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

Overview

1798. This Part contains the provisions concerning the income tax treatment of share-related remuneration. The chapters in this Part reflect the major divisions in the legislation relating to shares acquired by employees:

- Chapter 1 is introductory;
- Chapters 2 to 5 deal with topics whose principal purpose is to impose charges to tax by providing that certain share-related benefits count as employment income (see background in paragraphs 1802 to 1812); and
- Chapters 6 to 9 deal with income tax aspects of the various schemes and plans that confer tax advantages (see background in paragraphs 1813 and 1814). The sections in these Chapters are supplemented in each case by a Schedule (see background in paragraph 1815) containing the administrative provisions for the scheme or plan in question.

  Chapters 6 to 9 deal with income tax aspects of the various schemes and plans that confer tax advantages (see background in paragraphs 1813 and 1814). The sections in these Chapters are supplemented in each case by a Schedule (see background in paragraph 1815) containing the administrative provisions for the scheme or plan in question.

1799. Chapter 10 deals with a different topic: the exemption given to employees in connection with priority share allocations for employees when an offer of shares to the public is made. The material in Chapter 10 derives from section 68 of FA 1988.

1800. This Part also contains a final chapter (Chapter 11) which contains supplementary provisions relating to employee benefit trusts.

1801. This Part does not include any provisions dealing with the tax consequences of an employee acquiring employment related shares at less than market value. This topic is dealt with in section 162 of ICTA, which treats the acquisition of shares at less than market value as a notional loan to the employee, and uses the rules for beneficial loans to give a cash equivalent of the benefit. Section 162 also sets out the tax charge that arises when employment-related shares are disposed of for more than market value, treating the excess over market value as emoluments. Because of the relationship between

section 162 and the rules on beneficial loans, those provisions appear, in this Act, as part of the benefits code, in Chapters 8 and 9 of Part 3, following on from the chapter concerning the treatment of employment-related loans. There are cross-references to Chapters 8 and 9 of Part 3 in section 418(1) of this Act.

Background

1802. Companies have often wished to reward employees by allowing them to acquire shares in the company on advantageous terms. As a matter of legal form, the company may achieve this objective in any one of three ways, for the employee may be given:

- shares (if the company issues its own shares direct to the employee);
- a purely monetary benefit (if the company allows the employee to acquire shares on advantageous terms); or
- an option (if the company grants the employee an option to buy shares in the company at some future date).

1803. It is well established that if an employee is given shares, or is allowed to acquire shares on advantageous terms, the amount of the advantage is chargeable to income tax as an earning from the employment. The leading case is Weight (HM Inspector of Taxes) - v - Salmon (1935) 19 TC 174 (HL), where the taxpayer took up opportunities given to him to apply for unissued shares in the company at their par value, which was always less than their market value. The House of Lords held that the difference was an emolument of the taxpayer's employment. In the words of the basic charge to income tax under Schedule E, as it stood at that time, the taxpayer, who was a person "having or exercising an office or employment of profit" had received a "profit" from that office.

1804. As a means of avoiding the charge to tax on such arrangements, established by the decision in Weight - v - Salmon, share option schemes became increasingly popular. These schemes differed: but, typically, a company granted to employees, for a nominal sum, an option to buy a stated number of shares at a stated price, which was normally their market value at the date of the grant. If the price of the company's shares rose, an employee could exercise the option and acquire shares at less than the market value then current.

1805. The efficacy of share option schemes was tested in the case of Abbott - v - Philbin (HM Inspector of Taxes) (1960) 39 TC 82 (HL), [1961] AC 352, where the House of Lords had to consider two assessments to income tax for different years of assessment. The first assessment was for the year in which the taxpayer received the option. The decision regarding that assessment was that the taxpayer did receive an emolument during that year of assessment, but that the taxpayer obtained no benefit from it at that time, because the option was to buy at what was then the market value. The second assessment was for the year in which the taxpayer exercised the option. The House of Lords held, for that later year of assessment, that the advantage that arose was not a perquisite or profit from the office or employment during the year of assessment. Instead it was an advantage which accrued to the taxpayer as the holder of a legal right that he had acquired in an earlier year. (It might well have been possible to say that the taxpayer had made a gain from the disposal of an asset - the option - but capital gains tax was only introduced by FA 1965.)

1806. Legislation to counteract the effect of the decision in Abbott - v - Philbin was enacted as section 25 of FA 1966, which imposed a charge to income tax when the option was exercised. This legislation was later re-enacted, and eventually became sections 135 to 140 of ICTA 1988. It now constitutes Chapter 5 of this Part of this Act.

1807. As a means of avoiding a charge under section 25 of FA 1966, share incentive schemes became increasingly popular. These schemes differed: but, typically, a company awarded shares subject to restrictions to employees. The restrictions might (for example) have the result that the shares carried no rights to receive dividends or to

vote. The shares, consequently, might be expected to have only a low value. At a later date (or dates) the restrictions would be removed. The consequent increase in value, however, was not subject to the share option rules in section 25 of FA 1966: for the employee did not realise a gain by exercising an option to acquire shares. The shares were already owned.

1808. Legislation to counteract share incentive schemes by charging the employee to income tax on the increase in the value of the shares was introduced in FA 1972. That legislation was considerably amended over the years; and successor legislation was introduced by sections 77 to 89 of FA 1988. That legislation is rewritten in Chapter 4 of this Part of this Act.

1809. At a later stage, long-term incentive plans came increasingly to be used. These schemes also differed; but, typically, a company awarded shares to employees, at no cost or at nominal cost, in circumstances where the employee was only able to enjoy the benefit of those shares if performance conditions specified at the time of the award were met. Some time later, after the performance conditions had been met, the employee would become fully entitled to enjoy the benefit of the shares.

1810. It was initially assumed that there was no charge on the initial award of the shares, but that a charge arose when the employee became entitled to enjoy the full benefit of the shares. Prevailing practice reflected this assumption. However, the view was taken later that a charge arose on the initial award of the shares but not at the later time when the employee became fully entitled to enjoy the benefit of the shares.

1811. Legislation was accordingly introduced in section 50 of FA 1998, which provided for sections 140A to 140C to be inserted into ICTA. The new legislation broadly restored the position to the previous practice - this time on a statutory basis. This legislation now constitutes Chapter 2 of this Part of this Act.

1812. Further legislation was introduced in section 51 of FA 1998, which provided for sections 140D to 140F to be inserted into ICTA. This legislation was aimed at counteracting possible tax avoidance where there was a conversion of one class of shares into another. As a result of such a conversion it was possible to devise structures under which employees could be provided with valuable shares as a form of remuneration without the full value of the shares being brought into charge to income tax. This legislation imposed a charge to income tax at the time of conversion. This legislation now constitutes Chapter 3 of this Part of this Act.

1813. But not all of the legislation relating to employees who acquire shares or options in the companies for which they work is of the type so far described. Various Governments have decided that they wish to confer various advantages on a range of schemes and plans. This has meant additional legislation to set out:

- the characteristics to be possessed by the scheme or plan before it may be approved;
- the tax advantages that an approved scheme or plan possesses;
- any procedure to be undertaken before the scheme or plan may be approved;
- any tax charges that will apply if the shares or options are removed from the scheme or plan (or other "inappropriate" actions are undertaken); and
- any supplementary provisions.

1814. There are currently five different schemes or plans in existence:

- Approved profit sharing ("APS") schemes. The legislation relating to these schemes was originally contained in FA 1978; and that legislation was consolidated in sections 186 and 187 of, and Schedules 9 and 10 to, ICTA. These schemes are being phased out and they are not included in this Act. There is a cross-reference to these schemes in section 418(3).

- Approved save as you earn ("SAYE") option schemes. The legislation relating to these schemes was originally contained in FA 1980; and that legislation was consolidated in sections 185 and 187 of, and Schedule 9 to, ICTA. The legislation relating to these schemes now constitutes Chapter 7 of this Part and Schedule 3.
- Approved company share option plans ("CSOPs"). The legislation relating to these schemes was originally contained in FA 1984; and that legislation was consolidated in sections 185 and 187 of, and Schedule 9 to, ICTA. These schemes were then much affected by section 114 of FA 1996. The legislation relating to these schemes now constitutes Chapter 8 of this Part and Schedule 4.
- Share incentive plans ("SIPs"). The legislation relating to these schemes is principally contained in Schedule 8 to FA 2000, under the name "Employee share ownership plans". The legislation relating to these schemes now constitutes Chapter 6 of this Part and Schedule 2.
- Enterprise management incentives ("EMI"). The legislation relating to the options that qualify as EMI is principally contained in Schedule 14 to FA 2000. That legislation now constitutes Chapter 9 of this Part and Schedule 5 to this Act.

Arrangement of material for share schemes

1815. This Act provides for a "code" for each of SIPs, SAYE schemes, CSOPs and EMIs. That "code" includes all the legislation relating to the particular scheme or plan, covering the tax advantages and any consequential tax charges together with all the rules relating to the qualification criteria and administration of the scheme or plan in question. The material in each "code" has been divided into two principal categories. The material dealing with the tax advantages and consequential tax charges has been placed in the main run of sections in this Part of this Act; but the administrative provisions have been placed in the supporting Schedules 2 to 5 to this Act.

1816. This approach is intended to highlight the legislation relating to the actual tax advantages offered, and any consequential tax charges, so that all the information with a direct impact on an employee's tax liability appears in one place in the body of this Act.

1817. The provisions relating to the qualification criteria for each code are likely to be relevant to different sets of people (e.g. the company setting up the scheme and its advisers). It therefore seems logical to separate these out and to place them in a Schedule separate from the main run of sections concerning the taxation of employment income.

Chapter 1: Introduction

Overview

1818. This short introductory Chapter consists of five sections:

- Section 417 is concerned with the scope of this Part of the Act;
- Section 418 is concerned with other provisions relating to share related income;
- Section 419 introduces the provisions that impose duties to provide information to the Inland Revenue;
- Section 420 deals with a computational matter of general application;
- Section 421 deals with the application of this Part to office-holders.

Section 417: Scope of Part 7

1819. This section, which is a drafting addition, introduces the provisions of this Part of this Act. Those provisions contain special rules relating to employees or directors who

acquire shares in companies, or options relating to such shares, in connection with their office or employment (see *subsection (1)*).

