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The *Social Security Contributions (Share Options) Bill*

Bill 8 of 2000-2001

The *Social Security Contributions (Share Options) Bill* (Bill 8 of 2000-2001) was introduced in the Commons on 20 December 2000. Explanatory Notes to the Bill were also issued at this time (Bill 8-EN). The Bill is due to have its Second Reading on 23 January 2001.

The purpose of the Bill is to provide certainty to those companies with volatile share prices who have expressed concern that unpredictable National Insurance Contributions (NICs) on share options granted between 6 April 1999 and 19 May 2000 could endanger their investment strategies and damage their future growth by deterring investors.

This paper provides an introduction to the Bill, and some background on the wider issues of the tax treatment of share options, and aligning income tax and NICs.

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Summary of main points

The *Social Security Contributions (Share Options) Bill* (Bill 8 of 2000-2001) was introduced in the Commons on 20 December 2000. Explanatory Notes to the Bill (Bill 8 – EN) were published at this time. The Bill's Second Reading is set for 23 January 2001.

Since April 1999 National Insurance Contributions ('NICs') have been charged on gains arising when share options are exercised outside an Inland Revenue approved scheme if the shares are readily convertible into cash. Prior to this, NICs were payable on the grant of share options, but only if the options were granted at a discount. Any charge was limited to the discount. It has proved especially difficult for companies with a volatile share price to plan for NICs on share options. Legislation was enacted in sections 77 and 81 of the *Child Support, Pensions and Social Security Act 2000*, to allow employees to agree that they will pay the employer's NIC when they make a gain on their share options. This change was generally welcomed by the information technology sector, which had been particularly affected by this problem – although it would be fair to add that companies would have preferred the National Insurance liability on share options to have been abolished.

Several companies have expressed their concern that they cannot make agreements with their employees if an option had already been awarded. The purpose of the *Social Security Contributions (Share Options) Bill* is to help companies that granted options between 6 April 1999 and 19 May 2000. Companies may limit the liability to the gain attributable to the growth in company share price up to 7 November 2000. 6 April 1999 was the date on which gains on the exercise of unapproved share options became liable to NIC. 19 May 2000 was the date on which the Government announced the legislation allowing employees to agree to pay employers' NICs. It would appear that the Bill itself is relatively uncontroversial, and it has not attracted much attention from professional organisations or in the national press.

The structure of this paper is as follows. Part I provides an introduction. Part II looks at recent changes in the coverage of NICs, to bring them more into line with the coverage of income tax – including their extension to the exercise of share options outside an Inland Revenue approved scheme in April 1999. Part III examines the legislative changes made following the March 2000 Budget, to allow employers to make an election to transfer the NICs liability on options to employees. Part IV gives a short summary of the Bill, and Part V is an appendix, reproducing guidance published by the Inland Revenue on these rules.

National taxation (including NICs) remains a reserved matter.[1] The Bill has no direct consequences for either of the devolved assemblies.

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[1] With the obvious exception that the Scottish Parliament is empowered under ss 73 & 74 of the *Scotland Act 1998* to introduce a tax varying resolution, to increase or decrease the basic rate of income tax for Scottish taxpayers from the rate determined by the UK Parliament by up to 3p in the £.

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I Introduction

The Government's *Budget 2000* document touched on difficulties that some companies have faced in awarding employees share options, in relation to their liability to National Insurance Contributions (NICs):

> Many e-commerce and high-tech companies offer their employees substantial share options as part of their remuneration package. Where options are exercised outside an Inland Revenue approved scheme and the shares are readily convertible into cash, companies are liable for employers' NICs on the gain. For companies with volatile share prices this creates an exposure to an unpredictable NICs liability and can put at risk their investment strategies and damage future growth.
>
> The Government has received suggestions that employers' exposure to these difficulties could be resolved, for example, by allowing a voluntary agreement between employer and employee that all or part of the employer's NICs liability will be met by the employee. The Government is seeking views on these suggestions. It is attracted to improving flexibility in this area and is considering legislation as part of its support for the employees of companies with high growth potential.[2]

