Office of
Tax Simplification

Review of unapproved share schemes: Interim report

August 2012

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Foreword

This interim report forms the first part of the OTS's review of unapproved share schemes. It presents the facts and evidence found as a result of a programme of meetings involving stakeholders, advisers, administrators and companies. It also draws on evidence from an online survey.

Our report summarises key areas of difficulty that have been identified through this fact-finding exercise, and suggests certain priority areas of complexity for further attention. Before we start work properly on how these complexities can be simplified, we need to know if we have reflected properly the evidence we have gathered and the conclusions we have drawn.

Can we therefore urge people with a stake in the area of unapproved schemes to look critically at our report and tell us if they believe we have missed any key issues or in any way presented an incorrect balance of arguments. Please send any such feedback on this report as soon as possible but in any event **to ots-ess@ots.gsi.gov.uk by Friday 28 September 2012.**

The purpose of this report is not to make final recommendations about how simplification might be achieved. These will be included in the final report which will be published before the 2013 Budget. We will be carrying out further meetings and research in the coming months to develop our recommendations and would welcome contributions to that work. Some of the areas that we will be looking further at and would particularly welcome further input on from readers of this report are set out in Chapter 2. Comments or suggestions on these would be welcome at any time but preferably **by Friday 26 October, again to ots-ess@ots.gsi.gov.uk.**

The OTS would like to take this opportunity to express its thanks to all those who have participated in meetings or provided feedback, whether by the online survey or directly. Without your input, this report would not have been possible.

Michael J

Rt. Hon. Michael Jack

Chairman, Office of Tax Simplification

Executive summary

In March 2012, the Office of Tax Simplification (OTS) produced its review of tax advantaged (approved) employee share schemes. The report identified areas of complexity existing in relation to the four UK tax advantaged share plans – the Share Incentive Plan (SIP), the Save As You Earn (SAYE) scheme, the Company Share Option Plan (CSOP) and the Enterprise Management Incentive (EMI) scheme – and made a number of recommendations which were put forward to the Chancellor of the Exchequer. A consultation document[1] has recently been published by the Government to take forward many of our recommendations.

The OTS has now turned its attention to areas of complexity relating to share schemes and share based incentives which do not benefit from any tax advantages – so-called "unapproved" share schemes. Our terms of reference are broad, covering the most commonly used types of unapproved share scheme such as share option schemes, long-term incentive plans, deferred share awards and share matching plans, as well as ad hoc arrangements falling within the employment related securities regime. However, the report is not intended to cover cash-settled awards such as phantom options and stock appreciation rights.

This report should be read within the context of the recent *Nuttall Review*[2] which "explains the obstacles to promoting employee ownership and sets out a framework for knocking them down"[3]. Amongst other barriers, the Review devotes an entire chapter to the importance of reducing complexities, including complexities of tax legislation, relating to employee ownership[4].

Evidence gathering

As with our previous review of approved share plans, the OTS wished to take account of the views of a variety of different stakeholders, including legal and tax advisers, employers, scheme administrators, lobby groups, professional membership bodies and employees. We also sought input from government departments such as HM Revenue and Customs (HMRC), HM Treasury and the Department for Business, Innovation and Skills.

We arranged and attended some 30 meetings and presentations, many of which were attended by multiple stakeholders and included professional advisers and their clients, to seek their input on areas of complexity. A summary of the meetings we arranged is set out at Annex D.

In addition we produced and publicised an online survey aimed specifically at companies, to which we received around 120 responses[5].

We were given huge assistance by our Consultative Committee, whose members are set out in Annex A.

[1] http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_032132

[2] *Sharing Success: The Nuttall Review of Employee Ownership*, published 4 July 2012: http://www.bis.gov.uk/assets/biscore/business-law/docs/s/12-933-sharing-success-nuttall-review-employee-ownership.pdf

[3] *The Nuttall Review*, Foreword, page 6.

[4] *The Nuttall Review*, Chapter 5.

[5] Between 18 May and 8 June 2012, the OTS conducted a survey of companies using unapproved share schemes. In total, 116 responses were received, of which approximately 80 completed the entire survey. The sample covered a wide range of business size and industrial sectors, as well as both private and publicly listed companies.

The OTS is grateful to everyone who took the time to provide us with the information, feedback and technical expertise necessary to put together this report. **We welcome comments and feedback on this report to help influence our recommendations at the next stage.**

Please send any feedback on this report to ots-ess@ots.gsi.gov.uk.

Key areas of complexity identified

Our fact-finding identified the following key areas of complexity as reported to us by various participants. Feedback varied depending on whether respondents were listed companies or private companies (or, in the case of advisers, whether their clients were listed or private) and so these areas are divided accordingly. Examples and details of how these issues affect companies running unapproved share plans are set out in full in the main body of the report. Issues relating to all companies are covered in Chapter 5; those specifically relating to private companies are covered in Chapter 6.

Listed/all companies	Private companies
• PAYE penalties and deadlines[6]; • Managing internationally mobile employees; • The difficulty of obtaining clear and up to date guidance from HMRC on what is a very difficult and uncertain area of tax law; • Form 42 – the process HMRC has set up to notify them of awards of options or shares to employees; • Part 7A, ITEPA 2003 ("disguised remuneration" rules); and • Part 7, ITEPA 2003 (employment related securities legislation).	• Difficulties with valuation of private company shares • Tax issues for Employee Benefit Trusts (including inheritance tax issues and charges on loans to participators in a close company); and • Part 7, ITEPA 2003 (employment related securities legislation, in particular restricted securities).

Structure of the report

This report is structured as follows:

- Chapter 1 provides an introduction to the area of employee share plans, including a summary of the aims of this review;
- Chapter 2 sets out some key questions on which we seek confirmation and clarification of our findings. We welcome any responses to these questions;

[6] Including section 222 ITEPA 2003.

- Chapter 3 sets out a summary of the evidence that the OTS gathered from groups and individuals on the areas that they found particularly complex, including information on the types of unapproved share plans currently used;
- Chapter 4 investigates some of the key tax principles lying behind the current legislation; and
- Chapters 5 and 6 establish in more detail some of the complex areas as identified both by companies in general, and by private companies.

The Annexes to this report include additional information about the tax legislation governing employee share plans, as well as information about the meetings we have held and the members of our Consultative Committee.

1 Introduction

Aims of review

1.1 Employee share schemes are perceived to be a highly complex area of the tax code by companies and their advisers. Several of the Annexes to this report support this perception. Annex B sets out some of the common – though not always consistent – terminology used in this area; Annex C summarises some of the key legislation and guidance covering unapproved share plans. Finally, Annex E sets out two examples of companies implementing fairly straightforward unapproved share plan arrangements, and identifies the many considerations required to identify and calculate the correct tax charges that may arise.

1.2 The aim of this review is to identify particular areas of complexity relating to share based arrangements that do not fall into the tax legislation governing tax advantaged share plans and, in a final report, to make suggestions and recommendations to simplify such legislation. The OTS is interested in both technical complexities arising from the tax legislation and administrative problems stemming from how tax liabilities are computed, reported and settled.

1.3 Our terms of reference for this review required us to undertake an initial fact-finding exercise to report by 31 July 2012 to examine:

- The most commonly used types of unapproved share scheme such as share option schemes, long-term incentive plans, deferred share purchase plans and share matching plans;
- Ad hoc arrangements falling within the employment related securities regime;
- The drivers for companies to use such arrangements;
- Which parts of the tax system help or hinder their objective;
- Where the current rules create inappropriate complexity and disproportionate administrative burdens for users, including PAYE and NIC requirements; and
- Where users make common mistakes that lead to unexpected tax problems.

1.4 The final report, which will include our recommendations, will be published by Budget 2013.

Definition of “share scheme”

1.5 While many share based awards are structured by way of a set of formal rules which govern multiple awards to employees, there is a myriad of ways of providing equity based rewards to employees which may be less formally established. In private companies in particular, shares may be transferred to key individuals with a minimum of formality; nonetheless, such transfers will be subject to the large body of legislation, case law and guidance which govern employee share schemes (see Annex C). So, for example, a family owned business which promises shares to one key individual depending on his or her continued employment in the business will have to follow the same tax rules as an international business providing a global performance based share plan to thousands of employees.

1.6 For this reason, the OTS has taken a wide view of the meaning of "share scheme", and our review will take into consideration certain share based incentive arrangements which, technically, may not be described as a "scheme". This corresponds with the approach taken by our review of tax advantaged "schemes" which included the Enterprise Management Incentive scheme aimed at small and medium companies, as well as the share schemes aimed at all companies such as the Share Incentive Plan, Save As You Earn scheme and the Company Share Option Plan.

1.7 In addition, although our review has not specifically asked us to consider the use of employee benefit trusts (EBTs), for many companies these form an integral part of their share scheme arrangements, and we have received a significant amount of feedback and information about certain aspects of setting up and administering EBTs within this context.

2 Areas for further input

2.1 The OTS is interested in comments and input on any of the points below. We are also particularly keen to get further input on the whole area from unquoted, private companies who use share schemes.

Question 1: Difficulties with valuation of private company shares

What experience do you have of difficulties in the valuation of private company shares and how does this impact on the design and implementation of your share plans?

Question 2: Internationally mobile employees

What are the main difficulties you face when managing internationally mobile employees in the context of unapproved share plans?

Question 3: Readily convertible assets (RCAs)

What are the main difficulties you face in determining whether your shares are, or will be, RCAs or not?

Question 4: Form 42 – the process HMRC has set up to notify them of awards of options or shares to employees

What are your main issues with Form 42?

Question 5: "Disguised remuneration"

Can you provide any particular examples of how the disguised remuneration rules (Part 7A of ITEPA 2003) have impacted upon the design, implementation or administration of your unapproved share plans?

Question 6: Tax issues for Employee Benefit Trusts (EBTs)

Can you give examples of when the taxation of EBTs (e.g. Inheritance tax rules, loans to participators) has provided a barrier to the establishment of an unapproved share plan or caused you to have to restructure, or alter the design of, your share plan in a manner which has adversely affected the attainment of your commercial intentions?

Question 7: Employment related securities rules

Can you give examples of when the employment related securities rules – in particular the rules relating to restrictions on shares – have caused you difficulties in connection with your unapproved share plan arrangements?

Question 8: Timing of income tax charge

Chapter 4 sets out some of the difficulties that arise as a result of an income tax charge and PAYE arising on the date the beneficial ownership of the shares is acquired. There are possible arguments that it would be a simplification if in certain circumstances the income tax charge (or PAYE obligation) arose on the receipt of money on the sale from the shares. We welcome views on whether this would be a simplification and in what circumstances?

Question 9: Employment reward vs. capital growth

Do you agree that the current rules get the balance right when distinguishing between employment reward and capital growth? Could this be achieved effectively in a more simple way?

Question 10: Small/Private companies

Do you think there should be separate rules for small/private companies to account for the particular issues they face? How would this look?

2.2 Please send responses to any of the questions above to ots-ess@ots.gsi.gov.uk.

3 Summary of feedback on unapproved schemes: what is in use and problems encountered

3.1 As noted in Chapter 1, the OTS wished to take account of the views of a variety of stakeholders, and we have sought feedback from as many groups and individuals as possible in the time available. Nonetheless, we recognise that we have been unable to contact or speak to every company that uses unapproved share plans, and so the feedback included in this chapter should not necessarily be regarded as a full and accurate summary of all views on unapproved share plans.

3.2 Furthermore, this chapter seeks only to reflect the views and comments that we obtained during our evidence gathering. The comments included in this chapter therefore do not necessarily reflect the views of the OTS, nor should they be taken as representative of the opinion of all share plan users.

3.3 Should readers of this report consider the comments contained within this chapter to be unrepresentative of their own views, the OTS welcomes any feedback, in particular in connection with the questions set out in Chapter 2.

Commonly used unapproved share schemes

3.4 There is a considerable amount of data available in connection with the types of tax advantaged schemes used by companies, including information about the value and quantity of grants and awards made, and the numbers of companies and employees participating in these schemes. This is partly because the information is easily identifiable from plan-specific returns.

3.5 Information about unapproved schemes is less easily identifiable. The names given to plans vary according to users – so for example, the commonly recognised term Long Term Incentive Plan (LTIP) can refer to a variety of plans with different structures. For instance, some LTIPs are based around nil-cost options; others award shares immediately, but the shares are subject to forfeiture. Some further information about the terminology that applies to unapproved plans is set out at Annex B.

3.6 As part of the fact-finding exercise, both by way of the online survey and in face to face meetings, the OTS sought to identify which types of unapproved schemes were most commonly used, and why such schemes were established by companies.

Options and share awards

3.7 Unsurprisingly, the plans used vary considerably. Face to face meetings suggested that the use of market value options had fallen out of favour, particularly since 2003-04[1]. This resulted in companies turning instead to reward strategies which provided whole share values, rather than

[1] One reason for the decline in popularity of market value share options may be the change in accounting treatment which used to be more favourable than that for whole share value awards – this is no longer the case. Some of our commentators traced the decline further back – to a start in 1995 with the Greenbury report.

rewards based only on share price growth as is the case with market value options. Companies and advisers at the meetings strongly suggested that share awards (or nil cost options) are more commonly used instead. Direct feedback from larger companies and their advisers suggested that performance share plans which delivered whole value shares to participants were commonly used, whether delivered by way of nil cost options, contingent rights to shares, or shares with forfeiture conditions attached. Bonus deferral plans were also very popular in this group.

3.8 The online survey shows that, amongst those in the sample, slightly more companies used options than share awards (with some companies using a mixture of the two). Of those surveyed, private companies are more likely to use options[2]. Interestingly, none of the seven companies whose plans use shares that are listed both in the UK and overseas use options.

3.9 Some participants noted that fixed share awards are easier to administer from a PAYE perspective (and indeed in the case of Real Time Information) as all transactions occur at one time, whereas option plans offer more flexibility for employees who can choose when to exercise. This is particularly pertinent when income tax rates change (e.g. from 40 per cent to 50 per cent in 2011 and from 50 per cent to 45 per cent in 2013).

3.10 Of the companies using option grants, there was a fairly equal balance between nil cost and market value options. There was no significant difference in responses from private and listed companies who had completed the online survey.

3.11 Approximately 15 per cent of companies that responded use bonus deferral plans; of those companies, the majority of bonus deferral arrangements were compulsory. There was no marked difference in the use of bonus deferral schemes between private and publicly listed companies.

Performance conditions and time limits

3.12 A majority (around two-thirds) of the online survey respondents used performance conditions in connection with their unapproved share plans, and of these around 50 per cent based performance conditions on earnings per share, total shareholder return or a mixture of other corporate performance conditions. Again, the online survey did not suggest a significantly different approach between private and listed companies. In terms of time limits, some 85 per cent of the respondents required some time to pass before awards vested in the participants – and the majority of those (around two-thirds) opted for a three year vesting period, although there was a range of other time periods ranging from one year up to seven years.

Employee benefit trusts (EBTs)

3.13 More than half of the survey respondents operated an EBT and of those the majority were situated offshore, often administered by some of the large number of experienced offshore trustees who are able to offer competitive fee rates.

3.14 Companies are frequently advised to keep their EBTs offshore to avoid the double taxation charge which would otherwise arise for an onshore EBT. The acquisition of shares by an employee from an EBT falls within section 17 TCGA 1992. This means that a UK resident trust is treated as having received consideration equal to the market value of the shares at the time the beneficial ownership of these is transferred for no consideration. Therefore any increase in the value of the shares when held by the trust will be liable to CGT.

3.15 The employee will be subject to an income tax charge based on the market value of the shares at the time of acquisition. Therefore the increase in value of the shares will be taxed twice. Section 239ZA of TCGA 1992 does give some protection against the double tax charge in

[2] 60 per cent used options or both shares and options vs. 40 per cent who offered just shares or another contingent right to buy shares.

some circumstances but not, for example, where the employee has exercised a market value option and is not therefore taxed on the full value of the shares being acquired.

3.16 The use of EBTs was not limited to listed companies: over half of the private companies that responded to the questionnaire operated an EBT, and the data showed a slight preference for offshore EBTs amongst these private companies. Companies quoted on the UK stock exchange which operated an EBT used offshore EBTs in around 80 per cent of cases.

3.17 Almost all the private companies that gave a reason for using an EBT stated that it is used as a warehouse[3]; a small minority used it to operate an internal market[4]. The majority of listed companies that responded also stated that their EBT is used as a warehouse to hold shares for the satisfaction of awards and options.

