FRESHFIELDS BRUCKHAUS DERINGER

Employee share schemes – Budget and Finance Bill update

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Introduction

The 2003 Budget and the Finance Bill are introducing a number of major changes to the taxation of approved and unapproved share schemes. Inland Revenue approved share schemes include company share option plans (CSOPs), save as you earn schemes (SAYE schemes) and share incentive plans (SIPs). Some of these changes came into effect in April 2003 (either on 9 April, Budget Day or 16 April, the date the Finance Bill was published) and some will come into effect from a day linked to Royal Assent (probably in July 2003).

The key developments described in this guide are as follows.

- Section A: some fundamental changes to the tax treatment of CSOP options – the first material tax changes since these plans were introduced in 1984. Also described here are some other changes in April 2003 to approved schemes, mainly affecting CSOPs.
- Section B: some more technical changes to approved share schemes taking effect from Royal Assent. These include some important SIP changes and a rather half-baked change to the SAYE treatment of business/subsidiary sales.
- Section C: the new statutory corporation tax deduction for the cost of providing shares under share schemes.
- Section D: some fundamental changes to the tax treatment of unapproved share acquisition arrangements.
- Section E: some miscellaneous developments, having varying degrees of importance.

A Changes to approved schemes taking effect from April 2003

1 CSOPs – removal of the 'second three year rule'
Until 9 April, two key conditions needed to be satisfied for the exercise of an approved option under a CSOP (that is, an approved executive share option scheme under which the options are subject to a £30,000 exercise price ceiling) to be free of income tax. These were as follows:

- first, an option must have been held for at least three years before it was exercised; and
- second, there must not have been a tax relieved CSOP exercise within the three years prior to the exercise.

The second of these rules has now been removed, thus allowing an income tax free exercise of a CSOP option within three years of a previous tax-relieved CSOP exercise. Only in rare cases will this tax charge require an amendment to the CSOP scheme rules as the timing for exercise is seldom tied in to tax treatment. However, explanatory material which sets out the tax treatment of CSOP options is likely to require amendment.

2 CSOPs – better tax treatment for 'good leavers'
SAYE and SIP participants who cease to participate in a scheme for a 'good leaver' reason (injury, disability, redundancy or retirement at a specified age) are already exempt from income tax and National Insurance contributions (NICs) on their shares. This exemption has now been extended to 'early good leavers' under CSOPs who exercise their options within three years of grant. (There was previously no favourable tax treatment for CSOP good leavers, other than on death.)

This tax benefit is only available if exercise occurs within six months of the leaving date. Scheme rules sometimes permit 'early good leavers' to exercise for a longer period (eg twelve months, or a time period linked to testing of a performance target). Exercise after the six months (but before qualifying for tax relief after three years from grant) will attract income tax and NICs.

The only complexity arises from the retirement provision. For exercises after Royal Assent, the Finance Bill defines 'retirement' for this purpose as retirement at or after an age specified in the CSOP rules being not less than 55 and being the same for men and women. Most CSOP rules will already permit options to be exercised within three years of grant if a participant *either* retires at or after 'normal retirement age' or a contractual retirement age (neither of which is

usually before age 60), *or* is treated as an early retiree at the company's discretion. An age specified in the rules is a new concept imported from SAYE and SIP legislation – but unfortunately it will require CSOP rules to be amended to insert a specified age, and creates unnecessary complexity.

Companies can in principle take two broad approaches.

a. Where a pro-employee line is justified, it may be appropriate to replace the existing retirement provisions with an ability to exercise on retirement at or after age 55 (perhaps with a discretion to permit early exercise on retirement between 50 and 55, but in a non-tax favoured manner). This approach takes maximum advantage of the tax relief, and could be followed when the CSOP is operated on a widespread basis (eg as an extension to an SAYE scheme). But in many cases the creation of a *right* of early exercise for retirees from 55 onwards would be over-generous, and would often conflict with the operation of a corporate performance target (which usually applies in the case of retirees). This may point towards raising the specified age (eg to 60) or following the approach in b.

b. The least invasive approach would be to retain the existing exercise rules on retirement, but to overlay them with the statutory specified age. Unfortunately, a rule amendment to refer to specified age is unavoidable if the new relief is to be available to retirees after Royal Assent. This approach would not change the practical effect of existing rules, and therefore age 55 might as well be specified. Nor would it affect the operation of existing performance target provisions.

