

EMPLOYEE SHARE ACQUISITIONS: CORPORATION TAX RELIEF

ENDING STATUTORY CORPORATION TAX RELIEF FOR NEW PAYMENTS INTO A QUALIFYING EMPLOYEE SHARE OWNERSHIP TRUST

EXPLANATORY NOTES

Summary

The Government wishes to encourage growth in productivity and believes that employee share and share option schemes have a central role to play by motivating and encouraging employees to take a real interest in the success of their company. The Government announced in 2001 that it wanted to review the corporation tax treatment of employee share schemes. The review would look at current tax treatment and consider streamlining the process and making access to a corporation tax deduction easier, particularly for small companies.

The proposals that emerged from that work level the playing field between remuneration in the form of cash or shares by removing the need for complex and expensive arrangements using trusts in order to obtain a corporation tax deduction for the cost of providing shares for employee share schemes.

The draft clause 1 applies this Schedule (Schedule 1), which provides a statutory corporation tax deduction for the cost of providing shares for Employee Share Schemes. It does not affect the tax treatment of other amounts indirectly related to the provision of shares such as setting up, borrowing or administration costs. These continue to be dealt with under existing law and practise. Clause 2 introduces the changes to Qualifying Employee Share Ownership Trusts (QUESTs).

The schedule has six parts:

- Part 1 – general provisions
- Part 2 – rules applicable to the acquisition of shares awarded by reason of an employee's employment
- Part 3 –rules applicable to the acquisition of shares by exercise of a share options granted by reason of the employment
- Part 4 –rules that modify Parts 2 and 3 where shares acquired are subject to conditions of forfeiture
- Part 5 – supplementary provisions.
- Part 6 – commencement and transitional provisions.

The Schedule

Part 1 – General Provisions

Paragraph 1 – Introduction

Relief is available to a company that awards shares or grants share options (that are later exercised to acquire shares) by reason of an employee's employment. The shares might be acquired by a person other than that employee. The employee will generally be taxed when the shares are acquired and relief for the company is triggered at that time. Paragraphs 7, 14 and 20 specify the need for a tax charge on the employee.

Paragraph 1(3) contains general definitions relating to the schedule.

Paragraph 2 – Requirements for relief

This paragraph explains the overriding requirements of the schedule to facilitate easier navigation through the clauses.

Paragraph 3 – Business must be within the charge to corporation tax

This schedule provides a statutory corporation tax deduction where shares are acquired as part of an employee share scheme that provides a real stake in the company the employee works for. When a company rewards its employees in this way it does so for a business purpose. The shares are therefore awarded or a share option granted for the purposes of a business. That business must be carried on by the employing company and the profits of that business must be within the charge to corporation tax. It is not sufficient that the company itself is within the charge to corporation tax. It has to be the profits of the business for whose purposes the shares are awarded/options granted that are chargeable to corporation tax.

Paragraph 4 – Kind of shares acquired

Relief is provided where employees acquire a real stake in their company. Not all shares provided by a company achieve this so it is necessary to define the types of shares that can be used if a company wishes to qualify for the relief. It is also necessary to define the company whose shares can be used. This paragraph defines the types of shares that can be used. Paragraphs 6 and 12 define the qualifying companies whose shares can be acquired in the context of shares awarded and shares acquired by exercising options.

The shares acquired must be part of the ordinary share capital of a qualifying company. Shares must be:

- fully paid-up and non-redeemable
- of a class listed on a recognised stock exchange, or
- in a company that is not controlled by another company, or

- in a subsidiary of a listed company.

These rules are directly comparable to the rules for Inland Revenue approved schemes in Schedule 9 ICTA 1988 but less restrictive so that companies offering 'unapproved' share schemes to their employees can also benefit from the new provisions.

Employees might acquire shares that do not meet the requirements of this schedule. The availability of a tax deduction for the cost of providing those shares then follows ordinary tax principles. This will include, but is not restricted to, application of the new rules announced in the Pre-Budget Report relating to a restriction of deductions for employee benefit contributions. If relief were available for the provision of such shares it would be given at the same time as relief under this Schedule but may be in a differing amount.