Reasons for implementing plans

3.18 In face to face meetings, a common response to the question "Why do you operate unapproved share plans" was, simply, "because we cannot operate tax-advantaged plans". While this was not covered in the online survey, it was referred to in some of the comments submitted. It is likely that certain companies would like to take advantage of tax-advantaged plans, but are prevented from doing so because of their size, ownership structure or other reasons excluding them from operating a plan. In some cases – in particular in relation to the Company Share Option Plan (CSOP) – companies suggested that the tax advantages were outweighed by the complexity of establishing and administering the plan.

Box 3.A: Comment

> "Our share option scheme has no tax advantages, which is seen as a major weakness but there are no suitable alternative schemes for our circumstances. So in effect the government is offering no support or encouragement to align staff and shareholder interests." (*Large private company with more than 1,000 employees and a turnover of more than £100m*)

3.19 Responses to our online survey suggested that around 25 per cent of companies that operated an unapproved plan did not have any approved plans in place. However, the remaining 75 per cent of companies operating unapproved plans also ran an approved plan. This suggests that, where possible, companies will take advantage of the tax-approved plans, generally in the context of all employee schemes.

3.20 We reported on the tax-advantaged (approved) share schemes in March:

http://www.hm-treasury.gov.uk/d/ots_share_schemes_060312.pdf

3.21 HMRC is currently consulting on how to implement many of our recommendations. This consultation closes on 18 September 2012:

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&propertyType=document&columns=1&id=HMCE_PROD1_032132

3.22 It may well be that in the process of thinking about the issues raised in this second study new insights emerge that are applicable to the tax-advantaged share schemes. We would

[3] The EBT can buy shares when a shareholder wishes (or is required) to sell their holdings and this prevents the shares being sold to a third party.

[4] An internal market is required in order for employees to find a willing buyer to sell their shares to (for example when they leave the company).

encourage people to send these in to us or, if they are relevant to the issues on which HMRC is consulting, to HMRC as part of its consultation.

3.23 The key reasons for companies operating share plans at all were:

- Retention and recruitment of key staff;
- Alignment of employees' interests with shareholders' interests; and
- To drive performance targets (whether corporate or individual).

3.24 Many companies also pointed to market practice and employee expectation as a reason for putting plans in place. A number of respondents used the comments box to mention that the design and necessary generosity of their plan prevented them from using an approved share plan.

3.25 Retention and recruitment of key staff and alignment of employees' interests with shareholders' interests were also the most commonly cited reasons by small and medium sized (SME) companies[5] and privately owned companies[6].

Tax driven plans and arrangements

3.26 Tax consequences are acknowledged as important by all plan users, but for most companies to whom we spoke it was more important to be clear as to the consequences – both for the company itself and for the employees – than to put in place a plan whose key driver was to minimise tax, or to obtain a particular tax break. For example, for global companies in particular we were told that retention of staff was of much greater importance than designing plans to create tax advantages across an international, and often internationally mobile, workforce.

3.27 That said, it would be naive to say that no tax planning is involved in the design and implementation of share plans. As illustrated in the timeline at Annex F, and as explored further in the following chapter, it is clear that considerable efforts have been put into designing plans which have particular tax consequences – usually that a larger proportion of the value delivered is subject to capital gains tax rather than income tax than might be expected by a lay observer. It is perhaps unsurprising that we have had few responses acknowledging that, in certain circumstances, companies and their advisers will design a plan with beneficial tax consequences playing a more important part than commercial drivers.

Private companies and listed companies

3.28 As noted above, smaller private companies – and in particular, close companies[7] – may have very different share based incentive arrangements from large listed companies. It is also true that the tax legislation affects private and close companies in particular ways which do not impact upon those whose shares are publicly traded.

3.29 Our report therefore looks at specific issues for private and family owned businesses, as well as areas of complexity that are common for all companies.

[5] "SME" here refers to businesses with fewer than 250 employees as, in this context, the number of employees is an appropriate measure of size. The EU definition of an SME also includes a limit on turnover and balance sheet of approximately £40 million. In our sample 85 per cent of those with fewer than 250 employees also had turnover below £40 million.

[6] 13 of the 15 respondents that used private company shares in their plan marked *"Alignment of employees' interests with shareholders' interests"* as a key reason for operating a share plan.

[7] A close company is one which is controlled by 5 or fewer participants, or under the control of any number of participators who are also directors, and those participators would receive more than 50 per cent of the company's assets on a winding up.

Areas of legislation under consideration

3.30 Our fact-finding exercise has identified certain key areas of tax legislation of concern to stakeholders. Evidently, these include Parts 7[8] and 7A[9] of ITEPA 2003; however, certain other areas of legislation have also been raised. Participants in the fact-finding exercises had concerns about inheritance tax, capital gains tax, income tax and National Insurance Contributions (NICs), all of which caused difficulty for them when establishing and running their share schemes. Specific legislation identified by participants includes:

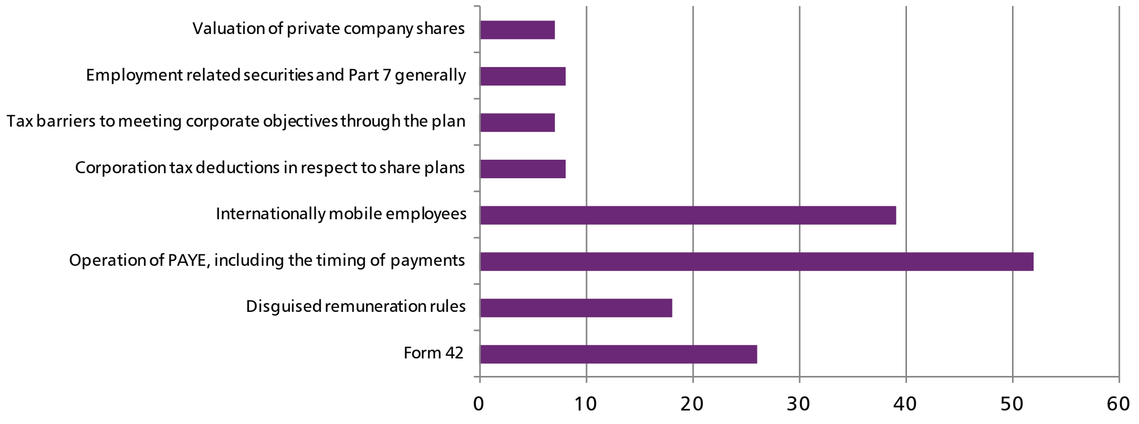
- Part 11 ITEPA 2003 (sections 696-702) (Pay As You Earn);
- Part 12 CTA 2009 (corporation tax relief for employee share acquisitions);
- Sections 438-468 CTA 2010 (rules relating to close companies); and
- IHTA 1984 (in particular sections 13, 86 and 94) (trusts for benefit of employees and close company rules).

3.31 It is worth noting that in total there are over 100 pages of primary legislation applicable to unapproved employee share schemes alone, supported by a huge body of supporting guidance and rules available from HMRC. To put this in context, shares for employees are essentially a benefit, in the same way as a company car is a benefit. Yet the primary legislation covering company cars, vans and fuel amounts to no more than 21 pages. A summary of the tax rules and guidance applicable to share schemes is set out at Annex C.

Key areas of complexity identified

3.32 The following graph summarises the number of times different areas of complexity were identified by all the companies (large and small) taking part in our online survey:

Chart 3.A: Areas of complexity for all companies



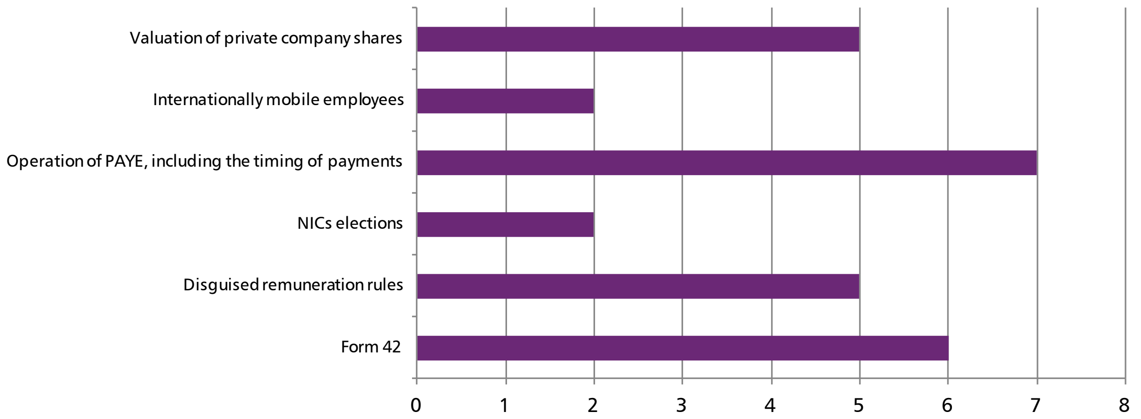
Source: OTS online survey

3.33 Unsurprisingly, smaller, unlisted companies tended to focus on different areas from the listed companies. The graph below represents the online feedback from companies with fewer than 250 employees with respect to areas of complexity:

[8] Employment income: income and exemptions relating to securities.

[9] Employment income provided through third parties.

Chart 3.B: Areas of complexity for companies with fewer than 250 employees



Source: OTS online survey

3.34 Our fact-finding exercise identified the following as key areas of complexity (broadly speaking, those areas identified by the greatest number of participants appear highest on the list):

- PAYE penalties and deadlines[10];
- Difficulties with valuation of private company shares;
- Part 7A ("disguised remuneration" rules);
- Form 42;
- Tax issues for employee benefit trusts (including inheritance tax issues and charges on loans to participators in a close company);
- The difficulty of obtaining clear and up to date guidance from HMRC on what is a very difficult and uncertain area of tax law;
- Managing internationally mobile employees; and
- Part 7 (employment related securities legislation).

Specific comments

3.35 The above is not an exhaustive list. There were a number of other points raised; including a frequently voiced concern that tax avoidance legislation was drafted far too widely, creating uncertainty for companies and their employees. This was felt to be the case particularly in the context of the use of employee benefit trusts (EBTs), which were widely viewed as useful, if not essential, tools in the establishment of employee share ownership arrangements. There was resentment from a number of people we spoke to that in their view all EBT arrangements were automatically viewed by HMRC as suspicious from a tax avoidance perspective, even when the reasons behind them were commercially driven[11]. It should be noted that HMRC share scheme specialists do not consider this to be the case; their view is that they fully understand that many EBTs are established for commercial, not tax avoidance reasons. Nonetheless, as noted above, this Chapter seeks only to report back on participants' perception of the position.

[10] Including section 222 ITEPA 2003.

[11] Many respondents referred to "genuine" EBTs, meaning employee benefit trusts that had been set up to facilitate the transfer of shares into the hands of employees by way of a share plan whose aims were commercial rather than tax driven.

Box 3.B: Comment

> "It seems to me that the direction of travel (and, indeed, quantum of legislation) in the past 10 years ... has been unduly directed at suspected avoidance and non-compliance rather than facilitating adherence to the intention of statute ...Part 7A has recently added a further layer of complexity, albeit that most arrangements can be argued to fall within one of the statutory carve-outs." (*Large PLC with more than 1,000 employees and a turnover of more than £100m*)

3.36 In the case of certain areas of complexity, some participants voiced their views strongly. For example, Form 42 was variously described as "a monster", "a nightmare" and – constructively – "ripe for a technology based approach".

3.37 Some areas were not viewed as particularly complex, but rather raised what might be described as "low level grumbles". For example, while most companies and practitioners seemed reasonably comfortable with the application of section 431 elections[12], there was a general comment that the 14 day time limit for completion of the election following acquisition of the shares was too short.

3.38 Participants' feedback on guidance and support from HMRC was interesting and largely supportive. There was, however, a significant degree of concern about the damaging diminution of resources, particularly in connection with the Employee Share Schemes Unit (ESSU), in recent years. Many respondents referred to the reduction in staff numbers, particularly the loss of a number of very experienced share schemes advisers. One participant's words emphasised the overall view: "Please pass on our thoughts on the catastrophe that has been visited on this department in the last few years [in terms of resources]"[13].

[12] An election made between employer and employee on the acquisition of restricted securities to calculate income tax as if the market value of the shares at the time of the acquisition was calculated completely ignoring the fact that the shares are restricted.

[13] If this comment seems to involve strong language, it must be appreciated that respondents clearly value the guidance provided by ESSU, feel such guidance (even if it is more than required by legislation) is much needed by the complexity of the rules; and believe that ESSU needs more resources.

4 Share schemes and the tax system: the key principles

4.1 This chapter lays out the key principles behind the taxation of unapproved share plans. More detailed and technical points are covered in Chapters 5 and 6.

4.2 The legislation relating to employee share plans is complex in part because it has been built up on a piecemeal basis to counteract avoidance (see Annex F for a timeline of how the legislation has developed).

4.3 Broadly speaking, the legislation has been put in place in order to differentiate between a reward for employment, and investment appreciation (i.e. the value obtained from genuine commercial growth in the value of shares). It can be very difficult to draw a line between the two – but differentiation is of fundamental importance because of the different tax treatment applying either side of that line, with the growth in value of shares liable either to income tax[1] if shares are treated as employment related securities, or to capital gains tax otherwise.

4.4 For some years the top rate of income tax (currently 50 per cent) has been significantly higher than the top rate of capital gains tax (currently 28 per cent). Capital gains tax also provides a useful annual exemption. This difference in rates has provided incentives for share based remuneration to be structured such that any increase in value is taxable as gains and not income. In addition, the value attributed to employment related securities is usually liable to NICs as well as income tax. The employer NICs charge (currently 13.8 per cent) represents an additional cost to business, unless the cost can be passed on to employees by way of agreement or election on the exercise of options or awards of shares, as is the case in some circumstances[2].

4.5 Over the years there have been many attempts to devise schemes that result in much of the value delivered to the employee being taxed as a capital gain rather than as income. In turn, anti-avoidance legislation has tried to police such schemes and ensure the income/capital gain split is fair. Examples include the creation of shares with artificial restrictions so as to reduce significantly the monetary value on award which is subject to income tax; when the restrictions are removed, the value significantly increases, with any gain subject to CGT. Targeting such arrangements has resulted in a very complex employment related securities regime (part 7, ITEPA 2003) – particularly restricted shares (Chapter 2) and convertible shares (Chapter 3).

4.6 The sections below set out a broad summary of the particular areas of tax legislation which govern how companies design, implement and administer their unapproved share plans.

Income tax and NICs

General principles

4.7 The treatment of remuneration delivered by the employer through shares follows the main principles that apply to other forms of remuneration such as cash and benefits.

[1] The amount chargeable to income tax is normally also subject to NICs. For simplicity, references to income tax in this and succeeding chapters should be taken as including NICs unless otherwise stated.

[2] The legislation permitting such transfer is set out in ITEPA 2003 sections 481, 428A, 442A and SSCBA 1992 Schedule 1 paragraphs 3A and 3B.

4.8 The general principle is that when an employee receives something of value from their employment they are liable to income tax on that value. On the face of it this is a consistent approach applied to all forms of remuneration whether cash or non-cash based.

4.9 Cash remuneration is straightforward for a number of reasons. Firstly the employer has no strategic interest in how the cash payment is used by the employee once it is paid. Secondly, the taxing event is usually when the employee receives the money and the value taxed is the amount of money they receive. This makes it easy for employers to discharge their obligation to operate PAYE and NICs by simply deducting this when making the payment to the employee. It is also easy for employees to understand.

Share based remuneration

4.10 The taxation of share based remuneration causes difficulties for various reasons.

Inconsistency with company objectives

4.11 One of the main objectives of share-based remuneration is to align the interests of employees and shareholders through the employees holding shares for the longer term. However, general tax principles mean that when an employee receives actual shares from his employer, the monetary value is liable to income tax at the time of award.

4.12 This tax charge is, however, independent of whether the employee chooses to sell some or all of the shares to realise their value. It may be that the employee has to sell some shares to pay the tax bill, thus pulling against the company objective of encouraging long-term share ownership.

Valuation and liquidity

4.13 Secondly, there is an issue of valuation for tax purposes. The immediate problem is: what are the shares worth? This can result in different issues for quoted shares and unquoted shares. For unquoted shares, or any shares with restrictions or other conditions on them, this creates valuation problems.

4.14 If the shares have a positive monetary value, this will be liable to income tax even when there is no market in the shares. Similarly, tax will be due in circumstances where there is a market but a restriction on sale has been imposed as a condition of the award. This moves into two subsets of the problem:

- that of liquidity or establishing a market; and
- the way a tax charge is created when there is no cash to meet the liability from the instrument that has created the charge.

