

**EXPLANATORY NOTE****CLAUSE 7: CHARGE TO INCOME TAX ON LUMP SUM****SUMMARY**

1. Clause 7 provides for the taxation of a social security pension lump sum ('the lump sum') in 'the applicable year of assessment'. The person entitled to the lump sum is to be taxed at the rate of income tax applicable to their other sources of income. This ensures that the lump sum does not form part of the person's total income, so that it does not in itself affect the person's age related personal tax allowances or the rate(s) of income tax chargeable on their other income.

**DETAILS OF THE CLAUSE**

2. Subsection (1) introduces a charge to income tax on the social security pension lump sum.
3. Subsection (2) specifies that the lump sum is to be treated as income but not as part of the recipients 'total income'. This means that the lump sum is treated separately to the other income for that year and does not in itself affect the person's age related personal tax allowances or rate(s) of income tax chargeable on their other income. This subsection lays the ground for subsection (5).
4. Subsection (3) specifies that the person liable to a tax charge on the lump sum is the person entitled to it and makes clear that the charge is not affected by their residence status.
5. Subsection (4) imposes the tax charge on the lump sum in the 'applicable year of assessment'.
6. Subsection (5) sets out the income tax rate to be applied to the lump sum in the 'applicable year of assessment'. Currently these are the starting rate, basic rate or higher rate, or if the recipient is not liable to tax the subsection confirms that no tax need be charged. The rate of tax is the highest rate applied to the recipients other income in the applicable year of assessment.
7. Subsections (6), (7) and (8) point to clauses 8, 9 and 10 for

- definitions of the terms used in the clause, including the ‘applicable year of assessment’;
- when the provisions for taxation of the lump sum will come into effect; and
- details of consequential amendments to ITEPA 2003.

### BACKGROUND NOTES

8. The Pensions Act 2004 provides people with a choice of reward for deferring their State Pension from April 2005. This can be taken as an increase in the weekly pension or a one-off taxable lump sum payment. This reflects the Government’s wish to increase the choices people have over when, and how, they move from work to retirement.
9. Although Schedule 5 to the Contributions and Benefits Act 1992 as amended by Schedule 11 to the Pensions Act 2004 takes effect in April 2005, there is a minimum 12-month deferral period before a lump sum can be claimed. The first time a charge to income tax could arise will therefore be 2006/7.
10. The Government wants to ensure that a person who defers their social security pension for at least a year from April 2005, and chooses to take a lump sum, is not disadvantaged by their choice. Clause 7 therefore provides that the lump sum will not be included in a person’s total income and so will not affect the amount of age related income tax allowances available to be set against that total income.
11. PAYE regulations will be made to enable DWP to deduct tax on the basis of a declaration by a pensioner as to the appropriate rate at which to deduct tax. People will be able to advise DWP of their likely highest tax rate (currently 10 per cent, 22 per cent or 405 per cent or 0 per cent if they are not liable to tax) for the year in which the lump sum is chargeable. If a declaration is not made the basic rate of income tax (currently 22 per cent) will apply initially. If too much or too little tax is deducted the position will be rectified by reference to the actual charge on the lump sum for the applicable year of charge.
12. If a person were only able to take the lump sum when they claim their pension, it would be taxed at the rate applicable to their other income in that year. If this was their last working year then the tax rate may be higher than in the following year (possibly because the

person is no longer working). Therefore the Secretary of State for Work and Pensions intends to make regulations so that once a pensioner has taken up their pension following a deferment of 12 months or more and chooses a lump sum, they will have the option of taking the lump sum either:

- at the time the state pension is claimed or if they so elect, or
- in the following tax year.

13. Clause 8 allows for this situation and provides that the tax rate shall be the one applicable to the year the person chooses to receive their lump sum.
14. The proposed tax treatment for the lump sum, and the intention to allow a choice in respect of the year of payment have been announced by both HM Revenue and Customs and DWP at 2003 and 2004 Pre-Budget Reports.

**EXPLANATORY NOTE****CLAUSE 8: MEANING OF ‘APPLICABLE YEAR OF ASSESSMENT’ IN SECTION 7****SUMMARY**

1. Clause 8 establishes that the charge to income tax on the social security pension lump sum under clause 7 shall apply in either :
  - the tax year which includes the first day on which the social security pension is paid (‘the first benefit payment day’). The clause defines that year as the ‘applicable year of assessment’; or
  - the tax year following, if the Department for Work and Pensions (DWP) make further regulations which allow a choice regarding the year in which the lump sum can be taken, and the pensioner so chooses.