1820. *Subsection (2)* then lists nearly all the chapters in this Part that follow this introductory Chapter. Of these, it may be said that Chapters 2 to 5 are primarily concerned with charges to income tax that may arise in certain circumstances. Chapters 6 to 9 then deal with the plans and schemes under which employees and directors may be offered shares or options on advantageous terms. And, finally, Chapter 10 deals with a particular income tax exemption that arises when employees or directors benefit from a priority allocation of shares.

1821. *Subsection (3)* lists the chapters in this Part that provide for amounts to count as employment income; and *subsection (4)* lists the chapters in this Part that provide for exemptions and reliefs from income tax. *Subsection (5)* records that there is also a supplementary chapter (Chapter 11) which contains provisions about employee benefit trusts.

Section 418: Other provisions about share-related income and exemptions

1822. This section, which is another drafting addition, sets out where other provisions dealing with share related income and exemptions may be found.

1823. *Subsections (1) and (2)* list other provisions of this Act that deal with share-related income and exemptions.

1824. *Subsection (3)* deals with approved profit sharing schemes ("APS schemes"). This subsection explains that, in view of the phasing out of these schemes, the legislation relating to APS schemes has not been rewritten in this Act. That legislation will accordingly continue to apply while APS schemes continue.

1825. *Subsection (4)* preserves the effect of sections 138 to 140 of ICTA where shares or interests in shares were acquired before 26 October 1987.

Section 419: Duties to provide information

1826. This section lists the provisions in this Part that impose duties to provide information to the Inland Revenue.

1827. This section is also a drafting addition, as, once again, it provides signposts to the various sections that are relevant in this context. As these sections are all placed near the end of the chapters in which they appear, they might otherwise be given insufficient attention.

Section 420: Negative amounts treated as nil

1828. The charges to income tax for which this Part of this Act provides constitute "specific employment income" (see sections 6(1) and 7(4) of this Act). Under ICTA this income is charged to income tax under paragraph 5 of section 19(1) of that Act.

1829. In this Part of this Act, where deductions from a chargeable amount are permitted, the relevant provision signals this fact by using a formula.

1830. This section, which is new, gives effect to the general proposition that it is not possible for an allowable loss to arise under paragraph 5 of section 19(1) of ICTA. Deductions might reduce a chargeable amount to nil; but, beyond this point, they could not be used to create a negative amount and (accordingly) an allowable loss. See *Note 43* in Annex 2.

Section 421: Application of Part 7 to office-holders

1831. The general rule is that the provisions of the employment income Parts apply equally to offices, unless the contrary is stated (see section 5(1)). But, with one exception, the

legislation rewritten in this Part does not apply to office-holders. This section deals with these propositions for the whole of this Part of this Act.

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.

Chapter 3: Convertible shares

Overview

1866. Sections 140D to 140F of ICTA (together with supplementary provisions in sections 140G and 140H) were introduced by FA 1998 and apply to shares acquired on or after 17 March 1998. The provisions are concerned with countering possible avoidance in the award of convertible shares by reason of employment. Such shares could be issued having a low value but be later converted to shares of a different class with a higher value. The emoluments charge on award of the shares would be measured by reference to the initial low value and without these provisions the uplift in value on conversion would escape taxation.

1867. The legislation imposes a charge to tax on the market value of the shares immediately after conversion as reduced by sums paid on acquisition or conversion and by any amounts already charged to tax in respect of those shares. No charge arises if all the shares of one class are converted to shares of a new single class and immediately before conversion the company was either controlled by outside shareholders or was employee-controlled.

1868. Sections 140G and 140H of ICTA contain supplementary provisions some of which apply solely to the provisions concerning convertible shares (sections 140D to 140F of ICTA), some of which apply solely to the provisions concerning conditional shares (sections 140A to 140C of ICTA) which were introduced at the same time and some which apply to both. In this Act the provisions on conditional shares appear in Chapter 2. This does mean that those supplementary provisions which apply to both types of share have been duplicated, but the overall result should be much easier to follow.

Section 435: Application of this Chapter

1869. *Subsection (1)* derives from section 140D(1) of ICTA and gives the basic condition that the shares must be acquired "as a director or employee" and that term is defined in section 436. The reference to interests in shares as well as shares themselves throughout the Chapter derives from section 140F(6) of ICTA. 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 which there is also a signpost in section 418(1).

1870. *Subsection (2)* is mainly derived from section 140D(2) of ICTA (but also parts of section 140G(6) and section 140H(5) of ICTA) and defines the meaning of "convertible".

1871. *Subsection (3)* derives from section 140F(2) of ICTA.

1872. *Subsection (4)* 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 446(1).

Section 436: Shares acquired "as a director or employee"

1873. This section derives from subsections (1), (2), (4) and (7) of section 140H of ICTA. It expands on what is meant by shares (or an interest in shares) acquired by a person "as a director or employee".

Section 437: Cases where this Chapter does not apply

1874. This derives from section 140H(3) of ICTA. It limits the application of this Chapter to cases where the earnings from the employment are within section 15 or 21 and reproduces the restriction in the source legislation to Case I employments.

Section 438: Charge on conversion of shares

1875. This is the charging provision for this Chapter. It derives from section 140D(3) and (4) of ICTA and imposes a charge when the shares are converted to shares of a different class.

Section 439: Amount of charge

1876. This section concerns the calculation of the taxable charge under section 438. It derives from section 140D(5) and (6) of ICTA. A formula has been introduced to make the provisions more user-friendly. As with section 428 the approach now adopted is to specify precisely what deductions are allowable in respect of amounts chargeable in respect of the acquisition of the interest. The three charges that are relevant are detailed in paragraphs (c), (d) and (e) of *subsection (2)*. See *Note 45* in Annex 2.

1877. *Subsection (3)* provides that charges under the provisions derived from sections 78 and 79 of FA 1988 are deductible. It derives from section 140D(6)(d) of ICTA. In contrast to section 428, there is no need to refer to "a different event" here since the conversion itself does not give rise to a charge under the FA 1988 provisions.

1878. *Subsection (5)* gives the meaning of "market value", the definition of which is not found in ICTA until section 140F(3).

1879. *Subsection (6)* derives from the definition of "taxable conversion" in section 140D(7) of ICTA.

1880. *Subsection (7)* is new. It meets the point that there should be no reason why a charge arising at the end of the seven-year period in section 79 of FA 1988 should not be a deductible amount. This is a minor change to the law. See *Change 112* in Annex 1.

Section 440: Case outside charge under section 438: conversion of entire class

1881. In ICTA the main exemption from the charge on conversion is tucked away in subsections (8) and (9) of section 140D with related definitions in section 140F. The exemption is now in a separate section and the definitions are in *subsections (4)* and *(5)*.

Section 441: Case outside charge under section 438: acquisition of conditional interest

1882. This section provides that no charge arises under this Chapter if the new shares are within the scope of Chapter 2. This ensures that where a conditional interest in shares is acquired on the conversion of other shares and under section 426 of the Act there is no charge in respect of the acquisition of the interest, there will not be a charge under this Chapter in respect of the conversion of the other shares. The section derives from section 140D(10) of ICTA.

Section 442: Amount or value of consideration given for shares or conversion

1883. This section derives from section 140E(1) to (6) of ICTA. Section 140E(7) has been taken to a separate section. It determines, for the purposes of section 439, the amount allowable as the cost of the shares or the cost of conversion.

Section 443: Amount or value of consideration given for right to acquire shares

1884. This section derives from section 140E(7) of ICTA which is concerned with calculating the allowable cost where an original option has been exchanged for a replacement option. That section simply refers to the workings of section 136 of ICTA which are not easy to follow. In order to assist readers, this section sets out what the allowable cost is and the wording follows section 485 which derives from section 136 of ICTA. See *Change 125* in Annex 1.

Section 444: Conversion in consequence of employee's death

1885. This section derives from section 140F(1) of ICTA which deems certain conversions within 12 months of death to have occurred immediately before death.

Section 445: Duty to notify conversions of shares

1886. This section derives from those parts of section 140G of ICTA concerning the information requirements when shares are converted and may result in a charge under this Chapter. The time limit for providing information has been extended from 30 to 92 days after the tax year in which the conversion takes place and expressed differently. See *Change 111* in Annex 1.

Section 446: Minor definitions

1887. This section brings together the definitions in section 140H of ICTA and elsewhere in the source legislation and adds some new labels for expressions used in section 435. 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".

1888. 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.

Chapter 4 – Post-acquisition benefits from shares

Overview

1889. This Chapter is concerned with the income tax charges which may arise in respect of shares (or an interest in shares) which have been awarded by reason of an individual's office or employment.

1890. The initial award of the shares may have given rise to a Schedule E charge as an emolument or benefit or taxed as general earnings under this Act. This Chapter is not concerned with that initial charge. Instead it provides for a charge to tax in certain

circumstances on the increase in value of those shares and in respect of any special benefits which are received by virtue of ownership of those shares. The increase in value charges do not apply where the shares have been issued under one of the share schemes approved by the Inland Revenue, but the special benefits charge may still apply.

1891. The provisions in this Chapter derive from sections 77 to 88 of FA 1988. They apply to shares acquired on or after 26 October 1987 and replace legislation in sections 138 and 139 of ICTA which had a similar, though rather more wide-ranging, effect. Sections 138 and 139 of ICTA, together with the interpretation provisions in section 140 of ICTA still apply to shares acquired before 26 October 1987 and that legislation remains on the statute book although it has not been rewritten. Paragraphs 55 to 57 in Part 7 of Schedule 7 to this Act contain the appropriate savings and also rewrite the transitional provisions in section 88 of FA 1988 that are still relevant.

1892. Section 84 of FA 1988 is a capital gains tax provision and is duplicated in section 120(1) of TCGA 1992. As it is not intended to include the provision in this Act, the section has not been rewritten. Amendments to section 120 of TCGA 1992 are made by paragraph 210 of Schedule 6 to this Act.

1893. The 1988 anti-avoidance legislation contains three distinct charges in sections 78, 79 and 80 of FA 1988. That ordering of the charges has been followed in this Act with the corresponding charges now in sections 449, 453 and 457. Other than that, however, much of the material has been moved to present it in a logical and more helpful order. One broad intention is that in respect of each charge the legislation sets out in the following order

- The scope of the charge
- The calculation of the charge
- The exceptions from the charge

Section 447: Application of this Chapter

1894. This section sets out the scope of the Chapter. *Subsection (1)* derives from the rule at the end of section 77 of FA 1988 that the provisions are concerned with acquisitions of shares in a company by a director or employee of that or any other company. The fact that these provisions only apply to shares issued on or after 26 October 1987 is made clear in Part 7 of Schedule 7 to which there is also a signpost in section 418(1).