4.15 It may well be that the employee has other resources – sometimes ample – out of which to meet the tax bill. However, the cash flow problem does exist.

4.16 This problem is exacerbated if the share is a readily convertible asset: if that is the case, the employer is required to operate PAYE and NICs on the monetary value in the same way as for cash remuneration, even though the employer has nothing to deduct the tax from. A further charge may arise in the event that the employer is unable to recover the tax accounted for through PAYE within 90 days of the acquisition of the share, even if this money is subsequently recovered.

4.17 There are valuation issues for quoted companies as well. The most common issue is determining when the beneficial ownership of the shares transfers to employees, particularly in the context of the exercise of share options, and whether the shares acquired are existing or newly issued shares. This is the point when the tax charge arises and the point at which the shares have to be valued. Secondly, a special regime can apply to cashless exercises where the shares can be valued using the actual share price per security sold for the purposes of covering the PAYE liability, provided the sale occurred on the date of exercise or the following day. This is a welcome relaxation but a sale of shares in this time frame may be difficult in practice.

Employment related securities rules

4.18 Thirdly, in addition to the general earnings charge that may or may not apply to shares as it does for cash remuneration, the complex employment related securities rules[3], also apply. The special rules apply in different ways depending on how awards are structured. There is a very large body of legislation, case law and guidance relevant to employee share schemes (see Annex C), and a significant amount of detailed terminology used to convey the meaning in this area (see Annex B). As well as the difficulty in understanding and applying these rules there is also the issue of the interaction between these and the general earnings charge, should this also apply.

4.19 Furthermore, this special regime has its own reporting obligations, which require taxpayers to complete Form 42[4]. This has been identified by many participants as a significant administrative burden. Questions were often raised with the OTS over how HMRC uses the information on the form and what value it provides to HMRC. This led participants to question whether this justifies the burden on companies. The OTS will discuss this with HMRC in the next stage of our work.

Restrictions and changes in valuation

4.20 Fourthly, an essential characteristic of a share is that its value goes up and down with the commercial value of the underlying company. Share plans often involve a series of events, e.g. award, vesting, exercise, etc. which occur during a typical share plan cycle of, say, three years. There will be movement in the share price over the period and it will be necessary to determine if any increase in value should be considered to be as a reward for services over the period or growth in the value of an asset. The purpose of the employment related securities rules is to distinguish between reward delivered through the use of shares or securities (which should be subject to income tax and national insurance, like other methods of reward) and genuine commercial growth on shares acquired by an employee as an investor. So if an employee has made full payment for the shares, or has suffered income tax on securities acquired for less than market value, he or she should, like anyone else, be subject only to capital gains tax on the ongoing growth.

4.21 In other words, there should be income tax on employment income, but capital gains tax on benefits that an ordinary investor would get, irrespective of whether they are employed by the company or not.

4.22 Complications arise, however, when employees acquire shares that are subject to restrictions that may reduce the value of the share on acquisition. When an employee acquires shares that are subject to such restrictions, and those shares have a lower monetary value than would otherwise be the case, this can result in a lower income tax charge on acquisition with the subsequent growth taxable under the beneficial capital gains tax regime.

4.23 As a result of perceived abuse the restricted securities regime[5] was introduced. The rules are very complex and can result in multiple income tax charges over time as value crystallises; this is in order to capture the relevant proportion of the increase in value of the shares on each chargeable event and charge this to income tax though it was noted that in the majority of cases there would be up to two taxable events, one on the acquisition of the security and on one subsequent chargeable event.

[3] Part 7, ITEPA 2003

[4] Section 421J ITEPA 2003

[5] Part 7 ITEPA 2003, Chapter 2

4.24 Even in the absence of tax avoidance, it should be recognised that the rules will be complicated because restricted shares are themselves a complicated asset.

Differences between domestic and internationally mobile employees

4.25 Lastly, the company may structure an award as a promise to acquire shares in the future or a formal share option arrangement either at nil cost or for the market value of the shares at the time of grant. The taxation of these arrangements can be particularly problematic for internationally mobile employees. The tax rules that apply to charges under Part 7 are different in a number of key respects to the rules applying to cash earnings and benefits, and one particular area of difference is how the charge is affected by the employee's residence. This misalignment of treatment of earnings and share based income causes difficulties for many companies operating globally mobile workforces. For more details and examples, see Chapter 5.

4.26 This area of complexity has been exacerbated as a result of the considerable change in the rules over recent years. There were significant changes to the rules on residence in FA 2008 which increased the complexity of the employment related securities regime and there is a consultation[6] and further changes proposed from April 2013.

Corporation tax

4.27 Employers want to encourage employee shareholding for good commercial reasons and there are rules designed to allow relief for employers from corporation tax at the time that the employee accesses the value and in the same amount that is charged to income tax, providing the shares meet the qualifying conditions. Since 2003 this has been a statutory deduction that applies on the same basis, whatever way the employing company chooses to structure and fund the employee share scheme. From this standpoint it is irrelevant whether a trust is used as part of the scheme, whether new shares are issued or whether existing shares are purchased in the market.

4.28 The corporation tax regime for employee share schemes is considerably more straightforward as a result and is generally supportive of all companies with employee share schemes as there is certainty and it is no longer necessary to put complex structures in place to obtain a corporation tax deduction. However, there can be situations – particularly when a company comes under the control of an unlisted company – when the corporation tax relief can be lost or is simply not available.

Employee benefit trusts (EBTs)

4.29 The shares may be made available by the employing company setting up a trust – usually termed an employee benefit trust (EBT) – and providing for shares to be transferred via the trust. The use of an EBT can be of significant practical benefit to companies – as noted in Chapter 3, a key benefit is to provide a market or warehouse for shares for private companies where no other ready market exists; for a listed company, the use of issued shares in an EBT can assist with dilution[7] and headroom issues. Chapter 5 of *The Nuttall Review* provides further expert analysis on the practical uses of EBTs, including the difficulties of creating an internal share market in a private company where no EBT is in place.[8] The company may contribute or loan funds to the EBT, which will have corporation tax implications, particularly in relation to the timing of the corporation tax deduction.

[6] Statutory definition of tax residence and reform of ordinary residence. Latest update 21 June 2012, summary of responses (and further consultation).

[7] The reduction in percentage terms of the holdings of existing shareholders when new shares are issued. For an EBT this is mitigated because it can acquire shares from existing shareholders who want to sell or from the stock market.

[8] *The Nuttall Review*, paragraphs 5.6 – 5.12 and 5.32 – 5.39

4.30 The EBT itself may be liable to inheritance tax charges that apply to the value of property in discretionary trusts. Provided that the property in a trust meets certain conditions[9], it is not considered to be relevant property for this purpose.

4.31 An EBT is normally a third party and is within the scope of Part 7A of ITEPA 2003 ("disguised remuneration" rules).

4.32 It is usual for EBTs to be located offshore. This is to avoid the double taxation charge outlined in Chapter 3.

Overall conclusion

4.33 As identified by many of the contributors to this interim report, a large majority of companies implementing share plans are doing so for genuine commercial reasons, rather than tax avoidance motives. Unfortunately for them, this is undoubtedly an area where avoidance has been prevalent and so anti-avoidance legislation is significant, meaning there are many traps to be negotiated. Many of those responding to the OTS did comment that there seems to be an assumption that an unapproved share plan – especially if it involves an EBT – is set up solely for avoidance reasons.

[9] Section 86 IHTA 1984

5 Areas of complexity for all companies

PAYE deadlines[1]

5.1 Where a charge to income tax arises in relation to the acquisition of shares in connection with employment, the employer is required to operate PAYE if the shares are readily convertible assets. This gives rise to particular complications which do not apply to straightforward payments of salary, and increases the likelihood of companies missing PAYE deadlines and being subject to penalties, not because of any failure on their part, but simply because the processes and procedures are so much more complex than for cash payments.

5.2 The employer is treated as making a notional payment of PAYE income on the relevant date and must calculate the amount of tax that should be accounted for, notify HMRC of this amount and pay this over at the same time as the PAYE deducted from cash remuneration for the month[2]. The notional payment does not involve the transfer of money, so the employer is unable to deduct tax from the payment in the usual manner but instead should deduct tax from pay paid in the same month as the notional payment. If the amount deducted is insufficient to enable the employer to pay the full amount of tax, the employer must account for the balance. A failure to operate PAYE correctly is potentially liable to penalties if this constitutes a failure to take reasonable care. Also, if the PAYE is remitted late this could attract a late payment penalty of up to 5 per cent of the amount paid late.

5.3 Furthermore, if the employee has not "made good" the balance paid by the employer within 90 days of the event giving rise to the notional payment, then a further liability arises under section 222 ITEPA 2003. The section 222 charge is reported as a benefit in kind of the employee on form P11D; he is liable to income tax on this "benefit" and class 1 NICs are also due from the employer via the payroll. Failure to account for the NICs would constitute a PAYE failure and be subject to penalties. Crucially, there is no reduction in the charge if the amount is subsequently made good.

1 Many companies/advisers have described the main deadline for operation of PAYE in relation to share schemes as "impossible" – particularly PLCs where large numbers of employees, on different payrolls, exercise options at the same time. Another difficulty noted by a number of participants was the position when options vest and are exercised at a company's year end which happens (not infrequently) to fall in March. There are a number of reasons why companies find this problematic, particularly in the context of international assignees. Firstly, share acquisitions occurring after the payroll cut-off date (typically mid-month) would usually be processed in the next available payroll with the result that PAYE would be operated and remitted to HMRC one month late and subject to late payment penalties. There was evidence that companies found this a particular issue in March and had to make manual adjustments to ensure share transactions were processed in the correct tax year.

[1] Including section 22 ITEPA 2003

[2] i.e. 14 days after the end of the tax month, which end on the 5th.

2 Secondly, certain practical and administrative steps must be followed to enable PAYE to be satisfied out of shares sold on behalf of the employee by the administrator. The time required for this process does not permit the PAYE to be operated and remitted to HMRC by the deadline. We reproduce the following comments made by a well-known share plan administrator which sets out a typical process and explains the difficulties of meeting the PAYE deadlines:

Box 5.A: Comment

"This deadline [should we say which deadline for clarity?] is problematic for administrators and plan issuer companies of tax-approved and unapproved plans alike, given the monthly plan issuer payroll cut-offs and processing deadlines and the timing of notification of leavers to administrators. Furthermore, any offer of choice to participants regarding how to fund the tax liability on their shares exiting the plans (i.e. self-fund, sell to cover, sell all), pushes administrators, participants and plan issuers even further outside the 30 day deadline. Restricting participants' choice, for example by defaulting to a 'sell all' instruction, may force individuals to take a capital loss in certain circumstances, does not bring the process within the 30 days, and is contrary to the spirit and purpose of share plans as a driver for greater distribution of capital and broader share ownership."

3 Thirdly, the administration process also includes the identification of the correct tax rate to be applied to the taxable value of the shares, so as to determine how many shares have to be sold to fund the tax. This has been more problematic since the introduction of the additional rate of tax (currently 50 per cent). Companies tend to apply the highest possible tax rate to mitigate any risk of under-withholding and sell the maximum number of shares. This is directly contrary to the objective of giving employees shares with the objective of long term shareholding. This is also the problem with the operation of the Zero T PAYE code, which must be operated where shares are provided to employees after leaving. This can result in more shares being sold and more income tax being paid over than is ultimately due for the year. It is worth noting that a special in year repayment process has been introduced by HMRC to make early repayment to individuals who have overpaid PAYE as a result of the application of the Zero T code.

4 Companies are also concerned about the implementation of Real Time Information (RTI,) compulsory from October 2013. Under the regulations there is an obligation for companies to make a report to HMRC "on or before" they make each payment of earnings to employees (including employment related securities). This seems impractical in relation to, for example, employees exercising options and creating a tax charge but the employer only becoming aware of the exercise a few days later.

5 Finally, during the course of this review we undertook a brief review of data from self assessment tax returns (SATR). There is no requirement for employers to provide information to employees about the extent to which share plan income is included on their P60 form. As a consequence, there is a risk that employees may report their gains in relation to share plans on their SATR when this is not actually required. There did appear to be some evidence of errors in this area (although the evidence was, admittedly, limited).

Part 7A of ITEPA 2003 – the "disguised remuneration" rules

5.4 Part 7A of ITEPA was introduced by Finance Act 2011 with the aim of "tackling arrangements involving trusts or other vehicles used to reward employees which seek to avoid or defer the payment of income tax or National Insurance Contributions (NICs)"[3].

5.5 Participants providing information to the OTS in various meetings were fully aware that the disguised remuneration rules were established to combat tax avoidance, particularly in relation to family benefit trusts, and the anti-avoidance principle was widely accepted. However, there were major concerns voiced by a majority of the businesses and advisers to whom we spoke that the legislation is so wide that it catches a huge variety of innocent arrangements, where tax avoidance was never in contemplation.

Bona fide employee benefit trusts (EBTs)

5.6 A common comment was that everyone in the field can easily differentiate a "genuine" commercial EBT from one that is set up purely for tax avoidance. Some participants felt that the proposed general anti-avoidance rule (GAAR) may help the position; others suggested the re-establishment of a statutory EBT, similar to the Qualifying Employee Share Trust, or QUEST (the statutory corporation tax deduction for contributions to a QUEST was withdrawn in 2003) which would provide a "safe haven" from the disguised remuneration rules without having to consider the complex exceptions.

5.7 There was understandable frustration that the introduction of the legislation had required businesses to spend considerable time and resources investigating their current arrangements, identifying areas where their share plan structures fell within the legislation, and then taking steps to ensure they were not caught by the rules. For example, companies were obliged to change their practices to ensure that information shared between administrators and trustees did not result in "earmarking". In some cases, it appears that the legislation has prevented companies from making commercial arrangements which would be in the best interests of shareholders and the company.

Box 5.B: Example

A private company found that having multiple employee shareholders resulted in increasingly complex administration and record keeping, and decided to establish an EBT to hold shares on behalf of its employees. The structure was broadly based on the John Lewis Partnership model, in that the trust would hold the shares in perpetuity. However, as a precaution, the company wanted to identify potential beneficiaries in the event that the trust should ever be wound up – although this was clearly not the intention. Identifying potential beneficiaries in this way constituted earmarking and would have resulted in an immediate tax charge. The company was prevented from establishing the trust.

Ongoing impact of the legislation

5.8 Most companies have now taken any necessary steps to deal with the impact on their existing arrangements. However, there continues to be a number of concerns about the legislation and its impact. These include:

[3] Source: Written Ministerial Statement, 9 December 2010: http://www.hmrc.gov.uk/budget-updates/autumn-tax/wms-aa.htm

- Changes and updates to share plan design and structure will require companies to check whether they fall within the legislation. This is an additional complication which is viewed as unnecessary in the context of standard commercial EBTs. Companies also resent the additional costs involved in terms of paying for tax and legal advice;

- Advisers are continuously coming across bona fide commercial arrangements which are not covered in the guidance, and which require additional investigation or clearance (see below), or exemptions which seem nonetheless to be caught;

- One adviser noted that his small firm alone had sought clearance on a number of transactions; he was concerned about the sustainability of effective clearance, on the basis that HMRC must be inundated with such enquiries;

- More than one adviser has noted that the new terminology used in Part 7A (e.g. "recognition", "award", "earmarking" and "for example") seems to be deliberately confusing in that it avoids using clearly recognised statutory language. Consequently, advisers and their clients will be subject to HMRC's interpretation of the legislation – or await clarification under case law. This adds uncertainty to an already complex piece of legislation; and

- Certain inconsistencies with Part 7 (e.g. exemption for family relationships).

Employment related securities – Part 7 ITEPA 2003

5.9 Part 7 has been in force for nearly ten years now but still causes difficulties, demonstrated in the following comment by Lord Walker during the *Grays Timber* case in 2010*:*

Box 5.C: Lord Walker

"I express the hope that Parliament may find time to review the complex and obscure provisions of Part 7 of ITEPA 2003" (*Grays Timber Products Ltd v HMRC (Scotland) [2010] UKSC 4*).

5.10 Comments made to the OTS have noted various technical points which still cause difficulties for companies when implementing unapproved share plans.

