



SHARE FOCUS

INTRODUCTION

Welcome to the second edition of the Share Schemes Team newsletter Share Focus.

We are very pleased with the favourable responses to the first edition (July 2002) and thank you to everyone who took the time to comment on this.

The last few months have seen substantial changes to the tax and NICs treatment of share options. This edition of Share Focus has details and guidance on some of the changes introduced in Finance Act 2003. We will continue to develop our guidance over the next few months and make this available through Share Focus and our website. This edition also contains some practical guidance on our procedures in obtaining outstanding share scheme returns and our view of the "blue pencil" provisions where options over £30,000 in value have been issued under an approved company share option plan. Practitioners may wish to advise their clients of this guidance.

A large number of readers have requested that they would like to receive Share Focus by email and I would like to take this opportunity to remind people of this free facility. We will no longer be publishing editions in paper format.

Our aim in future is to provide Share Focus solely through our website with notice being given to readers via email. Current and past editions can be found [here](#).

If you have any comments about the articles contained in Share focus or suggestions for any items that you would like to see in future editions then please contact kevin.meehan@ir.gsi.gov.uk

PRACTICAL ISSUES

Outstanding share scheme returns

We would like to inform companies and practitioners of a change to our procedures to encourage companies to file their share scheme returns on time. At the moment companies have three months from the date of issue of the return to complete the return and send it to the Share Schemes Unit. Where the company has not filed its return within that time we continue to write to the company asking the company to send in its completed return.

From the 30 November 2003 we will be writing to companies that have not sent back their returns advising them that they have 30 days from the date of issue of that letter before we start proceedings to withdraw approval from the scheme, or take action before the Commissioners in relation to the failure to send the return back. No further warnings will be given to the company.

Notifications that proceedings have been started will be issued by the Commissioners. If the return is still outstanding at the date of the Commissioners meeting an initial penalty of up to £300 may be imposed. And if the return is still outstanding after the award of the initial penalty, a further penalty may be awarded, not exceeding £60 for each day the return remains outstanding.

For approved schemes we may commence action to withdraw approval of the scheme, for example, where there are two or more years outstanding returns, we will warn companies that action to withdraw approval has started.

For approved scheme returns issued on or after 6 April 2004 companies will have three months from the date of issue of the return to complete and send it back to the Share Schemes Unit. If the return is not received within that time we will commence proceedings before the Commissioners to obtain the return. No further warnings will be given to the company.

For schemes and other arrangements that are not Inland Revenue approved schemes any one of 4 "responsible persons" have to provide before 7 July 2004 written details of any reportable events for the year ended 5 April 2004. Reportable events include the granting of securities options, acquisition of securities and chargeable events as a result of restrictions being lifted or varied etc.

If written details of reportable events are not received before 7 July 2004 each of the 4 "responsible persons" may be liable to an initial penalty of up to £300, followed by daily penalties of up to £60 per day in respect of each reportable event. In this case penalty proceedings will be commenced shortly after 7th July. No reminders or warning letters will be issued after 7th July.

This new practice will not affect the majority of companies who file their returns within the time allowed. It is aimed at those companies who fail to complete and send in their returns within that time. If companies have difficulty in completing their returns they should write to or telephone the Share Schemes Compliance Manager (Room 76, New Wing, Somerset House, London WC2R 1LB - Tel. 020 7438 4215) to discuss the problem.

Company Share Option Plan (CSOP)

There appears to be a misunderstanding amongst companies and practitioners on the number of options that can be granted before the statutory limit contained at Paragraph 6 Schedule 4 ITEPA 2003, currently £30,000 is exceeded. And where the £30,000 limit is exceeded which options become unapproved, usually referred to as the "blue pencil" provisions.

Our view is that an option cannot be granted in excess of the statutory limit and the "limiting and take effect" criteria which most plan rules now contain is, normally, sufficient to prevent such an occurrence. There is nothing to stop a company granting more than one option on the same day so that this limit is not exceeded e.g. Option A, with a value of £30,000, is granted under the approved Plan. Simultaneously, or shortly thereafter, Option B is granted with a value of (say) £50,000 under an unapproved Plan (or arrangement). The option certificates must clearly indicate under which plan the options are granted. We do not accept that the fundamental terms of an option (which includes the number of shares and the option price) can be altered unless an event occurs e.g. a change of control leading to an option exchange.