1895. *Subsections (2)* and *(3)* are new. They spell out what subsequent references to "the acquisition" and "the shares" are references to. The fact that this Chapter applies to prospective and former employees is made clear by the reference to the extended definition in section 470. The definition of "the employer company" is designed to avoid some rather tortuous references to it elsewhere in this Chapter.

1896. *Subsection (4)* derives from the rules in section 77(1) and in section 87(4) of FA 1988 which explain that the Chapter is concerned both with shares acquired by the employee directly and with shares first issued to another person and then assigned to the employee.

1897. *Subsection (5)* derives from section 83(1) of FA 1988. That provision ensures that where the shares are issued to a connected person because the opportunity was offered to that person rather than the employee himself, the acquisition is treated as having been made by the employee. The charges in the Chapter generally operate by reference to beneficial interests and it is not expressly provided in section 83(1) of FA 1988 that the deeming provision applies to beneficial ownership although that is the way the subsection has always been interpreted. This section clarifies the general understanding that the opening words "For the purposes of this Chapter" imply that the shares are deemed to have been acquired by the employee as a director or employee. This clarification is explained in detail in *Note 46* in Annex 2.

Section 448: Cases where this Chapter does not apply

1898. *Subsection (1)* derives from section 77(2) of FA 1988. It limits the scope of the Chapter to cases where the earnings from the employment are within section 15 or 21 reproducing the restriction in the source legislation to Case I employments. See *Note 47* in Annex 2.

1899. *Subsection (2)* derives from section 77(3) of FA 1988 and is an exemption for public offers.

1900. *Subsections (3) and (4)* derive from section 77(4) of FA 1988 and extend the public offer exemption to certain other offers which are made to employees separate from a public offer.

Section 449: Charge on occurrence of chargeable event

1901. This is the first of the charging provisions and derives from parts of section 78(1) and (3) of FA 1988. The meaning of chargeable event, the calculation of the charge and the exceptions appear in separate sections. *Subsection (5)* acts as a signpost to the provisions which remove the charge under various approved schemes.

Section 450: Chargeable events

1902. This section defines what is and is not a chargeable event and derives from section 78(2), (5), (6) and (7) of FA 1988. It will be noted that a new label "outside shareholders" is used as shorthand for the persons within section 78(6)(a) of FA 1988 and the term is defined in section 469.

1903. The words in section 78(6)(c) of FA 1988 "which is not a dependent subsidiary" have been omitted in new subsection (4)(c) on the grounds that they are unnecessary. It is already clear from section 78(1)(b) of FA 1988 that no charge arises if the company is a dependent subsidiary.

1904. *Subsection (6)* derives from section 78(7) of FA 1988. The term "are references to such" has been used instead of "include" to make better sense of the additional words "or in any other way".

Section 451: Amount of charge

1905. This section, which derives from section 78(3) of FA 1988, specifies the amount of the charge under section 449. The FA 1988 subsection is rather complex and so this section separates out the various ideas to make the provision easier to grasp.

Section 452: Cases outside charge under section 449

1906. This section brings together the various exceptions in sections 77 and 78 of FA 1988.

1907. *Subsection (2)* ensures that if a charge is taken under section 427 in respect of an event then no charge is taken under this section. It derives from the opening words of section 77(1) of FA 1988 which give priority to the charge on conditional shares in section 140A of ICTA (rewritten in Chapter 2 of this Part).

1908. *Subsection (3)* derives from section 78(4) of FA 1988 which contains the let-out if the employee has not been a director or employee of the company or an associated company within the seven years ending with the chargeable event. The source legislation uses the term "the person who acquired the shares" rather than the "employee". However, since shares acquired by connected persons are treated as acquired by the employee, the effect is the same.

1909. *Subsection (4)* derives from section 78(1)(b) of FA 1988. Shares in dependent subsidiaries are excluded from the charge under section 449 because they are instead subject to a charge under section 453. For the sake of clarity this section replaces the

word "at" in the phrase "at the time of the chargeable event" with "immediately before". See *Note 48* in Annex 2.

Section 453: Charge on increase in value of shares of dependent subsidiary

1910. This is the second of the charging provisions and derives from section 79(1) and (4) of FA 1988. Again, matters concerning what is chargeable, the calculation of the amount and the exceptions have been taken to separate sections.

1911. Subsection (3) derives from section 79(4) of FA 1988 and specifies the year of charge.

1912. *Subsections (4)* and *(5)* are new. Subsection (5) acts as a signpost to the provisions which remove the charge under various approved schemes.

Section 454: Chargeable increases

1913. This section derives from section 79(2) and (3) of FA 1988 and determines the period over which any rise in the value of the shares is measured in order to be an increase subject to charge.

Section 455: Amount of charge

1914. This section brings together all those parts of section 79 of FA 1988 which concern the calculation of the charge and in particular it makes clear what deductions should be made from the rise in value of the shareholding.

1915. *Subsection (1)* introduces a formula and *subsection (2)* specifies the items that are allowable deductions. *Subsection (3)* derives from section 79(6) of FA 1988 and is concerned with certain cases where the employee receives less than market value for the shares. The aim is to ensure that the employee is only charged on the difference between base value and the actual proceeds. That provision produces the right result where the chargeable increase is calculated by reference to the value of the shares at acquisition, but not where it is calculated by reference to the value of the shares at the later time that the company becomes a dependent subsidiary. The section produces the right result in both situations. It is a minor change to the law. See *Change 113* in Annex 1.

1916. *Subsection (4)* derives from the final two lines in section 79(4) of FA 1988.

Section 456: Cases outside charge under section 453

1917. *Subsection (2)* reflects the opening words of section 77(1) of FA 1988 "subject to section 140A of the Taxes Act 1988". It ensures that if a charge is taken under section 427 (conditional interests in shares) then no charge is taken under section 453. This is because if a disposal potentially gives rise to a charge under section 453 (which is more general in its application) and under section 427 then the latter charge has priority.

1918. *Subsection (3)* derives from section 79(7) of FA 1988 and provides a let-out if the employee has not been a director or employee of the company or an associated company in the seven years before the time that the company becomes a dependent subsidiary. As with section 452, the phrasing has been changed to produce a true exception and the reference is to "the employee" rather than "the person who acquired the shares".

Section 457: Charge on other chargeable benefits from shares

1919. This is the third of the charging provisions and derives from section 80 of FA 1988. The term "chargeable benefit" in *subsection (1)* has replaced "special benefit" in order to be consistent with "chargeable event" and "chargeable increase" in the other charging provisions in this Chapter.

1920. An amount in respect of benefits attaching to shares may be charged on the employee, not only when the shares are owned by the employee (section 80(1) of FA 1988), but

also when owned by other persons (section 83(1) and (4) of FA 1988). *Subsection (2)* brings together and clarifies how these rules are considered to operate and remedies the deficiencies in the wording of the source legislation. See *Change 114* in Annex 1.

Section 458: Chargeable benefits

1921. This section derives from the rather complex rules in section 80 of FA 1988 giving further conditions as to when a benefit is a chargeable benefit.

1922. *Subsection (2)* introduces the following three subsections. The approach adopted is to define what are chargeable benefits, replacing the approach in FA 1988 of saying that all benefits are chargeable benefits unless paragraphs (a) and (b) of section 80 apply. This makes the rules easier to understand.

1923. *Subsection (3)* derives from section 80(2)(a) of FA 1988.

1924. *Subsection (4)* derives from section 80(1A) of FA 1988.

1925. *Subsection (5)* introduces the conditions in *subsection (6)* which derive from section 80(3) of FA 1988. Subsection (6)(a) uses the new term "outside shareholders" which was first introduced in section 450.

1926. *Subsection (7)* contains two definitions which apply solely for the purposes of this section. The definition of "the company" is new and clarifies which company is being referred to in subsections (4) and (6). The other definition derives from section 87(1) of FA 1988.

Section 459: Amount of charge

1927. This section specifies the amount of the chargeable benefit. It derives from section 80(4) of FA 1988 and the definition of "value" in section 87(1) of FA 1988.

Section 460: Cases outside charge under section 457

1928. This section derives from section 80(5) of FA 1988 which contains the let-out where the employee has not been a director or employee of the company or an associated company in the seven years before the benefit is received. There are two points to note. Section 80(5)(a) of FA 1988 refers to the company in subsection (1) when that subsection contains no reference to a company. It clearly means the company whose shares are mentioned in subsection (1). See *Change 115* in Annex 1. Also, in section 80(5) of FA 1988 the test is expressed to apply to the person receiving the benefit. But by virtue of the connected persons rules in section 83(4) of FA 1988 the test effectively applies to the employee himself. Accordingly, the test is applied directly to the employee in this section.

Section 461: Related acquisitions of additional shares

1929. This section derives from section 82 (1) and (2) of FA 1988 and concerns the treatment of additional shares received by the employee in respect of an original holding which had been acquired by virtue of the employment. The effect is to treat the new shares as within the Chapter and as having been acquired at the same time as the original shares.

1930. An award of additional shares may give rise to a chargeable benefit within section 457. This section makes it clear that the timing rule in section 82(2)(b) of FA 1988 does not affect the date on which the charge under section 457 is taken. See *Change 116* in Annex 1.

Section 462: Company reorganisations etc.

1931. This section derives from section 82(3) of FA 1988 and concerns exchanges of shares under company reorganisations. The main effect is to adopt the capital gains tax rule under which new holdings are treated as acquired as the original shares were.

1932. *Subsections (3) and (4)* derive from section 82(3)(b) and (c) of FA 1988. Subsection (3)(b) reflects what is meant by the rather obscure phrase "as is mentioned in section 128(1) and (2)" in section 82(3)(b).

Section 463: Disposals of shares to connected persons etc. ignored

1933. This section derives from section 83(2) and (3) of FA 1988. It is reasonably plain what section 83(2) of FA 1988 is trying to do, namely to ignore disposals which are not at arm's length or are to a connected party so that the employee is deemed to retain the beneficial interest. However it is not clear whether the wording of that subsection achieves that result where the shares were originally issued to a connected party and so have already been subject to the deeming provision in section 83(1) of FA 1988. This has been made clear in this section by specifying that the employee retains the interest. It is a minor change to the law. See *Change 114* in Annex 1.

Section 464: Application to interests in shares

1934. This section derives from section 81 of FA 1988 (which applies for the purposes of charges under sections 79 and 80 of FA 1988). It sets out the supplementary rule that where a person's interest in shares is increased or reduced it is treated as the acquisition or disposal of a separate interest proportionate to the increase or reduction.