Definition of restricted shares

5.11 The restricted share regime set out in Chapter 2 of Part 7 was introduced to counteract arrangements which artificially reduced the market value of the shares on acquisition by attaching restrictions to the shares. This minimised the income tax paid on the value of the shares at acquisition, but ensured that, when the restrictions were removed and the market value of the shares increased, the resulting growth in value was subject to the more beneficial capital gains tax regime rather than income tax.

5.12 The rules relating to restricted shares are both complex and unpalatable. In the first instance, companies must identify whether their shares fall within the definition of "restricted securities". This is a two stage definition: the shares must be subject to a restriction imposed by a contract, agreement or arrangement, and that restriction must reduce the market value of the shares. There are broadly three types of restrictions:

- Forfeiture;

- Restriction on freedom to retain, dispose or exercise the rights associated with shares e.g. to vote or receive dividends; and

- Any other potential disadvantage afforded to a person with employment related securities.

5.13 Having identified whether the shares are "restricted" or not, employees may then choose to enter into an election to disapply the regime (section 431 election). This effectively disregards the effect on the value of the shares of any restrictions and ensures that income tax (and NICs, if applicable) is paid upfront on the unrestricted market value of the shares. If a section 431 election is not entered into, this can result in an income tax charge on the growth in value of shares after their acquisition instead of capital gains tax, where all or part of the growth is deemed to relate to the removal or variation in a restriction.

5.14 The issue identified was that private company shares are often subject to restrictions for good commercial reasons, rather than for any reasons of tax avoidance. It was sometimes difficult even to identify whether such restrictions brought the shares within the restricted shares regime at all. As a result, it is common practice for companies to "play it safe" and for their employees to enter into section 431 elections, just in case the shares fall within the regime. In some cases this is not even necessarily in connection with tax issues, but because of potential due diligence exercises in the situation of a future sale or acquisition of the company.

Share for share exchange and rollover provisions

5.15 There is an inconsistency in the legislation in relation to rollover provisions for the purposes of income tax in a share for share exchange situation. Rollover provisions exist in relation to Chapter 5 of Part 7 (options) but not for restricted securities under Chapter 2 or partly paid shares under Chapter 3C (all references to ITEPA 2003).

5.16 For example, if restricted shares in Company A are exchanged for restricted shares in Company B, there is an early crystallisation of the income tax charge, even if the new security is also subject to restrictions and the employee is unable to realise value by selling the shares.

5.17 Similarly, there is a position where there are no rollover provisions for partly paid or nil paid shares under Chapter 3C ITEPA. This can result in a tax charge being triggered on the disposal of such shares. Where the outstanding amount is paid back before the sale, or as part of the sale proceeds, the notional loan charge under Chapter 3C is treated as discharged. If, however, the outstanding amount is paid back later or over a period of time, a tax charge arises on the outstanding amount. There is no income tax relief to the extent the loan is subsequently repaid.

5.18 This can put employee shareholders whose share plan happens to involve the use of nil or partly paid shares in a significantly different tax position from other shareholders.

5.19 This occurs not only in sale situations but also when internal reorganisations are undertaken for purely commercial reasons. It puts employee shareholders in a completely different tax position from non-employee shareholders, who will generally not face an immediate capital gains tax charge in these circumstances. It also differentiates them from other employees who may hold unapproved share options, which can be rolled over without tax consequences and still be subject to vesting conditions.

Phantom options

5.20 Other examples of confusion in connection with the employment related securities legislation included the difficulty of differentiating between a phantom option (taxed as a bonus) and a contract for differences, which is considered as a security within Chapter 2 of the legislation.

Chapter 3D (shares disposed of at more than market value)

5.21 This is closely connected with the difficulties relating to valuation of private companies' shares. Private companies' articles frequently exclude a discount for minority shareholdings. This is a commercial approach reflecting the fact that, on a sale, all shareholders will receive the same amount irrespective of their holding. However, HMRC's Shares & Assets Valuation will apply a discount when determining the market value. In circumstances where a company is buying back shares from an employee, for example in a leaver situation, the price paid by the company may therefore exceed HMRC's share valuation, and income tax could arise under Chapter 3D.

Form 42

5.22 Form 42 requires companies to notify HMRC of any actions taken during the operation of their unapproved share plans. The form must be completed and returned annually to HMRC.

5.23 In our survey of companies there was a considerable amount of negative comment on this form. The key points raised were as follows:

- The form was a significant administrative burden, particularly as it is paper based;
- Companies did not understand what the form was used for and felt it was unreasonable for HMRC to place such an administrative burden on companies without transparency as to its use;
- The complex language of the form meant that companies needed to pay advisers to help them complete it; and
- Companies questioned the necessity of completing the form when no activities or taxable events had occurred.

5.24 In more detail, the comments included:

1. There was a query as to why information should be reported when **no taxable event** had occurred. This includes situations where the event in itself is not taxable, although a taxable event may occur in the future, e.g. in the case of the grant of an option – although it is very rare that tax arises on option grants and indeed many grants, once made, may lapse later in their life without ever incurring a tax charge if their performance conditions are not met. The form also requires the reporting of events where a tax event will never actually arise, e.g. when shares are acquired at full market value. One administrator noted that they had not observed HMRC ever using this information for any of its published plan statistics, unlike the all employee plans which are analysed and reported on widely. The administrator suggested the complete removal of section 1a from the Form;
2. The **terminology** on the form is difficult to understand, in that businesses cannot easily identify what section their grants or awards should fall into, particularly for less standard transactions. For example one administrator reported a client filling in every section for one option grant because they did not know which section they should use. Some advisers thought that using commercial terminology rather than tax terminology might be of help – e.g. grant of market value options; grant of nil cost options; award of shares; award of growth shares;
3. **Paper-based reporting** on individual grants/awards is unwieldy and can be very onerous. Businesses reported spreadsheets with up to 20 separate tabs of information; one business told us their Form 42 ran to 1,200 pages;
4. **Lack of clarity as to when events do not need to be reported**. For example, technically shares bought by employees at market value must be reported. In practice, many companies do not actually report such an event (many of them

simply do not realise that they are required to do so). The equivalent form in Ireland does not require such an event to be reported;

5 Clients did not believe some of the information could be **effectively tracked by HMRC**. For example, where individuals are provided with matching shares or a plan provides a dividend equivalent, it is not possible to link the amount of shares awarded at the outset with those eventually vesting. Furthermore, in such situations it is unclear at which point dividend equivalents or similar matching shares should be reported; and

6 There is a helpful "**summary of activity" section** on Form 35 (used to report CSOP grants), but this section is not replicated on Form 42. This is in spite of the fact that in many circumstances unapproved options granted in parallel to approved options are reported on at the same time, albeit on separate tax return forms. In practical terms it would be helpful for both plan issuer companies and plan administrators to have a section on Form 42 where activity may be summarised as this will aid the checking process and accuracy of submissions to HMRC.

5.25 Based on feedback at the OTS meetings, Form 42 was acceptable only to a small proportion of companies. These are ones which were large enough to have the proper systems to automate completion, yet did not have a sufficiently large number of employees to make completion unwieldy.

Internationally mobile employees

5.26 As noted at Chapter 4 above, companies with internationally mobile employees face a number of specific difficulties arising out of their tax treatment. A key issue is that the tax rules that apply to charges under Part 7 are different in a number of fundamental respects to the rules applying to cash earnings and benefits, particularly in connection with the effect on the charge of a change of residence.

The tax charge on earnings, and on employment income from securities

5.27 The rules for earnings (previously referred to as emoluments) were originally charged under what was section 19(1) ICTA 1988. For the earnings to be chargeable to tax, they must have fallen within one of the three cases of Schedule E, each of which was defined with reference to residence[4]. The rules on earnings also provided that if the earnings were earned in, or in respect of, a particular period they were earnings for the period (the "earnings period"). This meant that if there was a change in the employee's residence position during the earnings period, the earnings would be apportioned between the relevant cases of Schedule E and taxed accordingly. Taxable benefits and many other payments and expenses that are not in themselves "earnings" (for example, company cars) are treated as earnings and ultimately taxed under the same charging provision.

5.28 The special tax rules for employment-related securities (now in Part 7) do not treat employment related securities as earnings; instead they fall under an entirely independent charge. Historically, the previous equivalents to Part 7 – principally sections 135 and 140A-C of ICTA 1988 – were not subject to the residence conditions set out in the three Cases of Schedule E in respect of an earnings period, but instead relied on residence status at acquisition of the share or option; the employee had to be chargeable under Case I of Schedule E in respect of the employment at the time of acquisition. The apportionment rules relating to earnings do not

[4] Case I: resident and ordinarily resident; Case II: not resident or if resident but not ordinarily resident; Case III: resident whether or not ordinarily resident.

apply – or rather, they do not always apply: there are some exceptions which cause further complications and which are covered below.

5.29 After the sections in ICTA 1988 on income tax on earnings and pension were rewritten in 2003 into ITEPA, this distinction remained. Earnings were "general earnings" (section 62) and subject to the residence conditions (for earnings) set out in Part 2 of ITEPA (Employment Income: Charge to Tax) under Chapters 4 (Taxable Earnings: UK Resident Employees) and 5 (Taxable Earnings: Remittance Basis Rules and Rules for Non-UK Resident Employees). In contrast, Part 7 income was "specific employment income". Earnings continued to be taxed with reference to the residence position over the earnings period and Part 7 income with reference to residence position on the date shares or options were acquired. Essentially Part 7 is an all or nothing charge (although it can be reduced to prevent double taxation) whereas the earnings charge is apportioned.

5.30 There was an additional complication before 6 April 2008, since options granted or shares acquired by employees who were resident but not ordinarily resident on the relevant date did not fall within the charges under Chapters 5 or 2 of Part 7. There was, however, an alternative charge under Chapter 3C that treated any undervalue as a notional loan and, on the eventual sale of shares, the discharge of the notional loan. This charge did apply to individuals not ordinarily resident.

Implications

5.31 The tax charge is dependent on the employee's residence status on the date of the grant of the option or the acquisition of shares which could be subject to a Chapter 2 charge. There is no apportionment as is the case for earnings. This means that the tax treatment is particularly sensitive to the employee's residence position, and there is real scope to significantly reduce the tax charge by moving the date of grant from a period of residence to a period of non residence. This can result in the following:

- Extension of the Chapter 3C charge where an option is granted whilst the employee is not resident but "in contemplation" of UK duties;
- Split year residence does not apply to the Chapter 3C charge. This means that any gain made on the exercise of share options granted in the tax year in which an employee leaves the UK (and ceases to be UK tax resident) will be chargeable to income tax irrespective of whether it was granted before or after he left the UK. It is possible to split the tax year in all other respects; and
- The NICs rules[5] follow the tax rules in Part 7. This means that UK NICs can be due on any gain made on the exercise of an option granted whilst in the UK, even if the employee is not within UK NICs at the time of exercise. The rules are complex but depend on the country in which the individual is insured at the time of exercise.

Difference in residence rules

5.32 As a result, an individual could be resident in the UK at the grant and exercise of a share option but not be liable to income tax on any of the gain on exercise of the share option if they were not ordinarily resident at the time of grant. Had this been a cash bonus paid in respect of a three year earnings period, the whole of the payment would be taxed (subject to a deduction for non UK work days over the period). So a number of things happened to try and plug the gap:

- The Chapter 3C charge was used to charge tax on this circumstance by treating the acquisition of the shares at an undervalue as a notional loan. The eventual sale of

[5] Section 4 SSCBA

the shares was treated as a taxable discharge of the loan. The origins of the Chapter 3C charge were the beneficial loan rules and the charge was treated as earnings, so there was no need to distinguish between employees who were resident or those not ordinarily resident;

- A distinction is made between the tax treatment of legal options and other securities options[6]. In HMRC's view, other securities options (e.g. Restricted Stock Units or RSUs) are not within Chapter 5 and are therefore taxable as earnings if the employee is resident on exercise. Companies, however, see RSUs as essentially the same as share options, and so wonder why the tax treatment is different; and
- The different treatment is brought into sharp focus because of the potential interaction between Chapter 5, Chapter 3C and the general earnings charge. This is illustrated by the example below:

Box 5.D: Example

The Part 7 tax charge under Chapter 5 (securities options) takes precedence over the general earnings charge. The tax charge arises on a gain made on the exercise of the securities option, but the residence condition is applied on the date of grant of the option.

Employee A is resident in the UK on exercise and has been so resident for the last two years. However, he was not resident in the UK three years ago on the date of grant. Therefore he is not chargeable to tax on the gain under Chapter 5. Thus if Chapter 5 applies (e.g. in the case of a nil cost option), there will be no charge under it and – since this charge takes precedence over the general earnings charge – then the gain is not chargeable to UK tax, even though the employee is resident in the UK in the year of exercise.

If, however, Chapter 5 does not apply (e.g. in the case of a Restricted Stock Unit), there will be an income tax charge under the money's worth principle on the acquisition of shares at undervalue. The charge will be equal to the monetary value of the shares to the employee (i.e. what he can get for them less what he paid for them) which constitutes earnings. Under the earnings charge, earnings are apportioned over the earnings period (the period between grant and exercise) and in this case two-thirds of the monetary value of the shares is liable to income tax.

Further complications and changes in the legislation

5.33 From 6 April 2008, the distinction between residence and ordinary residence was removed from the charging provision and replaced by a deduction for overseas earnings (determined with reference to the period to which the earnings related) on a remittance basis. Rules were introduced to give effect to these reliefs for earnings. The effect of this for Part 7 income was that all UK resident employees at the time options were granted (irrespective of whether they were ordinarily resident at that time) were in scope of Chapter 2 or 5. However, as Part 7 income was not earnings, the relevant clauses on the deduction and remittance basis for earnings did not apply, so Chapter 5A, Part 2, ITEPA had to be enacted to give effect to this relief on the Part 7 charge only.

5.34 Now the charge is determined based on the employee's residence position at grant, unless the employee was not ordinary resident at that time, in which case the gain is apportioned over the relevant period (typically the period between grant and exercise) to calculate the relief.

[6] ERSM 70410

Specific issues arising

5.35 Companies and groups that we spoke to brought up some specific issues which they faced as a consequence of this mismatch in the legislation between earnings and income from securities. These included:

The difficulty of tracking leavers

5.36 Leavers who still hold shares and move internationally are very difficult to track. Any gain made on the exercise of share options by an individual not resident in the UK, but granted whilst UK tax resident, remains fully liable to UK tax, subject to relief under a double tax treaty for the part of the gain relating to the number of work days in the period of non-residence between grant and vesting of the option. The UK employer remains responsible for the operation of PAYE on the exercise of any such option. There is certainty in relation to the tax charge but acknowledgement that this is difficult to do from a practical perspective. Companies also reported difficulties in interpreting and applying the rules as to whether an option was granted in contemplation of a UK employment.

Box 5.E: Example

An example of a situation where HMRC would maintain that the grant of an option was in respect of UK duties would be where an employee is on a two year secondment to the US. Half way through year two he is granted a three year option when he knows he is returning to the UK. The exercise of that option in the UK is likely to incur liability under Chapter 3C because, at the time of grant, it was known that there would be two and a half out of three years' work in the UK to "earn" those shares.

A contrary scenario might involve a US citizen who receives his regular share option on, say, 1 January. Two months later he is invited to go on secondment to the UK. In those circumstances, where the employee has no prior knowledge of the secondment, HMRC will not seek to charge under Chapter 3C.

NICs treatment of gains

5.37 The NICs treatment of a gain made on the exercise of an option follows the same principle as income tax. Where there is a charge on exercise by virtue of an option being granted whilst UK resident, there is a class 1 NICs charge[7]. For NICs purposes, the whole of the gain is sourced to the UK and liable to UK NICs, with no apportionment allowed – even if at the time the option is exercised the employee is no longer working in the UK – or indeed has been resident elsewhere for almost the whole duration of the exercise period.

Internationally mobile employees

5.38 Tax treatment of internationally mobile employees under Chapter 3C. Chapter 3C is used to charge income tax on gains made on the exercise of an option when the securities option rules in Chapter 5 do not apply to internationally mobile employees. Confusion arises out of a number of issues, largely to do with the clear identification of the definition and meaning of a "legal" option. So, for example, it is unclear whether the award of a Restricted Stock Unit to an individual in the US, who subsequently moved to the UK, would be taxed as an option under Chapter 3C or Chapter 5, or as a bonus under the general income tax charge, or fall outside the UK tax regime altogether. There is no clear guidance from HMRC, and opinions vary widely among the advisers.

