

Avoidance and employment-related securities – proposals to amend Part 7 of ITEPA 2003

Technical Note

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Introduction

1. Rules requiring the disclosure of certain tax schemes were introduced by the Finance Act 2004. Since then, the Inland Revenue has received disclosures of schemes involving employment earnings paid in forms other than cash. In particular, these schemes seek to side-step the rules in Part 7 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA), which deal with earnings paid in the form of shares and other securities.

Timetable and Start Date

2. The amendments outlined in this Note will take effect from 2 December 2004 in relation to events of charge on or after that date whether those events are in respect of securities acquired on or after that date, or in respect of securities already held on that date. Draft legislation will be published within 8 weeks.

Background

3. Part 7 of ITEPA deals with charges and reliefs in relation to employment-related securities. Unless otherwise indicated, all statutory references in this Note are to ITEPA as amended and refined by Finance Acts 2003 and 2004.
4. Finance Act 2004 (together with related regulations) introduced new rules that require certain tax schemes to be disclosed to the Inland Revenue. These include arrangements connected with employment.
5. Following the start of the new disclosure regime, the Inland Revenue has received disclosures indicating a significant level of avoidance planning in relation to non-cash remuneration and specifically securities related remuneration focussing on the provisions in Part 7.
6. Many of the schemes, which have been disclosed to the Inland Revenue under the 2004 legislation, seek to avoid or defer full Income Tax and National Insurance Contributions (NICs) due on what are effectively disguised cash bonuses to employees.

7. The aim of the legislation contained in Part 7 of ITEPA is to tax value when it is transferred to, or realised by, an employee through an interest in employment-related securities. Value is normally received by an employee at the time the securities are received, and also by an increase in the value of the securities held (separate from the normal commercial growth in the value of the securities) for which there are various post-acquisition charges. The aim is to treat growth in the value of securities proportionate to the original investment as capital gains, but disproportionate growth as income.

8. The initial charge on acquisition of a security is normally under section 6 of ITEPA. This charges tax on employment income on general earnings and specific employment. For the purposes of that section, the acquisition of a security is charged as earnings by reason of being “money’s worth” within the definition of earnings under section 62. Part 7 modifies the basic charge under section 6 in several ways.

9. The structure of the relevant chapters of Part 7 is as follows:
 - Chapter 1 (ss417-421L) contains the principal definitions and information powers;
 - Chapter 2 (ss422 – 432) applies to securities and interests in securities that are restricted at the time of acquisition, including securities which are subject to a condition of forfeiture;
 - Chapter 3 (ss435 - 444) applies to convertible securities and interests in convertible securities at the time of acquisition, that is, securities which may be exchanged for different ones;
 - Chapter 3A (ss446A – 446J) applies to securities whose market value has been artificially depressed by things done otherwise than for genuine commercial purposes;
 - Chapter 3B (ss446K - 446P) applies to securities where their market value has been artificially enhanced by things done otherwise than for genuine commercial purposes;

- Chapter 3C (ss446Q - 446W) applies to securities acquired for less than market value and partly-paid shares;
- Chapter 3D (ss446X – 446Z) applies to securities disposed of for more than their market value;
- Chapter 4 (ss447 – 450) covers benefits relating to employment-related securities that are not otherwise chargeable to income tax;
- Chapter 5 (ss471 – 484) applies to securities options.

10. In Chapter 1, subsections (1) to (4) of section 420 define what are securities for the purposes of Chapters 1 to 5 of Part 7 and subsection (5) specifies exceptions.

11. In Chapter 2, section 424 disapplies the Chapter's provisions where certain types of restriction apply. Section 425(2) removes the initial "money's worth" charge where the security is potentially "forfeitable". A charge is applied if a "chargeable event" occurs on the lifting of a restriction or the sale of the security. The measure of charge is determined by applying the formula set out in section 428. Section 429 lists other cases that are outside the charge, where the company is employee-controlled just before the chargeable event or where at the same date the majority of the company's shares of that class are not employment-related securities. Section 431 provides for joint elections by the employer and employee to disregard any restriction at the time of acquisition.

12. Chapter 3 effectively operates by treating convertible securities as two assets. Section 437 works in such a way that only the value of the underlying securities, ignoring the right to convert, is charged to tax on acquisition. The right to convert is treated as if it were the grant of an option. There is no charge on the acquisition of this right, but the charge on exercise is computed on the value of the new securities acquired, less the then value (ignoring the right to convert) of the old securities given up. Section 443 lists cases that are outside the charge, where the company is employee-controlled immediately before the chargeable event or where at

the same date the majority of the company's shares of that class are not employment-related securities.

- 13.** Chapter 3C deals with securities acquired for less than market value and partly-paid shares, deeming there to be a notional beneficial loan within the Part 3 benefits code of an amount equal to the undervalue or the call. As well as the annual charge, there is a final charge on a deemed discharge of the notional loan, generally on disposal of the securities. Section 444R lists cases that are outside Chapter 3, where the company is employee-controlled when securities are acquired and where at the same date the majority of the company's shares of that class are not employment-related securities.
- 14.** Chapter 4 charges benefits related to the ownership of employment-related securities that are not otherwise chargeable to Income Tax. The amount or market value of the benefit is taxed on receipt. Section 449 lists cases that are outside the charge, where the company is employee-controlled immediately before the benefit is received or where at the same date the majority of the company's shares of that class are not employment-related securities.
- 15.** The Finance Act 2004 introduced "main purpose" tests into sections 429, 443 and 449 so that the exemptions offered by these sections were removed if the main purpose or one of the main purposes of acquiring the shares was the avoidance of tax or NICs.