Section 465: Duty to notify acquisitions of shares or interests in shares

1935. This section derives from section 85 of FA 1988 which is the information requirements provision.

1936. The section makes explicit what is implicit in section 85 that the time limit runs by reference to the year in which the additional shares are acquired. This is a minor change to the law. See *Change 116* in Annex 1.

1937. *Subsection (3)* provides that the particulars must be given to the Inland Revenue instead of to the inspector. See *Change 158* in Annex 1.

1938. *Subsection (4)* rewrites the 92-day time limit by requiring the information to be provided before 7 July. This is in line with the new practice in Chapters 2 to 5 of this Part.

1939. *Subsection (5)* is new and ensures that notification of an acquisition need be made only once. This is a minor change to the law. See *Change 116* in Annex 1.

Section 466: Duty to notify chargeable events and chargeable benefits

1940. This section also derives from section 85 of FA 1988 and contains the information requirements where certain charges arise.

1941. *Subsection (2)* provides that the particulars must be given to the Inland Revenue instead of to the inspector. See *Change 158* in Annex 1.

1942. The time limit of 60 days has been extended to 92 days. See *Change 111* in Annex 1.

Section 467: Meaning of "dependent subsidiary"

1943. This section derives mainly from section 86 of FA 1988. For ease of use *subsection (1)* is now introductory and the various conditions have been placed into four separate subsections. In *subsection (4)* the directors' certificate is now to be given to the Inland Revenue rather than the inspector. See *Change 158* in Annex 1.

1944. The definition of "period of account" in *subsection (8)* derives from section 86(3) of FA 1988. That definition was repealed by FA 2002 and a new definition was inserted into section 832(1) of ICTA. In relation to a company the definitions are effectively the same.

Section 468: Meaning of "employee-controlled"

1945. This section derives from section 87(2) of FA 1988. The definitions of "connected persons" and "control" in ICTA are applied by sections 718 and 719 respectively.

Section 469: Shares "held by outside shareholders"

1946. This section explains the new shorthand term which is used in sections 450 and 458. The definition derives from sections 78(6)(a) and 80(3)(a) of FA 1988.

Section 470: Minor definitions

1947. This section picks up the remainder of the definitions in section 87(1) of FA 1988 which are not included elsewhere. The meaning of "interest in shares" has been expanded to make it clear that it excludes a right to acquire shares eg options. See *Change 117* in Annex 1.

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.

Chapter 6: Approved share incentive plans

Background

2003. This Chapter, together with Schedule 2, derives from the legislation relating to share incentive plans (or "SIPs" for short). SIPs were previously known as employee share ownership plans (or "ESOPs" for short). The SIPs legislation is the result of a policy designed to bring share ownership in a company to the whole of that company's workforce.

2004. Nearly all the SIPs legislation is contained in Schedule 8 to FA 2000 (introduced by section 47 of that Act). Schedule 8 to FA 2000 was amended, to a certain extent, by Schedule 13 to FA 2001 (introduced by section 61 of that Act), and also by section 95 of that Act. Further amendments to Schedule 8 of FA 2000 were made by section 39 of FA 2002 and also by the Employee Share Schemes Act 2002.

2005. The new legislation relating to SIPs, the majority of which is contained in this Chapter and Schedule 2, is called "the SIP code": a term introduced in section 488.

2006. The core of the SIP code is that a company establishing a share incentive plan must offer either "free shares" or "partnership shares" (or both) to its employees. Two other types of shares - "matching shares" and "dividend shares" - are dealt with in the SIP code; and either or both of these may also be offered to employees - although this is not essential. And if a SIP is to be "approved" for the purposes of the legislation (and thus obtain the tax advantages available to an approved SIP), there are general requirements to be met, and also further requirements relating to the eligibility of individuals, to the types of shares that may be awarded, and to the trustees.

2007. The SIP code, accordingly, has a number of distinguishable components:

- it specifies requirements that a SIP must meet before it may be "approved" for the purposes of the SIP code;
- it deals with the procedural aspects relating to the approval of plans and the withdrawal of approval;
- it specifies the tax advantages that an approved SIP possesses;
- it specifies the tax charges that may arise in certain circumstances (for example, when shares cease to be subject to the plan); and
- it deals with supplementary matters (including interpretation).

2008. Of the components listed in the last paragraph, this Chapter deals with the tax advantages that an approved SIP possesses, and with the tax charges that may arise.

2009. Schedule 2 deals with the other components listed in that paragraph. After the introduction (in Part 1), that Schedule deals with the requirements that a SIP must meet before it may be "approved" for the purposes of the SIP code (in Parts 2 to 9); with the approval of plans and the withdrawal of approval (in Part 10); and with supplementary matters (in Part 11).

2010. Schedule 8 to FA 2000 also contained other provisions relating to corporation tax, capital gains tax and stamp duty. These other provisions are dealt with in Schedule 6 to this Act (consequential amendments). Schedule 7 to this Act includes provisions designed to avoid any transitional problems arising from the replacement of Schedule 8 by the provisions contained in this Act.

Overview

2011. In this Chapter, after an introductory section (section 488), the first major topic dealt with is the tax advantages that an approved SIP possesses (in sections 489 to 499). The second major topic dealt with is the tax charges that may arise (in sections 500 to 508). The provisions relating to each major topic have been arranged to deal with the award of shares, then with the holding of shares, and then, finally, with shares ceasing to be subject to the plan. This Chapter concludes with provisions dealing with the making of PAYE deductions in connection with the tax charges that may arise (in sections 509 to 514), and with a section referring to the other provisions in the Tax Acts that deal with SIPs (in section 515).

Section 488: Approved share incentive plans (SIPs)

2012. This section is introductory. It indicates the main components of the SIP code, and defines some terms of general application.

2013. *Subsection (1)* is new, and indicates the main topics dealt with in the SIP code. *Subsection (2)*, which is also new, then indicates which of those topics are dealt with in Schedule 2.

2014. *Subsection (3)* contains the definition of "the SIP code". This definition is also new.

2015. *Subsection (4)* defines terms used generally in the SIP code. Of these terms:

- the definition of an "approved" plan may be deduced from the definition of "approved employee share ownership plan" in paragraph 129(1) of Schedule 8 to FA 2000; but, in this Act, the definition is now followed by a new provision, stating that the word "approval" has a corresponding meaning;
- the definition of a "PAYE deduction" generalises the partial definitions in paragraphs 95(10) and 96(5) of Schedule 8 to FA 2000; and
- the definition of a "share incentive plan" derives from the definition of an "employee share ownership plan" in paragraph 1(1) of Schedule 8 to FA 2000.

2016. *Subsection (5)* draws attention to the fact that there is an index relating to the SIP code at the end of Schedule 2. Expressions contained in that index have the meanings that are indicated there.

The tax advantages

2017. Sections 489 to 499 relate to the first major topic dealt with in this Chapter: the tax advantages possessed by an approved SIP.

Section 489: Operation of tax advantages in connection with approved SIP

2018. This section is introductory, being concerned with the general scope of the tax advantages applying to an approved SIP. Those advantages do not apply to an individual who is not chargeable to tax under Part 2 in respect of the eligible employment (as defined) (see *subsection (2)*).

2019. This section is the first of two that derive from paragraph 77 of Schedule 8 to FA 2000 (the other being section 500).

2020. *Subsections (2)* and *(3)* are derived from paragraph 77(2) of Schedule 8 to FA 2000. The material in that sub-paragraph has been divided to make it easier to understand; and the definition of "the eligible employment" is new.

Section 490: No charge on award or acquisition of shares: general

2021. This section is the first of four that deal with the tax advantages connected with the award of shares. It contains the basic proposition that the employee is not liable to income tax on the value of the beneficial interest in the plan shares that passes to the employee at the time those shares are acquired.

2022. This section derives from paragraph 78(1) of Schedule 8 to FA 2000, a sub-paragraph that has now been divided into two subsections.

Section 491: No charge on award of shares as taxable benefit

2023. This section is the second of four that deal with the tax advantages connected with the award of shares. It provides that an employee is not liable to income tax under Chapter 8 of Part 3. That Chapter forms part of the benefits code, and provides for income tax liabilities to arise on acquisitions of shares.

2024. This section derives from paragraph 78(2) of Schedule 8 to FA 2000. That sub-paragraph contains a second sentence stating that any charge to tax under section 162(6) of ICTA remained unaffected. As the provision is expressed in this section in a form that does not impinge in any way on the provisions rewriting section 162(6) of ICTA (in Chapter 9 of Part 3), this second sentence has been omitted on the basis that it is unnecessary.

Section 492: No charge on partnership share money deducted from salary

2025. This section is the third of four that deal with the tax advantages connected with the award of shares. It provides that an employee is not liable to income tax under Part 2 where partnership share money is deducted from the employee's salary under a partnership share agreement. The expressions "partnership share agreement" and "partnership share money" are defined in Schedule 2 (in paragraphs 44 and 45 respectively); and these expressions may also be found in the index of defined expressions in paragraph 100 at the end of that Schedule.

2026. This section derives from paragraph 83 of Schedule 8 to FA 2000.

Section 493: No charge on acquisition of dividend shares

2027. This section is the last of four that deal with the tax advantages connected with the award of shares. It provides that a scheme participant is not liable to income tax on the amount applied by the trustees in acquiring dividend shares on the participant's behalf.

2028. This section derives from paragraph 89 of Schedule 8 to FA 2000. *Subsection (1)* reorganises the material in paragraph 89(1); in *subsection (2)* the word "amount" replaces the words "amounts of dividends"; and *subsections (3)* to *(5)* vary the order of material drawn from paragraph 89(3) and (4) of Schedule 8 to FA 2000.

Section 494: No charge on removal of restrictions applying to shares

2029. This section is the first of three that deal with the tax advantages connected with the holding of shares. *Subsections (1)* and *(2)* apply where a participant's plan shares are subject to provision for forfeiture, and that provision is varied or removed. In these circumstances a participant is not liable to income tax by virtue of sections 427 or 449. Those sections may be found, respectively, in Chapters 2 and 4 of this Part. *Subsection (3)* provides that a participant is not liable to income tax by virtue of section 449 when the holding period comes to an end. The expressions "provision for forfeiture" and "holding period" are defined in Schedule 2, in paragraphs 99(1) and 36 respectively.