[7] Section 4 SSCBA 1992

5.39 Apart from the inherent uncertainty arising out of such complexity, there can also be unfairness. For example, an election for the employee to pay the employers' NICs liability can only be made if tax is charged under the employment related securities regime, rather than under a general charge. Therefore, depending purely on the view taken – which, as explained above will vary hugely – some individuals will pay employers' NICs on their equity based rewards, while others will not.

5.40 Taking the example of nil cost options versus RSUs, therefore, a nil cost option will allow the transfer of NICs to the employee, but an RSU or promise to get shares in the future will not. This leaves the company with an unknown, uncapped employer's NICs liability – the precise reason why the ability to transfer such NICs to the employee was introduced.

Change of control issues

5.41 There can be issues for companies where the corporation tax deduction is lost on a cash earnout or on a change of control. There is also a degree of uncertainty relating to the payment of NICs on share options exercised following a business transfer, when the previous employer may be liable for PAYE, but the new employer may be required to account for NICs.

Miscellaneous

5.42 Participants identified a number of other areas which caused confusion and difficulty. These included, but were not limited to:

- Employment losses relief and a clawback on vested options;
- Close period exemption unavailable for unapproved schemes;
- Untidy legislative references (in particular in connection with inheritance tax and capital gains tax); and
- Whether or not stamp duty paid on behalf of an employee is a "benefit in kind".

6 Areas of complexity for private companies

6.1 Meetings with advisers of private and close companies, and private companies' responses to our online survey, identified some specific areas of difficulty for private and close companies in the establishment and running of their unapproved share plans.

Valuation of private company shares

6.2 By far the most difficult area for private companies operating share schemes – and even for those simply gifting or transferring shares to an individual employee – is how to value their shares for tax purposes. This is clearly fundamental to the taxation of such shareholdings, but is so fraught with difficulty that the tax consequences of putting in place a share plan can be, for many private companies and their employees, almost a totally unknown quantity.

6.3 In the first instance, valuing shares which are not listed on the open market for tax purposes necessarily causes difficulties. Valuation, as has often been remarked, is an art not a science. There are numerous approaches to valuing private company shares, depending, among other things, on the company's sector, its position in the business life cycle and the performance of listed "comparator companies" (which may in fact not exist, or may be so very different from the private company as to bear no comparison).

6.4 Essentially, however, placing a tax value on private company shares is almost meaningless in terms of what shareholders may actually receive for their shares. Firstly, the shares are illiquid (see section on readily convertible assets below) so that until a buyer is available they are in effect worth nothing; secondly, should a buyer become available, the shares are worth what s/he will pay for them – irrespective of the tax value placed upon them previously. To all intents and purposes, the tax value is a fictional value which may bear no resemblance to the actual value of the share when (if) it is ever sold.

6.5 Added to this, the employment related securities legislation requires companies not only to ascertain the actual market value of the shares – i.e. taking into account the possible reduction in their value caused by restrictions contained within the articles or any shareholders' agreement in existence – but also to value the unrestricted market value of those shares, ignoring the effect of any such restrictions.

6.6 Separately from such restrictions is the likelihood that, if an employee is to hold only a small number of shares in a company, a discount may be placed upon those shares to reflect the fact that they are a minority shareholding. Should the company be sold to a third party, the minority shareholders will receive the same price for each of their shares as the other shareholders. The minority shareholding discount is, in commercial reality, little more than a fiction – but a dangerous fiction, because in this situation, the minority shareholder receiving the pro rata value for his shares will suffer a charge to income tax on the "excess" above the minority shareholding basis of valuation.[1]

6.7 Valuation of private company shares is, of itself, difficult. For the purposes of unapproved arrangements, it is made more so by the inability of private companies to agree a valuation of

[1] Chapter 3D, Part 7 ITEPA 2003

their shares with HMRC Shares and Assets Valuation (SAV) before a transaction (e.g. before the grant of options). For options granted under an Enterprise Management Investment scheme (EMI), SAV will provide a valuation for tax purposes prior to the grant of options.

6.8 The non-availability of a pre-transaction value for unapproved arrangements has a number of consequences for private companies seeking to provide equity incentives for their employees:

- Uncertainty about the likely income tax charge on employees (and the NICs charges, should the shares be deemed readily convertible assets – see below);
- Difficulty in identifying Actual Market Value and Unrestricted Market Value when shares are restricted;
- Difficulty in calculation of income tax (and NICs, if appropriate) where an earnout is contemplated; and
- Inability to communicate clearly to employees their likely tax position (lack of clarity tends to reduce the motivational aspects of equity based incentives).

Uncertainty with regard to readily convertible assets (RCAs)[2]

6.9 There are two key issues that arise with RCAs:

- PAYE must be operated on shares if they are deemed to be RCAs; and
- NICs are normally chargeable.

Defining RCAs

6.10 The definition of RCAs is very widely drawn. This is understandable, given the provision's basis in anti-avoidance. It includes situations where there is a market for the shares at the time they are provided; but also if trading arrangements are likely to come in to existence in accordance with any existing understanding. There are trading arrangements whenever arrangements which would enable a person to obtain an amount of money for the shares that is, or is likely to be, similar to the expense incurred in the provision of the shares. The rules on trading arrangements were introduced to counter avoidance activity in relation to commodities such as platinum sponge provided instead of cash bonuses, but also catch genuine commercial arrangements such as share plans.

6.11 The rules are straightforward for companies with shares listed on a recognised stock exchange where shares can be freely sold. These shares will clearly be RCAs and PAYE and NICs will always apply. However, these rules can also catch shares in unquoted private companies where on the face of it there is no market for the shares.

6.12 For example, many private companies use share plans that will only vest on an exit, which can include a sale or Initial Public Offering (IPO). In this case, the shares would presumably be RCAs because when the shares are acquired there would be arrangements in place to enable the shares to be sold. Likewise, if shares are acquired in advance of an IPO but at a time when there are plans to float, these could constitute potential trading arrangements and result in the shares being considered RCAs – even if the flotation never takes place.

6.13 Other private companies operate employee benefit trusts (EBTs) as a warehouse for shares, which may also constitute a trading arrangement, resulting in the shares being viewed as RCAs.

[2] Section 702 ITEPA 2003

6.14 Few private companies consider these arrangements genuinely create a market for shares – in reality, private company shares remain illiquid. However, in certain circumstances[3], HMRC will deem the shares as RCAs, at which point PAYE must be operated and NICs will become chargeable.

6.15 There is an additional complication for companies in that, even if there is no market for the shares as described above, shares will be treated as RCAs unless the employing company is entitled to corporation tax relief under Part 12 of CTA 2009 (previously, Schedule 23 FA 2003)[4]. One consequence of this is that shares in the subsidiary of a private company will be always be RCAs.

Managing RCAs

6.16 Feedback to the OTS suggests that the issue is not particularly the fact that PAYE and NICs could be charged on a taxable event involving private company shares (although inevitably a NICs charge would not be welcomed), or the issues connected with PAYE deadlines (see Chapter 5). What concerns private companies is the lack of certainty created by what is widely recognised as a "grey area". As with other issues, the point made repeatedly to the OTS is that if a company knows in advance with certainty what the tax consequences will be, those consequences can be planned for, managed and communicated.

6.17 The OTS would welcome suggestions for how these issues might be addressed, with due regard to the anti-avoidance nature of the rules. Points made already include clearer guidance (both private companies and their advisers cite unclear guidance as an additional complexity) and clearance that the mere existence of an EBT, or the potential of a sale/initial public offering, does not of itself create an RCA.

Loans to participators[5]

6.18 If a company is close, making a loan to finance an EBT can give rise to a tax charge whereby the company must pay an amount to the value of 25 per cent of the loan to HMRC. The amount can be reclaimed once the loan is repaid or written off, but there is no credit given against the company's liability to corporation tax.

6.19 This can be a disincentive to establishing share schemes for private companies controlled by a small number of shareholders.

Tax relief on loans from close companies[6]

6.20 Currently, interest on a loan to a director or employee to acquire shares in a close trading company generally qualifies for tax relief only if the borrower either holds 5 per cent of the share capital in the company or, if he holds less, spends most of his time "in the actual management or contract of the company". This discriminates in favour of senior management and the position is exacerbated (according to some participators) by HMRC's narrow interpretation of the legislation quoted. The result is that few employees obtain relief in practice; it would be helpful for the OTS to hear of instances where this has proved a significant problem in practice.

Inheritance tax charges on employee benefit trusts

6.21 EBTs are regarded as discretionary trusts and accordingly fall into the inheritance tax discretionary trust regime. This brings various inheritance tax complications, including:

[3] For examples of RCAs, see ERSM 170040 (http://www.hmrc.gov.uk/manuals/ersmmanual/ERSM170040.htm)

[4] ITEPA s 702(5A)

[5] Section 455 CTA 2010

[6] Sections 392-395 ITA 2007

- The gift of a controlling interest in shares by an individual to an EBT will be a chargeable transfer for inheritance tax unless relief is available[7];
- There is a risk of ten year and exit charges on property held in a trust, unless the trust meets certain requirements[8];
- If a close company makes a transfer of value to an EBT which is a participator, an inheritance tax charge can arise for participators unless the EBT meets certain requirements[9].

6.22 A number of groups and individuals from whom we sought feedback have questioned the necessity of commercial EBTs falling within inheritance tax charges at all.

Simple transactions caught by legislation

6.23 Private companies frequently undergo transactions that result in employees holding shares in their employing company, but which could not be described as "schemes". Common arrangements can include straightforward subscriptions for shares at market value, gifts of shares to employees as rewards for past service, "golden hellos" for new starters, founder shares, transfers of shares among family members who are also employees, and awards of shares based on an individual's continued employment within the company.

6.24 In many cases, companies do not even realise these fall within either Part 7 or Part 7A of ITEPA 2003. Consequently, they are unaware of the complexities of the tax treatment, or the requirement to report on the grant or award, and subsequent taxable events, on Form 42[10]. For private and family owned companies in particular there is an inconsistency in that there is an exception for family relationships under Part 7[11], but no such exception is available under Part 7A.

[7] Section 28 IHTA 1984

[8] Sections 65 and 86 IHTA 1984

[9] Section 13 and 94 IHTA 1984

[10] Section 702 ITEPA 2003

[11] Section 421B(3) and 471(3) ITEPA 2003

A Consultative Committee Members

Consultative Committee Members

Andrew Richens	Bishop Fleming and ex-OTS
Ann Govier	Marks & Spencer
Clare Ashton	HM Treasury
David Cohen	Share Plans Lawyers Group and Norton Rose
David Fleming	Unite
David Pett	Pett Franklin
Diane Hay	PwC
Fiona Bell	Quoted Companies Alliance and Memery Crystal
Geraldine Pamphlett	Foster Wheeler and ex-OTS
John Collison	ifs ProShare
John McLoughlin	HM Revenue and Customs
Kay Ballard	Kingfisher
Martin Osborne-Shaw	Killik and Co
Martyn Drake	Computershare
Michael Landon	ESOP Centre & MM&K
Peter Vassallo	BP
Philip Fisher	PKF

B Examples of terminology

Glossary of terms taken from HMRC Business Income Manual (44001)

431 Election
An election made between employer and employee on the acquisition of restricted securities to calculate income tax as if the market value of the shares at the time of the acquisition was calculated completely ignoring the fact that the shares are restricted

All Employee Share Ownership Plan (AESOP)
Tax advantaged, all-employee share award scheme approved by HMRC under ITEPA03/SCH2 (formerly FA00/SCH8), now known as a Share Incentive Plan (SIP)

Approved profit sharing scheme (APS)
Tax advantaged, all-employee share award scheme approved by HMRC under ICTA88/SCH9 until April 2001

Approved scheme
Share award or share option scheme approved by HMRC, which gives favourable tax and NICs advantages to employees and employers

Case law trust
Employee share ownership trust or general purpose EBT which relies on tax case law rather than specific legislation as authority for allowing tax deductions for employers' contributions

Company Share Option Plan (CSOP)
Tax advantaged discretionary share option scheme approved by HMRC under ITEPA03/SCH4 (formerly ICTA88/SCH9)

Conditional share award
An award of a number of shares of which the employee will become the owner at a future date if specified conditions are met

Discounted option
A share option which gives the option-holder the right to buy shares at an exercise price lower than the market value of the shares when the option was granted

Employee Benefit Trust (EBT)
A trust set up by an employing company or its group parent company to provide employees with benefits which may take a variety of different forms

Employee share ownership trust (ESOP trust or ESOT)
A trust set up by an employing company or its group parent company to provide employees with benefits in the form of shares or options over shares in that company

Enterprise Management Incentive (EMI) option
Option over shares in an EMI company which qualifies for tax advantages under ITEPA03/SCH5 (formerly FA00/SCH14)

Exercise of option
When the option-holder uses the rights under the option to buy shares at the option exercise price

Exercise price

Price at which the holder of a share option has the right to buy shares

Forfeitable shares

Shares given to employees subject to a risk that they may have to be forfeited if specified conditions are not met during a forfeiture period

Forfeiture period

Period during which employees holding forfeitable shares are at risk of having to forfeit them if specified conditions are not met during the period

Grant of option

Giving the option-holder a right to acquire shares in the future – options must be granted under seal or deed or for consideration (usually a nominal amount such as £1)

Group scheme

An employee share scheme set up by the parent company of a group under which share-related benefits are provided to employees of nominated companies in the group

Joint Share Ownership Plan (JSOP)

An arrangement under which an employee acquires the beneficial ownership of shares jointly with (typically) an EBT on terms which provide that, when sold, the proceeds of sale of the shares are divided unequally so that (typically) the employee is entitled to some or all of the growth in market value

Long Term Incentive Plan (LTIP)

Term often used for a conditional share award scheme or a scheme providing employees with forfeitable shares

Market value option

A share option which gives the option-holder the right to buy shares at an exercise price equal to the market value of the shares when the option was granted

Performance conditions

Conditions or targets which must be satisfied during a specified performance period before employees can acquire shares under conditional share awards or by exercising share options

Performance period

Specified period over which performance conditions or targets, to which share awards or share options may be subject, must be met

Phantom share option

A right to receive a payment in cash (not shares) based on the increase in value of a set number of shares over a set period

Profit sharing scheme

See approved profit sharing scheme (APS)

Qualifying employee share ownership trust (QUEST)

A trust that meets the requirements of FA89/SCH5. Favourable tax treatment was given for employers' contributions to QUESTs in accounting periods starting before 1/1/2003

Replacement option

A new share option granted in exchange for the surrender of an old option, usually when the company whose shares were the subject of the old option is taken over (see Rollover of options)

Restricted shares

Shares acquired by an employee which are subject to restrictions (such as restrictions on voting or dividend rights, or the employee's ability to sell the shares). Includes forfeitable shares

Rollover of options

When an old option is exchanged for a new option, usually over shares in a new parent company following a takeover (see Replacement option)

Savings-related or SAYE share option scheme

Tax advantaged, all-employee share option scheme approved by HMRC under ITEPA03/SCH3 (formerly ICTA88/SCH9)

Share award

An award of a number of shares of which the employee will become the owner at a future date, usually if certain conditions are met (see conditional share awards)

Share Incentive Plan (SIP)

Tax-advantaged share award scheme approved by HMRC under ITEPA03/SCH2 (formerly FA00/SCH8), originally known as an All Employee Share Ownership Plan (AESOP)

Share option

A right to acquire a set number of shares at a set price during a set period

Single company scheme

An employee share scheme set up by an employing company under which benefits in the form of shares or options over shares in the employing company are provided to its employees

Unapproved scheme

A share award or share option scheme which does not qualify for favourable tax and NICs advantages given to approved schemes

Underwater option

A share option whose exercise price is higher than the current market value of the shares

Vesting

When an employee becomes entitled to a given number or proportion of award shares as a result of attaining performance targets or continuous service over a given period, notwithstanding that those shares may not be released or transferred until a later date

Terminology

B.1 The following guidance has been kindly provided by Michael Landon of remuneration consultants MM&K, a member of the OTS Consultative Committee. The short extract below forms part of a larger report on an overview of unapproved share plans in the UK, and helps to demonstrate the differences in terminology that exist in the field of unapproved share plans:

"There are considerable differences in the terminology used for unapproved share plans. For example:

"ESOP" can mean "employee share ownership plan", a term often used in the past for share plan arrangements which include the use of employee benefit trusts (EBTs). Alternatively, it is sometimes used to mean "executive share option plan".

"LTIP" is sometimes used to mean any type of long-term incentive plan (whether or not share-related). It is also a term used for a specific type of plan, which is [also sometimes] referred to as "conditional share awards".