Part 2 – Award of Shares

Paragraph 5 – Introduction

Shares acquired by reason of the employment might be awarded to the employee or another person or acquired by the exercise of a share option. The shares acquired might then be subject to conditions of forfeiture for some period of time. Part 2 deals with the situation where shares are awarded and is modified by the rules in Part 4 if those shares are subject to conditions of forfeiture. If the shares are acquired on the exercise of an option then the rules in Part 3 apply, again modified by Part 4 if those shares are subject to conditions of forfeiture.

Paragraph 6 – The company whose shares are acquired

When a company rewards its employees using equity it is not necessarily the shares of the employing company that are used. In a group situation it is probably more common to use shares of the intermediate or ultimate parent to provide the real stake in the undertaking.

Paragraph 4 specifies the type of shares that can be used. The purpose of this rule is to define which company's shares can be awarded. There are similar rules in Part 3 relating to shares acquired by exercising share options.

The general rule is that starting from the employing company it is allowable to look upwards through a group or consortium structure to a company whose shares are awarded. Employees cannot be awarded shares in companies at the same level as the employing company or below it in the group structure if relief is to be available under this schedule. This is because such shares do not give a real stake in the company or group the employee works for.

It is of course not only singleton or group companies that award shares by reason of the employment. A consortium might ultimately own an employing company and shares in one of the consortium members or the parent of such a company might be

awarded by reason of the employment with the employing company. The rules provide for relief in such circumstances.

Paragraph 28(1) defines a consortium for the purposes of this schedule as five or fewer companies that hold at least 75% of the ordinary share capital of a company where each member of the consortium owns at least 10% of that capital. This definition is used in paragraphs 6(1)(c) & (d). It is comparable to the definition used for Capital Gains Tax Taper Relief.

Paragraph 6 is widely worded (as is paragraph 12 in Part 3) to include as many corporate structures as possible where there is a definable link between the shares awarded and the provision of a real stake in the corporate structure within which the employee works. The test is carried out at the time of the award.

The company whose shares are acquired can be:

- Paragraph 6(1)(a) – The employing company
- Paragraph 6(1)(b) – A parent of the employing company in a 51% group structure.
- Paragraph 6(1)(c) – A member of a consortium or its 51% parent that owns either the employing company or the employing company's 51% parent.
- Paragraph 6(1)(d) – Deals with rare circumstances where two or more members of a consortium are so closely linked that they are viewed as a single undertaking. In such cases shares in one consortium member might be awarded to employees of the other consortium member's group. This rule follows very closely the Capital Gains Tax Taper Relief definition of a Joint Enterprise Company (defined in Paragraph 24, Schedule A1, TGCA 1992) and is targeted at companies that need to take advantage of that provision for Taper Relief purposes.

Paragraph 7 – Income Tax position of employee

The underlying policy objective of this measure is to recognise the use of shares as part of remuneration packages for employees. The aim is to match relief for the company with the taxation of the income on the employee. To do this eligibility to the relief is dependent on the employee being taxed.

Relief under this part of the schedule is available only where the award of the shares is chargeable under S19 ICTA 1988 on the employee. However, in certain circumstances the Income Tax Act does not impose a charge on the employee when shares are awarded. An example of this would be where the employee is employed by, and is awarded shares by reason of that employment with the employing company but is resident outside the UK when the award is made. To ensure relief is available to the employing company in such instances an exception to the general rule is required. This is defined in paragraphs 7(1)(b) and 7(2).

Paragraph 8 – Amount of relief

The amount of relief recognises that the employee is taxed on receiving income by reason of the employment. The deduction is design to match that remuneration cost. The deduction is equal to the difference between the market value of the shares when they are acquired and any amounts paid or payable for the employee's (or other person's) acquisition of the shares. These latter amounts might be payable by the employee or a third party.