On 19 May 2000 the Government announced that legislation would be introduced as soon as possible to tackle this problem:

- first, to allow the whole or part of an employer's NICs on options to be recovered from the employee (subject to a voluntary agreement with the employee), or transferred to the employee, following the employer and employee making a joint election to that effect approved by the Inland Revenue;

- second, to allow employees to set the employer's NI paid by them as a result of this change against their liability to income tax on the share option.[3]

To this end legislation was introduced in the *Child Support, Pensions and Social Security Act 2000*,[4] and the *Finance Act 2000*.[5] On 9 October 2000 the Government laid regulations to provide the supporting legislation to enable employers to make elections.[6]

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[2] HM Treasury, *Budget 2000*, HC 346 March 2000 p 47

[3] Inland Revenue press notice 96/00, 19 May 2000

[4] specifically section 71 of the *Child Support, Pensions and Social Security Act 2000*, with equivalent provisions apply to Northern Ireland in section 81

[5] specifically section 56 of the *Finance Act 2000*

[6] the *Social Security (Contributions) (Amendment No.10) Regulations* SI 2000/2744, with equivalent provision for Northern Ireland under the *Social Security (Contributions) (Amendment No.10) (Northern Ireland) Regulations* SI 2000/2743. Consequential amendments were made in the *Income Tax (Sub-contractors in the Construction Industry and Employments) (Amendment) Regulations* 2000 SI 2000/2742

In the *Pre-Budget Report* published in the November 2000 the Government announced that it would introduce new legislation to cover options issued before 19 May:

> Having addressed the concern over share options issued after 19 May 2000, new legislation will be introduced to cover share options issued between 6 April 1999 and 19 May 2000. Under these rules, companies will have the option of removing all uncertainty through settling their NICs liabilities on those options based on market values at the time of this Pre-Budget Report. This will remove future growth from the charge to employer's National Insurance. Together with the option of transferring liability to the employee, this will solve the difficulties for those high growth firms.[7]

This is the purpose of the *Social Security Contributions (Share Options) Bill 2000-01*, which was introduced in the Commons on 20 December 2000.

Legislation dealing with NICs is not included in the annual Finance Bill, and generally changes to NI that require primary legislation are made by including provisions within a much larger Act covering a range of social security issues.[8] It is a Parliamentary convention that Finance Bills are concerned with moneys that go into the Consolidated Fund. As receipts from NICs go into the NI Fund and not the Consolidated Fund, legislative provisions relating to NI are not contained in the Finance Bill. In the absence of an 'all-encompassing' Bill of this nature being introduced in this Session, the Government has decided to introduce this measure with a single Bill that has just six clauses.

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[7] Cm 4917 November 2000 p 47

[8] for example, provisions related to NICs and benefits in kind that came into effect in April 2000 comprised part IV of the *Child Support, Pensions and Social Security Act 2000*

II Changes to the coverage of NICs

A. The Taylor Report

National Insurance (NI) benefits are funded by a system of compulsory contributions, paid by employees, employers and self-employed people. Employees pay primary Class 1 contributions, charged at 10% of earnings between a Lower Earnings Limit (LEL) and an Upper Earnings Limit (UEL).[9] Employers pay secondary Class 1 contributions, charged at 12.2% on employees' earnings above the LEL.[10] (There is no upper ceiling.) Self-employed people pay a flat rate contribution, plus a separate profits-related contribution (Class 2 and Class 4 contributions respectively). Voluntary contributions are also possible to assist people to qualify for basic Retirement Pension and Widows' Pension (Class 3 contributions).[11]

Following the 1997 General Election, the Chancellor Gordon Brown set up a Task Force, chaired by Martin Taylor then chief executive of Barclays Bank,[12] in line with the Labour party's manifesto commitment to "examine the interaction of the tax and benefits systems so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life."[13] Mr Taylor's report was published at the time of the March 1998 Budget.[14] In his discussion of NI he argued that the schedule of rates, and the basis of the tax, imposed a burden on the low paid and distorted the labour market. More specifically he recommended:

- the introduction of a single flat rate of employer NICs (prior to April 1999 there were four separate rates)
- the abolition of the 'entry fee' for employer and employee NICs
- aligning the lower earnings limit for employer and employee NICs with the single person's income tax allowance (provided that the rules on contributory benefits were amended to prevent significant loss of employees' benefit entitlement).[15]

In his March 1998 Budget speech the Chancellor announced that he had accepted this programme for a "simpler, fairer and more employment-friendly national insurance

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9 There is a rebate set at 1.6% of earnings for employees who have opted out of the State Earnings Related Pension Scheme (SERPS) because they are in their employer's pension scheme.

10 The rate of secondary Class 1 contributions is to be cut to 11.9% from April 2001.

11 An introduction to the NI system is provided in a memorandum produced by the Department of Social Security, submitted to the Social Security Select Committee, in relation to its Fifth Report published in June 2000 (*The Contributory Principle* 7 June 2000 HC 56-II 1999-2000 pp 167-197).

12 HM Treasury press notice 47/97, 19 May 1997

13 *New Labour: because Britain deserves better*, April 1997 pp 12-13

14 HM Treasury, *Work incentives: a report by Martin Taylor*, March 1998 The report is available from the Treasury's internet site at: www.hm-treasury.gov.uk/budget/1998/taylor.pdf

15 The Taylor Report is discussed at more length in Library Research paper 99/12, S*ocial Security Contributions (Transfer of Functions etc) Bill [HL]*, 5 February 1999.

system."[16] Over the following three years each of these proposals was implemented. The changes in employer NICs were made in April 1999, whereas the changes in employee NICs were made in two steps in April 2000 and April 2001. To protect the benefit entitlement of those on low earnings, employees will pay a zero rate of NICs on earnings between the LEL (set at £69 a week) and a 'primary threshold' (set at £87 a week), which is aligned with the personal income tax allowance (£4,535 for 2001-02). Both employees and employers pay Class 1 NICs on earnings above this threshold – at the rate of 10% and 11.9% respectively from April 2001. In his March 1999 Budget the Chancellor also announced that the UEL would be increased in two steps, in line with these increases in the LEL, to £535 per week from April 2000, and £575 per week from April 2001.[17]

In his report Martin Taylor had argued the lack of alignment between NI and income tax was a cause for concern, particularly as employers were faced with separately recording and accounting for two sorts of NICs as well as income tax. He suggested that the NICs coverage of benefits in kind should be extended:

> At present, benefits in kind are not subject to NICs, other than the employer-only Class 1A charge on company cars and car fuel. This gives employers an advantage in offering benefits in kind, so reducing the NICs yield and distorting competition. However, it does not look straightforward to value benefits in kind, at least on anything like the income tax rules, on the current NICs pay period basis. So a full employee and employer NICs charge may not be easy for employers to handle. The pragmatic solution may be to extend, perhaps at a higher NICs rate, the Class 1A employer-only charge.[18]

In discussions with employers, Mr Taylor found strong support for aligning NICs and income tax:

> Understandably, some employers and representative bodies argue for closer alignment of the detailed charging rules for tax and NICs, as well as for broader alignment. Bringing benefits in kind generally into a Class 1A NICs charge would be such an alignment, assuming it also followed income tax rules. There are strong arguments for looking for further alignment of NICs with the employment income charge and with the boundaries of the PAYE charge.[19]

Mr Taylor's conclusions were echoed in a major study of employers' tax compliance costs, carried out by the Centre for Fiscal Studies at the University of Bath.[20] It found that, "some employers found it frustrating and costly that treatment of benefits is not

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[16] HC Deb 18 March 1998 c 1104

[17] *Budget 99* HC 298 March 1999 p 102 Historically the UEL for NICs has been between 6½ and 7½ times the earnings point at which NICs first become payable.