2030. This section derives from paragraph 80(1) and (2) of Schedule 8 to FA 2000. There is a new subsection (1), setting out the circumstances in which subsection (2) applies.

Section 495: No charge on increase in value of shares of dependent subsidiary

2031. This section is the second of three that deal with tax advantages connected with the holding of shares. It provides that a participant is not liable to income tax by virtue of section 453 (charge on increase in value of shares of dependent subsidiary) in respect of any of the participant's shares that are subject to the plan when the chargeable increase is determined for the purposes of that section.

2032. This section derives from paragraph 80(3) of Schedule 8 to FA 2000. In order to make that provision easier to understand, the rewritten legislation now consists of two subsections.

2033. *Subsection (1)* makes a minor change to the law. If plan shares are sold while they are still in the plan it is not the practice of the Inland Revenue to attempt to charge income tax under the dependent subsidiary charge in section 79 of FA 1988. However, there is a problem with the wording in paragraph 80 in that if the "appropriate time" for the purposes of that section is the time of sale it is debatable whether at that point the shares are still subject to the plan. In order to make it clear that no charge to income tax arises under section 453 in such circumstances, the words "or immediately before" have been added before the words "the appropriate time" at the end of this subsection. See *Change 126* in Annex 1.

Section 496: No charge on cash dividend retained for reinvestment

2034. This section is the last of three that deal with the tax advantages connected with the holding of shares. It provides that a participant is not liable to income tax in respect of the amount of a cash dividend that is not reinvested but is carried forward and held by the trust with a view to reinvestment at a later date. It derives from paragraph 91 of Schedule 8 to FA 2000.

Section 497: Limitations on charges on shares ceasing to be subject to plan

2035. This section is the first of two that deal with the tax advantages connected with shares ceasing to be subject to approved SIPs. It provides that liability to income tax only arises in specified limited circumstances when shares cease to be subject to the plan.

2036. This section brings together three general propositions contained in paragraphs 81(7), 86(6) and 93(6) of Schedule 8 to FA 2000 respectively. The opportunity has been taken to bring these three sub-paragraphs into better alignment. All three subsections now refer to "income tax" (as opposed to "tax"); and in *subsection (2)* the reference to "the employee" has been omitted. Paragraph 77(1) of Schedule 8 to FA 2000 may be relied on for the change to the use of the term "income tax".

Section 498: No charge on shares ceasing to be subject to plan in certain circumstances

2037. This section is the second of two that deal with the tax advantages connected with shares ceasing to be subject to approved SIPs. It provides that a participant is not liable to income tax on shares ceasing to be subject to the plan if the shares so cease because the participant ceases to be in relevant employment in the circumstances specified in subsection (2). The meaning of a participant ceasing to be in relevant employment is explained in paragraph 95 of Schedule 2 to this Act.

2038. This section derives from sub-paragraphs (1) and (2) of paragraph 87 of Schedule 8 to FA 2000. *Subsection (2)(d)* reorganises the material to be found in paragraph 87(3)(d) of Schedule 8.

2039. That paragraph concludes by providing two definitions. The first definition (that of "redundancy") has now been placed in paragraph 99(1) of Schedule 2 to this Act; and the second (which appears in the rewritten legislation as a definition of "the specified retirement age") has now been placed in paragraph 98 of Schedule 2.

2040. The material set out in *subsection (2)* of this section is also set out in full in paragraph 32(2) of Schedule 2. This duplication should assist the reader.

Section 499: No charge in respect of incidental expenditure

2041. This section is concerned with incidental expenditure incurred in operating the plan; and provides that an employee is not liable to income tax in respect of such expenditure of the trustees, the company that established the SIP or the employee's employer.

2042. The section derives from paragraph 78(3) of Schedule 8 to FA 2000, which was added by paragraph 4 of Schedule 13 to FA 2001.

2043. This section makes a minor change to the law in that it is now provided that there is also no liability to income tax for incidental expenditure incurred by the company which established the plan. See *Change 127* in Annex 1.

The charges to tax

2044. Sections 500 to 508 relate to the second major topic dealt with in this Chapter: the consequential tax charges that may arise in certain circumstances.

Section 500: Operation of tax charges in connection with approved SIP

2045. As in the case of section 489, this section is introductory, being concerned with the general scope of the tax charges applying to an approved SIP. Those charges do not apply to an individual who is not chargeable to tax under Part 2 in respect of the eligible employment (as defined) (see *subsection (2)*).

2046. This section is the second of two that derive from paragraph 77 of Schedule 8 to FA 2000 (the other being section 489).

2047. As in the case of section 489, *subsections (2)* and *(3)* are derived from paragraph 77(2) of Schedule 8 to FA 2000. Once again the material in that sub-paragraph has been divided to make it easier to understand; and the definition of "the eligible employment" is new.

Section 501: Charge on capital receipts in respect of plan shares

2048. This section is the first of three that impose tax charges connected with the holding of shares. It imposes a charge to income tax if a capital receipt is received by a participant in respect of plan shares which have been held for less than five years (three years in the case of dividend shares). The meaning of the term "capital receipt" is dealt with in the following section.

2049. This section is the first of two that derive from paragraph 79 of Schedule 8 to FA 2000. This section derives from sub-paragraphs (1) and (5) of that paragraph, and deals with the matters directly relevant to the charge. *Subsections (1)* to *(5)* of this section are all derived from paragraph 79(1) of Schedule 8 to FA 2000, which has been divided to make it easier to understand; and *subsection (6)* simplifies the wording of paragraph 79(5) of Schedule 8 to FA 2000.

Section 502: Meaning of "capital receipt" in section 501

2050. This section follows on from section 501, and deals with the definition of the term "capital receipt". The term is given a very wide definition.

2051. This section is the second of two that derive from paragraph 79 of Schedule 8 to FA 2000. This section derives from the definitional provisions in sub-paragraphs (2) to (4) of that paragraph.

2052. In order to emphasise the provision that will apply most often in practice, *subsection (2)* begins with the words "The general rule".

2053. In *subsection (5)* the words "pursuant to a direction" have been changed to "as a result of a direction".

Section 503: Charge on partnership share money paid over to employee

2054. This section is the second of three that impose tax charges connected with the holding of shares. The section imposes a charge to income tax if an amount is paid over to an individual under any of the provisions in Schedule 2 that are listed in this section.

2055. This section derives from paragraph 84 of Schedule 8 to FA 2000.

Section 504: Charge on cancellation payments in respect of partnership share agreement

2056. This section is the last of three that impose tax charges connected with the holding of shares. The section imposes a charge to income tax if an individual receives any money in respect of the cancellation of a partnership share agreement.

2057. This section derives from paragraph 85 of Schedule 8 to FA 2000; but the wording of this section differs very substantially from the wording of that paragraph.

2058. As in the case of other sections in this Chapter, the year that is "the relevant tax year" is specified. The point at which the tax charge arises is not specified in Schedule 8 to FA 2000; but the point has been dealt with explicitly in *subsection (3)*. See *Note 3(B)* in Annex 2.

Section 505: Charge on free or matching shares ceasing to be subject to plan

2059. This section is the first of three that impose tax charges connected with shares ceasing to be subject to SIPs. This section is the main charging provision for free and matching shares; and it provides for the charge to vary with the length of the period for which the shares have been held. If the shares have been held for more than five years, there is no income tax liability under this section.

2060. This section derives from sub-paragraphs (1) to (6) of paragraph 81 of Schedule 8 to FA 2000.

2061. *Subsection (1)* introduces two new terms, "the award date" and "the exit date". These two terms are then deployed in *subsections (2)* to *(5)*. *Subsection (5)*, by providing that the "relevant tax year" is the tax year in which the exit date falls, has the effect that any charge to tax will arise in that year. See *Note 3(B)* in Annex 2.

2062. *Subsection (6)* combines material at present contained in sub-paragraphs (5) and (6) of paragraph 81.

Section 506: Charge on partnership shares ceasing to be subject to plan

2063. This section is the second of three that impose tax charges connected with shares ceasing to be subject to SIPs. This section is the main charging provision for partnership shares; and, as in the case of section 505, it provides for the charge to vary with the length of the period for which the shares have been held. If the shares have been held for more than five years, then once again there is no income tax liability under this section.

2064. This section derives from sub-paragraphs (1) to (5) of paragraph 86 of Schedule 8 to FA 2000.

2065. *Subsection (1)* introduces a new term, "the exit date". This term is then deployed in *subsections (2)* to *(5)*.

2066. As in the case of other sections in this Chapter, the year that is "the relevant tax year" is specified. The point at which the tax charge arises is not specified in Schedule 8 to FA 2000; but as there can be little doubt about the answer, the point has been dealt with explicitly in *subsection (5)*. See *Note 3(B)* in Annex 2.

Section 507: Charge on disposal of beneficial interest during holding period

2067. This section is the last of three that impose tax charges connected with shares ceasing to be subject to SIPs. It applies if a participant disposes of the beneficial interest in free or matching shares during the holding period in breach of the obligations imposed by paragraph 36(1)(b) of Schedule 2 to this Act.

2068. This section derives from paragraph 82(1) of Schedule 8 to FA 2000. (Paragraph 82(2) of Schedule 8 to FA 2000 was repealed by paragraph 5 of Schedule 13 to FA 2001.) *Subsection (1)(a)* contains additional wording to emphasise that this section applies if free or matching shares cease to be subject to the plan during the holding period applying to those shares.

2069. As in the case of other sections in this Chapter, the year that is "the relevant tax year" is specified. As in the case of those other sections, the point at which the tax charge arises is not specified in Schedule 8 to FA 2000; the point is dealt with explicitly in *subsection (3)*. See *Note 3(B)* in Annex 2.

Section 508: Identification of shares ceasing to be subject to plan

2070. This section contains provisions for identifying shares that cease to be subject to SIPs.

2071. This section derives from paragraph 122(6) of Schedule 8 to FA 2000, which is one of the supplementary provisions in Part 13 of that Schedule. It is more convenient to deal with this topic here, alongside the provisions dealing with the tax charges connected with shares ceasing to be subject to SIPs.

2072. Paragraph 122(6) of Schedule 8 is drafted in terms of shares being "awarded" to a participant; but, while it is appropriate to speak of an award of free shares, partnership shares or matching shares, it is not clear that such terminology is appropriate for dividend shares. It is, however, the intention that all shares in the trust for a particular employee should be pooled, and that shares should come out of the trust on a first in first out basis. *Subsection (2)* has been added to this section to deal with this point. See *Change 128* in Annex 1.