The approach in b. is very unlikely to require shareholder approval, and could clearly apply to existing options as well as future grants (as no new rights of exercise are created). In contrast, the approach in a. may not fall within the board's amendment powers, and it is not clear that the Revenue would agree such a fundamental change where it is sought to apply it to existing options.

3 CSOPs – less favourable tax treatment on early exercise

This is the flip-side to the new tax relief for 'early good leavers' described in 2 above. Until 9 April, where an optionholder was permitted to exercise a CSOP option within three years from grant, the optionholder would become liable to income tax (but not NICs) in respect of that exercise. This tax liability was collected through the optionholder's self-assessment tax return, not under PAYE.

This has now been changed so that:

- NICs (both employer's and employee's) will now become due on the exercise (other than where the optionholder leaves for an 'early good leaver' reason – see 2 above); and
- the optionholder's employing company will be obliged to operate PAYE to collect both the income tax and NICs liabilities.

This is an important (and potentially expensive) change as early exercise often results from events outside the optionholder's control – such as a takeover of the optionholder's parent company, or the sale of his employer outside the parent's group. These events seldom fall into the 'early good leaver' tax exemption described in 2 above (the main exception being where a business sale under TUPE also qualifies as a redundancy under the *Chapman v CPS Computers* principle).

In contrast, SAYE options which are exercised early do not attract NICs or a PAYE deduction.

The changes are retrospective and affect all subsisting and future options. There is therefore a new risk of unanticipated NICs costs from operating CSOPs.

Scheme rules will need to be amended to ensure that the employing company has a power to make the necessary PAYE withholding upon exercise. Until the Budget, the Revenue refused to permit an approved scheme to contain a PAYE withholding power on a 'just in case the law changes' basis – this will now pose problems for employers should exercise occur in circumstances where a PAYE liability arises. Proper authority to deduct PAYE in relation to future option grants would be obtained by the rule amendment. For existing option grants, the employee would have a respectable legal argument that the employer had no authority to deduct PAYE on exercise because he was not bound by the relevant rule amendment without his written consent (because it would be detrimental to him). In practice, companies are likely to obtain the requisite authority in the small print of the documentation by which the employee exercises early. But it should be emphasised that the employer is generally the party at risk if PAYE is not deducted. In acrimonious takeover situations, employers may feel constrained to pay the PAYE themselves in the absence of proper authority under the rules – a potentially convenient poison pill.

Finally, it is worth noting that employers will be able to transfer the employer's potential NICs liability on approved CSOP options to an employee by way of the same procedure that has to date been used for unapproved options (either by way of a reimbursement or

through the use of an approved form of joint election to transfer the liability). In the case of existing options the employee would need to consent (and care would need to be taken in persuading him to do so). For future option grants, the terms of grant could require the employee to bear any NICs liability.

4 CSOPs – greater flexibility on funding arrangements
Until 9 April, the Inland Revenue did not permit 'cashless exercise' arrangements for approved CSOP options – for example, giving an undertaking to pay the exercise monies from a sale of shares after exercise. This will now be permitted, provided that the arrangement does not amount to a right to receive cash (in other words the employee must become the owner of the shares prior to their sale).

Scheme rules and employee documentation are likely to need to be amended to take advantage of this.

5 CSOPs – determining market value for share scheme purposes
Until 9 April, where shares over which CSOP options were to be granted were not listed on the London Stock Exchange or the New York Stock Exchange, it was necessary to obtain advance approval from the Shares Valuation Division of the Inland Revenue for the valuation of those shares – even where the share price was quoted daily in the UK press. This often caused delay. Scheme rules can now specify market value by reference to published share prices on a 'Recognised Investment Exchange' (eg NASDAQ, the Australian Stock Exchange and a range of European stock exchanges). This administrative change should speed up the process of agreeing values for such shares with the Shares Valuation Division. CSOP rules for relevant companies may need to be amended in order to benefit from this.