Our continuing review of the annual returns for the year ended 5 April 2003 has highlighted many instances of options being awarded with an aggregate market value in excess of the statutory limit. In addition some Plan Administrators do not seem to appreciate that £30,000 is not an annual limit. Some returns have been submitted giving details of an option granted to individual employees with an aggregate market value of (say) £29,000 when he already held options, granted in an earlier year, over shares valued at (say) £15,000.

When queried Companies (or their advisers) have claimed that the "blue pencil" provisions should be invoked to limit the option under the approved Plan to £30,000 with the balance being unapproved. Alternatively this is often claimed to be an administrative error which it is proposed be rectified on similar lines to those referred to above. We do not accept either of these arguments. Once an option has been returned on form 35 (which is a statutory form) we assume that the company intends to honour that option in full. If the aggregate Market Value of the option exceeds £30,000 our view is that the whole of the option, or that option which causes the limit to be exceeded, (and not just the excess) is unapproved.

It is a matter between the company and the option holder whether the option is valid or void in its entirety. It follows that if the option is accepted as being valid any subsequent "gain" on exercise will be liable to income tax (PAYE if granted after 26 November 1996) and National Insurance contributions if the shares which are acquired are Readily Convertible assets.

TECHNICAL UPDATES

Finance Act 2003

The Finance Act 2003 made substantial changes to the taxation of employee remuneration in the form of shares, share options and securities. Details of the new legislation on Approved schemes (Schedule 21 FA 2003), Unapproved schemes (Schedule 22 FA 2003) and Corporation Tax (Schedules 23 and 24 FA 2003) can be found [here](#).

Explanatory Notes on these Schedules (Clauses 138-141) can also be found [here](#).

Answers to a number of frequently asked questions on the operation of the new legislation can be found at

[Approved schemes](#) and [Unapproved schemes](#)

National Insurance Contributions

A [Tax Bulletin Special Edition](#) has been issued explaining the changes that have been introduced to National Insurance Regulations, with effect from 1st September 2003, to align NICs treatment of securities-based earnings with tax treatment following Finance Act 2003. Also the article will explain how the NIC Regulations have been amended to clarify treatment of share options (and replacement options) granted before 6th April 1999.

Numerical examples will be included to support explanations.

Joint NICs Elections – A reminder

In February 2002 we introduced a 'fast track' process for approving Joint NICs Elections. The aim was to issue formal approval to such elections within 14 days of receipt. However, fast track approval was only guaranteed if:

1. the election matches our model election published on our website [here](#).

or

2. the election matches a format previously approved by us and allocated a unique fast track reference number,

and

3. this unique reference number is quoted with the request for approval.
4. In addition, all the relevant information must be submitted with the request for fast track approval.

Unfortunately, we are finding that the unique reference number is not always being quoted and the agreed format is not always replicated, despite a request to 'fast track' the approval. We will **not** issue formal approval within **14 days** if the unique fast track reference is not quoted. Also it is not sufficient to say '...the election is *based on* one previously approved...'. It must exactly match the format agreed by us and to which we have allocated the corresponding unique fast track reference. Any elections submitted for approval without meeting these requirements will be treated as a non-fast track election.

Please contact Sahd Ullah on 020 7438 8272 if you would like further information.

Company Share Option Plans

We are taking this opportunity to issue further guidance on two of the changes in FA 2003 that appear to have a significant impact for employers operating CSOPs.

Retirement Age

If option holders, who retire and have to exercise their options early (within three years of grant), are to qualify for the new tax relief then the scheme rules must specify a retirement age and that age must not be less than 55 years. Inserting a specified retirement age in the scheme rules does not affect the exercise rights that option holders already have. For example, the scheme rules may specify a retirement age of 60 and that option holders have a right to exercise their options at the "contractual retirement age" (age 65) or any other age agreed between the option holder and the Board of Directors. By agreement an option holder exercises their options at age 62 and in doing so exercises within three years of grant. As the scheme rules have specified a retirement age of 60 they would qualify for the new tax relief. But if by agreement the option holder exercised at age 58 they would not qualify as the specified age has not been reached.