Broadly speaking this is the amount taxable on the employee and therefore matches the deduction for the company with the taxation of the employee. However, to retain simplicity for companies the Capital Gains Tax meaning of market value is used rather than the slightly differing valuation requirements of the income tax charging sections.

Paragraph 8(2) puts beyond doubt that the performance of any duties of the employment are not to be taken into account as part of the value of any consideration given for the purposes of computing the amount of relief due.

An employee may make a payment when shares are acquired that is partly to acquire the shares and partly for other reasons. Paragraph 8(3) recognises this and requires an apportionment of the total amount. This ensures that only the amount payable in respect of the share acquisition is included as 'consideration given' thereby reducing the amount of the deduction under this schedule.

A company may have more than one business. For instance a trade and a property letting business. Paragraph 8(4) in conjunction with paragraph 9(4) require the deduction calculated under the schedule to be apportioned between the different businesses if the employee was awarded the shares for the purposes of more than one of those businesses.

Paragraph 9 – How relief is given

The relief is available to the company that awards the shares as a deduction in computing the Corporation Tax profits of the business carried on by it. This follows the rules in S203FB ICTA 1988, which determine which company is to operate PAYE when employees are taxed in respect of their share acquisitions. This will minimise additional administrative requirements on companies.

Investment and insurance companies obtain relief as an expense of management (paragraphs 9(2) & (3)).

Paragraph 9(4) builds on the requirements in paragraph 8(4) to ensure that relief is apportioned between businesses where appropriate.

Paragraph 10 – Timing of relief

The timing of the relief is targeted to recognise that the shares are acquired as part of the employee's remuneration. Relief is therefore due for the accounting period in which the employee acquires the shares and is taxed on that acquisition.

Paragraph 10(2) explains what is meant by the 'time when the shares are acquired'. This is when the recipient (defined in paragraph 1(3)) acquires a beneficial interest in the shares, not when the shares are conveyed or transferred to that person.

Part 3 – Grant of Option

Paragraph 11 – Introduction

If the shares are acquired on the exercise of an option then the rules in this part apply to determine the timing and amount of any relief. Again these rules are modified by Part 4 if the shares acquired are subject to conditions of forfeiture.

Paragraph 12 – The company whose shares are acquired

The rules in this paragraph define exactly the same types of company whose shares can be used to satisfy the exercise of share options as those companies described in paragraph 6. The difference here is the time at which the test is performed. In the case of options it is at the time the option was granted, not the later time when the option is exercised and the shares acquired.

The reason for this is that the company required to operate PAYE is determined at this time by S203FB ICTA 1988. To minimise additional administrative burdens and to retain the link between the provision of shares for remunerative purposes and the company employing the individual this time is adopted for the purposes of this relief.

Paragraph 12(2) contains definitional terms used in the rest of the schedule to ensure that relief is available when a company is reorganised and share options in the old company are replaced by options over shares in the new company.

Paragraph 13 – Takeover of company whose share are subject of option

A company may be reorganised in the period between the grant of an option and the exercise of that option. When this happens options might be cancelled, in which case relief would not be available, as shares would not be acquired by anyone.

Alternatively, options over shares in the original company might be replaced by options over shares in the acquiring company. Where this happens the employee would remain taxable on exercise of the option, subject of course to the option being under an Inland Revenue approved scheme or Enterprise Management Incentives. Relief continues to be available in these circumstances.

Paragraph 13 deals with this by treating the shares acquired by exercise of the replacement option as if they were acquired by exercise of the original option, as long as the company over whose shares the replacement options are granted meets the requirements of this paragraph. Broadly speaking the rules are similar to those in paragraph 12 and define a qualifying company as the acquiring company, a consortium of which the acquiring company is a member or a parent in relation to that company. The rest of the schedule continues to apply in relation to the new options granted.

Paragraph 14 – Income Tax position of employee

This paragraph is equivalent to paragraph 7. It requires a tax charge on the employee when shares acquired by exercising a share option. That tax charge will be under either S19 or S135 ICTA 1988.