6 CSOPs – simplifying the approval process
A CSOP cannot be operated until it has been formally approved by the Inland Revenue. Until 9 April, Inland Revenue approval has usually been a two stage process – informal approval based on draft documents, followed by formal approval once the scheme has been adopted by shareholders or the board. The second stage will now be removed: where a scheme has been informally approved by the Inland Revenue, formal approval will be effective from the moment the scheme is adopted, provided there have been no relevant changes to the scheme, the legislation or the circumstances of the company since informal approval was given. This will, therefore, enable companies to grant options immediately after a scheme has been adopted. The relevant shareholders' or board resolution will need to be submitted to the Revenue in due course.

7 Unapproved schemes – extension of time for refunding PAYE charge

Until 9 April, where a PAYE income tax deduction arose on the exercise of an option, the employee was under an obligation to refund the employer the amount of the PAYE deduction within 30 days of the date on which the option was exercised. Failure to meet this deadline could result in an effective surcharge of 16 per cent on the gain. This deadline has now been extended to 90 days. The rules governing NICs will also be changed (from a date to be fixed after Royal Assent) so that the 90 day period also applies to any Class 1 NICs liabilities.

B Changes to approved schemes taking effect from Royal Assent to the Finance Act 2003

The following Budget announcements will take effect when the Finance Act 2003 receives Royal Assent – this is likely to occur in July 2003. With the exception of the change in Inland Revenue practice in approving scheme amendments and the SIP changes, these are generally changes of a more technical nature. For most schemes, it will be possible to make these changes without shareholder approval, but this should always be checked.

1 CSOPs and SAYE schemes – general

Material interest

The definitions of 'material interest' for the purposes of CSOP and SAYE schemes are currently different and will be conformed so that both refer to a 25 per cent interest. This is relevant to the exclusion from scheme participation of substantial shareholders and connected persons in unquoted close companies. Definitions in scheme rules may need to be amended.

Scheme amendments

Companies are currently required to obtain prior approval from the Inland Revenue before any amendments to approved CSOP and SAYE scheme rules, however minor, can take effect. This requirement is to be conformed to the current SIP legislation, such that only amendments to 'key features' of schemes will require prior approval. 'Key features' of the rules are those features which are necessary in order to obtain approval under the applicable legislation. The existing amendment powers in scheme rules may need to be amended (and approved by the Inland Revenue) before a company can take advantage of this change.

2 SAYE – sale of employing business/subsidiary

SAYE schemes usually provide that if an optionholder leaves the group in which options are granted because he works in a subsidiary or business which is sold, he may exercise his option within six months of leaving (provided he is not then employed in an associated company). A change to the legislation will permit an SAYE scheme to provide for exercise *either* upon leaving the group (as is currently possible) *or* upon leaving the new group which he joins, but only if he leaves the new group in 'good leaver' circumstances prior to the relevant bonus date. The scheme rules must make the choice upfront, not at the time of a transaction.

So it is now open to a company to design a scheme whereby the sale of a subsidiary does not give an automatic right of exercise, but defers the right of exercise until such time as the employee leaves his

new employer as a result of injury, redundancy or retirement. This is an odd – and rather unattractive – approach because an employee who survives with the new employer until the maturity date of his option will lose any right of exercise since he will not be an employee of the original group at the maturity date.

The new alternative arguably produces a strange result if a business (as opposed to a subsidiary) is sold. Under the *Chapman* principle mentioned above, a transfer of a business is a redundancy for option taxation purposes and most schemes will provide for a redundancy to give rise to a right of exercise. So if a scheme provides for the new second alternative there may be some difficulty in deciding whether participants have to exercise within six months of leaving the original group by reason of their *Chapman* redundancy rights or have the possibility of retaining their options and exercising them at some later unpredictable date if they are unfortunate enough to be a 'good leaver' from the new group.

If companies wished to adopt the new approach we think that shareholder approval would be required and that it is unlikely to be possible to amend existing options so as to provide for the second alternative.

3 SIPs – general

The following changes will simplify SIPs and provide increased flexibility for employers and employees.