If the specified age is in the contract of employment that is acceptable provided that the scheme rules make it clear that "Retirement age is the age specified in the eligible employee's contract of employment" or some other format. But the link must be made to the scheme rules. If the scheme rules do not refer to the employment contract then even if the retirement age is specified in that contract it would not be specified in the scheme rules. It is also not sufficient for the scheme rules to be drafted in terms of "the age at which an employee is bound or entitled to retire under the terms of his contract of employment" and then the contract of employment to say "any age agreed by the Board/Company/Directors in excess of 55" or some other formulation. That is not specifying an age.

PAYE and NIC withholding provisions

We have previously published guidance and a draft scheme rule dealing with the provision that companies may wish to make to recover PAYE and NIC where options are exercised early (within 3 years of grant) and the exercise does not qualify for tax relief. An additional example of a scheme rule is shown below and is also published on our website.

Draft rule

"If the company is obliged in any jurisdiction to account for tax and national insurance contributions for which the Option holder is liable by virtue of the exercise of the Option and the company has not received from the Option holder the necessary amount, then the company shall be entitled to discharge such liability by selling sufficient Shares in respect of which the Option has been validly exercised and allotting or procuring the transfer of the balance of the Shares to the Option holder."

Both of these model rules are acceptable for existing and new options. If, however, a scheme is to make use of withholding arrangements the following points should be noted.

Existing options

For existing options, that is options granted before the PAYE and NIC withholding rule is adopted, our view is that any provision for recovery of PAYE and NIC cannot be made a condition of exercise. For example, we have seen cases where the exercise right is being changed to make it a condition of exercise that the option holder enters into a NIC election, or that the option holder cannot exercise unless they enter into agreement to pay the PAYE and NIC, or the number of shares issued following notice of exercise is restricted. This type of provision changes the exercise rights of existing option holders and is not acceptable.

But the scheme rules can provide for the company to advise the option holder, at or after the time of exercise, of the amount of PAYE and NIC that is due and how the company intends to recover the PAYE and NIC. This could be, for example, through the option holder paying that amount to the company or where the option holder does not pay the amount due by the company selling sufficient shares to recover the amount of PAYE and NIC due.

New options

It is acceptable for scheme rules to be amended to make it a condition of exercise that the option holder will pay any PAYE and NIC due but this type of rule can only apply to new options granted after the date the amendment was made. That is, this type of rule is a condition of exercise at the time the options are granted. The company may determine the method of any PAYE and NIC recovery in relation to new option grants.

We consider that withholding provisions are a "key feature" of the scheme and all amendments together with the appropriate documentation will need to be approved before they are implemented.

Administrative changes

We have also made a number of changes to our administrative procedures to streamline the approval process for CSOPs.

- A company will often wish to grant options immediately a scheme is established. Under our current practice, we ask for sight of the establishing document (usually a certified copy of a company or directors resolution) before giving formal approval. This can lead to several days delay before we can issue our formal approval.

We will now advise companies, when giving informal approval to draft schemes, that our formal approval will be effective from the moment the scheme is established provided that there are no changes to the form of the scheme, the legislation or the circumstances of the company in the interim. We will require the company to inform us of the date when the scheme is established within 14 days of the date of adoption of the scheme.