"Share incentive plan" can either refer to any kind of share-based incentive arrangement or specifically to Share Incentive Plans approved by HMRC under Schedule 2 to ITEPA 2003."

B.2 The following is an extract taken from Chapter 8 of the well-known reference manual *Employee Share Schemes*[1]. This extract seeks only to summarise the main types of LTIPs available, it demonstrates the complexity facing companies and advisers who seek to implement an unapproved arrangement of this type:

"LTIPS, broadly, fall into the following categories:

Type A

- The participant has no contractual entitlement from the outset – merely an expectation of benefit;
- If, and to the extent that, the three-year performance target is met, the participant *then* acquires either an immediate beneficial interest in the shares or an enforceable right to the shares exercisable after a further period of one, two or three years, either in full or in equal tranches at the end of, say, the fourth, fifth and sixth years (the "deferred period");
- If the participant leaves within the three-year performance period for *any* reason, all entitlement is lost;
- Payment out may be in cash, or shares (as the trustee determines); and
- No entitlement to dividends during the deferred period.

Type B

- Awards are made to selected executives on an annual basis in the form of options to acquire shares (at no cost);
- An award is made in respect of a specified maximum number of shares;
- The participant has, from the outset, an enforceable (but conditional) right to the shares subject to the attainment of a three-year performance target;
- Exercise of the options is conditional upon the company attaining a pre-set performance target;
- The *proportion* of the award shares which the participant may acquire after three years arises according to the extent to which the company's performance exceeds the performance target; and
- If the participant leaves for "good" reasons (i.e. disability, injury, redundancy or retirement) then he will become entitled to a time-apportioned proportion of the award shares which, in due course, vest. The right is forfeited if the participant leaves for "bad" reasons (i.e. dismissal or voluntary resignation).

In some instances of both Type A and Type B, "bonus" shares representing shares acquired by reinvestment of dividends received in the performance deferred period are added to the shares acquired on exercise or vesting. The company may, in either case, reserve the right to settle the participant's entitlement by making a cash payment (subject to income tax and NICs under PAYE) in lieu of shares or the grant of an option.

[1] *Employee Share Schemes*, David Pett; edited by David Pett and David Cohen, published by Sweet & Maxwell

Type C – contingent share awards

Such awards take the form of a conditional right to acquire shares (a nil cost option) similar to Type B but by contrast when, after the end of the performance period (typically a fixed period of three successive accounting periods), the number of award shares which vest is determined, according to the extent to which the performance target(s) is (are) met or exceeded, the vested shares are unilaterally transferred to the awardholder. Unlike a conventional share option, the awardholder does not have the freedom to defer his acquisition of the shares – and therefore, the time when income tax and, if the shares are readily convertible assets, NICs are charged. Although the employee does not have the flexibility to decide when to call for the vested shares, he will typically acquire them "pursuant" to an employment-related securities option, so that his acquisition of the shares will fall to be taxed under Chapter 5, Part 7 of ITEPA 2003.

The advantages to the grantor company of granting such "contingent share awards", in preference to Type B nil cost share options, are:

- By curtailing, and fixing, the maximum option period the accounting period to be recognised in respect of the awards is likely to be significantly reduced – see Chapter 19;
- If the employer company chooses not to transfer to the awardholder the burden of the employer's secondary Class 1 NICs on the award gain, then by foreshortening the option period in this way, the exposure to the (uncapped) risk of further share price growth leading to higher liability to such NICs is minimised; and
- By taking away the investment decision of the awardholder as to when to exercise his right to acquire the vested shares, the company limits its requirement to "hedge" the obligation to procure that the shares are held ready to satisfy the exercise of such right (typically by a transfer of shares out of the employees' trust which has agreed before the award was made to satisfy the award.

Type D

Following the changes made by FA 2003 to the charge to income tax on employment-related securities, it is possible to secure more favourable tax treatment for the participant by reversing the basis on which the plan operates. Participants acquire at the outset beneficial interests in a given number of shares on the basis that such interests are at risk of forfeiture (by transfer back to the plan trustee for no consideration) if or in so far as performance targets are not met. Such interests fall to be taxed as "employment-related interests in securities" pursuant to ITEPA 2003, Part 7, Chapter 2. By making the appropriate election pursuant to s.431, the employer and participant can ensure that the participant is charged to income tax (and NICs) when the award is made, on the full unrestricted market value of the shares without regard to the risk of forfeiture. Any subsequent growth in the value of the award shares is chargeable only to capital gains tax, with time running for the purposes of taper relief from when the shares, or interest in the shares, is first acquired. If the growth in value of the shares is, or is likely to be, high relative to their initial unrestricted market value, the overall saving of income tax and NICs can be significant. However, this assumes that the shares are not forfeited because the performance targets are not met! The employee, if so permitted by his employer, could estimate at the outset the proportion of award shares likely to be forfeited and make such an election only in respect of the balance.

For obvious reasons, a Type C LTIP is likely to be of attraction only to those companies whose initial share value is small relative to the growth anticipated, and where the risk of failure to meet the performance target is relatively low."

B.3 In addition to this summarising paragraph, this section of the manual includes a table setting out the different tax treatments applicable to each type of LTIP, as well as a guide to some common terms. The list of terms is headed by the following caveat: “Care must be taken as many plans use some of these terms in subtly different ways that can lead to confusion”.

C Summary of tax legislation and guidance

Income Tax

ITEPA 2003, Part 3

Chapter 1 – Earnings

C.1 Section 62, in Para (2) "earnings" means any gratuity, profit or incidental benefit of any kind obtained by the employee if it is money or money's worth.

C.2 In Para (3), money's worth means something of direct monetary value or (something) capable of being converted into money or something of direct monetary value.

C.3 Money's worth will include when a security is acquired by an employee through his employment for free or for less than market value.

Chapter 12 – Payments treated as earnings

C.4 Section 222 – income tax charged when notional payment arises (on the acquisition of shares) and employee does not make good the income tax paid within 90 days of the date of the notional payment.

ITEPA 2003, Part 7

C.5 There are eight separate chapters setting out details of the taxation of a variety of employment related securities. Part 7 also includes six further chapters covering government approved plans, and certain supplementary provisions in connection with employee benefit trusts.

Chapter 1 – General

C.6 Includes definitions (e.g. "securities", "market value", "consideration" and the requirement to provide information (section 421J) and description of reportable events.

Chapter 2 – Restricted securities

C.7 Includes definitions of "restricted securities" and "restricted interest in securities". Sets out details of chargeable events, including calculations relating to the amount of charge, and details of elections for disapplication of the Chapter (section 431 election) as well as other elections.

Chapter 3 – Convertible securities

C.8 Includes definition of convertible securities, details of the tax charge on the occurrence of a chargeable event including calculations relating to the amount of charge.

Chapter 3A – Securities with artificially depressed market value

C.9 Sets out details of when tax charge will apply and how it will be calculated. Contains details of interaction between this Chapter and Chapters 2 and 3 above. Allows for various adjustments to market value of the shares.

Chapter 3B – Securities with artificially enhanced market value

C.10 Provides calculation relating to non-commercial increases in the value of the shares and details of the calculation of the charge on such increase, as well as calculations relating to the shares if they are also restricted securities (such calculations vary according to the period during which the relevant shares are held).

Chapter 3C – Securities acquired for less than market value

C.11 Sets out details of when this Chapter will, and when it will not, apply. Cross references sections relating to interest-free loans and sets out the relevant calculations of the amount of the loan. Sets out when a notional loan is deemed to be discharged.

Chapter 3D – Securities disposed of for more than market value

C.12 Sets out the application of this Chapter and the calculation of the amount that shall be charged to income tax on acquisition.

Chapter 4 – Post-acquisition benefits from securities

C.13 Covers the charge on any benefits acquired in connection with employment related securities.

Chapter 4A – Shares in research spin out companies

C.14 Sets out details of how to calculate the market value of shares, and the taxable amount on acquisition, of shares acquired in spin out companies.

Chapter 5 – Securities options:

C.15 Sets out details of the options to which the Chapter applies, and where the Chapter does not apply; lays down details of the tax charge on the occurrence of a chargeable event, and how to calculate the charge. Also explains the application of the Chapter on exchange of one option for another.

PAYE

ITEPA, Part 11

Chapter 4

C.16 Section 696 – Readily convertible assets (on acquisition of shares generally).

C.17 Section 698 – special charges on employment related securities e.g. restricted securities, convertible securities, securities for less than market value etc.

C.18 Section 700 – PAYE: gains from securities options.

C.19 Section 702 – Meaning of readily convertible asset.

C.20 Section 710 – Notional payment: accounting for tax.

NICS

Social Security Contributions and Benefits Act 1992

C.21 Section 4, Payments treated as earnings.

Social Security (Contributions) Regulations 2001

C.22 Regulation 22, Amounts to be treated as earnings.

Social Security (Contributions) Regulations 2001

C.23 Regulation 69, transfer of liability from secondary contributor to employed earner and Schedule 5.

ITEPA 2003

C.24 Section 481, income tax relief for secondary NICs paid by employee.

Corporation Tax and transfer pricing

Corporation Tax Act 2009, Part 12

C.25 Sections 1001 – 1037 set out the requirements relating to a corporation tax deduction on the acquisition of shares or exercise of options by employees.

Capital Gains Tax

Taxation of Chargeable Gains Act 1992

C.26 Sections 144 – 144ZD, Section 144A: Options, forfeited options and cash settled options.

C.27 Sections 149A, 149AA, 149B override Section 17 (consideration treated as at market value where acquisition is other than arm's length bargain).

C.28 Section 119A – the amount charged to income tax is treated as consideration for the acquisition of the shares.

Employee benefit trusts

ITEPA 2003, Part 7A

C.29 Covers the taxation of employment income provided through third parties, including employee benefit trusts. Includes definitions of "relevant steps" and "earmarking"; sets out numerous exclusions including those for approved plans and employee share schemes.

Inheritance Tax Act 1984

C.30 Provides for life time inheritance tax charges on relevant property held in discretionary trust i.e. the exit and 10 year charges, unless section 86 IHTA 1984 applies (Trusts for the benefits of employees).

Close companies

Corporation Tax Act 2010

C.31 Section 455: Loans to participators.

Taxation of Chargeable Gains Act 1992

C.32 Section 239: transfer of an asset to an employee benefit trust at undervalue.

Inheritance Tax Act 1984

C.33 Sections 13 and 94: contribution to employee benefits trust treated as disposition for inheritance tax purposes if transfer of value.

C.34 Various other sections (e.g. section 10, section 103) may be relevant in certain circumstances, e.g. if business property relief applies, or if value within an EBT is less than the nil-rate band.

Case law

Money's worth charge

C.35 Shares are money's worth in themselves if they are acquired for below market value and chargeable to income tax. The charge is independent of the employee selling the shares and receiving the profit – *Weight v Salmon (19TC174*).

C.36 Shares are money's worth even if they may be subject to forfeiture or other restrictions on sale. The restriction does not prevent a tax charge arising but is something taken in to account in the valuation of the monetary value of the shares – Ede v Wilson (26TC381).

C.37 It is on the grant of a share option that an employee received money's worth and not on the exercise – Abbott v Philbin (39TC82). Note specific rules contained in Part 7 and earlier legislation to override this tax case (otherwise gain on exercise would not have been chargeable to income tax). This does have consequences in the international context.

Transfer pricing

C.38 Where a parent company allows the employees of its subsidiaries to participate in its share schemes, the arm's length principle requires that the subsidiaries make a contribution to the parent – Waterloo plc v IRC (SPC301).

Corporation tax

C.39 Corporation tax deduction not available on "potential emoluments" paid into employee benefit trust; employing company not entitled to claim a corporation tax deduction for its payments until the accounting period in which those amounts are actually received as 'emoluments' by employee – Macdonald (HMIT) v Dextra Accessories Ltd & others [2005] UKHL 47.

HMRC Manuals and other materials

C.40 Employment Related Securities Manual.

C.41 Employment Income Manual – operation of PAYE (EIM 11800 – 12400).

C.42 Employment Income Manual – disguised remuneration (EIM 45000 – 45165).

C.43 Business Income Manual.

C.44 International Business Manual – for transfer pricing.

C.45 NICs Manuals.

Other guidance

C.46 Form 42 – A guide to completing form 42.

C.47 Booklet 480 – benefits in kind, chapters 23 and 26, returns and operation of PAYE.

C.48 CWG2 – employers further guide to PAYE and NICs.

Self assessment

C.49 Additional information pages (SA101).

C.50 Additional information notes.

C.51 Help sheet 305 – employee shares and securities – further guidance.

C.52 Help sheet 287 – employee share schemes and capital gains tax.

D List of meetings

Type of organisation/individual	Number of meetings[1]
Legal Advisers	16
Accountants	5
Administrators	4
Lobbying/Business Groups	6
Corporates (listed)	14
Corporates (unlisted)	2
HR Consultants/Advisers	2

D.1 Note that at a number of the meetings the accountants and other advisers were accompanied by corporate clients, whose views were also taken into account and who have been included in this table. The total number of meetings was 30.

[1] Some meetings contained more than one organisation/individual so the *total* number of meetings is fewer.

E Table of examples

Example 1:

E.1 This example deals with a straightforward three year long term share incentive plan with performance conditions, which is a typical plan used by quoted companies to reward executives, and sets out the different ways that such a plan can be structured and the differing tax consequences of each.

E.2 Tom, Dick and Harry are employed by Hard Work Ltd which is owned by a US parent, Hard Work Inc and is quoted on the New York Stock Exchange (NYSE). The parent company has a global long term share incentive plan to incentivise senior management. The plan was designed to give employees a beneficial ownership in shares, in three years time for no consideration, provided that company performance conditions were met and the employees remain employed by the company at the end of the period. The plan was flexible and could provide the following types of awards:

- An award of nil cost share options vesting in three years time, subject to the performance and employment conditions being satisfied, which the employee could then exercise at any time to acquire shares for no consideration ("nil cost option");
- A conditional right to acquire shares for no consideration to be unilaterally transferred to the employee at, or shortly after, the end of the vesting period, so the employee cannot choose when to acquire the shares ("conditional shares"); and
- An immediate award of actual shares to employees (with normal voting and dividend rights etc.) who would forfeit the shares if they left employment within 3 years of the award and if the performance conditions were not met ("immediate award subject to risk of forfeiture").

E.3 On 6 December 2011 the following awards were made to the senior employees of Hard Work Ltd:

- Tom – 10,000 Nil Cost Option (at no cost), vesting in three years' time;
- Dick – A conditional right to acquire 10,000 shares on 6 December 2014 (at no cost); and
- Harry – An immediate award of 10,000 shares (at no cost), subject to risk of forfeiture within three years so far as performance or employment conditions are not met.

E.4 The share price on 6 December 2011 was £5 per share. This increased to £10 in December 2014 and £12 in July 2015. All of the performance conditions were met and all of the 2011 awards fully vested in December 2014.

E.5 The following additional information is known:

- Hard Work Ltd has not entered into an agreement to transfer the secondary NIC to its employees;
- The highest tax rate was 50 per cent for tax years 2011/12 to 2012/13 but was reduced to 45 per cent from April 2013;
- Maximum CGT rate of 28per cent. Annual exemption ignored; and
- All employees sold their shares on 6th July 2015 when the share price was £12 per share.

Table E.1: Example 1 – 3 year long term flexible share incentive plan

	Nil cost option – Tom	Conditional shares – Dick	Immediate acquisition subject to short term risk of forfeiture – Harry
Facts	The performance targets were met and his nil cost option vested on 6 December 2014 and was capable of being exercised by Tom. Tom decided to exercise his options on 6 July 2015 and acquire 10,000 shares in Hard Work Inc (at no cost). The shares were worth £120,000 at that time.	The performance targets were met and on 6 December 2014, the beneficial ownership of 10,000 shares in Hard Work Inc. was transferred to Dick (for no cost).	On 6 December 2014, the 10,000 shares owned by Harry were no longer subject to forfeiture.

Income tax on individuals	Tom	Dick	Harry
Is there any income tax charge on award in **2011-12** either under the money's worth charge that constitutes general earnings or under Part 7?	**Grant of option: NIL** No. Any discount on grant (£5 per share) is considered money's worth under section 62 (Abbott vs. Philbin) but this is disapplied under Chapter 5 (securities options). No income tax charge arises in year of grant.	**Grant of conditional award: NIL** No. A conditional award is a right to acquire shares in the future and is taxed under the same rules as share options. No income tax charge arises in the year of grant	**Acquisition of the shares – depends on if election is made:** **No election: NIL** Money's worth charge under section 62 based on a reduced market value to take into account the affect on the value of the risk of forfeiture but this is disapplied by Section 425(2) of Part 7[1]. **431 Election[2] made: £50,000** Money's worth charge is calculated on the full unrestricted market value of shares without regard to the risk of forfeiture. **10,000 x £5/share = £50,000** **Tax (@50%) £25,000**

[1] Note it is possible to make an election under section 425(3) to ignore section 425(2) and for general earnings charge to apply. In this case, there would be an initial income tax charge on acquisition based on the reduced market value, however the lifting of the forfeiture would be a chargeable event and the untaxed proportion would then be charged.

