though not immediately relevant since an EMI option cannot be granted over shares in a subsidiary, can apply to shares acquired on exercise of the option if there is a subsequent take-over.
2187. The section also describes what relief may be available as a deductible amount from a charge to tax under sections 427 or 438 in respect of shares acquired under the option.
2188. This section derives from paragraphs 54 (2) and 55 of Schedule 14 to FA 2000.