- The current restriction that employees can only purchase partnership shares through deductions from monthly salary of £125 or 10 per cent of the employee's salary in a tax year, whichever is lower, is to be abolished. Employees will be permitted to purchase up to the £1,500 annual limit of partnership shares at any time within the year.
- The current requirement that employers have to use 'salary' (that is, total remuneration less taxable benefits) when calculating the maximum percentage that can be spent on partnership shares is to be abolished. Employers will be permitted to decide whether all or part of an employee's salary will be used when calculating the maximum percentage of salary to be spent on partnership shares. This change removes the administrative difficulties for employers caused by monthly variations in overtime payments and bonuses received.
- Employees will be permitted to participate in two SIPs run by connected companies in the same tax year, although not at the same time. This change will enable employees to continue to participate in a SIP where the employee has transferred from one company which

operates a SIP to another company within the same group which operates a separate SIP.

- The changes to the holding period for dividend shares proposed in the Budget have now been withdrawn.

C Corporation tax relief for share schemes

A new statutory corporation tax deduction for the costs of providing shares for employee share schemes will be available for accounting periods beginning on or after 1 January 2003. This deduction was announced at the end of 2002, but is being implemented in the Finance Act 2003.

Under the previous regime, employers were not entitled to a corporation tax deduction for the costs of providing a share scheme – mainly because of the principle that the issue of new shares at less than market value (for example, on exercise of an option) did not involve a cost, and did not therefore attract a deduction. However, a deduction could often be obtained with careful structuring – for example, the use of symmetry arrangements to satisfy options and, more generally, the routing of share acquisitions at market value through employee benefit trusts. These arrangements were often administratively inconvenient. QUESTs were a variation on the same theme, but could only be used with SAYE schemes.

The new relief secures a deduction for the cost of providing shares to employees in the following circumstances.

- The shares must be acquired in an accounting period starting on or after 1 January 2003 (although the option to acquire shares may have been granted, or the award of shares made, earlier than this).
- The deduction becomes available for the accounting period in which the employee acquires the shares.
- The employee must be chargeable to income tax on the acquisition of the shares (or would be chargeable except that the share acquisition is exempt from income tax under an Inland Revenue approved or Enterprise Management Incentive scheme, or the employee is not subject to UK income tax).
- The amount of the deduction is based on the market value of the shares at the date the employee becomes chargeable to income tax, less any contribution payable by the employee for the acquisition of the shares. Thus, if shares have a £3 market value, a deduction of £2 would be available where an employee pays £1 on exercise of an option. A deduction for £3 would be available if the employee received the shares without payment – eg under a nil cost LTIP award.
- There is no relief for the expenses of establishing, administering or borrowing for the purpose of a scheme, and the deductibility of such expenses continues to follow the normal rules.

- The deduction will only be available if the shares satisfy certain requirements which mirror the requirements of the approved share scheme legislation. The shares must be fully paid up, non-redeemable ordinary shares. They must be shares of a class listed on a recognised stock exchange, or shares in a company that is not under the control of another company, or shares in a company that is under the control of another company whose shares are listed on a recognised stock exchange.
- The deduction will be offset by any corporation tax relief previously obtained in respect of the shares. So, for example, where shares have been warehoused in a trust for an LTIP award and a deduction was obtained several years ago when monies were contributed to the trust, that deduction will reduce the statutory deductions that can be obtained when the LTIP award is exercised/released.
- The corporation tax relief for SAYE options sourced through a QUEST will end for new payments made in accounting periods beginning on or after 1 January 2003. As a result, most companies will wish to wind up their QUESTs as soon as the 'pipeline' of shares which have already been hedged in the QUEST (and a deduction sought) has dried up. Where shares to meet SAYE options are not already in the QUEST – but are available to be called by the QUEST under a back-to-back subscription agreement – then the existing arrangement should generally be unwound and the new statutory deduction relied on.
- The new rules do not affect the more generous corporation tax relief available under the Share Incentive Plan legislation.

This new deduction will interlock with draft accounting proposals (set out in the Accounting Standards Board's FRED 31) under which the 'cost' of options would be charged to the profit and loss account. The deduction will be determined on the basis set out above, rather than using the amount determined under the accounting standard.

D Unapproved share acquisition arrangements

1 Introduction

Schedule 22 of the Finance Bill has introduced significant changes to the income tax treatment of unapproved share schemes. This will mainly impact US-style 'restricted stock', and arrangements that are commonly put in place in private equity transactions where shares acquired by managers are at risk of forfeiture or subject to performance ratchets.