PAYE implications

2073. Sections 500 to 508 deal with the various charges to income tax as employment income that may arise under the SIP code. Sections 509 to 514, which derive from paragraphs 94

to 96 of Schedule 8 to FA 2000 (as amended), deal with the circumstances in which PAYE may be applied to those payments.

Section 509: Modification of section 696 where charge on shares ceasing to be subject to plan

2074. This section, with its reference to section 696, has the effect of providing that where there is an amount that counts as employment income as the result of shares ceasing to be subject to an approved SIP, and where the shares in question are readily convertible assets, PAYE is to be applied on the amount likely to count as employment income under the SIP code.

2075. This section derives from paragraphs 94 and 128 of Schedule 8 to FA 2000, two paragraphs since amended by section 39(2) and (6) of FA 2002.

2076. This section has the consequence that the employer has to use his best estimate of the amount that will be chargeable: there is no requirement that PAYE has to be operated on the precise amount that will eventually count as employment income.

Section 510: Payments by trustees to employer company on shares ceasing to be subject to plan

2077. This section applies where any plan shares cease to be subject to the plan; where there is an amount that counts as employment income of the participant; and where there is an obligation to deduct PAYE in respect of that amount. In these circumstances the principal obligation to account for any PAYE due is that of the employer company (an expression defined in *subsection (7)*). The plan may require the participant to pay sufficient money to the employer company in order to meet the PAYE liability; but, to the extent that it does not do so, this section provides for the trustees to pay sums to the employer company.

2078. This section is the first of three that derive from paragraph 95 of Schedule 8 to FA 2000. That paragraph is long; and it has been thought advantageous to divide it. This section derives from sub-paragraphs (1) to (6) of paragraph 95.

2079. *Subsection (7)* takes account of the amendment made to paragraph 95(6) of Schedule 8 to FA 2000 by section 39(3) of FA 2002.

Section 511: PAYE deductions to be made by trustees on shares ceasing to be subject to plan

2080. This section is relevant where any plan shares cease to be subject to the plan and as a result there is an amount that counts as employment income of the participant. In such a case if either there is no employer company or the Inland Revenue are of the opinion that a PAYE deduction is impracticable, and direct that this section is to apply, the trustees have to account for the PAYE as if the participant were a former employee of the trustees. The practical effect of this is that the trustees have to deduct income tax at the basic rate.

2081. This section is the second of three that derive from paragraph 95 of Schedule 8 to FA 2000. This section derives from sub-paragraphs (7) and (8) of paragraph 95.

Section 512: Disposal of beneficial interest by participant

2082. This section provides for sections 510 and 511 to apply in a modified form where a participant disposes of his beneficial interest in any of his plan shares.

2083. This section is the last of three that derive from paragraph 95 of Schedule 8 to FA 2000. This section derives from sub-paragraph (9) of paragraph 95.

Section 513: Capital receipts: payments by trustees to employer company

2084. This section and section 514 apply where the trustees receive money which gives rise to a capital receipt that counts as employment income in the hands of the participant (see section 501). This section then applies to deal with the "basic" case that arises in these circumstances. The trustees are to pay over an amount equal to the amount of employment income to the employer company (an expression defined in *subsection (5)*), and the employer company is then to account for the PAYE and to pay the balance to the employee.

2085. This section is the first of two that rewrite paragraph 96 of Schedule 8 to FA 2000. This section derives from sub-paragraphs (1) and (2) of paragraph 96. *Subsection (5)* takes account of the amendment made to paragraph 96(2) of Schedule 8 to FA 2000 by section 39(4) of FA 2002.

Section 514: Capital receipts: PAYE deductions to be made by trustees

2086. Section 513 and this section apply where the trustees receive money which gives rise to a capital receipt that counts as employment income in the hands of the participant (see section 501). This section applies in circumstances where either there is no employer company or the Inland Revenue are of the opinion that a PAYE deduction is impracticable, and direct that this section is to apply. In these circumstances, and when making the capital payment to the participant, the trustees are to make a PAYE deduction as if the participant were a former employee of the trustees. The practical effect of this is that the trustees have to deduct income tax at the basic rate.

2087. This section is the second of two that rewrite paragraph 96 of Schedule 8 to FA 2000. This section derives from sub-paragraphs (3) and (4) of paragraph 96.

Section 515: Tax advantages and charges under other Acts

2088. This is a new section, explaining where the remaining provisions in the SIPs code are to be found. The majority are to be found in ICTA *(subsection (1))*; but others are to be found in TCGA 1992 *(subsection (2)(a))*, or in FA 2001 *(subsection (2)(b))*.

Chapter 7: Approved SAYE option schemes

Overview

2089. This Chapter tells an employee receiving or exercising a share option whether or not the option is within the Save-as-You-Earn ("SAYE") rules and what the tax consequences are. A SAYE option scheme is defined in section 516. This label has not been used in the statute up to now. The name in the source legislation is "savings-related share option scheme" and these schemes are commonly referred to as SAYE share option schemes or simply SAYE schemes in practice.

2090. The label SAYE denotes a SAYE option scheme in these notes.

2091. Unlike in sections 185 and 187 of and Schedule 9 to ICTA, in this Act SAYE has been separated from the CSOP schemes in an attempt to make these rules easier to read and understand.

2092. The rules for APS schemes (profit sharing schemes approved under Schedule 9 to ICTA) are not rewritten in this Act. These rules will therefore still be found in sections 186 and 187 of and Schedules 9 and 10 to ICTA. There is reference to this in section 418(2) and in Part 8 of Schedule 7 to this Act.

2093. The redrafting of the SAYE and CSOP schemes has been influenced by the way the newer schemes, Enterprise Management Incentives ("EMI") and Share Incentive Plans ("SIP"), were drafted in FA 2000. This is a matter of style and also part of an attempt to achieve consistency across the share schemes where possible. Codes have been

introduced for each scheme or plan as explained in the notes on the introduction to this Part.

2094. Each section of this Chapter and each paragraph of Schedule 3 has a heading to help explain its contents and there are several examples of both sections and paragraphs containing introductory material.

2095. The requirements for the initial and continuing approval of the scheme are now contained in paragraphs 40 to 44 of Schedule 3. There are transitional provisions in Schedule 7 to ensure that a scheme approved under Schedule 9 to ICTA is treated as a SAYE option scheme approved under this Act.

Section 516: Approved SAYE option schemes

2096. This section sets out what is contained in this Chapter and in Schedule 3. It sets the scene: SAYE is a scheme which requires prior approval by the Inland Revenue and which enables the option-holder to benefit from income tax relief.

2097. There are references in the SAYE code in several places to the Inland Revenue, where in ICTA these refer to the Board. This reflects practice and is in line with the approach in FA 2000 to the EMI and SIP codes. The Inland Revenue is defined in section 720 as "any officer of the Board of Inland Revenue". See *Change 158* in Annex 1.

2098. In *subsection (3)(c)* there is a cross-reference to Part 2 of Schedule 7D to TCGA 1992 which covers the capital gains tax angle (see Schedule 6 to this Act).

2099. Share options are described as being granted rather than obtained in most contexts and especially where the timing of the grant is significant. This ties in with the terminology in EMI and perhaps gives a clearer indication of the exact date of the occasion.

2100. The definitions derive from section 187 of ICTA. There are minor definitions and a new index of defined expressions, at the end of Schedule 3 to this Act. This is based on the approach in the tax-relieved share schemes, introduced by FA 2000. The definition of "share option" matches the one used for EMI in FA 2000 (and in the EMI code). In section 516 there is also a fuller definition of the SAYE option scheme itself than in ICTA.

Section 517: Share options to which this Chapter applies

2101. This is an introductory section, which derives from section 185(1) of ICTA. This Chapter applies to an individual who obtains an option in accordance with the provisions of an approved scheme by reason of his or her employment. This phrase in section 185(1) matches the expression in the benefits code. The rules in paragraph 10 of Schedule 3 to this Act govern the particular employment.

2102. The reference to a commencement date in section 185(1) of ICTA is spent and is not rewritten.

Section 518: No charge in respect of receipt of option

2103. This derives from section 185(2) of ICTA. Here, as elsewhere, the phrase "no liability to income tax arises" expresses this type of exemption.

Section 519: No charge in respect of exercise of option

2104. This and the following section derive from section 185(3) and (4) of ICTA and explain the conditions for relief from income tax on the exercise of an option and on post-acquisition benefits.

2105. The relief and the exceptions are set out in a more straightforward way and in a positive framework. No liability to income tax arises in the circumstances set out in this section (subject to the two conditions in *subsections (2) and (3)*) on the exercise of an option in

accordance with the approved provisions of the scheme. Under condition A, the option is exercised after three years from the date on which it is granted. This period between grant and exercise is the norm for a SAYE scheme.

2106. There are a number of circumstances however for an early (pre-three year) exercise which are catered for in SAYE schemes. Rules about these appear in Schedule 3 to this Act. Following on from section 185(4) of ICTA, this section identifies those circumstances for which tax relief is provided. But under condition B the position is expressed positively, although the formulation makes reference to the circumstances where tax relief is not available on the early exercise of an option.

2107. There is a clarification of the time limit in section 185(4) of ICTA, which refers to the exercise of an option within three years of its being obtained in subsections (2) and (3)(a). This section confirms that the period is inclusive of the date of the grant. So, if granted an option on 1 January 2002, an employee can be confident that it can be exercised on the same date three years later and the exercise will qualify for income tax relief. See *Change 129* in Annex 1.

2108. There are similar clarifications in the CSOP code and there are references to time limits elsewhere in the notes on the approved schemes. These are instances where, to a greater or lesser extent, doubt may exist as to whether or not the "trigger date", from which a period is measured, is to be included in the period. As the law ignores fractions of a day when computing periods of this nature, the start date for the various periods has been identified.

2109. The Inland Revenue practice under which the charge on the exercise, assignment and release of unapproved share options is lifted after the death of an option holder has now been given statutory effect in section 477(4). There is a cross-reference to this section in *subsection (4)*. Also, to make it clear that the operation of section 477 acts in conjunction with the approved share scheme rules, which concern the time when a share option lapses after death, there is also a signpost to paragraph 32 of Schedule 3 to this Act in *subsection (5)(a)*.

2110. In *subsection (5)(b)* there is a direct signpost to paragraph 42(3) of Schedule 3 to this Act, under which, for SAYE, the option holder is protected against the possibility of approval being withdrawn from an approved scheme.