**DETAILS OF THE CLAUSE**

2. Subsection (1) specifies that the term ‘the applicable year of assessment’ used in Clause 7 is defined by this clause.
3. Subsection (2)(a) defines the applicable year of assessment as the tax year which includes the ‘first benefit payment day’ (defined in subsections (3) and (4)). Or if the person dies before the beginning of that year, subsection 2 (b) defines the applicable year of assessment as the one, which includes the date of death. This is a contingent measure to meet the situation if:
  - DWP allows in future for someone to claim their social security pension before the end of the period of deferment, for payment after the end of the deferment period;
  - the period straddles two tax years;
  - they die before the later year.
4. Subsection (3) defines ‘the first benefit payment day’ subject to a qualification in subsection (4) as the day in which the state pension, shared additional pension or graduated retirement benefit becomes payable following deferment.
5. Subsection (4) qualifies the definition of ‘the first benefit payment day’ in one specific instance. This is where a surviving spouse (‘P’) may claim a lump sum in respect of the deceased’s (‘S’) period of deferment and, on the day S died, P is already receiving

their own State pension. Within this sub-section the surviving spouse takes on the identity 'P' and the spouse who has died is referred to as 'S' The first benefit payment day is then deemed to be the day S died.

6. If the surviving spouse ('P') is not entitled to a social security pension at the time S dies, then P will not be entitled to claim the inherited period of deferment until their own first benefit payment day. Upon reaching retirement age the normal tax rules will apply to P. Therefore it will be P's rate of tax for the applicable year of assessment that will apply.
7. Subsection (5) specifies that subsections (6) and (7) apply where when P elects under any future regulations made by the Secretary of State for Work and Pensions to take the lump sum in the next tax year following the applicable year of assessment.
8. Subsection (6)(a) determines the applicable year of assessment if an election is made under further regulations made by the Secretary of State for Work and Pensions referred to in paragraph 7. In such a case, the applicable year of assessment is the year immediately following the year in which the first benefit payment date falls.
9. Subsection (6)(b) confirms that if P dies in the year that includes the 'first benefit payment day', but had previously elected for the applicable year of assessment to be the later year, this election will be overridden and the applicable year of assessment will be the year in which P died.
10. Subsection (7) addresses the position where P dies after the end of the applicable year of assessment in which the first benefit payment day falls having made no election as to when he wants to take the lump sum. In these circumstances, providing DWP regulations so permit, P's executors may elect for the applicable year of assessment to be the next tax year.
11. Subsection (8) confirms that any delay in the recipient actually receiving their lump sum payment does not alter the applicable year of assessment.
12. Subsection (9) defines the meanings of the terms 'Category A or Category B retirement pension'; 'graduated retirement benefit', 'shared additional pension' and 'social security regulations' for the purposes of this section.

13. Subsection (10) provides that clause 8 is to be read together with clause 7.

### BACKGROUND NOTES

14. The Pensions Act 2004 provides people with a choice of reward for deferring their state pension from April 2005. This can be taken as an increase in the weekly pension or a one-off taxable lump sum payment. This reflects the Government's wish to increase the choices people have over when, and how, they move from work to retirement.
15. The Secretary of State for Work and Pensions intends to make regulations so that once a pensioner has taken up their pension following a deferment of 12 months or more and chooses a lump sum, they will have the option of taking the lump sum either
- at the time the social security pension is claimed or if they so elect
  - in the following tax year
16. To ensure that pensioners are not taxed on the lump sum at a higher rate just because their earnings take them into a different tax band in their last working year, a pensioner may elect to take the lump sum in the following tax year. The marginal rate of tax (as outlined in Clause 7) will then be the one that applies for that later year.
17. DWP will deduct tax when making the payments. PAYE regulations will be made to enable pensioners to inform DWP of the likely rate of charge for the applicable year of assessment ( or the later if appropriate ), and for DWP to deduct by reference to that likely rate.

## **EXPLANATORY NOTE**

### **CLAUSE 9: INTERPRETATION AND COMMENCEMENT**

#### **SUMMARY**

1. Clause 9 provides definitions of terms used in clauses 7, 8, 10 and this clause.

#### **DETAILS OF THE CLAUSE**

2. Subsection (1) defines a ‘social security pension lump sum’ for the purposes of clauses 7 and 8.
3. Subsection (2) defines a ‘graduated retirement benefit lump sum’, a ‘shared additional pension lump sum’ and a ‘state pension lump sum’ for the purposes of this clause and clause 8.
4. Subsection (3) defines ‘NIA 1965’, ‘NIA (NI) 1966’, ‘SSCBA 1992’ and, ‘SSCBA (NI) A 1992’ for the purposes of this clause and clause 8.
5. Subsection (4) confirms clauses 7, 8 and this clause relates to the tax year 2006/7 and later years.

