

CLAUSE 204 AND SCHEDULES 1 AND 2: EMPLOYEE SECURITIES: ANTI-AVOIDANCE

SUMMARY

1. This draft clause and Schedule, which will be included in the next Finance Bill, amend the Income Tax (Earnings and Pensions) Act 2003. The changes strengthen parts of the income tax legislation relating to employment related securities that certain taxpayers have attempted to exploit in order to try to avoid income tax and National Insurance Contributions (NICs).

DETAILS OF THE CLAUSE

2. The clause gives effect to the Schedule.

DETAILS OF THE SCHEDULES

3. Any reference in these notes to a numbered section is to that section of the Income Tax (Earnings and Pensions) Act 2003 (“ITEPA”). NICs refer to National Insurance Contributions.

Schedule 1

4. Paragraph 1 introduces the Schedule and refers to ITEPA.

Rights under certain insurance contracts

5. Paragraph 2 Sub-paragraph (1) provides for the following amendments to section 420:
6. Sub-paragraph (2) amends subsection (1) of section 420 by adding a new paragraph (aa). This brings rights under contracts of insurance, other than excluded contracts, into the definition of securities.

7. Sub-paragraph (3) amends paragraph (b) of that subsection so that rights under contracts of insurance will not be regarded as instruments creating or acknowledging indebtedness.
8. Sub-paragraph (4) does the same for paragraph (g) of that subsection so that rights under insurance contracts will not be regarded as rights under contracts for differences or similar contracts.
9. Sub-paragraph (5) inserts new subsections (1A) and (1B) into section 420. Subsection (1A) lists those insurance contracts that are excluded contracts of insurance:
 - (a) a contract for an annuity that is or will be pension income;
 - (b) a contract of long-term insurance, other than an annuity contract, that does not have, and is not capable of acquiring, a surrender value whether on conversion or in any other circumstances;
 - (c) a contract of general insurance provided that it would not be accounted for as a financial asset or liability in accordance with generally accepted accounting practice.

Subsection (1B) provides for the terms contract of insurance, contract of long-term insurance and contract of general insurance respectively to have the same meaning as in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.
10. Sub-paragraph (6) repeals subsection (5)(d) of section 420, which had previously excluded insurance contracts from the definition of securities.
11. Sub-paragraph (7) cross-references the definition of “generally accepted accounting practice” to section 832(1) of the Income and Corporation Taxes Act 1988.
12. Sub-paragraph (8) sets the commencement date. This paragraph has effect on or after 2nd December, and will apply to rights under contracts of insurance whenever acquired.

However for the purposes of Chapter 3B of Part 7 of ITEPA (securities with enhanced market value) sub-paragraph (8)(a) provides that where the rights were acquired before 2nd December 2004 section 446O (meaning of “relevant period”) has effect as though they were acquired on that date.

Sub-paragraph (8)(b) ensures that “generally accepted accounting practice” bears its defined meaning from the outset of the legislation.

13. Example illustrating the effect of sub-paragraph (8):

An employee acquires an insurance contract with a surrender value from his employers on 1st November 2004 at a cost of £10 (its correct market value). As part of an avoidance scheme his employers artificially increase the value of the contract to £1m on 7th November 2004.

Under Chapter 3B of Part 7 the amount to be treated as employment income under section 446L is the market value of the employment-related security on the valuation date, less what would have been the market value then if non-commercial increases during the relevant period were disregarded. The first relevant period for this purpose begins on the date of acquisition and ends on the following 5th April.

Sub-paragraph (8) will ensure that for insurance contracts only non-commercial increases in the market value that arise on or after 2nd December will be taxed. In the example, the non-commercial increase that occurred on 7th November will be disregarded.

Restricted securities

14. Paragraph 3 introduces the amendments to Chapter 2 of Part 7 of ITEPA.
15. Paragraph 4, sub-paragraph (1) provides that the existing section 424 will be renumbered as subsection (1) of a newly extended section 424.
16. Sub-paragraph (2) provides that employment-related securities that are, or are an interest in, redeemable securities will now come within Chapter 2. This means that if additional value is transferred to the employee at a later date when a restriction is lifted then this will be chargeable to income tax and NICs.
17. Sub-paragraph (3) inserts a purpose test to cover the remaining exemptions from Chapter 2. Certain partly paid securities or securities that have restrictions on sale where employment ceases

through misconduct in general remain outside Chapter 2. But if one of the main purposes of arrangements under which the right or opportunity to acquire such securities is the avoidance of tax or NICs then they will be brought within Chapter 2. This means that if additional value is transferred to the employee at a later date when a restriction is lifted this will be fully chargeable.