It will not impact on most UK-style LTIPs where the employee only has a future entitlement to the shares and that entitlement is dependent on satisfying a corporate performance target. However, care will need to be taken with LTIPs which involve compulsory holding periods after vesting if the employee does not have full ownership rights in that period.

The landscape is being re-drawn, with the existing income tax charges under the 'dependent subsidiary' regime and the Finance Act 1988 'growth in value' rules being removed. While more arrangements will be caught by the new regime, some of the changes may provide a fairer result for some taxpayers. In brief they will impose an income tax charge when a restriction or condition is lifted, but will often enable income tax to be paid upfront on any undervalue arising at the time of acquisition by reference to the market value of the shares (ignoring the restriction) – thus ensuring that any further growth in value attracts a capital gains tax charge rather than an income tax charge. However, there are new anti-avoidance provisions which evidence the Inland Revenue's determination to close loopholes and impose income tax and NICs where the value of shares is 'manipulated' upwards or downwards other than for 'genuine commercial reasons'. These are widely drafted and it will take some time before we can assess how the Revenue will deploy their new anti-avoidance weapons.

The first change is to introduce the concept of 'employment-related securities'. 'Securities' goes beyond just shares, and now includes gilts, interests in collective investment schemes and contracts for differences (it is just possible that the latter include phantom options).

2 Restricted securities

Chapter 2 of part 7 of Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) (as introduced by schedule 22) will change the basis on which 'restricted securities' are taxed on acquisition and will introduce the concept of an income tax charge when restrictions attaching to restricted securities are removed. This will replace (i) the charge under section 78 of the Finance Act 1988 when value was

injected into shares as a result of restrictions being lifted or varied, and (ii) the charge under section 140A of the Income and Corporation Taxes Act 1988 (ICTA) on 'conditional only' shares.

'Restricted securities' are securities which have restrictions attaching to them which affect their market value. Examples are a prohibition on disposing of shares for a limited period of time, a drag provision contained in a shareholders' agreement, limited voting or dividend rights, pre-emption provisions which are not imposed on other shares of the same class, and compulsory sale provisions.

Generally, restricted securities will be taxed upon acquisition unless they are 'conditional only' shares (as to which see below). Under normal principles an income tax charge and an NICs charge will arise on the value of the restricted securities taking account of the restriction (the restricted market value) less any consideration paid to acquire the shares.

Under the current regime there would be no further income tax charge providing the restriction was just time-based and value was not injected into the shares when the restriction was varied or removed.

However, the new regime will impose a further income tax charge when the shares are sold or a restriction is lifted (whichever is earlier) on the growth in value of that proportion of the shares' value which was not taxed as income on acquisition. The charge is wider in its impact than the old section 78 charge since under the new regime it is not necessary that the lifting or variation of restrictions has the effect of increasing the value of the shares. Equally, the new charge will arise when the shares are sold even if they still remain restricted at that point (although in this last situation the tax charge could be expected to be nil).

Example

If an employee is awarded (without payment) shares worth £100 which he may not sell for four years and it is determined that the time-based dealing restriction reduces the value of the shares by 25 per cent to £75, the income tax at 40 per cent and NICs charge on acquisition will be based on the restricted market value of £75.

If after four years the shares are worth £200, the new regime will then impose a further income tax charge and NICs when the dealing restriction is lifted on 25 per cent of the £200 value, therefore, on £50. If the shares were sold at that point, 75 per cent of the increase in value ie £75 (75 per cent of £100) would be subject to capital gains tax at 10 per cent (assuming full taper relief).

This would contrast to the current regime, where income tax and NICs would normally be charged on the £75 restricted market value at the time of acquisition, but not on the £25 element (either at acquisition or subsequently).

The new regime is rather unwieldy (not least from a valuation viewpoint), and there is now an ability for an employee to elect to pay income tax upfront on the full value of the shares as if they were not restricted. This has the effect of avoiding the post-acquisition charge, with the whole of the increase in value after acquisition being taxed as capital (with the benefit of taper relief). The election has to be made jointly with the employer within 14 days of acquiring the shares.

Example

If, in the above example, an election was made so that the employee pays income tax and NICs on the initial unrestricted market value of £100, the new regime would not apply. On a sale after four years, capital gains tax would be payable on the increase in value of £100.