#### **BACKGROUND NOTES**

6. The tax treatment for a lump sum payment, and the intention to allow a choice in respect of the year of payment have been announced by both HM Revenue and Customs and DWP at 2003 and 2004 Pre-Budget Reports.
7. Although Schedule 5 to the Contributions and Benefits Act 1992 as amended by Schedule 11 to the Pensions Act 2004 takes effect in April 2005, there is a minimum 12-month deferral period before a lump sum can be claimed. Therefore the first time a charge to income tax could arise would be 2006-07.

**EXPLANATORY NOTE****CLAUSE 10: CONSEQUENTIAL AMENDMENTS****SUMMARY**

1. Clause 10 comprises consequential amendments to the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) as a result of the provisions which introduce a charge to income tax on a social security pension lump sum. These consequential amendments will treat a social security pension lump sum as PAYE income and provide for the Department for Work and Pensions (DWP) to withhold income tax at the point of payment.

**DETAILS OF THE CLAUSE**

2. Subsection (1) confirms ITEPA 2003 shall be amended.
3. Subsection (2) adds a new subsection 1(A) to section 577 ITEPA 2003 to exclude the social security pension lump sum from the definitions in subsection (1) of section 577 ITEPA 2003. This means that the lump sum is neither part of taxable pension income, or total income chargeable to income tax.
4. Subsection (3) inserts a reference in 683(3) ITEPA 2003 to a new subsection (3A) of section 683 ITEPA 2003.
5. Subsection (4) comprises the new subsection (3A) to section 683 after subsection (3) ITEPA 2003. This new subsection (3A) establishes that the social security pension lump sum will be defined as PAYE income. This lays the ground for income tax to be withheld at the point of payment under a PAYE type arrangement.
6. Subsection (5) of this clause inserts a reference after subsection (1) of section 686 ITEPA 2003 to a new subsection (5) of that section. That new subsection is inserted by subsection (6) of this clause.
7. Subsection (6) introduces a new subsection (5) of section 686 ITEPA 2003. This has the effect of ensuring that tax will not be

deducted by DWP until the lump sum is paid. This does not affect the amount of tax, which is deducted.

8. Subsection (7) inserts the Finance (No 2) Act 2005 (when assented) as an abbreviation 'F(No 2)A 2005' into the list of abbreviations and defined expressions in schedule 1, Part 1 ITEPA 2003.

### BACKGROUND NOTES

9. Any tax due on the social security pension, which is paid gross, is normally collected by restricting personal allowances when setting a PAYE code for another source of income. However for pensioners whose lump sum will be subject to tax, this is not feasible, because of the potential size of a lump sum payment.
10. If DWP paid lump sums gross, as they do with the normal weekly pension, the pensioner would need to complete a tax return for the year of charge and then pay the outstanding tax by January of the following tax year.
11. Therefore to make things simpler for pensioners (many of whom will not previously have had to deal directly with the tax authorities) DWP will deduct tax at source through PAYE based on an initial self-declaration provided by the pensioner. This self declaration will mean that for most pensioners the tax deducted will be correct, so that the tax position is finalised at the time of payment.
12. It may be that sometimes a pensioner who has claimed a lump sum has to file a tax return for a year for which a lump sum is chargeable, but DWP has not actually paid the lump sum by the filing date. The HM Revenue and Customs will ensure that there is no question of seeking any further tax which may be due in respect of the lump sum until the actual payment has been made by DWP.

**EXPLANATORY NOTE**

**CLAUSE 11: DONATIONS TO CHARITY BY  
INDIVIDUALS**

**SUMMARY**

1. Clause 11 amends section 25 Finance Act 1990 as it applies where a right of admission is granted in return for a donation. It sets out the circumstances in which a right of admission will be disregarded for the purposes of Gift Aid. It also extends the types of charities that can benefit.