18. Sub-paragraph (4) provides that the changes to section 424 apply on or after 2nd December 2004, regardless of the date on which the securities were acquired. For securities newly brought within Chapter 2 the requirement that they were restricted securities or a restricted interest in securities at acquisition is removed.
19. Paragraph 5, sub-paragraph (1) inserts a new subsection (10) in section 428, which deals with the amount of the charge under Chapter 2. Subsection (9) of section 428 reduces the taxable amount pro-rata if the consideration for the disposal of the securities is less than the actual market value at that date. This relief will no longer be available if something has been done at or before the chargeable event that affects the securities as part of a scheme or arrangement to avoid tax or NICs.
20. Sub-paragraph (2) provides that paragraph has effect where something such as is mentioned in section 428(10) has been done on or after 2nd December 2004.
21. Paragraph 6, sub-paragraph (1) inserts a new purpose test at subsection (1A) of section 429, which takes certain company shares outside the section 426 charge. If something has been done at or before the chargeable event that affects the securities as part of a scheme or arrangement to avoid tax or NIC then the exception will not apply.
22. Sub-paragraph (2) provides that this will have effect where something such as is mentioned in section 429(1A) has been done on or after 2nd December 2004.
23. Paragraph 7, sub-paragraph (1) inserts a new section 431B after section 431A. The new section provides that where the right or opportunity to acquire restricted securities or an interest in restricted securities was part of a scheme or arrangement where one of the main purposes was to avoid tax or NICs then the employer and employee will be deemed to have made an election under section 431(1). So any restrictions on the shares will be

disregarded and the unrestricted market value will be liable to tax at the date of acquisition.

24. Sub-paragraph (2) provides that this paragraph will have effect for employment-related securities acquired on or after 2nd December 2004.

Convertible securities

25. Paragraph 8 introduces the changes to Chapter 3 of Part 7, which deals with convertible securities.
26. Paragraph 9, sub-paragraph (1) substitutes “entitlement, whether immediate or deferred and whether conditional or unconditional” for “immediate or conditional entitlement” in section 436(a). An immediate entitlement can be conditional or unconditional and a conditional one immediate or deferred. This amendment sets out all possible cases in a clearer way and paves the way for the new section 437(3). This section refers back to section 436.
27. Sub-paragraph (2) renumbers the existing section 437 as subsection (1) of an extended section 437.
28. Sub-paragraph (3) inserts the new subsections into section 437. The new subsection (2) of section 437 disapplies subsection (1) where the right or opportunity to acquire the securities was part of a scheme or arrangement to avoid tax or NICs. This means that the market value on acquisition of securities acquired under such an arrangement will not be calculated ignoring the right to convert. The disapplication will not however apply if the market value ignoring the right to convert would be less or the same as the market value taking into account the right to convert.
29. The new subsection (3) of section 437 achieves this by determining the entitlement to convert as both immediate and unconditional if it is not either or both of these. Circumstances are deemed to be such that an entitlement to convert arises immediately, and provision has been made for immediate conversion.
30. The new subsection (4) of section 437 defines immediate and fully convertible so the maximum possible gain is taken into account without paying anything for or incurring any expenses in connection with the conversion. But the securities into which the original securities may be converted may not actually be in existence at acquisition of the originals. In such a case it will be

assumed in appropriate cases for the purposes of calculating market value that the securities are in existence at that time. An example of an appropriate case might be where the company exists but not the particular class of shares. .

31. Example. The market value of an A share is 100. As part of arrangements to avoid tax or NICs the employee is instead given another security, convertible into this A share under certain conditions. This security only has a market value of 10 at acquisition if the right to convert is ignored. Subsection (2) will ensure that the real benefit that has passed to the employee will be taxed, by assuming the new security is immediately and unconditionally converted into the A share, market value 100. However suppose an avoidance scheme attempts to exploit this by giving the employee a security with a market value of 1000 that has a right to convert into the A share. Subsection (2) would not then apply and the original market value of 1000 would continue to be used to calculate the taxable benefit arising.
32. Sub-paragraph (4) provides that the paragraph applies for acquisitions on or after 2nd December 2004.
33. Paragraph 10, sub-paragraph (1) inserts a new subsection (3A) into section 440. This adjusts a later charge under section 438 where the new subsection (2) of section 437 has taken account of the right to convert at the date of acquisition of the convertible security. When conversion, etc, actually occurs this subsection will ensure account is taken of any additional amount taken into account for market value at an earlier chargeable event.
34. Paragraph 10, sub-paragraph (2) provides that this section has effect on and after 2nd December 2004.
35. Paragraph 11, sub-paragraph (1) amends the purpose test at subsection (1A) of section 443, which takes certain company shares outside the section 426 charge, for consistency with the form of new purpose tests elsewhere. If something that affects the securities has been done at or before the time when section 438 would apply as part of a scheme or arrangement to avoid tax or NICs then the exception will not apply.
36. Sub-paragraph (2) provides that the paragraph will apply if something such as is mentioned in section 443(1A) has been done on or after 2nd December 2004.

