

CHARGEABLE GAINS: EXERCISE OF OPTIONS ETC – *INTRODUCTORY TEXT*

In his Pre-Budget Report on 2nd December 2004 the Chancellor announced the Government's intention to change the treatment provided by the Taxation of Chargeable Gains Act 1992 where assets are disposed of or acquired by exercising an option in certain circumstances. The change is being made to counter schemes that seek to avoid tax on capital gains, or to create or augment capital losses, by exercising an option at an uncommercial price.

The new rules will apply in relation to options exercised on or after 2nd December 2004, irrespective of when the options were granted. Broadly the new rules will apply where the relevant transactions are not all at arm's length and –

- an option to sell one or more assets is exercised when the exercise price is less than the value of what is sold; or
- an option to buy one or more assets is exercised when the exercise price is more than the value of what is bought.

Where the new rules have effect, what is bought or sold on the exercise of the option will be treated for the purposes of tax in respect of chargeable gains as acquired or disposed of at its market value at the time of exercise. The exercise price and any consideration given for the option will be disregarded.

These changes will not alter the capital gains rules applying to disposals or acquisitions of assets under an option where the transactions are at arm's length. Nor will they have any effect in relation to the exercise of certain options over shares or securities which are acquired by an individual in connection with his or her employment.

The Inland Revenue has today published draft legislation for these changes, accompanied by an Explanatory Note. The legislation will be included in the next Finance Bill.

Further advice

If you have any questions about this change please contact your local tax office.

1 Chargeable gains: exercise of options etc

Schedule 1 (which makes provision, for the purposes of the taxation of chargeable gains, in relation to options) has effect.

SCHEDULE 1

Section 1

CHARGEABLE GAINS: OPTIONS

PART 1

APPLICATION OF MARKET VALUE RULE IN CASE OF EXERCISE OF OPTION 5

Application of market value rule in case of exercise of option

- 1 (1) Section 144ZA of TCGA 1992 is amended as follows.
- (2) In subsection (1) (cases in which the section applies) at the beginning insert “Subject to section 144ZB,”.
- (3) In subsection (4) (where market value rule is set aside by the section, amount or value to be taken into account is, subject to section 120, to be actual amount or value) for “(subject to section 120) the actual amount or value” substitute “(subject to section 119A) the exercise price”. 10
- (4) After that subsection insert –
- “(4A) In subsection (4) above “exercise price”, in relation to an option, means the amount or value of the consideration which, under the terms of the option, is – 15
- (a) receivable (if the option binds the grantor to buy), or
- (b) payable (if the option binds the grantor to sell),
- as a result of the exercise of the option (and does not include the amount or value of any consideration for the acquisition of the option (whether directly from the grantor or not)).” 20
- (5) For subsection (5) substitute –
- “(5) Subsections (5) and (6) of section 144 shall apply for the purposes of this section and sections 144ZB to 144ZD as they apply for the purposes of that section.” 25

Application of market value rule in case of exercise of option: exception

- 2 After section 144ZA of TCGA 1992 insert –
- “144ZB Exception to rule in section 144ZA**
- (1) This section applies where – 30
- (a) section 144ZA would apply but for this section in relation to an option, and