In relation to share options an additional exemption from the requirement for a tax charge on the employee is needed. This is because companies operating Inland Revenue approved share option plans or Enterprise Management Incentives also qualify for a CT deduction for the relief despite the fact that the employee is not chargeable to income tax on any share option gain. Paragraphs 14(1)(b) and 14(2) provide the necessary exemption.

Paragraphs 14(1)(c) and 14(3) provide the same exemption from the requirement for an income tax charge as that provided by paragraph 7(1)(b) and 7(2) on the award of shares. A common example of this is where an employee is chargeable under S162 ICTA 1988 when shares are acquired by exercising a share option due to the residence position when the option was granted. There would not therefore be a S135 ICTA 1988 charge on the employee but relief would still be available to the company.

Paragraph 15 – Amount of relief

This paragraph applies the same rules to determine relief in the case of shares acquired by exercising share options as those applied by paragraph 8 for share awards.

Where shares are acquired by exercising share options the employee and employer can enter an agreement or joint election for the employee to pay the employer's National Insurance Contributions. The additional rules in paragraph 15(2)(b) put beyond doubt that such amounts are not to be taken into account for the purposes of computing the amount of relief due.

Paragraph 16 – How relief is given

This paragraph operates in the same way for shares acquired on the exercise of an option as paragraph 9 operates when shares are awarded to the employee or another person by reason of the employee's employment.

Paragraph 17 – Timing of relief

As with paragraph 10, relief is due for the accounting period in which the employee acquires the shares and is taxed on that acquisition. In this instance that is when the share option is exercised.

Part 4 – Provisions applying in case of shares subject to forfeiture

Paragraph 18 – Introduction

Shares acquired by award or by exercising an option might be subject to conditions of forfeiture for a period of time. In such cases the tax charge on the employee is deferred until the conditions of forfeiture are lifted or the shares are disposed of with the conditions still attaching. This part of the schedule modifies Parts 2 and 3 so that the relief for the employing company is matched with the employee being taxed.

Paragraph 19 – Meaning of shares being “subject to forfeiture”

This paragraph defines what shares being “subject to forfeiture” means so that a company can decide whether Part 2 applies to determine when and in what amount relief is due.

The paragraph applies the same definition of shares subject to forfeiture for the purposes of this relief as the definition found in S140A, S140B and S140C ICTA 1988 where such shares are defined for Income Tax purposes. Employers who offer shares to their employees in the expectation of a charge on the employee under S140A ICTA 1988 will know that they need to look at Part 2 of this schedule to calculate the amount of any CT deduction.

Paragraph 20 –Income Tax position of the employee in cases of shares subject to forfeiture

This paragraph modifies the rules in paragraphs 7 and 14 by requiring a tax charge on the employee under S140A ICTA 1988. This arises when the conditions of forfeiture are lifted or the shares are sold while still being subject to those forfeiture conditions.

Where forfeitable shares are acquired by exercising an option the CT deduction for the company is matched with the later tax charge on the employee under S140A ICTA 1988 even though tax may have been payable on the earlier exercise of

the option. This achieves the policy aim of matching the deduction for the company with the taxation of the employee and ensures that shares subject to forfeiture are treated in the same way irrespective of the method by which they were acquired.

The same exemptions apply here as in paragraph 7 and 14 for non-resident employees.

Paragraph 21 – Amount of relief in cases of shares subject to forfeiture

Again, these rules are comparable to those in paragraphs 8 and 15.

As with paragraph 15(2)(b), paragraph 21(4)(b) excludes from any consideration given the employer's national insurance contributions paid by the employee as a result of an agreement or joint election made for that purpose. Although elections and agreements to make such payments relate only to the exercise of share options, forfeitable shares may be acquired as a result of exercising such an option. Where this happens the employee will be taxed when the option is exercised and might have paid the employer's National Insurance Contribution. Paragraph 21(4)(b) ensures that such sums do not reduce the employer's CT deduction even though the payment of the employer's National Insurance does not relate to the tax charge on the employee under S140A ICTA 1988.