If, under their restricted terms, shares are at risk of compulsory sale (forfeiture) at some time in the future at a price which is less than their market value at the time of sale (for example, if an employee would be required to sell his shares in the event of resignation) then there is a slightly different tax regime depending on whether the risk of forfeiture would expire within five years of the shares being acquired (these are the old style 'conditional only' shares) or later. If the risk of forfeiture were to last for more than five years the shares would be taxed on acquisition as described above.

As a general rule 'conditional only' shares will, as now, not be taxed on acquisition but will be taxed as income on the basis of the unrestricted value at the time the risk of forfeiture has fallen away (eg when the 'vesting' period has expired) or when the shares are sold (if earlier).

Example

If an employee is gifted shares worth £100 which he must forfeit if he leaves employment within three years, and it is determined that their restricted value is £75, he will not immediately have a tax charge.

Under the new regime, he will be taxed on the unrestricted value of the shares at the end of three years (or, if a sale occurs first, on the sale proceeds). If he sells the shares for £200 after the three years, he will pay income tax and NICs on £200. This is the same as under the old regime.

However, as with restricted securities, an employee can make an election to pay income tax on the full unrestricted market value of 'conditional only' shares at the date of acquisition ie the £100. He will then avoid any further income tax when the shares are sold or the forfeiture condition lifts.

In one respect, the new regime is more onerous than the old 'conditional only' share regime. Amongst other exclusions, shares were outside the old regime if the only circumstance in which they could be compulsorily sold was on termination of employment pursuant to a provision in the company's articles of association.

Unfortunately, this exclusion is not available under the new regime. The only exclusion is if the cessation of employment is as a result of misconduct (this exclusion also applied under the old regime).

The key difference between the new and old 'conditional only' regimes is that the employee can now achieve a very tax effective result if he is prepared to gamble that he will become fully entitled to the shares. He can use the election to take an upfront income tax charge so that any future growth in value will be taxed as a capital gain and not as income. Since the taper relief period runs from the time the shares are acquired, there is every chance that the gain will be taxed with the benefit of full business asset taper relief so that a higher rate taxpayer will incur tax at a rate of 10 per cent rather than at the income tax rate of 40 per cent.

There are benefits for an employer in the election being made. Any amount subject to income tax will also be subject to employer's NICs. In the example where the shares have been gifted, the use of the election would result in NICs of £12.80 on the initial unrestricted value being paid as compared to NICs of double that amount if an income tax charge arises at the later date. Since the election has to be a joint election, an employer may insist that the only basis on which shares will be awarded will be if the employee makes the necessary election.

3 Convertible securities

The provisions of chapter 3 of part 7 of ITEPA relating to convertible shares have also been replaced. Under these provisions, where convertible shares are acquired by reason of employment, a charge to tax arises on the market value of the convertible shares on the date on which they are acquired. On conversion there is a further charge to tax on the market value of the new shares less the amount already charged to tax and less any amount paid by the employee on the conversion.

This approach was considered to be defective as it did not reflect the fact that the employee was acquiring a share plus a right to convert the share into another share or security. The Finance Bill seeks to address this by treating the convertible share as two assets: first, the share itself (ignoring the right to convert) and, secondly, the right to acquire another share or security.

The new income tax charge will operate as follows.

- A charge to tax will arise when the convertible shares are acquired, based on the market value of the shares if they were not convertible – for example, if an employee is awarded convertible shares for no consideration having a market value (including the conversion

right) of £1,100 and a market value of £1,000 (ignoring the conversion right), the employee will be taxed on the £1,000 value.

- On conversion, the tax charge will be on the market value of the new shares acquired on conversion less the market value of the old security at conversion (ignoring the conversion right) and less any consideration paid by the employee on conversion – for example, if the value of the new shares acquired on conversion is £2,400, the value of the old shares at the time of conversion (ignoring the conversion right) is £2,000; the charge to tax will be on the £400 difference.

Under ITEPA 2003, based on the above example, the tax charge would have been as follows:

- tax charge on £1,100 on acquisition (the full market value of the shares); and
- tax charge on conversion on £1,300 (£2,400 less £1,100).

The new rules ensure that any growth in value of the element which is taxed on acquisition (£1,000) is not taxed as income, and that the income tax charge on conversion is limited to the value of the right (£100) and the growth in value of that right (£300).