- (b) the exercise of the option is non-commercial (see section 144ZC).
- (2) But this section does not apply if—
- (a) the option is a securities option within the meaning of Chapter 5 of Part 7 of ITEPA 2003 (see section 420(8) of that Act) to which that Chapter applies or would, apart from section 474 of that Act, apply (see section 471 of that Act), or 5
- (b) section 144ZD of this Act (value of underlying subject matter of option altered with a view to obtaining a tax advantage) applies in relation to the option. 10
- (3) Where this section applies, neither section 144ZA nor the following provisions of section 144 shall apply in relation to the option—
- (a) in subsection (2), the words from “and accordingly” to the end of that subsection, and
- (b) in subsection (3), the words from “and accordingly” to the end of that subsection; 15
- but subsection (4) or (5) below shall instead have effect (subject to subsection (6) below).
- (4) If the option binds the grantor to buy—
- (a) the cost of acquisition incurred by the grantor in buying in pursuance of his obligations under the option, and 20
- (b) the consideration for the disposal of what is bought by the grantor,
- shall be deemed for the purposes of tax in respect of chargeable gains to be the market value, at the time the option is exercised, of what is bought. 25
- (5) If the option binds the grantor to sell—
- (a) the consideration for the sale, and
- (b) the cost to the person exercising the option of acquiring what is sold, 30
- shall be deemed for the purposes of tax in respect of chargeable gains to be the market value, at the time the option is exercised, of what is sold.
- (6) But if the whole or any part of the underlying subject matter of the option (see subsection (7)) is subject to any right or restriction which is enforceable by the person disposing of the underlying subject matter or a person connected with him— 35
- (a) the market value of the underlying subject matter shall be determined for the purposes of subsection (4) or (5) above as if the right or restriction did not exist, and 40
- (b) to the extent that subsection (6) or (7) of section 18 would apply apart from this paragraph, it shall be disregarded.
- (7) In this section “underlying subject matter”, in relation to an option, means—
- (a) if the option binds the grantor to sell, what falls to be sold on exercise of the option; 45
- (b) if the option binds the grantor to buy, what falls to be bought on exercise of the option.

144ZC Section 144ZB: non-commercial exercise of option

- (1) For the purposes of section 144ZB, the exercise of an option which binds the grantor to buy is non-commercial if the exercise price for the option (see subsection (3)) is less than the open market price (see subsection (4)) of what is bought. 5
- (2) For the purposes of section 144ZB, the exercise of an option which binds the grantor to sell is non-commercial if the exercise price for the option is greater than the open market price of what is sold.
- (3) In this section “exercise price”, in relation to an option, means the amount or value of the consideration which, under the terms of the option, is— 10
- (a) receivable (if the option binds the grantor to buy), or
- (b) payable (if the option binds the grantor to sell),
- as a result of the exercise of the option (and does not include the amount or value of any consideration for the acquisition of the option (whether directly from the grantor or not)). 15
- (4) In this section “open market price”, in relation to the underlying subject matter of an option (see section 144ZB(7)), means the price which the underlying subject matter might reasonably be expected to fetch on a sale in the open market at the time the option is exercised; and subsections (5) to (7) below apply for the purposes of this subsection. 20
- (5) If the whole or any part of the underlying subject matter of the option is subject to any right or restriction which is enforceable by— 25
- (a) the person disposing of the underlying subject matter, or
- (b) a person connected with him,
- the open market price of the underlying subject matter shall be determined as if the right or restriction did not exist.
- (6) Section 272(2) (no reduction in estimated market value on account of assumption that whole of assets are placed on market at one time) shall apply in estimating the open market price of the underlying subject matter of an option as it applies in estimating the market value of any assets. 30
- (7) Where the underlying subject matter of an option comprises or includes assets to which section 273 applies (unquoted shares and securities), subsection (3) of that section (assumption that relevant information is available) shall apply in determining the open market price of those assets as it applies for the purposes of a determination falling within subsection (1) of that section. 35
- (8) This section is to be construed as one with section 144ZB. 40

144ZD Section 144ZB: alteration of value to obtain tax advantage

- (1) This section applies in relation to an option if each of the following conditions is satisfied (as to the effect of this section applying, see section 144ZB(2)(b)).
- (2) Condition 1 is that section 144ZB would, apart from subsection (2)(b) of that section, apply in relation to the option. 45