**DETAILS OF THE CLAUSE**

2. Subsection 1 amends the Gift Aid legislation for individuals contained in section 25 Finance Act 1990. It replaces subsections (5E) to (5G) with new subsections (5E) to (5J).
3. New subsection 5E means that a right of admission to view the property of a charity will not be regarded as a benefit in determining whether a gift to charity is eligible for Gift Aid where the conditions of subsections 5F to 5H are met.
4. New subsection 5F requires that any member of the public has the right to make a gift to charity that attracts a right of free or reduced price admission to view the work of the charity.
5. New subsection 5G replaces the old requirement based on the purpose of the charity. Previously the exemption applied where the sole or main object of the charity was to preserve heritage property or conserve wildlife for the benefit of the public. The new requirement is that a right of admission is granted to view specified types of property preserved, maintained, kept or created by a charity in pursuance of its charitable purposes. The subsection sets out a list of types of property which may be eligible if the other conditions are met. The list is not exhaustive.
6. New subsection 5H specifies two alternative situations where the exemption may apply. The first is where a right of admission

given in return for the gift is valid for a period of at least one year at all times that the general public can gain admission. The number of visits within this twelve-month period should not be restricted, except within the limits set out in new subsection 5J.

7. The second situation is where the right of admission is for less than one year. The gift must be at least 10% more than the amount that any member of the public would have to pay to gain the same right of admission. If there is not a comparable public ticket the normal Gift Aid benefit rules in section 25(5A) Finance Bill 1990 apply.
8. New subsection 5I provides definitions for terms used in 5E and 5H. For the purposes of 5E it defines “right of admission” as having three elements. The first is that a right of admission is granted to a person making a gift, or to that person and one or more family members. The person making the gift and his family members do not have to exercise the right at the same time. Second, the property must be one to which the public is required to pay an admission fee to enter. Third, the person making the gift either pays no admission fee or a reduced admission fee. For the purposes of 5H “the same right of admission” is defined as a right of admission that applies to the same property, classes of person, or periods of time as the right received as a result of making a gift. So a gift that gives the right of admission for a specified period or to a particular property must be compared to what the public would pay for a ticket for that same period or for that property.
9. New subsection 5J partially overrides the requirement in subsection 5H(a) that admission given must be valid at all times that the general public can gain admission. Charities can disregard a small number of days on which events take place for the purposes of determining whether the access requirement is met. So, where a right of admission is granted for a twelve-month period, the conditions of 5H(a) will be met where up to 5 days are excluded because events are being held which are open to the public. Where the right of admission is granted for longer than 12 months, the charity can exclude 5 days for every whole or partial calendar year covered by the right of admission.
10. Subsection 2 sets out when the new provisions will have effect. This will be for gifts made on or after 6 April 2006. There are no transitional arrangements.

## **BACKGROUND NOTES**

### *The existing legislation*

11. Section 25 Finance Act 1990 provides relief for gifts to charity by individuals. Relief is available where gifts are “qualifying donations”.
12. Subsection (2) of section 25 sets out the criteria that a gift must satisfy to be a “qualifying donation”. Broadly these are that it must be a monetary payment and must not be subject to condition of repayment, or be in respect of consideration for the acquisition of an asset by the charity from the donor or a connected person. Section 25(2)(e) stipulates that the donor, or any connected person, cannot receive benefits in return for the donation outside of prescribed limits.
13. The prescribed limits are set out in section 25(5A). They are:
  - (a) gifts up to £100, 25 per cent of the amount of the gift;
  - (b) gifts exceeding £100 but not exceeding £1,000, £25;
  - (c) gifts exceeding £1,000, 2.5 per cent of the amount of the gift’ with an overriding cap of £250.
14. The special exemption for certain charities is set out in section 25(5E) FA1990. This prevents any benefit consisting of a right of admission to view certain charity property from being taken into account as a benefit for the purposes of Section 25(2)(e).
15. The charities that benefit from the special exemption are set out in section 25(5F). Broadly they must have as their sole or main purpose the preservation of heritage property, or the conservation of wildlife, for the public benefit.

### *What is the problem this measure rectifies*

16. Improvements were made to the Gift Aid scheme in Finance Act 2000 to encourage new donations to charity. The decision was made to retain the existing special treatment with respect to rights of members of certain charities to view the use to which their donations were put.

17. An unintended result of these changes was that a payment for admission could become eligible for Gift Aid if the right of admission granted met the terms of S25 (5E). Charities are able to offer 'free' admission to sites that charge an admission fee in return for a payment at least equal to the normal entrance fee and reclaim Gift Aid on this payment as a donation. The existing rules do not prevent this but it is not what Gift Aid was intended to do.
18. The existing rules allow only charities whose sole or main object is the preservation of heritage property or conservation of wildlife to disregard the right of admission granted to donors. Many other types of charities allow visitors to pay to view property they are preserving or maintaining in pursuance of their objects and it is unfair that heritage and conservation charities benefit from special treatment.