[18] *Work incentives: a report by Martin Taylor*, March 1998 p 14

[19] *op.cit.* p 15

[20] *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96: Inland Revenue Economic Papers No.3*, 1998

consistent across PAYE and NI" and recommended that, "the treatment of benefits in kind should be common across PAYE and NI Class 1A contributions."[21]

In his March 1999 Budget speech the Chancellor confirmed that the Government would introduce legislation to extend Class 1A NICs to all taxable benefits in kind not already subject to NICs: such as private medical insurance, beneficial loans and assets transferred to the employee.[22] In a press notice issued at this time, it was suggested that the revenue raised by this change had allowed for the wider changes in NI mentioned above: "Not levying NICs on these benefits means NIC rates elsewhere in the system have to be higher. Since this Government's major objective as far as National Insurance is concerned is to make it fairer, and to structure it so that it does not discourage work, the revenue from NICs on benefits in kind has been put to very good use, cutting NIC rates for low earners and improving work incentives."[23]

To this end legislation was included in the *Child Support, Pensions and Social Security Act 2000.*[24] Following the scrutiny of these provisions in Standing Committee,[25] the Government announced in the March 2000 Budget that an exception would be made for childcare benefits in kind:[26] all forms of childcare provision would remain exempt from employers NICs.[27] The issue was raised at the Report stage of the Bill, when, speaking for the Opposition, David Willetts MP argued that this was inconsistent, and that the Government should reverse the decision to include private medical insurance within the scope of Class 1A NICs:

> If an employer is so public spirited as to want to provide child care facilities for his staff, and will not bear employers national insurance contributions for that, and if he wishes to provide flu jabs for his staff, why is that not at least equally deserving? Why does not that, as well as the entire range of medical insurance payments, merit exemption from employers NICs?
>
> We say that if there is an argument for an exemption from employers NICs for child care, there is at least as good an argument for an exemption for private health care. If the argument is good enough for the Chancellor to use with reference to child care, we want to hear from the Minister why he thinks that employers providing medical care in whatever form for their employees should be taxed more heavily - should bear an extra 12 per cent. employers NICs - than for providing child care. We regard the benefits as equally desirable, and we see

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21 *op.cit.* p 87
22 HC Deb 9 March 1999 c 187
23 HM Treasury Budget press notice HMT9, 9 March 1999
24 specifically s 74 of the *Child Support, Pensions and Social Security Act 2000*, and the *Social Security (Contributions) (Amendment No.8) Regulations Order* SI 2000/2207. Equivalent provision for Northern Ireland was made under s 78 of the Act and SI 2000/2008.
25 Standing Committee F 29 February – 2 March 2000 cc 658-690
26 Inland Revenue Budget press notice REV9, 21 March 2000
27 This exemption includes employers contracting for places in commercial nurseries or for the services of a childminder, as well as providing workplace nurseries or childcare vouchers.

> no basis for exempting one from national insurance contributions, but not the other.[28]

Jeff Rooker, Minister for State at the Department for Social Security, rejected this argument, and the House voted against an Opposition amendment on these lines; part of the Minister's speech is reproduced below:

> Excluding private health care provision from class 1A contributions would undermine the main purpose of the measure, which is to align the tax and national insurance treatment of benefits in kind and to make the national insurance system fairer by bringing closer together the treatment of cash and non-cash earnings. The extension of class lA will reduce the distortion in the national insurance system, which provides the incentive for employers to remunerate their employees with benefits rather than cash …
>
> The measure's prime purpose is to make the scheme fairer and to reflect modern pay practices. Rather than subsidising large firms, which can afford to offer their employees large packages of benefits in kind, at the expense of small firms and their employees, we prefer to level the playing field - and put more money into the national health service.[29]

B. Wider changes in the NICs base

Over the past eight years there have been a series of changes in the coverage of NICs, of which the extension of Class 1A contributions discussed above is the most recent. The written answer reproduced below provides a chronology, which culminated in the extension of NICs to an employer's provision of own company shares and share options in December 1996 (these last change is examined in the following section of this paper):