-
- (3) Condition 2 is that, at the time the option is exercised, the open market price (see section 144ZC(4)) of the underlying subject matter of the option (see section 144ZB(7)) differs from the open market price of the underlying subject matter of the option at the time the option was granted. 5
- (4) Condition 3 is that some or all of that change in the open market price of the underlying subject matter of the option results to any extent, directly or indirectly, from arrangements (see subsection (8)) (“the relevant arrangements”) – 10
- (a) to which a relevant person is or has been a party, or
 - (b) which include one or more transactions to which a relevant person is or has been a party.
- (5) In subsection (4) above “relevant person” means any of the following – 15
- (a) the grantor of the option;
 - (b) any person who at any time holds the option;
 - (c) a person connected with one or more of the persons mentioned in paragraph (a) or (b) above.
- (6) Condition 4 is that, if there were to be disregarded so much of that change in the open market price of the underlying subject matter of the option as results to any extent, directly or indirectly, from the relevant arrangements, the exercise of the option would not be non-commercial (see section 144ZC). 20
- (7) Condition 5 is that (apart from this section) as a result, directly or indirectly, of the relevant arrangements – 25
- (a) the grantor of the option, or
 - (b) the person exercising the option,
- would obtain or might be expected to obtain an advantage (see subsection (9)) in relation to capital gains tax or corporation tax in respect of chargeable gains directly or indirectly in consequence of, or otherwise in connection with, the exercise of the option. 30
- (8) In this section “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).
- (9) In this section “advantage”, in relation to capital gains tax or corporation tax in respect of chargeable gains, means – 35
- (a) relief or increased relief from, or repayment or increased repayment of, that tax, or the avoidance or reduction of a charge to that tax or an assessment to that tax or the avoidance of a possible assessment to that tax, or 40
 - (b) the deferral of any payment of that tax or the advancement of any repayment of that tax.
- (10) This section is to be construed as one with sections 144ZB and 144ZC.”.

PART 2

MISCELLANEOUS AMENDMENTS RELATING TO SHARE OPTIONS ETC

Shares acquired on same day: election for alternative treatment

- 3 (1) Section 105A of TCGA 1992 is amended as follows.
- (2) In subsection (1) (cases in which subsection (2) applies) in paragraph (b) (some of the acquired shares to be approved-scheme shares) for subparagraphs (i) and (ii) substitute –
- “(i) the exercise of a qualifying option within the meaning given by section 527(4) of ITEPA 2003 (enterprise management incentives) in circumstances where section 530 or 531 of that Act (exercise of option to acquire shares) applies, or
- (ii) the exercise of an option to which Chapter 7 or 8 of Part 7 of that Act (approved share option schemes) applies in circumstances where section 519(1) or 524(1) of that Act applies.”.

Employment-related securities options

- 4 (1) Section 149A of TCGA 1992 is amended as follows.
- (2) In subsection (1) (cases in which the section applies) for paragraph (b) (option to consist of right to acquire shares in body corporate and to be obtained by individual by reason of his office or employment) substitute –
- “(b) the option is a securities option within the meaning of Chapter 5 of Part 7 of ITEPA 2003 (see section 420(8) of that Act) to which that Chapter applies or would, apart from section 474 of that Act, apply (see section 471 of that Act), and”.
- (3) In that subsection, in paragraph (c) (section 17(1) to apply for calculating consideration for grant of option) after “section 17(1)” insert “of this Act”.
- (4) The heading of the section accordingly becomes “Employment-related securities options”.

Interpretation of TCGA 1992

- 5 (1) Section 288 of TCGA 1992 is amended as follows.
- (2) In subsection (1A) (employment-related securities options) for the second sentence substitute –
- “In this subsection “employment-related securities option” means a securities option within the meaning of Chapter 5 of Part 7 of ITEPA 2003 (see section 420(8) of that Act) to which that Chapter applies or would, apart from section 474 of that Act, apply (see section 471 of that Act); and other expressions used in this subsection and that Chapter have the same meaning in this subsection as in that Chapter.”.

PART 3

COMMENCEMENT

Commencement

- 6 (1) The amendments made by paragraphs 1 to 3 have effect in relation to cases where the option in question is exercised on or after 2nd December 2004 (whenever the option was acquired). 5
- (2) The amendments made by paragraphs 4 and 5 have effect in relation to options granted on or after 2nd December 2004.