Paragraph 22 – Timing of relief in cases of shares subject to forfeiture

Again, the rules here are similar to those in paragraphs 10 and 17 and provide relief for the accounting period in which the conditions of forfeiture are lifted or, if earlier, when the shares are sold.

Part 5

Supplementary Provisions

Paragraph 23 – Relationship between relief and other deductions: priority of deductions under SIP code

The Share Incentive Plan (SIP) has its own rules to determine when and in what amount Corporation Tax relief is due. Paragraph 23 ensures that SIP relief is not affected by this schedule and that where relief is available under the SIP rules that it is not available also under this schedule.

Paragraph 24 – Relationship between relief and other deductions: exclusion of other deductions

Relief under this schedule is for the cost of providing shares and overrides accounting entries. Either the employing company or another company may make accounting entries in relation to the provision of the shares in accordance with generally accepted accounting principles. Paragraph 24 requires all deductions made in arriving at the taxable profits of any company that are in respect of the cost of providing those shares to be added back for tax purposes.

This might be amounts relating to actual payments, accruals for future payments or the requirement to spread amounts over a performance period in accordance with accounting principles.

It is explicit in paragraph 24(1) that this rule applies to any company, not just the employing company and to any deductions made in computing profits of that other company for corporation tax purposes that relate to the provision of the shares.

Paragraph 24(2) explains what is meant by the cost of providing shares and makes it clear that this includes any amounts payable by a company in respect of the employee's participation in a share scheme. Commonly this would manifest itself as an inter-company recharge. The rule applies where employees of a UK subsidiary participate in the share scheme of an offshore parent company in the same way that it applies to UK-based groups. Any recharge made in these circumstances must be added back in the tax computation of the company being recharged. When the employee acquires the shares a separate computation under the rules in this schedule provide CT relief for the employing company though its corporation tax self-assessment.

The relief provided by this schedule relates only to the cost of providing the shares. To achieve this certain amounts must be subtracted from the initial amount calculated using the market value of the shares less the amount payable for them. The amounts subtracted reduce the total amount of relief available to the company. Paragraph 24(3) makes it clear that the amounts to be subtracted do not include the costs of establishing or administering a scheme, borrowing costs associated with a scheme or fees and commissions etc. Such expenditure continues to be treated for tax under existing rules; this schedule does not affect the treatment of such expenses.

Paragraph 25 – Meaning of “employment”

Paragraph 25 describes employment for the purposes of the schedule and includes office holders.

Paragraph 26 – Exercise of option after death of employee or recipient

Companies sometimes allow options to be exercised following the death of an employee. In such circumstances it is reasonable to allow a CT deduction for the employing company even though a tax charge might not arise, or might arise by reference to a different time. Paragraph 26 ensures that the normal rules apply in such circumstances.

Paragraph 27 – Meaning of “group company”

Throughout the schedule there are references to a group or a parent company. These terms are defined in this paragraph.

A group for the purposes of this schedule is a 51% group.

Paragraph 28 – Meaning of “consortium” and “commercial association of companies”

These two terms are used in paragraphs 6 and 12 to determine the companies whose shares, when acquired, trigger relief under this schedule. They are needed because the relief is targeted at all corporate structures that use employee share schemes to provide their employees with a real stake in the business they work for.

Paragraph 28(1) defines a consortium as five or fewer companies that hold at least 75% of the ordinary share capital of a company where each member of the consortium owns at least 10% of that capital. This definition is used in paragraphs 6(1)(c) & (d) and 12(1)(c) & (d).

Paragraph 28(2) defines a commercial association of companies used in paragraphs 6 and 12 to include the rare situations where two or more members of a consortium are so closely linked that they are viewed as a single undertaking. In such cases shares in one consortium member might be awarded to employees of the other consortium member's group. This rule follows very closely the Capital Gains Tax Taper Relief definition of a Joint Enterprise Company (defined in Paragraph 24, Schedule A1, TCGA 1992) and is targeted at companies that need to take advantage of that provision for Taper Relief purposes.