Securities acquired for less than market value

37. Paragraph 12 introduces changes to Chapter 3C of Part 7, which deals with securities acquired for less than market value.
38. Paragraph 13, sub-paragraph (1) amends the purpose test at subsection (1A) of section 446R, which takes certain company shares outside the Chapter, for consistency with the form of new purpose tests elsewhere. If something that affects the securities has been done at or before acquisition as part of a scheme or arrangement to avoid tax or NICs then the exception will not apply.
39. Sub-paragraph (2) provides that the paragraph will apply if something such as is mentioned in section 446R(1A) has been done on or after 2nd December 2004.
40. Paragraph 14, sub-paragraph (1) inserts a purpose test into section 446U. The new paragraph (c) will treat a notional loan as having been discharged when something that affects the securities is done as part of a scheme or arrangement to avoid tax or NICs.
41. Sub-paragraph (2) provides that the paragraph will apply if something such as is mentioned in section 446U(1)(c) has been done on or after 2nd December 2004.
42. Paragraph 15, sub-paragraph (1) inserts a new section 446UA. It provides that sections 446S to 446U will not apply where the employment-related securities were acquired under a scheme or arrangement to avoid tax or NICs. Instead of deeming a notional loan to exist, the amount that would otherwise be equal to the initial notional loan will be treated as employment income for the tax year when acquisition takes place.
43. Sub-paragraph (2) provides that the paragraph will apply for acquisitions on or after 2nd December 2004.
44. Paragraph 16, sub-paragraphs (1) to (3) amend section 698 which deals with PAYE on employment-related securities. An amount counting as employment income under the new section 446UA will be within the PAYE provisions.
45. Sub-paragraph (4) provides that the paragraph will have effect on and after Royal Assent to Finance Act 2005.

Post-acquisition benefits from securities

46. Paragraph 17 introduces amendments to Chapter 4 of Part 7, which deals with post-acquisition benefits from securities.
47. Paragraph 18, sub-paragraph (1) introduces amendments to section 447, the charging section for other chargeable benefits from securities.
48. Sub-paragraph (2) amends the wording of the existing subsection (1) of section 447 to be more consistent with wording used elsewhere in Part 7 and remove any doubt that benefits arising may not be from the ownership of securities.
49. Sub-paragraph (3) amends the existing subsection (4) of section 447. The exemption from a Chapter 4 charge where income tax is otherwise chargeable on the benefit will not be available if anything has been done that affects the securities as part of a scheme or arrangement to avoid tax or NICs.
50. Sub-paragraph (4) deals with commencement. Sub-paragraph (2) will have effect on and after 2nd December and subparagraph (3) above where something such as is mentioned in section 447(4) has been done on or after 2nd December 2004.
51. Paragraph 19, sub-paragraph (1) amends the existing purpose test in section 449, which takes certain company shares outside Chapter 4, for consistency with new purpose tests elsewhere. If something that affects the securities has been done as part of a scheme or arrangement to avoid tax or NICs then the exception will not apply.
52. Sub-paragraph (2) provides that the paragraph will apply if something such as is mentioned in section 449(1A) has been done on or after 2nd December 2004.

BACKGROUND NOTE

53. Part 7 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA), which was amended by Finance Act 2003 to make the regime fairer, provides the income tax rules in cases where securities, interests in securities or securities options are acquired

in connection with employment. Further amendments of the provisions were undertaken in Finance Act 2004 to counter avoidance schemes of which the Revenue had become aware.

54. The amendments made by the Finance Act 2003 are designed to ensure that all of the value received by way of remuneration in the form of shares or other securities is subject to income tax and NICs at an appropriate time. The rules provide flexibility in respect of the timing of the charges. For example, the employer and employee can jointly elect to pay tax and National Insurance on a higher proportion when the shares are acquired, leaving future commercial growth in value of the shares in the capital gains tax regime.
55. The Inland Revenue became aware through the operation of the disclosure rules introduced in Finance Act 2004 of a number of schemes which use shares or other securities in order to pass remuneration value to employees in a way that attempts to avoid Income Tax and NICs.
56. The changes to be made by this Schedule, effective from 2nd December 2004, will ensure that the proper income tax and National Insurance Contributions charges apply on the value from the shares and securities acquired from these schemes.