DRAFT CLAUSE AND SCHEDULE: CHARGEABLE GAINS: EXERCISE OF OPTIONS ETC

SUMMARY

1. This draft clause and Schedule, which will be included in the next Finance Bill, amend provisions in the Taxation of Chargeable Gains Act 1992 (TCGA) which relate to the computation of gains and losses in certain circumstances where assets are acquired or disposed of on the exercise of options. The main changes correct a defect in the current rules whose exploitation could enable people to avoid tax on chargeable gains, or to realise capital losses in circumstances where no commercial loss (or a commercial loss of a lesser amount) has been incurred. The Schedule also makes a number of minor amendments to the tax regime for options to rectify omissions or provide clarification. Most of the new provisions will apply in relation to options exercised on or after 2nd December 2004.

DETAILS OF THE CLAUSE

2. The clause gives effect to the Schedule.

DETAILS OF THE SCHEDULE

3. Any reference in these notes to a numbered section is to that section of the TCGA. References to “ITEPA” are to the Income Tax (Earnings and Pensions) Act 2003. The draft legislation refers to the TCGA as “TCGA 1992”: interpretation for that abbreviation and for corresponding abbreviations of certain other Acts will be provided in a clause in the Finance Bill.

Part 1

4. Paragraph 1 amends section 144ZA, with effect for options exercised on or after 2nd December 2004, as follows—

- sub-paragraph (2) amends subsection (1) to provide for the application of section 144ZA to be subject to section 144ZB (see paragraphs 6 to 12 below);
- sub-paragraph (3) replaces an outdated cross-reference in subsection (4);
- sub-paragraph (4) introduces a new subsection, subsection (4A), which provides interpretation for the reference to “exercise price” in the amended subsection (4); and
- sub-paragraph (5) provides for the existing subsection (5) to be replaced: the new subsection provides interpretation for references to “option” in each of sections 144ZA to 144ZD, but, apart from that, the change in wording is made for clarificatory purposes.

5. Paragraph 2 inserts three new sections, sections 144ZB, 144ZC and 144ZD into the TCGA: they have effect in relation to options exercised on or after 2nd December 2004.

Section 144ZB Exception to rule in section 144ZA

6. Subsection (1) sets out the conditions for section 144ZB to apply. These are that, subject to subsection (2) preventing section 144ZB applying—

- section 144ZA would apply in relation to an option if it were not displaced by section 144ZB, and
- the exercise of the option in question is “non-commercial” (see paragraphs 13 to 18 below).

7. Subsection (2) provides that section 144ZB does not apply where—

- the option is a securities option within the meaning of certain ITEPA provisions, or
- section 144ZD applies (see paragraphs 19 to 22 below).

8. Subsection (3) provides that in any case where section 144ZB applies in relation to an option, the rules in subsection (4) or, as the case may be, subsection (5) apply in place of those in section 144ZA and paragraphs (a) and (b) of subsection (2) or, respectively, subsection (3) of section 144.

9. Subsection (4) applies in relation to options which bind the grantor of the option to purchase (these are known as “put options”). It provides that, for the purposes of tax in respect of chargeable gains—

- the acquisition cost of what the grantor buys as a result of the option being exercised is the market value, at the time the option is exercised, of what is bought; and
- the amount or value of the consideration for the disposal of what is bought by the grantor is the market value, at the time the option is exercised, of what is bought.

10. Subsection (5) applies in relation to options which bind the grantor of the option to sell (these are known as “call options”). It provides that, for the purposes of tax in respect of chargeable gains—

- the amount or value of the consideration for the disposal of what is sold by the grantor as a result of the option being exercised is the market value, at the time the option is exercised, of what is sold; and
- the cost to the person exercising the option of acquiring what is sold is the market value, at the time the option is exercised, of what is sold.