[2] Section 431(1) permits an employee to elect to pay income tax under the general earnings charge on acquisition on the full unrestricted market value ignoring risk of forfeiture.

	Tom	Dick	Harry
Is there any income tax charge in 2014-15 on vesting of options / conditional shares and lifting of the restrictions, either under the money's worth charge that constitutes general earnings or under Part 7?	**Vest: NIL** No income tax arises when the option vests i.e. when it is first capable of exercise.	**Vesting and acquisition of shares: £100,000** Income tax charged[3] on market value of the 10,000 shares on the date of acquisition (£10 per share) less consideration paid for them (NIL – as acquired at no cost) less any other deductions[4] 10,000 x £10 per share = £100,000 Tax (@45%) £45,000	**Lifting of forfeiture restriction:** **No election: £100,000** On the untaxed proportion of the value at the time the shares cease to be restricted securities. (10,000 x £10) x 100%[5] = £100,000 Tax (@45%) £45,000 **With election: NIL[6]**

[3] Section 478 ITEPA 2003. Conditional shares are considered rights to acquire shares and fall within the definition of securities options.

[4] Note a deduction is permitted under section 482 ITEPA 2003 for the secondary NIC paid by employee for the employer under Schedule 1 SSCBA 2001. No election has been made in this case.

[5] This is 100% as there was no income tax charge on acquisition by virtue of section 425(2). Had an election been made under Section 425(3) and a proportion of the value taxed on acquisition then only the untaxed proportion would be chargeable in 2014/15.

[6] With election any increase in value after acquisition is chargeable only to capital gains tax.

	Tom	Dick	Harry
Is there any income tax charge on any subsequent event?	**Exercise (2015/16): £120,000** Yes, income tax charged[7] on market value of the 10,000 shares on the date of acquisition (£12 per share) less consideration paid for them (in this case NIL) less any other deductions[8]. Income tax is chargeable on £120,000 in 2014-15. **Tax (@45%) = £54,000**	**N/A**	**N/A**
Capital gains tax	Tom	Dick	Harry
What gain is liable to capital gains tax on sale of shares[9] in July 2015 (2015-16)	Sale proceeds: £120,000 Less: Consideration: £NIL Less: charge to income tax £120,000 Gain: NIL No capital gains tax payable	Sale proceeds: £120,000 Less: Consideration: £NIL Less: charge to income tax £100,000 Gain: £20,000 Tax (28%) £5,600	No election: same as for Dick With election: Sale proceeds: £120,000 Less: consideration £NIL Less: charge to income tax: £50,000 Gain: £70,000 Tax (28%) £19,600

[7] Section 478 ITEPA 2003.

[8] Assumed to be NIL. Note a deduction is permitted under section 482 ITEPA 2003 for the secondary NIC paid by employee for the employer under Schedule 1 SSCBA 2001.

[9] Special rules apply which disapply the market value rules under section 17 TCGA 1992 for employment related securities. Cost is actual consideration given for shares plus any amounts charged to income tax in respect of the acquisition of shares.

	Tom	Dick	Harry
Total Taxes paid	**£54,000**	**£50,600**	**No election: £50,600** **With election: £44,600 (%)**
Employer issues: PAYE & NICS			
Does PAYE apply?	Yes, £120,000 is deemed to have been paid on 6 July 2015 and is liable to PAYE as shares in Hard Work Inc. are readily convertible assets[10]. PAYE must be operated in July 2015 and paid over to HMRC by 19 August 2015 and recovered from employee by 5 October 2015[11]	Yes, £100,000 is deemed to have been paid on 6 December 2014 and is liable to PAYE as shares are readily convertible assets. PAYE must be operated in December 2014 and paid over to HMRC by 19 January 2015 and recovered from employee by 5 March 2015	Yes, PAYE applies on £50,000 in 2011-12 (if election is made) or on £100,000 (if no election) in 2014-15.
Do NICs apply?	Employee NI (2%): £2,400 Employer NIC (13.8%): £16,560 Total payable[12]: £ 18,960	Employee NI (2%): £2,000 Employer NIC (13.8%): £13,800 Total payable: £15,800	Employee NI (2%): £1,000 Employer NIC (13.8%): £6,900 Total payable: £7,900[13]

[10] Section 696 and 700 ITEPA 2003.

[11] To note that Section 222 ITEPA 2003 charge will apply if PAYE on £100,000 (say £54,000) is not made good by employee within 90 days of the chargeable event then the £54,000 would be reportable on form P11D as a benefit subject to further employee income tax of up to a further £24,000 and is also liable to employee and employer NICs in 2015/16.

[12] Payable by the same deadline as for PAYE.

[13] Assuming a 431 election has been made. Otherwise the NIC liability will be the same as for Dick.

Corporation tax	Tom	Dick	Harry
When is there a corporation tax deduction in relation to the provision of shares	Hard Work Ltd will get a tax deduction for £120,000 in relation to their accounting period ended 31 December 2015, equal to the amount on which Tom is liable to income tax plus for the employers NIC payable of £16,560 in respect of the gain.	Hard Work Ltd will get a tax deduction for £100,000 in relation to their accounting period ended 31 December 2014, equal to the amount on which Dick is liable to income tax plus for the employers NIC payable of £13,800 in respect of the gain.	Hard Work Ltd will get a tax deduction for £50,000 in relation to their accounting period ended 31 December 2011, equal to the amount on which Harry is liable to income tax plus for the employers NIC payable of £6,900 in respect of the gain (if a 431 election is made). Otherwise the deduction will be as for Dick.
Source: OTS			

Example 2:

E.6 This example sets out the tax consequences of a simple unapproved share option arrangement vs. the acquisition of shares on a partly paid basis, which are both fairly typical of arrangements that could be used by unquoted companies to transfer shares to employees.

E.7 Companies A Ltd & B Ltd are both small unquoted companies. For the purposes of this example the approximate value of their shares is £10 per share.

E.8 Both companies want to encourage a new senior manager to acquire shares to retain them in the business and to align his interest with shareholders generally.

E.9 A Ltd decides to grant Jennifer a market value option over 1,000 shares at £10 per share on 6th April 2011. The option cannot be exercised until after the expiry of 3 years from the grant date. The company expects to grow significantly in that time frame and for the share value to double in the period.

E.10 B Ltd agrees to allot and issue Alice 1,000 shares at their current market value £10,000 on 6th April 2011 on terms that leave the consideration outstanding for 3 years or earlier if sold.

E.11 The market value of both companies doubles in 3 years.

E.12 Jennifer exercises her option after 3 years and acquires shares and sells her shares immediately. Alice also sells sell her shares in B Ltd after 3 years and immediately repays the loan.

Table E.2: Example 2 – Market value option vs. partly paid shares

	Market value option – Jennifer	Partly paid shares – Alice
Income tax on individuals		
Is there any income tax charge on the grant / acquisition of shares in 2011-12 either under the money's worth charge that constitutes general earnings or under Part 7?	Grant of option: NIL No income tax charge arises in year of grant under either charging provision.	Acquisition of shares: No income tax charge under general earnings principles as shares are acquired for market value[14]. Beneficial loan charge[15]: £10,000 x 4% = £400 @ 50% = £200.
2012-13 & 2013-14	N/A	Beneficial loan charge = £10,000 x 4% = £400 @ 45% = £180pa x 2 = £360

[14] Note this assumes Alice acquires the shares from B Ltd and not an employee benefit trust (EBT). If the shares were acquired from an EBT there would be an immediate charge under Part 7A ITEPA 2003

[15] For so long as there is an amount outstanding on the shares that remains unpaid an annual income tax charge will arise on the "notional loan" at the official interest rate (currently 4%) (chapter 3C, Part 7)

	Jennifer	Alice
2014/15	On 6 April 2014, Jennifer exercises her option to acquire shares. She pays £10 per share (£10,000) to exercise the option. The market value of the shares had increased to £20 per share Gain: £20,000 – £10,000 = £10,000 Tax[16] + NIC[17] = £4,700	On 6 April 2014, Alice repays the loan of £10,000 (out of sales proceeds – see below[18]). No income tax liability arises as the notional loan is repaid and is not written off.
Capital gains tax		
On the sale of shares for £20,000 on 6 April 2014.	Sales proceeds £20,000 Less: consideration £10,000 Less: gain charged to income tax £10,000 Capital Gain £NIL No Capital gains tax payable	Sales proceeds £20,000 Less: consideration £10,000 Less: gain charged to income tax £NIL Capital Gain £10,000 Tax (28%) £2,800
Total Tax & NIC	£4,700 (47%)	£2,800 + £560 = £3,360 (33.%)

[16] Tax rate assumed to be 45 per cent.

[17] Employee NIC rate assumed to be 2 per cent.

[18] HMRC practice is to accept that no charge arises under Section 446U ITEPA if the amount outstanding is immediately repaid out of the proceeds of the sale of the shares.

Employer charges & corporation Tax	Market value option – Jennifer	Partly paid shares – Alice
Employer NIC cost	Class 1 NIC: £10,000 x 13.8% = £1,380 (due in May 2014)	Class 1A NIC: £400 x 13.8% = £55.2 per annum
Corporation tax	A Ltd will get a tax deduction for £10,000 in relation to their accounting period ended 31 December 2014, equal to the amount on which Jennifer is liable to income tax plus for the employers NIC payable of £1,380 in respect of the gain.	No corporation tax relief is given for the gain made by Alice of £10,000. B Ltd can claim a deduction for the Class 1A NIC cost.

Source: OTS

F History of anti-avoidance share schemes legislation

Year **Summary**

1935 Weight vs. Salmon (1935) 19TC 174 9 (HL)

The difference between the market value of shares allotted and the par value of those shares was a profit (emolument) from an office and liable to income tax.

1960 Abbott vs. Philbin (1960) 39 TC82 (HL)

The taxpayer had received a profit (emolument) from his employment when he acquired the option but its taxable value was the market value of the option at that time – which was nil. The profit obtained from the exercise of the option accrued to the taxpayer as the holder of a legal right that he had acquired in the earlier year and not from his office or employment, so was not taxable as income.

1966 Section 25 FA 1966 (became section 135 ICTA 1988)

Imposed a liability to income tax (under Schedule E) on the value of directors' and employees' share options at the date when they are exercised. Where Section 25 imposed a charge to income tax on the exercise of the option, there would be no income tax on the grant of the option.

1973 FA 1972, Schedule 12

More consistent tax treatment of gains made under share incentive and share option schemes and the introduction of approved schemes under Schedule 12 (the forerunner of SAYE schemes). Section 25 FA 1966 (latterly section 135 ICTA 1988) would not apply to any gain on the exercise of a share option under a scheme approved under Schedule 12.

1974 Temporary ending of approved schemes: section 20 FA 1974

1976 Further charges introduced: section 67 FA 1976 (became section 162 ICTA 1988)[1]

Special rules applied where after 6 April 1976 higher paid employees[2] acquired shares in a company at an undervalue pursuant to a right or opportunity available by reason of employment. The undervalue was to be treated as a beneficial loan, and the cash equivalent benefit of the loan treated as an emolument and chargeable to income tax under Schedule E[3].

[1] This act introduced tax on benefits in kind in relation to directors and higher paid employees (defined as those earning at a rate of £5,000 pa or more).

[2] Those earning at a rate of £5,000 pa or more.

[3] Section 66(1) FA 1976 (section 160(1) and schedule 8 ICTA 1988)

1978

Approved profit sharing scheme (“APSS” schemes): FA 19784 (latterly section 186 & Schedule 9 ICTA 1988)

Including the introduction of an approval process whereby Inland Revenue must approve the scheme in advance. Shares acquired under the scheme were not subject to an income tax charge.

1979

1979 NICs Regulations

No national insurance contributions (NICS) on the grant or exercise of share schemes

1980

Introduction of approved savings-related share option schemes (“SAYE schemes”): section 47 FA 1980[5,6] (Section 185 & Schedule 9 ICTA 1988)

No income tax on grant of option, nor on exercise on the increase in value between grant and exercise of the share option provided the option is not exercised within 3 years of it being obtained.

1984

Approved share option schemes (“executive schemes”): section 38 FA 19847 (Section 185 & Schedule 9 ICTA 1988)

Largely the same tax treatment as for SAYE schemes, except that an immediate charge to income tax was imposed by section 38(5) on any discount, if the price fixed at the time the option was granted was less than the market value. Executive schemes have now been phased out (in 1996) and replaced with “company share option plans (“CSOPs”)[8] with significantly reduced maximum benefits available.

1988

Consolidation of ICTA 1988

Exemption for priority share allocations for employees: section 68 FA 1988

Exempted from income tax the benefit that could arise when employees acquire shares in a public offer at the same price as members of the public.

Unapproved employee share schemes: Sections 77 to 89 FA 1988 replace section 79 FA 1972 and sections 138 and 139 ICTA 1988 (“share incentive schemes”)

Introduction of new charge on a “chargeable event” – broadly, if and to the extent the value is shifted preferentially into the employee shares as a result of manipulation of rights or restrictions relating to those. The amount of the charge was the amount by which the value of shares is increased by the chargeable event and not simply the increase in value during the relevant period, including any increase in value attributable to the growth of the business.

Special rules were introduced to charge income tax on the increase in value of shares in dependent subsidiaries.

[4] The APSS was repealed in 2001 (TBC)

[5] Intention was to revive with some variation the 1973 legislation (repealed in 1974) to give tax advantages of SAYE linked share option schemes.

[6] Now Part 7, Chapter 7, and Schedule 3 ITEPA 2003

[7] The notes to these clauses noted that share option schemes are recognised by companies as an effective way of motivating and enhancing the performance of key directors but these are less attractive under present tax arrangements because of the income tax liability on those exercising options, which has led to them selling the newly acquired shares in order to finance payment. Such sales destroy the association of interest between company and employee that the share option was designed to create. The proposed changes in the tax treatment are aimed at reducing these disadvantages, so that fresh impetus is given to the spread of company share option schemes.

[8] Part 7, Chapter 8, ITEPA 2003

The original charge to income tax on any special benefits received by employees by virtue of their ownership or interest in the shares where those benefits are not otherwise subject to income tax is essentially unchanged.

1991 NICS: Shares disregarded as a payment in kind and liable to NICs (subject to some exceptions)

1994 Tradeable asset legislation for PAYE: FA 1994

Introduced PAYE on the acquisition of shares at less than their market value with effect from 25 May 1994. Extended to gains on the exercise of share options granted on or after 27 November 1996 where shares were readily convertible assets.

1995 NICS Regulations: extension of earnings definition to include shares with trading arrangements

From 6 April 1995, NICs regulations were extended such that amounts obtainable under "trading arrangements" were earnings liable to Class 1 NICs.

1996 Company share option plans ("CSOPs"): Section 114 FA 1996

Replacement of the income tax relief for executive share options by the new relief for company share option plans[9]. The new relief is subject to a limit of £30,000 on the value of shares under option which may be held by an employee at any one time (calculated with reference to the value of shares when the options are granted) and to the condition that the option must be granted at a price not manifestly less than market value of the shares at the date of grant.

Extension of NICs earnings definition to include own shares under unapproved share schemes

From 5 December 1996, all own company shares that were unapproved with "trading arrangement" were subject to Class 1 NICs.

1998 Conditional acquisition of shares: section 50 FA 1998 (inserting sections 140A to 140C ICTA 1988) effective 17 March 1998

Introduced to legislate for the generally accepted position that no income tax liability arose on the occasion of an original award of shares (conditional on satisfaction of performance conditions) but that there was an income tax charge at the point at which the performance conditions were met and the employee's interest in the shares became indefeasible.

Section 140A(3) provided that there would be no income tax charge under Schedule E when the shares were first acquired, provided the period in which the employee interest in the shares was or might be conditional was five years or less. There was an immediate income tax charge on the employee obtaining the conditional interest if the employee interest in the shares was or might be conditional lasted more than five years.