Proposed Changes

- 16.** As noted above, schemes which have been disclosed to the Revenue, commonly seek to side-step the rules in Part 7 of ITEPA. The changes announced today affect Chapter 1 (definitions); Chapter 2 (restricted securities); Chapter 3 (convertible securities); Chapter 3C (securities acquired for less than market value); and Chapter 4 (benefits not otherwise chargeable to Income Tax).

Chapter 1 (definition of “securities”)

17. The amendment to Chapter 1 will amend the definition of “securities” to include rights under contracts of insurance. But the following will continue to be excluded:

- those contracts of long-term insurance (not being annuity contracts) which do not have a surrender value when made, and are not capable of acquiring a surrender value at any time during their life;
- annuities and similar contracts that are part of pension provision for employees, and
- contracts of general insurance that cannot lead to cash sums being obtained by an employee.

This amendment applies for insurance contracts held before or after 2 December if an event of charge occurs on or after that date.

Chapter 2 (restricted securities)

18. Section 424 currently exempts securities from the provisions of Chapter 2 where they are restricted securities solely by reason of being:

- unpaid or partly paid shares,
- securities liable to forfeiture for misconduct, or
- redeemable securities,

Section 424(c) will be repealed to remove redeemable securities from this exemption. This change will apply to securities that are acquired before or after 2 December if an event of charge occurs on or after that date.

19. An expanded main purpose test will be included in section 424 in relation to the remaining exceptions. The main purpose test will apply to securities that are acquired before or after 2 December so that from 2 December no exemption will be available where securities are or have been used as part of arrangements to avoid tax or NICs.

20. The amendments will disapply section 425 where the main purpose, or one of the main purposes, of the relevant arrangements is the avoidance of tax or NICs in relation to the securities at the time of acquisition and

subsequently. This will result in a charge arising on the acquisition of the securities under section 62, as “money’s worth” within the definition of earnings.

21. In addition, the charge that is levied on such an acquisition will be levied by reference to the unrestricted market value, rather than the actual value.
22. Section 428(9) provides a measure of relief where securities are disposed of for less than their market value. A “main purpose” test will also be introduced to remove this relief if the test is failed.
23. Section 428(9) will also be disapplied where there has been a depression in the market value of the securities within the terms of Chapter 3A.
24. Section 429 disapplies Chapter 2 to events that would otherwise be chargeable where the company is employee-controlled immediately before that date or where at the same date the majority of the company’s shares of that class are not employment-related securities. The main purpose test currently contained in section 429 looks for an avoidance motive on acquisition of the shares. This will be extended to disapply the effect of section 429 where avoidance or tax or NICs is the only or main purpose of arrangements at any subsequent time.

Chapter 3 (convertible securities)

25. A main purpose test (similar to that for section 425) will be introduced in relation to section 437, which currently reduces the tax charge on acquisition of convertible securities. If convertible securities are acquired as part of an arrangement to avoid tax or NICs there will be two effects on the market value on which the acquisition charge is based:
 - the right to convert will no longer be disregarded in arriving at market value, and
 - the market value will be as if there were an immediate and unfettered right to convert (which means any limitations on the right to convert the

securities will be disregarded so the value will reflect the current value of the securities that might be acquired on conversion);
The value used will be the greater of this value and the value of the convertible securities without the right to convert.

- 26.** Provision will be made for this increased charge to be relieved against any subsequent gain on conversion of the securities.
- 27.** Section 443 disapplies Chapter 3 for situations where the company is employee-controlled immediately before that date or where at the same date the majority of the company's shares of that class are not employment-related securities. The main purpose test currently contained in section 443 tests for an avoidance motive on acquisition of the shares. This will be extended to also disapply the section if arrangements are subsequently entered into where one of the main purposes is to avoid tax or NICs.

Chapter 3C (securities acquired for less than market value)

- 28.** Section 446R lists cases that would otherwise fall outside the scope of Chapter 3C. There is already a main purpose test in section 446R. We will complement this for cases that are within the Chapter. Where arrangements are put in place which seek to avoid the charge under section 446U the notional loan will be treated as discharged when the relevant transaction occurs.

Chapter 4 (benefits)

- 29.** Chapter 4 currently encompasses benefits that arise by virtue of the ownership of employment-related securities. This will be amended to cover benefits received in connection with employment-related securities for consistency with section 477(3) of Chapter 5. Chapter 5 deals with benefits received in connection with securities options.
- 30.** Section 447(4) disapplies Chapter 4 when the benefit is otherwise chargeable to income tax. This subsection will be subject to a main

purpose test and will not be available where the avoidance of tax or NICs is the only or one of the main purposes in the arrangements to acquire the securities or at any time up to when the benefit is received.

- 31.** Section 449 disapplies Chapter 4 for certain shares where the company is employee-controlled immediately before that date or where at the same date the majority of the company's shares of that class are not employment-related securities. The current main purpose test in section 449 only applies at the date of acquisition of the shares. This will be extended so that section 449 does not apply where arrangements are made subsequent to the acquisition and the main purpose(s) is not satisfied.

Date of Effect

- 32.** The changes set out in this Technical Note will apply with effect from today's date, 2 December 2004 in relation to events of charge on or after that date whether those events are in respect of securities acquired on or after that date, or in respect of securities already held on that date.