11. Subsection (6) adds a rider to the provisions in subsections (4) and (5). Its effect is that where the whole, or any part of, the underlying subject matter (“USM”) of the option is subject to any right or restriction which can be enforced by the person selling it, or by a person “connected” with him (within

the meaning in section 286), the existence of the right or restriction is disregarded in establishing the market value.

12. Subsection (7) provides that the expression “underlying subject matter” means, for the purposes of section 144ZB, what falls to be sold on the exercise of a call option, and what falls to be bought on the exercise of a put option.

Section 144ZC Section 144ZB: non-commercial exercise of option

13. This section determines whether the exercise of an option is “non-commercial” for the purposes of section 144ZB (see paragraph 6 above).

14. Subsection (1) provides that the exercise of a put option is non-commercial if the exercise price is less than the open market price of the USM.

15. Subsection (2) provides that the exercise of a call option is non-commercial if the exercise price exceeds the open market price of the USM.

16. Subsection (3) defines “exercise price”, in relation to an option, for the purposes of section 144ZC.

17. Subsection (4) provides that, for such purposes, the “open market price” of the USM of an option is the price which it might reasonably be expected to fetch if it were to be sold in the open market at the time the option is exercised. Further interpretation is given by—

- subsection (5), which provides for any right or restriction which can be enforced by the seller, or by any person connected with him, to be disregarded in establishing the open market price; and
- subsections (6) and (7), which provide for sections 272(2) and 273(3), which apply in certain circumstances in relation to the determination of the market values of assets for TCGA purposes, to be applied in like fashion in relation to establishing the open market price—
 - in the case of section 272(2) or 273(3), of the USM of an option, or
 - in the case of section 273(3), of assets forming part of the USM of an option.

18. Subsection (8) provides for section 144ZC to be construed as one with section 144ZB: this has the effect that expressions used in both sections have the same meaning.

Section 144ZD Section 144ZB: alteration of value to obtain tax advantage

19. This section determines the circumstances in which section 144ZB does not prevent section 144ZA applying in cases where—

- the exercise of the option is non-commercial, and

- the option is not a securities option within the meaning of certain ITEPA provisions.
20. Subsection (1) provides that five conditions must be satisfied in relation to the option if section 144ZB is not to apply in such a case. The conditions, which are provided by subsections (2) to (4), (6) and (7), are that—
- section 144ZB would apply in relation to the option if it were not prevented from doing so by virtue of subsection (2)(b) of that section;
 - the open market price of the USM of the option at the time it is exercised differs from its open market price at the time it was granted;
 - some or all of that change in price results to any extent, directly or indirectly, from arrangements to which a relevant person (see paragraph 21 below) is, or has been, a party, or which include a transaction to which such a person is, or has been, a party (these arrangements are referred to as “the relevant arrangements” in what follows);
 - the exercise of the option would not be “non-commercial”, as determined by section 144ZC, if such of the change in open market price which results directly or indirectly to any extent from the relevant arrangements were to be disregarded; and
 - if section 144ZD were not to apply, then, as a result directly or indirectly of the relevant arrangements, an advantage (see paragraph 21 below) in relation to capital gains tax, or corporation tax in respect of chargeable gains, resulting directly or indirectly from the exercise of the option would be, or might be expected to be, obtained by the person who granted the option or the person who exercised it.
21. The meanings of the references to “advantage”, in relation to capital gains tax or corporation tax in respect of chargeable gains, “arrangements” and “relevant person” are provided by subsections (5), (8) and (9).
22. Subsection (10) provides for section 144ZD to be construed as one with sections 144ZB and 144ZC.

Part 2

23. Paragraph 3 amends section 105A, which forms part of the rules for identifying which shares are disposed of on the part-disposal of a holding. The effect of the amendment is that references to certain income tax provisions are updated so as to take account of their migration to ITEPA. The change has effect for options exercised on or after 2nd December 2004.
24. Paragraph 4 amends section 149A, which, in the cases where it applies, has effect to determine what is treated for TCGA purposes as the amount of consideration given when an employee or director of a company is granted an option to acquire shares. The amendment extends the scope of section 149A by replacing the existing reference to a right obtained by reason of an individual’s

office or employment with a reference to the relevant ITEPA provisions which relate to rights to acquire securities in certain circumstances. The changes have effect in relation to options granted on or after 2nd December 2004.