- We now allow rules to specify "Market Value" by reference to published prices on Recognised Investment Exchanges in terms similar to those for shares listed on London and New York Exchanges. Previously we required schemes to specify that Market Value was determined in accordance with section 272 Taxation of Chargeable Gains Act 1992. Companies or practitioners still have to agree valuations with Share Valuation where the published price is not listed on the London or New York exchanges.
- We have previously regarded arrangements ("cashless exercise") for the funding of the exercise price of CSOP options as "neither essential nor reasonably incidental to the purpose of providing share options". So long as these arrangements are made solely to facilitate the exercise of options and, for example, do not give a right to acquire cash we propose to accept them as relevant features of approved schemes as they facilitate the operation of the scheme. We have not changed our view set out in Share Focus 1 that a cashless exercise facility must not impose an obligation on the option holder to sell shares. In our view such an obligation is a restriction on the shares.
- Previously it has been the policy of the Share Schemes Unit when approving new Schemes to only review ancillary documents if a "health warning" stating that the legislation will take precedence over the rules in areas of conflict was not included. With effect from the date of this issue of Share Focus all ancillary documents submitted will be reviewed prior to approval being given regardless of whether or not they carry a "health

warning". This change recognises that ancillary documents are part of the scheme documents and that changes to them may need to be approved as a key feature of the scheme.

Share Incentive Plan

Salary

We understand that the amount of salary to which the 10 per cent limit is applied in calculating the maximum amount of salary that can be used in purchasing partnership shares is causing some confusion. Our view is that salary means the amount of salary after the deduction of allowable superannuation contributions and payroll charity giving.

This view is based on the meaning of salary in paragraph 43 Schedule 2 ITEPA 2003 and generally means earnings from the eligible employment subject to PAYE, after deduction of expenses and benefits in kind. And those earnings are subject to PAYE after the deduction of

- (a) allowable superannuation contributions, and
- (b) any sum withheld from an employee in accordance with section 202 of the Taxes Act". (Section 202 of the Taxes Act covers the provisions of payroll charity giving.)

Following Finance Act 2003, it is now acceptable to exclude a particular description of earnings, such as overtime or bonus payments, from the salary. If the company so wishes, this allows for the use of a specified amount of salary only for the purpose of the 10% limit. If a particular description of salary is to be excluded it must apply to all participants in the plan. You cannot, for example, exclude bonus payments where only some participants receive bonuses.

EMI

Grant of a replacement option on a company reorganisation

Where a qualifying EMI option is replaced by a new option, there is obviously the need to notify the Inland Revenue - an option cannot be a qualifying option unless notice of the option is given to the Revenue within 92 days after the date of grant of the option.

This has caused confusion to some companies who have seen that a replacement option is treated as granted on the date on which the old option was granted.

They have concluded that the 92-day period will have expired before the new option is granted, making the notification within the time limit impossible.

The answer is to remember that we are considering two separate things. The notification of the option to the Revenue and the treatment of that option for tax purposes. Clearly we need to know about the option before we can decide how to treat it, and the notification requirement is part of the communication process. The requirement to tell us about the option is therefore linked to the real time at which the new option is granted. It refers to the grant of an option and it is that time that is relevant for notification purposes. The paragraph that links the option to the earlier date of grant then comes into play in deciding how to treat the option, and for that purpose - and that purpose only - we have a notional earlier grant date.

Finance Act 2003 gives a boost to EMI

Under the new rules employees and employers can jointly elect to treat "restricted shares" as if they were not restricted. Income tax and NICs are then payable, or in the case of EMI relieved, on the full unrestricted market value at that time. If an election is made on acquisition of restricted EMI shares all future commercial growth is capital.

For instance, suppose EMI shares are acquired that cannot be sold for 12 months. The old rules taxed any growth in value arising from the early lifting of the restriction. Under the new rule, with an election, no tax or NIC are payable either when the EMI option is exercised or when the restriction is lifted.

If, exceptionally, the EMI options are discounted and the share price falls the charge on exercise will be based on the difference between the amount paid and the restricted market value. With an election the amount of the charge will be higher (the difference between the amount paid and the unrestricted market value), but any charge on the lifting of the restriction will have been removed. In these circumstances the same considerations on whether or not to make an election will apply, as for non-EMI options.

More information, and worked examples, are on the Share Schemes web site in the form of frequently asked questions which can be found [here](#).