Paragraph 29 – Minor definitions

Paragraph 29 includes a number of minor definitions for the purposes of this schedule.

Paragraph 30 – Index of defined expressions

A list of expressions contained within the schedule and cross-references to those locations to assist interpretation of the rules.

Part 6 – Commencement and transitional provisions

Paragraph 31 – Commencement

The deduction is available for shares acquired by employees in accounting periods of the employing company beginning on or after 1 January 2003. If those shares relate to awards made or options granted before that date then the transitional provisions in paragraph 32 explain how the deduction is computed.

Paragraph 32 – Transitional provisions

This schedule applies to all share acquisitions by employees in accounting periods beginning on or after 1 January 2003 irrespective of when the shares were awarded or the share option granted. As a result relief may already have been obtained under the rules that predate the introduction of this schedule and the transitional provisions ensure the correct amount of relief is given in total.

The employing company, which is now entitled to the new relief, might have obtained relief under the old rules. Alternatively another company might have obtained relief under the old rules. This paragraph ensures that CT relief is given only once in relation to the employee's acquisition of the shares. It achieves this by requiring any relief claimed or available under the old rules to be subtracted from the deduction calculated under this schedule. This includes relief obtained under the rules in S67 FA 1989 for payments into a Qualifying Employee Share Ownership Trust (QUEST).

This might reduce the deduction under this schedule to nil but does not create a tax charge if relief under the old rules exceeds relief under this schedule.

ENDING STATUTORY CORPORATION TAX RELIEF FOR NEW PAYMENTS INTO A QUALIFYING EMPLOYEE SHARE OWNERSHIP TRUST

EXPLANATORY NOTES

Summary

Statutory CT relief for payments into a Qualifying Employee Share Ownership Trust (QUEST) has been available for a number of years. It is mainly used by companies that operate Inland Revenue approved Save as you Earn (SAYE) share option schemes, though a small number of other companies take advantage of the relief for succession planning. The majority of companies taking advantage of QUEST CT relief make payments into the QUEST, and therefore claim a CT deduction, when employees exercise their share options. The new CT relief is therefore very similar in terms of both timing and amount to the relief currently enjoyed under QUEST. QUESTs are expensive to administer and there are many rules to be satisfied to guarantee a deduction.

The recent Employee Share Scheme Act 2002 makes changes to the Share Incentive Plan (SIP) legislation in Schedule 8 Finance Act 2000. It provides an up-front CT deduction for payments into a SIP trust if certain conditions are met. For instance shares must be awarded to employees within a maximum of 10 years. This provides an alternative route to a CT deduction for companies that have used QUEST for succession planning etc.

As a result of the two new CT reliefs for companies and to further simplify the CT treatment of employee share schemes QUEST CT relief is ending when the statutory CT deduction for employee share acquisitions takes effect. QUEST CT relief will therefore no longer be available for new payments made to a QUEST in accounting periods beginning on or after 1 January 2003.

To enable companies to transfer shares held in a QUEST to a Share Incentive Plan trust without relief already given being clawed back under the QUEST rules changes are being made to S69 FA 1988.

All other rules in the QUEST legislation remain unchanged, so existing QUESTs can continue to hold and distribute shares in the same way as they could before the changes.

Clause 2 – Ending of relief for contributions to QUESTs

Clause 2(1) is effective to end relief for new payments made to a QUEST in accounting periods beginning on or after 1 January 2003.

Clause 2(2) extends the rules introduced into S69 FA 1988 when the Share Incentive Plan (SIP) was announced that allow shares to be transferred to a SIP trust without triggering a claw back of QUEST CT relief already claimed. The original rules required shares to be held in the QUEST or purchased with funds held in the QUEST on 20 March 2000. These rules are being extended so that they apply to shares or

funds held at 26 November 2002. This will help companies that wish to wind-up their QUESTs to move the shares into a SIP trust without losing relief previously claimed.