25. Paragraph 5 replaces some words in section 288 (which provides general interpretation for the purposes of the TCGA). The new words, which have effect in relation to options granted on or after 2nd December 2004, amend the meaning of the expression “employment-related securities option” which applies for the purposes of subsection (1A).

Part 3

26. Paragraph 6 contains the various commencement provisions.

BACKGROUND NOTE

27. In what follows, reference is made to put options and call options. These expressions are defined in paragraphs 9 and 10 above. “USM” means “underlying subject matter” (see paragraph 12 above).

The current treatment of options for the purposes of tax on chargeable gains

28. Where an asset is acquired or disposed of as a result of an option being exercised, the tax rules for chargeable gains and losses provide that the grant or acquisition of the option and the disposal or acquisition of the asset on the exercise of the option are treated as being parts of a single transaction.

Cases where the relevant transactions are at arm’s length

29. Where the transactions to which the grantor is a party (that is, the grant of the option and its exercise) are at arm’s length, any gain or loss arising to him on the disposal of the USM of a call option as a result of the option being exercised is calculated on the basis that the disposal proceeds are the sum of the amount received for the grant of the option and the amount received when the option was exercised (the “exercise price”). Similarly, where the transactions to which the person who exercises the option is a party (that is, his acquisition of the option and its exercise) are at arm’s length, the cost of acquiring the USM on the exercise of the option is treated as being the sum of the exercise price and the amount given to acquire the option.

30. For example, if a person received £100 for granting an option entitling its holder to purchase an asset from the grantor for £500, the disposal proceeds of the asset are £600 – that is, the sum of £100 received for the grant of the option and the £500 exercise price. If the person exercising the option is the person to whom it was granted, the cost to that person of acquiring the asset is also treated as being £600. If the person exercising the option did not acquire it

directly from the grantor, the acquisition cost of the asset, for such purposes, is treated as being the sum of the amount that person paid to acquire the option from the previous holder and the £500 exercise price. (All transactions mentioned in this paragraph are assumed to be at arm's length.)

31. Corresponding rules apply in relation to put options in such cases.

Other cases

32. It is possible for an option to be granted (or otherwise acquired) by way of an arm's length transaction, but exercised otherwise than at arm's length, or *vice versa*. This can occur because the option has changed hands in the interim, or because the relationship between the grantor and the person exercising the option has changed between grant and exercise of the option. In all these cases, section 144ZA applies to give a treatment which corresponds broadly to that described in paragraphs 28 to 31 above. Paragraphs 33 and 34 below provide further details.

33. For **the grantor of the option**—

- if the option is granted at arm's length, the following outcomes apply if it is not exercised at arm's length:
 - if it is a **call option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the sum of the exercise price and the amount received for the grant;
 - if it is a **put option**, the cost to the grantor of acquiring the USM on exercise is treated as the amount of the exercise price less the amount received for the grant.
- if the option is not granted at arm's length, the outcomes are:
 - if it is a **call option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the sum of the exercise price and the market value of the option at the time it was granted;
 - if it is a **put option**, the cost to the grantor of acquiring the USM on exercise is treated as the amount of the exercise price less the market value of the option at the time it was granted.

34. For the **person who exercises the option**,

- if the option was acquired at arm's length, the following outcomes apply if the exercise is not at arm's length:
 - if it is a **call option**, the cost to him of acquiring the USM on exercise is treated as the sum of the exercise price and the amount paid to acquire the option;
 - if it is a **put option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the exercise price, and the amount paid to acquire the option is treated as an incidental cost of the disposal of the USM.