Section 520: No charge in respect of post-acquisition benefits

2111. This section mirrors the previous section and gives relief in the same circumstances from income tax on specified charges on an increase in the value of shares acquired by way of a tax-relieved exercise.

2112. There is a signpost in *subsection (3)* to paragraph 42(3) of Schedule 3 to this Act under which, for SAYE, the option holder is protected against the possibility of approval being withdrawn from an approved scheme.

Chapter 8: Approved CSOP schemes

Overview

2113. This Chapter tells an employee receiving or exercising a share option whether or not the option is within a CSOP scheme and what the tax consequences are. A CSOP scheme is defined in section 521. The acronym CSOP stands for a company share option plan. This label has not been used in the statute up to now but it is commonly used in practice.

2114. The label CSOP denotes a CSOP scheme in these notes.

2115. Unlike in sections 185 and 187 of and Schedule 9 to ICTA, in this Act CSOP has been separated from the SAYE schemes in an attempt to make these rules easier to read and understand.

2116. The rules for APS scheme (profit sharing schemes approved under Schedule 9 to ICTA) are not being rewritten in this Act. These rules will therefore still be found in sections 186 and 187 of and Schedules 9 and 10 to ICTA. There is reference to this in section 418(2) and in Part 8 of Schedule 7 to this Act.

2117. The redrafting of the CSOP and SAYE schemes has been influenced by the way the newer schemes, Enterprise Management Incentives ("EMI") and Share Incentive Plans ("SIP"), were written in FA 2000. This is a matter of style and also part of an attempt to achieve consistency across the share schemes where possible. Codes have been introduced for each scheme or plan as explained in the notes to the introduction to this Part.

2118. Each section of this Chapter and each paragraph of Schedule 4 has a heading to help explain its contents and there are several examples of both sections and paragraphs containing introductory material.

2119. The requirements for the initial and continuing approval of the scheme are now contained in paragraphs 28 to 32 of Schedule 4. There are transitional provisions in Schedule 7 to ensure that a scheme approved under Schedule 9 to ICTA is treated as a CSOP scheme approved under this Act.

Section 521: Approved CSOP Schemes

2120. This section sets out what is contained in this Chapter and in Schedule 4 to this Act. It sets the scene: CSOP is a scheme which requires prior approval by the Inland Revenue and which enables the option-holder to benefit from income tax relief. There is also provision here for amounts to count as employment income in certain circumstances.

2121. There are references in the CSOP code in several places to the Inland Revenue, where the relevant provisions in ICTA referred to the Board. This reflects practice and is in line with the approach in FA 2000 to EMI and SIP codes. The Inland Revenue is defined in section 720 as "any officer of the Board of Inland Revenue". See *Change 158* in Annex 1.

2122. In *subsection (3)(c)* there is a cross-reference to Part 3 of Schedule 7D to TCGA 1992 which covers the capital gains tax angle (see Schedule 6 to this Act).

2123. Share options are described as being granted rather than obtained in most contexts and especially where the timing of the grant is significant. This ties in with the terminology in EMI and perhaps gives a clearer indication of the exact date of the occasion.

2124. The definitions derive from section 187 of ICTA. There are minor definitions and a new index of defined expressions, at the end of Schedule 4 to this Act. This is based on the approach in the tax-relieved share schemes, introduced by FA 2000. The definition of "share option" matches the one used for EMI in FA 2000 (and in the EMI code). There is for the first time a definition of the CSOP scheme in section 521.

Section 522: Share options to which this Chapter applies

2125. This is an introductory section, which derives from section 185(1) of ICTA. This Chapter applies to an individual who obtains an option in accordance with the provisions of an approved scheme by reason of his or her employment. This phrase in section 185(1) matches the expression in the benefits code. The rules in paragraph 8 of Schedule 4 to this Act govern the particular employment.

2126. The reference to a commencement date in section 185(1) of ICTA is spent and is not being rewritten. This is also the case with section 185(9) of ICTA, which is specific to CSOP.

Section 523: No charge in respect of receipt of option

2127. *Subsection (1)* derives from section 185(2) of ICTA. Here as elsewhere the phrase "no liability to income tax arises" expresses this type of exemption.

2128. *Subsection (2)* also derives from section 185(2) of ICTA.

Section 524: No charge in respect of exercise of option

2129. This and the following section bring together section 185(3) and (5) of ICTA and incorporate paragraph 27(3) of Schedule 9 to ICTA, which was formerly referred to in section 185(3).

2130. These two sections explain the conditions for relief from income tax on the exercise of an option and on post-acquisition benefits. As with the SAYE provisions, this section makes the circumstances of relief and the exceptions more straightforward, expressing them in a positive form.

2131. No liability to income tax arises in the circumstances set out in the condition in *subsection (2)*. The option has to be exercised between three years and ten years after receipt and three years after a previous exempt exercise, as defined in *subsection (3)*.

2132. There are therefore three dates crucial to this relief. The three year period in *subsection (2)(a)(i)* begins with the day on which the option is granted. There is a minor change in relation to the exercise on the tenth anniversary of the grant in *subsection (2)(a)(ii)*. See *Change 129* in Annex 1.

2133. In *subsection (2)(b)* the rule makes it clear that the period is inclusive of the exercise of the current option. (In section 185(5)(b) of ICTA the period looks back to the date of an earlier exercise.) The effect is that if there is an exempt exercise of an option on 1 January 2002, an employee can be confident that a further exercise on the same date three years later will qualify for income tax relief.

2134. There are similar clarifications in the SAYE code and there are references to time limits elsewhere in the explanatory notes on the approved schemes. These are instances where it might be open to doubt whether or not the trigger date, from which a period is measured, is to be included in the period. As the law ignores fractions of a day when computing periods of this nature, this section identifies the start date for the various periods.

2135. The Inland Revenue practice under which the charge on the exercise, assignment and release of unapproved share options after the death of an option holder is lifted has now been given statutory effect in section 477(4). There is a new cross-reference to this section in *subsection (4)*. Also, to make it clear that the operation of section 477 acts in conjunction with the approved share scheme rules, which concern the time when a share option lapses after death, there is a signpost to paragraph 25 of Schedule 4 in *subsection (5)*.

Section 525: No charge in respect of post-acquisition benefits

2136. This section mirrors the previous section and also derives from section 185(3) and (5) of ICTA. It gives relief in the same circumstances from income tax on specified charges (post-acquisition charges under section 449 and section 453) on an increase in the value of shares acquired by way of a tax-relieved exercise. The exercise has to meet the condition set out in section 524. See *Note 50* in Annex 2.

Section 526: Charge where option granted at a discount

2137. This section derives from section 185(6) and (8) of ICTA. Section 185(7) of ICTA which covers the capital gains tax consequences (relief against a double charge) is now in Part 3 of Schedule 7D to TCGA 1992 (see Schedule 7 to this Act).

2138. The section imposes a charge in the rare case that the total of any consideration given for the grant of the option and the amount payable on exercising the option is less than the market value of the shares at the time the option is granted. The option has to be granted at a price which is not manifestly less than the market value at that date (which is the rule in paragraph 22 of Schedule 4, formerly paragraph 29 of Schedule 9 to ICTA). Therefore this charge can only occur where there has been an agreement to fix the value earlier than the date of the grant or a mistake is made on the valuation.

2139. The language of *subsections (2)* and *(4)* reflects the new approach to expressing "charge".

2140. In response to a suggestion made in the consultation process leading up to this Act, "the price" in *subsection (1)(b)* has been changed to "the amount payable" since price implies an amount payable per share. A further clarification has also been introduced. This is the reference to "the maximum number of shares" that can be acquired under the option, which specifies the number of shares in the frame in order to make the comparison required.

2141. The reference to the discount being earned income has been dropped, as this has no continuing effect.

2142. Under *subsection (4),* "knock-on" relief is given against further income tax charges on the same shares. This is a signpost only now; the way the relief is given is included in sections 194, 479 and 480.

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.

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.

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.

Chapter 10: Priority share allocations

Overview

2189. This Chapter derives from section 68 of FA 1988 which applies to offers made on or after 23 September 1987. That section exempts the benefit derived by directors and employees from a priority allocation of shares.

2190. Section 68 of FA 1988 starts by granting a complete exemption from the charge as emoluments in respect of any benefit derived from an entitlement to a priority allocation of shares. Then, in some circumstances, the legislation brings back into charge any discount enjoyed by employees. It does so by excluding the relevant amount from the initial exemption. The rules for calculating this amount are different from the normal rules for calculating emoluments.

2191. When section 68 of FA 1988 was enacted, it only dealt with relatively straightforward offers where there was a single public offer under which both members of the public and directors and other employees applied for shares including any priority shares.

2192. Successive amendments catered for more complex share offers. These included offers where, because of legal and other technical issues, the priority shares for directors and employees were subject to a separate employee offer. Each new tranche of legislation was “bolted on” to what had gone before. This was done by imposing the fiction that the separate public and employee offers were in fact a single offer – “the offer”.

2193. This led to some rather dense and convoluted legislation – particularly in the rules for the limits on the number of priority shares and the "similar terms" condition. In order to try to make the provisions easier to understand, that fiction has been abandoned and the Act instead uses the following structure: sections 542 and 543 deal with single share offers; sections 544 and 545 deal with share offers with separate public and employee offers; and sections 546 to 548 deal with supplementary material that is common to both.

2194. It should be noted that section 68(4) of FA 1988 (dealing with the capital gains aspects) does not appear in this Chapter. Instead, paragraph 212 of Schedule 6 to this Act inserts a new section 149C in TCGA 1992. In addition, section 68(6) of FA 1988, the original commencement provision, is omitted on the grounds that it is spent.

Section 542: Exemption: offer made to public and employees

2195. This section is concerned with offers which are open to both the public and employees. *Subsection (1)* derives from section 68(1) of FA 1988 and introduces the basic conditions for the exemption. The exemption itself is found in *subsection (2)* and is from liability to income tax as earnings. It follows that the exemption does not apply to a benefit received in connection with a change or termination within Chapter 3 of Part 6 of this Act which derives from section 148 of ICTA.

2196. *Subsections (3) to (6)* derive from sections 68(2), (2A) and (2B) of FA 1988 and give the detailed conditions which must be satisfied in order for the exemption to apply. In contrast to the source legislation, dealing with the conditions one by one should be clearer.

2197. *Subsection (7)* introduces section 543 which excludes certain discounts from the exemption in this section.