E Miscellaneous developments

1 Reversal of the decision in *Mansworth v Jelley*

For options exercised on or after 10 April 2003, the Court of Appeal decision in *Mansworth v Jelley* is reversed. The situation will now be as follows. For capital gains tax purposes, the acquisition cost or base cost of shares acquired on exercise of employee share options will be calculated as the aggregate of the exercise price paid plus the amount of the gain on which income tax was payable. Generally, this means that the acquisition cost equals the market value of the shares at the date of exercise. If the shares are sold immediately following exercise, there should be no capital gain or capital loss. In *Mansworth v Jelley*, it was held that the acquisition cost is the market value of the shares at the date of exercise (rather than the actual price paid) plus the amount of gain on which income tax is payable. This resulted in a higher based cost which should reduce the taxable capital gain or in some cases turn a gain into an allowable loss.

This change restores the position to what was understood to be the position prior to *Mansworth v Jelley*. Nevertheless, there remains the opportunity to claim *Mansworth* capital losses in respect of unapproved exercises prior to 10 April 2003.

2 Securities with artificially depressed and artificially enhanced values

Two new chapters are also introduced into ITEPA 2003 by the Finance Bill. If the value of employment-related securities is depressed or enhanced due to non-commercial transactions then an employee is to be subject to income tax on that reduction or enhancement in value.

3 Closure of loophole in unapproved schemes

Currently, a charge to NICs will only arise on the exercise of unapproved options which have been granted on or after 6 April 1999. The lack of a charge to NICs on options granted before 6 April 1999 has apparently led to artificial arrangements being put in place in relation to these options to avoid charges to NICs arising – for example, arrangements to pay cash bonuses through these options. Now, exercises of options which have been manipulated in order to take remuneration outside the NICs charge will be subject to NICs.

4 Definition of shares

'Unapproved' schemes currently give rise to a tax charge on gains arising from shares and company securities. With effect from 16 April 2003, for the purposes of any charge to income tax (and from a day to be appointed for any charge to NICs) the definition will be extended to include a variety of financial products.

5 Reporting requirements

Reporting requirements for unapproved schemes are to be extended to enable the relevant information to be obtained from any of the employer company, the 'host' company (where the employee remains employed by a foreign corporation), the company issuing the shares, or the company whose shares are the subject of the issue.

6 National Insurance changes

As announced in the 2002 Budget, the following increases in employee's NICs took effect from 6 April 2003:

- on earnings between the lower and upper earnings limits, employee's NICs rise from 10 per cent to 11 per cent; and
- additional employee's NICs of 1 per cent are now payable on all earnings above the upper earnings limit (£595 per week) – in order to enable employers to cope with this 1 per cent increase, the existing limit on the amount that may be recovered from an employee each month is to be abolished.

Employer's NICs have risen to 12.8 per cent on earnings over £89 per week.

7 Treasury shares

Companies are not currently permitted to hold their own shares. Under the Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003, companies that are listed on a stock exchange (including AIM) or are listed on an equivalent market in the European Economic Area will be permitted to purchase their own shares, hold them in treasury, and then subsequently either cancel them or sell them back into the market. For tax purposes, shares purchased into treasury will be treated as if they had been cancelled and shares sold out of treasury will be treated as newly issued. While they are held in treasury, shares will be treated as if they do not exist. The Regulations will come into force on 1 December 2003.

8 Employee benefit trusts

Draft legislation was published on 27 November 2002 to counter the avoidance of income tax and NICs through the abuse of employee benefit trusts (EBTs). The new legislation (which is contained in the Finance Bill) provides new rules for determining when an employer can claim a corporation tax deduction for contributions made to an EBT (or other third party) where such contributions are to be used to provide benefits to the company's employees. The new legislation (which replaces sections 43 and 44 of the Finance Act 1989) defers the employer's corporation tax deduction for the contribution until a payment is made out of the EBT in a form which gives rise to a liability to income tax and NICs. This legislation will not apply to

deductions permitted under the new statutory corporation tax deduction for employee share schemes (see section C above) or for contributions under retirement benefit, personal pension or accident benefit schemes. The new rules apply in respect of deductions for contributions made on or after 27 November 2002.

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