- if the option was acquired otherwise than at arm's length, the outcomes are:
 - if it is a **call option**, the cost to him of acquiring the USM on exercise is treated as the sum of the exercise price and the market value of the option at the time he acquired it;
 - if it is a **put option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the exercise price, and the market value of the option at the time he acquired it is treated as an incidental cost of the disposal of the USM.

The defect in the current rules

35. The use of the exercise price in calculating the amount of a gain arising on the disposal of the USM of an option when it is exercised may have inappropriate results where the option would not be exercised at that price in normal commercial circumstances. This can happen broadly where—

- in relation to a **call option**, the exercise price exceeds the value of the USM at the time the option is exercised, and
- in relation to a **put option**, the exercise price is less than the value of the USM at the time the option is exercised.

36. This effect is illustrated in the following example. C and D are connected persons. C grants to D an option that allows D to sell an asset worth £90,000 to C for £30,000 in two months' time. D pays nothing for the option, which, at the time it is granted, has no value. D paid £30,000 for the asset three years ago. D exercises the option and sells the asset to C. The current rules provide that D's disposal proceeds are treated as the price prescribed by the option, £30,000. So D has disposal proceeds of £30,000, from which are deducted his acquisition cost of £30,000. This means that there is no chargeable gain. C's acquisition cost of the asset is treated as the price paid on exercise of the option, £30,000. But D has effectively given away an asset worth £90,000. If he had simply disposed of it to C without using an option he would have been liable to tax on a gain (ignoring incidental costs of disposal and any reliefs to which he was entitled) of £60,000 (the market value of the asset less his acquisition cost of £30,000).

The effect of the revised rules

37. In the circumstances described in paragraph 35 above, if the option is exercised on or after 2nd December 2004, each party to the transaction will be treated as having disposed of or, as the case may be, acquired the asset at its market value at the time the option is exercised.

38. But the current rules will continue to apply in the case of certain options over shares or securities that are acquired by an individual in connection with his or her employment.

39. And the current rules will continue to apply in the case of other options in circumstances where—

- the exercise of the option is non-commercial;
- the value of the USM changes between the grant and exercise;
- the change results to any extent directly or indirectly from arrangements to which any of the following persons is a party:
 - the grantor of the option,
 - any person who has at any time held the option, and
 - any person connected with the grantor or any person who has at any time held the option;
- the exercise of the option would not be non-commercial if such of the change in value of the USM which results directly or indirectly from such arrangements were to be disregarded; and
- if the revised tax treatment were to apply, the grantor of the option or the person who exercises it would, or might be expected to, obtain a tax advantage in relation to capital gains tax, or corporation tax in respect of chargeable gains, in consequence (directly or indirectly) of the exercise.

40. The circumstances described above could arise if, for example—

- a call option is granted on terms favourable to the option-holder (for example, an option to acquire USM worth £1,000 for £100) so that the option has a high market value when it is granted: a sum equal to the amount of that value is paid to the grantor by grantee, and
- before the option is exercised arrangements are made by the grantor which have the effect of reducing the value of the USM to £50, and the option is exercised non-commercially, so that the effect of the new rules would be to treat the grantor as having disposed of the USM for £50.

41. In such a case, under the current rules, the grantor is potentially liable to tax in respect of chargeable gains on virtually the full value of the asset as it stood before that value was reduced in consequence of the arrangements. (This is because the full value of the option at the date of grant and the exercise price are taken into account in calculating the amount of the chargeable gain arising on the disposal of the USM.) But, if the new rules were to apply as described in paragraph 37 above, the amount of any chargeable gain or loss which arises to him on the disposal of the USM would be computed by reference to the market value of the USM at the time of exercise, an amount (£50) which is much lower than the original value of the asset (£1,000). The arrangements that reduced the original value of the USM could be unwound after the option has been exercised, so that its full value is restored and the person exercising the option gets the full value of the asset. The exception to the new rules described in paragraph 39 above prevents this outcome.