Section 543: Discount not covered by exemption in section 542

2198. This section derives from section 68(1A) of FA 1988 and excludes from the exemption in section 542 the benefit of certain discounts enjoyed by a director or employee in acquiring the priority shares. The discount therefore remains taxable as earnings. In calculating the taxable discount the amount of any registrant discount (see section 547) is disregarded.

Section 544: Exemption: different offers made to public and employees

2199. This section is concerned with cases where there are separate offers to the public and employees. *Subsection (1)* derives mainly from section 68(1ZA) of FA 1988 and introduces the basic conditions for the exemption. The exemption itself is found in *subsection (2)* and is from liability to income tax as earnings. It follows that the exemption does not apply to a benefit received in connection with a change or termination within Chapter 3 of Part 6 of this Act which derives from section 148 of ICTA.

2200. *Subsections (3)* to *(6)* derive from sections 68(1ZB), (2), (2A), (2B) and (2C) of FA 1988 and give the detailed conditions which must be satisfied for the exemption to apply. Subsection (3) requires the case of each company whose shares are subject to the employee offer to be considered. In the FA 1988 provisions, the fiction that the public offer and the employee offer are a single offer means that, reading subsections 68(2)(a) and 68(2C) together, a company whose shares are *only* subject to the public offer also has to be considered. In such a case, the limit on the number of shares allocated to employees, imposed by section 68(2)(a), will never be exceeded. These companies are not therefore mentioned. See *Note 52* in Annex 2.

2201. *Subsection (7)* introduces section 545 which excludes certain discounts from the exemption in this section.

Section 545: Discount not covered by exemption in section 544

2202. This section derives from section 68(1) of FA 1988 and excludes from the exemption in section 544 the benefit of any discount (disregarding the registrant discount) enjoyed by a director or employee in acquiring the priority shares. The discount therefore remains taxable as earnings.

2203. *Subsections (3)* to *(6)* derive from the rather complex provisions in section 68(5B) and (5C) of FA 1988 which determine the "appropriate notional price" of the shares in the offer. Generally this is the notional price, but in some circumstances it is a proportion of the notional price. A formula has been introduced to make the basis of the calculation clearer.

Section 546: Meaning of being entitled "on similar terms"

2204. This section derives from sections 68(3) and (3A) of FA 1988 and explains the condition that entitlement to a priority allocation of shares must be on "similar terms".

2205. *Subsections (3)* to *(6)* only apply where the allocation of shares in a company for directors and employees of the company is different from the allocations for directors and employees of other companies.

Section 547: Meaning and amount or value of "registrant discount"

2206. This section derives from section 68(5A) of FA 1988 which defines "registrant discount". Section 68(5A)(b) requires at least 40% of shares which are allocated to members of the public *other than employees and directors* to be allocated to individuals entitled to the discount. It is not made explicit what this phrase means. *Subsection (4)* has been drafted to make clear that the intention is to exclude employees and directors who are entitled to a priority allocation. This change in approach is explained in detail in *Note 53* in Annex 2.

2207. In this section the label "subscribing employee" has been used to describe those directors and employees who subscribe for shares under the offers and who comply with the same registration requirements as members of the public.

Section 548: Minor definitions

2208. This section contains the definitions used in this Chapter and mainly derives from section 68(5) of FA 1988. That legislation does not define "director" (except to include prospective and former directors) or "shares". The definitions introduced here are discussed in *Change 132* in Annex 1.

Chapter 11: Supplementary Provisions about employee benefit trusts

Background

2209. Chapters 6, 7, 8 and 9 of this Part set out the provisions for the four types of share scheme: share incentive plans ("SIPs"), Save As You Earn option schemes ("SAYE"), company share ownership plans ("CSOPs") and enterprise management incentives ("EMIs").

2210. Each of those schemes includes a number of requirements that the employee must meet. One of the conditions common to each of the schemes is that the employee must not have a "material interest" in the company whose shares are subject to the scheme. A "material interest" means entitlement to more than a certain percentage of the relevant company's share capital.

2211. In determining whether or not the "material interest" test is satisfied, the entitlement of the individual to any of the company's shares includes any such entitlement held by any "associates" of the individual.

2212. One kind of associate could be a trustee of a settlement of which the individual is a beneficiary. And one kind of trust that may well exist in the context of a company that is running share incentive schemes is an employee benefit trust. An employee wishing to participate in the share scheme may therefore need to know whether or not to count the trustees of the employee benefit trust as "associates" for the purposes of the "material interest" test.

2213. Each of the four types of share scheme mentioned in paragraph 2209 includes provisions directed to the issue whether the trustees of an employee benefit trust should be counted as associates. The provisions are to the same effect, and state, in each case, that the general rule is that the trustees are not counted as associates if neither the individual in question (with or without associates) nor any associate of the individual (with or without associates) controls more than a stated percentage of the ordinary share capital of the company.

Overview

2214. This Chapter contains provisions relating to employee benefit trusts. It deals with two issues.

2215. The first issue dealt with is the obvious question "What is an employee benefit trust?". In the source legislation an employee benefit trust is stated, in the case of each of the four schemes, to have the same meaning as in paragraph 7 of Schedule 8 to ICTA. That Schedule is not being re-enacted, as it relates to profit-related pay schemes which will be effectively spent by the time that this Act takes effect. It will therefore no longer be possible to refer to the meaning of "employee benefit trust" as used in the legislation relating to profit related pay schemes. That definition, instead, is set out in this Chapter. The definition, in sections 550 and 551, derives from paragraph 7 of Schedule 8 to ICTA.

2216. The second issue dealt with relates to the general rule mentioned in paragraph 2213: for there are cases where the general rule is supplemented by further rules. In these cases, which depend upon the employee or an associate receiving a payment from the employee benefit trust, the employee (or the associate) is treated as owning the "appropriate percentage" of the ordinary share capital of the company, in addition to any percentage of that share capital actually owned. These provisions, in sections 552 to 554, derive from paragraph 7(9) to (12) of Schedule 8 to ICTA.

Section 549: Application of this Chapter

2217. This section sets out the ambit of this Chapter. *Subsections (1)* to *(3)* are drafting additions, while *subsection (4)* derives from material in paragraph 7(3) and (12) of Schedule 8 to ICTA.

2218. In *subsection (4)(b)*, the words "the company which are subject to" have been added near the end of this provision. Although these words do not form part of paragraph 7(12), it is thought that they should have been included, and that the legislation is easier to understand if they are included. See *Note 54* in Annex 2.

2219. *Subsection (5)* provides that, in this Chapter, the term "employee" includes the holder of an office. This general proposition holds good for the employment income Parts (see section 5), but was disapplied for the purposes of Part 7 in section 421. However, the provisions of this Chapter are governed by the definition of the term "employment" in section 169(1) of ICTA, which includes an office, so the general proposition that an "employee" includes an office-holder has been reinstated.

Section 550: Meaning of "employee benefit trust"

2220. This section sets out the basic ingredients of an employee benefit trust, as follows:

- all or most of the employees of the company must be eligible to benefit; and

- apart from certain exceptions, there have been no disposals of property subject to the trust since 13 March 1989.

2221. This section derives from paragraph 7(5) of Schedule 8 to ICTA.

2222. *Subsection (4)* provides more information about the exceptions to the "no disposals since 13 March 1989" rule. Disposals that do not prevent the trust from being an employee benefit trust are either those made in the ordinary course of the management of the trust or "qualifying disposals", as defined in section 551.

Section 551: "Qualifying disposals" for purposes of section 550

2223. This section sets out that a "qualifying disposal" can be of any of the ordinary share capital of the company, or money paid outright, provided one of three conditions is met. This section derives from paragraph 7(6) and (7) of Schedule 8 to ICTA.

2224. The conditions mentioned are set out in *subsections (2)*, *(4)* and *(5)*.

2225. *Subsection (3)* is new. Although *subsection (2)* refers to "employees of the company", it is Inland Revenue practice to extend the benefit of this provision to employees of a subsidiary company (a subsidiary company being taken to mean a company under another company's control, with the word "control" taking the meaning in section 840 of ICTA). Subsection (3) reflects that Inland Revenue practice. See *Change 133* in Annex 1.

Section 552: Attribution of interest in company to beneficiary or associate

2226. This section sets out that in certain circumstances the individual (or an associate of the individual) is treated as owning the "appropriate percentage" of the company's ordinary share capital. It derives from paragraph 7(9) of Schedule 8 to ICTA.

2227. The relevant circumstances are that the individual in question (or an associate) has received a payment from the employee benefit trust since 13 March 1989 and the property subject to the trust included any ordinary share capital of the company at any time during the three years preceding that payment.

2228. The "appropriate percentage" of the company's ordinary share capital that the individual (or associate) is treated as owning in those circumstances is specified in section 553.

Section 553: Meaning of "appropriate percentage" for purposes of section 552

2229. This section sets out how the "appropriate percentage" is to be calculated. It derives from paragraph 7(10) of Schedule 8 to ICTA.

2230. There are a number of factors to be taken into account in working out the "appropriate percentage" of the company's ordinary share capital for the purposes of section 552. The main calculation consists of a straightforward fraction using "P" and "D" to signify the numbers to be fed into that fraction. The expressions "P" and "D", however, take rather more explaining.

2231. "P" is either the total of any payments received by the individual or associates from the trust during the 12 months up to and including the day the relevant payment is made (*subsection (2)*) or, if smaller, the distributions made by the company to the trustees of the employee benefit trust during the period of three years up to and including the day the relevant payment is made (*subsection (3)*).

2232. "D" is the aggregate distributions made during the three years preceding the relevant payment, divided by the number of years in which such distributions were actually made (*subsection (4)*).

2233. It is difficult to express the ideas in this calculation in simpler terms than those used in paragraph 7(10) of Schedule 8 to ICTA; but the section includes a mini method statement for the calculation of "D".

Section 554: Attribution of further interest in company

2234. This section sets out in that in certain circumstances the individual (or an associate of the individual) is treated as owning, not only the "appropriate percentage" of the company's ordinary share capital determined under section 552 but an additional percentage as well. It derives from paragraph 7(11) of Schedule 8 to ICTA.

2235. The "appropriate percentage" may be increased if the individual (or associate) receives payments from other trusts that own shares in the company. This section sets out in what circumstances the appropriate percentage may be so increased, and how to work out the total percentage of the company's share capital that the individual (or associate) is treated as owning.

2236. *Subsection (3)* sets out material that has no precise counterpart in ICTA; but its inclusion in this Act should make the legislation clearer.