Date of grant for EMI options

The EMI legislation requires the grant of an EMI option to be in the form of a written agreement and that this must contain or set out specific terms. Pages 22 to 24 of the EMI guide IR 2006 provide guidance on this issue. Grants of options can be made by several mechanisms, however for practical reasons, where a number of employees are involved, it is common for companies to grant options under deed or seal, to ensure for administrative ease all the employees involved are granted their options on the same day. Where this is the case the date of grant of the option, will be the date the document is executed and the right acquired by the employee.

Although a company or the board or a committee may pass a resolution prior to the granting of the option(s) by deed or seal, this date is not material and has no direct relevance to determining the date the right is acquired. When considering any questions about date of grant of an option we will look at the facts of the case. For the future only the date the deed or seal that grants the option is executed, will be accepted as the date of grant.

Establishing the Market Value of the shares under EMI option.

A company granting an EMI option must complete and send to the Small Business Enterprise Centre (SCEC) notice of the grant of the option within 92 days of making the grant. When doing this it is important to provide the market value of the shares under the EMI option. Without this the company cannot be sure the £100,000 limit has not been exceeded.

Establishing the market value will enable any tax/NICs liability at the time the EMI option is exercised to be calculated e.g. if the price payable to acquire the share under the option is less than the market value of the share at the date of grant. Obtaining a valuation of the shares at the time of grant is also useful for Capital Gains Tax purposes.

We are aware some companies when notifying EMI options are not providing the market value of the shares at the time the option is granted. If a company's shares are listed on a Recognised Stock Exchange the quoted price can be used as the market value of the shares on the date of grant. If a company's shares are unquoted, a market value of the shares can be agreed with Inland Revenue Shares Valuation.

To agree a market value with them you will need to propose a value for the shares and provide background information to support the proposal. Form Val 231 must be completed and this is available from any Inland Revenue office or from our website at www.inlandrevenue.gov.uk.

The form outlines the information you should give to support the proposed valuation. It needs to be sent to Inland Revenue Shares Valuation (share schemes) at the following addresses:

(For companies in England, Wales & Northern Ireland)

Fitzroy House
PO Box 46
Castle Meadow Road
Nottingham NG2 1BD
Tel:-0115 974 2355

(For companies in Scotland)

Meldrum House
15 Drumsheugh Gardens
Edinburgh EH3 7UH
Tel:-0131 777 4180

If you have already notified the SCEC of grant of an EMI option, but not provided the market value of the shares, this can be done now by contacting the addresses above.

COMMUNICATION MATTERS

www.inlandrevenue.gov.uk/shareschemes

Last year our website was re-designed to make it more user friendly and easier to navigate. The site now has separate sections for employers and advisors, and employees and there is a new look home page. Two indexes have been added to make it easier to find information. This responded to customer research we carried out at the end of last year.

There is extensive information and guidance on the website on all tax and NIC advantaged employee share schemes. There is also a section on the tax treatment of share awards that fall outside the scope of an Inland Revenue approved employee share scheme.

We regularly up-date and improve the website. We would like to know what you think of the new arrangements and whether you think there is anything that could be improved. Any comments/suggestions should be sent to karen.morgan@ir.gsi.gov.uk.

Comings and Goings

The last year has seen a number of changes in the Share Schemes Team, and an up-to date contact list is provided on the back page.

In December 2002 Ros Fenton retired whilst Alan Wood and Malcolm White have left us on promotion. Our third leaver was Derek Tilstone who is now Personal Assistant to our former head of Team Caroline Rookes. Ann Marsh has also recently left to work in another policy area where she has linked up with another ex colleague Liz Welsh. In the last month two Scheme Administrators, Judy Candlish and Neil Pawsey have been successful in gaining promotion and have both left the team.

Joanne Collings joined us from RP Personal Tax in January 2003 as Policy Adviser on approved schemes. We have also recruited three new Scheme Advisers two joining us from the Network, Steve Lig from North West London Region and Ellie Mayor from Westminster and Andy Thomas who rejoins the team after a spell in another policy area. We also recruited three Scheme Administrators, Tina Joshi who has recently joined us from RP Corporate Services, Jose Veiga and Nina Kumar who are new to the Revenue.