[9] The withdrawal of income tax relief for executive share options followed recommendations in The *Greenbury Report ("Directors Remuneration: Report of a Study Group chaired by Sir Richard Greenbury").*

Convertible shares: section 51 FA 1998 (inserting sections 140D to 140F ICTA 1988)

The growth in value charge in section 78 FA 1988 did not necessary apply where one class of share was converted in to another and hence it was possible to artificially increase the value of the share acquired by employees by making them convertible into another (more valuable) class of share without the resulting growth in value being subject to income tax. The sections apply where the person has acquired shares as a director or employee and the shares carry a right or possible entitlement to covert the shares in to shares of a different class. The charge is on the market value of the new shares following conversion less any deductible amounts.

PAYE & NICs on cash cancellation payments and post-acquisition gains on conditional shares and convertible shares

All cash cancellation payments subject to PAYE from 6 April 1998 even for those options granted before 27 November 1996 (where the gain on exercise was not liable to PAYE) and where the shares themselves were not RCAs.

PAYE & NIC imposed respectively from 6 April 1998 (PAYE) and 1 October 1998 (for NICs on shares acquired on or after 9 April) on post-acquisition gains on conditional shares (section 140A ICTA 1988 charge) and convertible shares (section 140D charges).

PAYE concept of Readily Convertible Assets was applied to NICs.

1999 NICs on share options brought in to line with income tax rules

From 6 April 1999, no NICs on the grant of share options but only on the gain on exercise, assignment or release of the option. Option granted pre 6 April 1999 remained liable to NICs at grant including replacement options at parity. Where the new options were more valuable than the old there was an immediate NICs charge on the difference. Thereafter NICs on share options, conditional and convertible shares followed the PAYE treatment.

2000 Enterprise Management Incentive scheme (“EMI”). FA 2000 Schedule 14

The introduction of a tax favoured share option scheme intended for small, high risk companies, providing relief from income tax in respect of the grant or exercise of qualifying options.

All Employee Share Ownership Plans (“AESOPs”): FA 2000 Schedule 8 (later, Share Incentive Plans, or SIPs)

The introduction of a new approved scheme targeted at all employees providing income tax, NICs and capital gains tax relief on shares awarded to employees under the plan.

The phasing out of approved profit sharing schemes (“APSS”): Section 49 FA 2000

As a result of the introduction of the ESOP scheme, the APSS was withdrawn.

Class 1A charge extended to all benefits including notional loans within section 162 ICA 1988 with effect from 6 April 2000: section 10 SSCBA 1992 amended by section 74(2) CSPSSA 2000

As a result NICs was payable by option holders with employments liable to tax under Case II of Schedule E on the annual charge and when the shares were sold, on discharge of the notional loan.

NICs elections and agreements – Section 77 CSPSSA 2000

From 28 July 2000, Schedule 1 SSCBA was amended to allow the employers secondary NICs to be transferred to the employee by agreement or joint election. Income tax relief is available to employees who enter into such an agreement or joint election to meet the secondary NIC on share options gains arising after 19 May 2000.

2001 Capping of employers' NICs liabilities: SSC(SO)A 2001

Designed to protect companies from exposure to unpredictable secondary NICs charge on exercise of share options. Permitted companies to settle the NICs liability at a special rate within 92 days of 11 May 2011, based on the gain attributable to the growth in the company share price up to 7 November 2000.

2002 Technical amendments to AESOP and EMI – Section 61 & Schedule 13 (AESOP) and Section 62 & Schedule 14 (EMI)

Increase in the gross assets limit for EMI companies from £15m to £30m with effect from 1 January 2002.

Change to Section 135 ICTA 1988 (in preparation for ITEPA 2003)

Amendment to replace the deduction of tax paid on the grant of an option against the tax payable on exercise with a deduction for the amount chargeable to income tax on grant from the amount charged on exercise.

Mansworth vs. Jelley

Confirmation that the "market value rule"[10] applied in the case of a disposal of shares by an employee acquired pursuant to the exercise of a share option. Resulted in the ability for an employee to deduct both the market value of the shares on acquisition and the tax paid on the exercise from the disposal proceeds, creating a capital loss where no economic loss arose. This decision resulted in considerable capital loss claims being made.

2003 Employee Share Schemes Act 2002 amending legislation on SIPs

Including permission for employee representatives to sit on boards of SIP trust; corporation tax deduction for the payment into an employee benefits trust (EBT) to buy a block of shares to be used to satisfy future awards under the SIP provided the shares were awarded within a 10 year period; tax exemption for dividends and gains arising in the 10 year period.

[10] Section 17 TCGA 1992 substitutes the market value of the asset for the price paid where the asset is acquired and disposed of in connection with a person's office or employment or other than by way of an arm's length bargain (the "market value rule").

A short lived consolidation – ITEPA 2003

Consolidated the existing share scheme rules into Part 7 ITEPA, with 11 chapters dealing with 1. General rules; 2. Conditional shares (section 140A); 3. Convertible shares (section 140D), 4. Post-acquisition benefits (Section 77 – 87 FA 1988); and 5. Share options (section 135) as well as additional chapters on the legislation on the various approved schemes in one place. As indicated below chapters 1 to 5 were replaced with a new set of rules introduced in Schedule 22 of Finance Act 2003.

Also contained fundamental changes such as the abolition of the three cases of Schedule E taxing cash earnings and benefits depending on residence status under 19(1) 1 ICTA 1988, whereas the specific share related charges fell under section 19(1)5. The former became "general earnings" taxed under Section 62 ITEPA 2003 and the latter "specific employment income" taxed under part 7 ITEPA 2003.

Introduction of section 144ZA TCGA 1992 to disapply Section 17 TCGA 1992

On the exercise of a share option and acquisition of shares on or after 10 April 2003, the amount deductible from the sales proceeds when determining any amount liable to capital gains tax is the actual consideration and not the market value. This was in response to the decision in *Mansworth v Jelley* (see above).

Extension of PAYE time limit (section 222 ITEPA 2003)

As from 9 April 2003, extension of the time limit in section 222 (previously section 144A ICTA 1988) from 30 days to 90 days to give more time for the employee to refund to his employer the tax on notional payments.

Technical amendments to approved schemes – Section 139 and Schedule 21 FA 2003

Including permission for one off payments to purchase partnership shares under SIPs; removal of rule denying tax relief for exercise of CSOP options within three years of a previous exercise; introduction of good leaver rules for CSOP; and simplified approval process for SAYE and CSOP.

Close down NICs avoidance schemes in relation to adjustable options – SI 2003/1059

Measures introduced to prevent the use of replacement options to enhance the value of share option gains free of NICs.

Taxed (unapproved) schemes – section 140 & Schedule 22 FA 2003

The underpinning principle behind the changes in Schedule 22 was that employment related reward delivered through the use of shares or securities should be subject to PAYE and NICs, whereas genuine commercial growth on shares acquired by an employee as an investor i.e. for full payment or having suffered the tax on securities acquired for less than full value should attract only capital gains tax, as for any other investor. Schedule 22 also sought to use common concepts defined in similar ways for each of the various charges.

Chapters 1 to 5 were re-written and two new anti-avoidance chapters were added: Chapter 3A (securities with artificially depressed market value) and Chapter 3B (securities with artificially enhanced market value). The notional loan charge previously in Part 3, ITEPA 2003 was rewritten as Chapters 3C and 3D within Part 7.

Chapter 1 – introduction

Definition of security widened to cover list of "specified investments" under FSMA 2000; list of exclusions such as options added.

Adoption of CGT definition of market value for all charges under Part 7; money's worth concept still applies for the general earnings charge on acquisition of securities. Chapter 3C can provide a residual charge on acquisition if CGT value exceeds money's worth value.

New deeming provision that all securities obtained from the employer or a connected person to be available by reason of employment were employment related securities. Employment deemed to include both former and prospective employments. Replacement or additional securities retain the designation of employment related securities; rules set out to explain when shares cease to be employment related securities.

Exclusions for residence: Part 7 charges are specific employment income, so the residence rules for general earnings in Chapters 4 and 5 of Part 2 do not directly apply. Part 7 rules are based on the position as at the time of acquisition of securities or options.

Consolidation of rules on duty to provide information and categories of responsible person.

Chapter 2 – restricted securities

The new legislation was introduced from 1 September 2003, in respect of restricted securities acquired on or after 16 April 2003. The old legislation applied to chargeable events between 16 April and 31 August 2003, and to shares acquired before 16 April 2003.

The rules on "employment related" growth in value after acquisition of employment related securities were rewritten and brought together in one chapter. Previously, shares with restrictions could be taxed under section 140A ICTA 1988 ("conditional shares") or under the growth in value charge (section 78 FA 1998). The taxpayer could opt out of section 140A and into the section 78 charge, which was less effective on charging tax on the growth in value of conditional shares.

Employment related securities fell to be taxable under this chapter if there was a contract, agreement, arrangement or other specified condition which resulted in the market value of the security was less than it would otherwise be.

This included "conditional shares" and provided for an exemption from tax at the time of acquisition if forfeiture period lasted 5 years or less. A new joint election (section 425(3)) was introduced to ignore the exemption and pay tax on acquisition but a charge would still arise on the lifting of restriction.

Tax is charged on a chargeable event (including when securities cease to be restricted securities, on the variation of a restriction and disposal to an unconnected person) and a formula was provided to calculate charge for event.

A new election (section 431) was introduced to treat all restrictions as not applying on acquisition (money's worth charge on the unrestricted market value at acquisition and no further income tax charges) or to treat a specified number of them as not applying.

Chapter 3 – convertible securities

Charge to tax only on the increase in value of the shares on conversion and not on any growth in the value of the original share from acquisition to conversion (as under the 1998 charge). The new legislation was extended to cover all securities (as opposed to convertible shares only, as for the 1998 charge).

Definition of convertible securities was extended to cover circumstances where someone else could determine when they were converted.

Charge on acquisition modified to ignore the value of the right to convert when valuing the security (consistent with Chapter 5 not charging on the grant of an option). The circumstances giving rise to the charge (“chargeable event”) also mirror the rules for share options.

Chapter 3C securities acquired for less than market value

The new chapter replaced the old section 162 ICTA charge on notional loans in respect of acquisition of shares, bringing all employment related securities within Part 7 and the discharge of a notional loan within the charge to PAYE and NICs.

Chapter 3D – securities disposed of for more than market value

The new chapter replaced the old section 162(6) ICTA 1998 charge, bringing all employment related securities within part 7 and to apply PAYE and NIC to this charge.

Chapter 4 – Post acquisition benefits

Sweeping up provision derived from section 80 FA 1988.

Chapter 5 – securities options

Significant changes relating to shares and company loan notes from 1 September 2003 and from 16 April 2003 for other securities options. The principal driver for the earlier date was an avoidance scheme using options over government gilts.

The “by reason of employment” test was deemed to extend to all options granted by the employer. Employment included former and prospective employments.

Introduction of new chargeable event on the receipt of a benefit in connection with the option in specified circumstances. This captured share option gains arising from cash compensation paid where a company had been taken over and there was no right to exercise or dispose of the options held by employees.

Change to wording as to the tax point reflecting that the charge arises when a beneficial ownership is acquired (and not at the time when securities are conveyed or transferred, if that time is different).

A deductible amount in calculating the section 478 charge to reflect that the amount of employer's NICs payable by agreement or election is also deductible.

Corporation tax deduction for the cost of employee shares – section 141 to 143 with Schedules 23 & 24

Following the Dextra case, companies could obtain a corporation tax deduction for share scheme costs where the employer made a contribution to an intermediary i.e. an employee benefit trust, intended to provide benefits to employees without shares being provided to the employees.

Schedule 24 required companies to pay the benefit or expense within nine months of the contribution to obtain the corporation tax deduction. Further, the benefit must give rise to an income tax charge. The deduction was the lesser of the amount chargeable to income tax and the payment to the intermediary.

Schedule 23 was introduced based on the principle of giving a corporation tax deduction for the accounting period in which the ITEPA charge arose and in the same amount. Schedule 23 provided relief for acquisition of shares which were acquired by reason of employment, provided certain requirements were met.

QUESTs to run their course but no CT deductions for future payments to new or existing QUESTs.

2004 Relief for employer's NICs for restricted and convertible securities – Section 3 NICSPA 2004 and Section 85 & 86 FA 2004

Extension of the scope of joint NICs elections to restricted and convertible securities. Deduction in respect of secondary NICs paid by the employee by agreement or election.

Section 86 – 87 FA 2004

Re-write of section 446E to apply even if the forfeitable securities were disposed without consideration. A further charge on lifting of restrictions where securities were sold for nil consideration or cancelled.

Availability of relief from a charge under Section 426 (post acquisition chargeable events) was subject to an anti-avoidance test.

Section 88 – 90 FA 2004

Amendment to the definition of "associated person" and "relevant linked person" so that once connected always connected.

Originally Section 421G provided an exemption for SAYE, SIP and CSOP from Chapters 2 to 4 of Part 7 ITEPA. This section was repealed to counter avoidance by inflating the value of shares under CSOP.

Deemed section 431 election (section 431A) for all shares acquired by way of SIP, SAYE, CSOP and EMI where no liability arises under Section 530.

Paymaster General announcement on 2nd December 2004

Announcement of government's intention to deal with NICs avoidance in connection with employment related securities via retrospective legislation if necessary.

2005 University spin outs relieved - Sections 20 to 22 FA 2005

More avoidance – insurance contracts, restricted and convertible securities – section 12 & Schedule 2 Finance Act (No. 2) A 2005

Extension of definition of "securities" to include insurance contracts.

Restricted securities – anti avoidance

Removal of redeemable securities from section 424 exemption and purpose test for exemptions added.

Convertible securities – anti avoidance

Definition extended from "immediate or conditional entitlement" to "entitlement" to convert. Purpose test extended to include avoidance done after acquisition but before the Chapter 3 chargeable event.

Chapter 3C

The purpose test extended to include avoidance done after acquisition but before the Chapter 3C chargeable event. Charge to tax on "discharge of notional loan" was extended, with a deemed discharge where part of an avoidance scheme. New charge introduced where the purpose test was failed.

Chapter 4

Introduction of a purpose test disapplying the exception to the charge if its main purpose or one of the purposes of the arrangement was avoidance of tax or NICs.

The purpose test extended to include avoidance done after acquisition but before the Chapter 4 chargeable event.

Mansworth v Jelley revisited – Para 2 Sch 5F (No 2) 2005

New sections 144ZB to 144ZD TCGA to add to section 144ZA.

2008 EMI changes – FA 2008

Scope of EMI restricted to meet EU state aid concerns. A limit of 250 employees was introduced; certain trades prohibited. Individual limit was increased from £100,000 to £120,000 from 6th April 2008.

Residence rules brought in to line – FA 2008

As part of the reforms on residence, all earnings of UK residents (including those not ordinarily resident) were brought into section 15.

Although this brought resident/not ordinarily resident employees into Chapters 2, 3, 4 and 5 for the first time, it meant that those employees on remittance basis on cash earnings were subject to full tax and NICs on Part 7 income.

As a result a new Chapter 5A was introduced into Part 2 to apply the remittance basis on Part 7 income. A new section 41A provides for gains to be apportioned if taxpayer opts to claim the remittance basis.

G Glossary

CSPSSA 2000	Child Support Pensions and Social Security Act 2000
CGT	Capital gains tax
CSOP	Company Share Option Plan
CTA 2009	Corporation Tax Act 2009
CTA 2010	Corporation Tax Act 2010
EBT	Employee benefit trust
EMI	Enterprise Management Incentives
ERSM	Employment Related Securities Manual
FA 2003	Finance Act 2003
FSMA 2000	Financial Securities and Markets Act 2000
GAAR	General Anti-Avoidance Rule
HMRC	Her Majesty’s Revenue and Customs
ICTA 1988	Income and Corporation Taxes Act 1988
IHT	Inheritance tax
IHTA 1984	Inheritance Tax Act 1984
ITA 2007	Income Tax Act 2007
ITEPA 2003	Income Tax (Earnings and Pensions) Act 2003
LTIP	Long Term Incentive Plan
NICs	National Insurance Contributions
NICSPA	National Insurance Contributions and Statutory Payments Act 2004
PAYE	Pay As You Earn
RCA	Readily convertible asset
SAYE	Save As You Earn
SIP	Share Incentive Plan
SME	Small or Medium Enterprise
SSCBA 1992	Social Security Contributions and Benefits Act 1992
SSC(SO)A 2001	Social Security Contributions (Share Options) Act 2001
TCGA 1992	Taxation of Capital Gains Act 1992

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