## EXPLANATORY NOTE

### CLAUSE 12 AND SCHEDULE 2: EMPLOYEE SECURITIES: ANTI-AVOIDANCE

#### SUMMARY

1. Clause 12 and Schedule 2 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. Clause 12 gives effect to Schedule 2.

#### DETAILS OF THE SCHEDULE

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 2

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 2 December 2004, 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 2 December 2004 section 446O (meaning of “relevant period”) has effect as though they were acquired on that date.
13. Sub-paragraph (8)(b) ensures that “generally accepted accounting practice” bears its defined meaning from the outset of the legislation.

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

An employee acquires an insurance contract with a surrender value from his employers on 1 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 7 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 5 April.

Sub-paragraph (8) will ensure that for insurance contracts only non-commercial increases in the market value that arise on or after 2 December 2004 will be taxed. In the example, the non-commercial increase that occurred on 7 November 2004 will be disregarded.

### **Restricted securities**

15. Paragraph 3 introduces the amendments to Chapter 2 of Part 7 of ITEPA.
16. Paragraph 4, sub-paragraph (1) provides that the existing section 424 will be renumbered as subsection (1) of a newly extended section 424.
17. 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.
18. 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.

19. Sub-paragraph (4) provides that the changes to section 424 apply on or after 2 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.
20. 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.
21. Sub-paragraph (2) provides that paragraph has effect where something such as is mentioned in section 428(10) has been done on or after 2 December 2004.
22. 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.
23. 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 2 December 2004.
24. 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.

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

**Convertible securities**

26. Paragraph 8 introduces the changes to Chapter 3 of Part 7, which deals with convertible securities.
27. 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.
28. Sub-paragraph (2) renumbers the existing section 437 as subsection (1) of an extended section 437.
29. 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.
30. 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.
31. 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.

32. 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.
33. Sub-paragraph (4) provides that the paragraph applies for acquisitions on or after 2 December 2004.
34. 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.
35. Paragraph 10, sub-paragraph (2) provides that this section has effect on and after 2 December 2004.
36. 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.
37. 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 2 December 2004.

**Securities acquired for less than market value**

38. Paragraph 12 introduces changes to Chapter 3C of Part 7, which deals with securities acquired for less than market value.
39. 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.
40. 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 2 December 2004.
41. 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.
42. 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 2 December 2004.
43. 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.
44. Sub-paragraph (2) provides that the paragraph will apply for acquisitions on or after 2 December 2004.
45. 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.
46. Sub-paragraph (4) provides that the paragraph will have effect on and after Royal Assent to Finance (No.2) Act 2005.

**Post-acquisition benefits from securities**

47. Paragraph 17 introduces amendments to Chapter 4 of Part 7, which deals with post-acquisition benefits from securities.
48. Paragraph 18, sub-paragraph (1) introduces amendments to section 447, the charging section for other chargeable benefits from securities.
49. 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.
50. 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.
51. 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 2 December 2004.
52. 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.
53. 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 2 December 2004.
54. Paragraph 20, subparagraph (1) provides for minor and consequential amendments to Schedule 23 of Finance Act 2003, which deals with corporation tax relief where shares have been provided to an employee.
55. Sub-paragraph (2) amends paragraph (7) of Schedule 23 to insert a new requirement for corporation tax relief as subparagraph (3). It must now be the case that section 446UA does not operate in relation to the shares.

56. Sub-paragraph (3) amends paragraph 21(8) of Schedule 23 of Finance Act 2003 so that section 446E(6) is disregarded when determining the corporation tax relief due on a chargeable event under section 426. This reflects a numbering change brought in by Finance Act 2004, which moved the previous section 446E(3) to 446E(6).
57. Sub-paragraph (4) amends paragraph 22C of Schedule 23 of Finance Act 2003, which determines the relief due in the case of convertible shares. The new section 22C(4A) provides that subsections (2) and (3) of section 437 are to be disregarded when determining the amount of corporation tax relief due.
58. Sub-paragraph (5) amends paragraph 25(1) of Schedule 23 of Finance Act 2003, which excludes certain other deductions when relief is due under Schedule 23. The first sentence now reads "Where relief under this Schedule is, or, apart from paragraph 7(3), would be available for any accounting period, no other deduction is allowed for any corporation tax purposes (whether for that or any other period) in respect of the cost of providing the shares."
59. Sub-paragraph (6) provides that sub-paragraphs (2), (4) and (5) above apply for awards on or after the date of Royal Assent to the second Finance (No.2) Act 2005.
60. Sub-paragraph (7) provides that sub-paragraph (3) is to be treated as coming into force on 7 May 2004.

### **BACKGROUND NOTES**

61. 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.
62. 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.

63. HM Revenue and Customs 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 or reduce Income Tax and NICs.
64. The changes to be made by Schedule 2, effective from 2 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.