> **Mr. Malcolm Bruce:** To ask the Secretary of State for Social Security if he will list, for each of the last seven years, the extensions of the application of employers' national insurance contributions to benefits in kind designed to eliminate the avoidance of national insurance contributions on bonuses and other one-off benefits in kind; if he will give his estimate of the savings accruing from each measure; and if he will make a statement.
>
> **Mr. Heald:** The measures introduced in December 1996 to prevent national insurance contribution - NIC - avoidance by paying employees in their own company's shares and share options were announced in my written answer of 4 December, Official Report, column 715-16, to the hon. Member for Chingford (Mr. Duncan Smith). The following measures to combat NIC avoidance were introduced prior to December 1996.

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[28] HC Deb 3 April 2000 c 646
[29] *op.cit.* cc 653-654

> In 1991 payments by way of a wide range of financial instruments such as shares, other than own company shares, gilts and insurance policies became subject to NICs.
> In 1993 payments by way of commodities capable of being sold on a recognised investment exchange or the London bullion market such as precious metals and gold bullion and vouchers for these commodities became subject to NICs.
> In 1994 payments by way of alcoholic liquors on which no UK duty had been paid, gemstones and any vouchers for these assets became subject to NICs.
> In 1995 payment by way of assets for which trading arrangements exist, vouchers for those assets and vouchers which are themselves the subject of trading arrangements became subject to NICs.
> Employers are not required to identify bonuses or other one-off payments. The behavioural effects of measures against NICs avoidance, particularly those aimed at a wide range of asset-based avoidance, make precise long-term estimates of savings unreliable.
> The Inland Revenue estimates, in respect of the changes made in December 1996 specifically related to own-company shares, that the annual savings would amount to about £30 million.[30]

Subsequently a new class of employer NICs – Class 1B contributions – was introduced from April 1999. The origin of this measure was a working group set up under the previous Government's deregulation initiative, to find changes to the definitions of income (for tax) and earnings (for NICs) which would cut employers' costs and make it easier for them to meet their obligations in the administration of both.[31] The Deregulation Task Force recommended the two systems should be replaced by a unified tax-based system.[32] The then Conservative Government rejected this proposal;[33] unsurprisingly, perhaps, given the difficulties inherent in such a wide-ranging reform.[34] More recently Martin Taylor firmly ruled out integrating income tax and NICs in his 1998 report on work incentives.[35]

Nonetheless the Conservative Government accepted the principle of closer alignment between the rules for income tax and NICs, part of which was the proposal that annual voluntary settlements for NICs would be introduced so that employers who volunteered to pay their employees' tax on some expense payments and benefits in kind could do so in a lump sum. This way they would not have to reach a separate settlement for each individual employee. In 1996 the Inland Revenue introduced a statutory scheme - PAYE Settlement Agreements (PSAs) - to replace annual voluntary settlements from October of

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[30] HC Deb 11 February 1997 c 172W

[31] DSS, *Deregulation Review: Report of the Tax/NICs working group*, 1993

[32] *Deregulation Task Forces Proposals for Reform*, January 1994 para 350

[33] *Business Deregulation Task Forces Proposals for Reform: Update*, November 1995 para 350

[34] The issue is discussed in, Social Security Select Committee, *Tax and Benefits: an interim report*, 19 November 1997 HC 283 1997-98 paras 25-39. Prior to this, the case against integration was made in *The Reform of Personal Taxation*, Cmnd 9756, March 1986 pp 37-39.

[35] HM Treasury, *Work incentives: a report by Martin Taylor*, March 1998 p 13

that year.[36] Under this framework employers can settle the income tax liability on certain benefits in kind and for expenses in a single payment. PSAs can include expenses payments and benefits which are minor, or irregular, or provided in circumstances where it is impracticable to apply PAYE or to apportion the value to particular employees. Following a consultation exercise,[37] the Government introduced legislation as part of the *Social Security Act 1998* to introduce a new class of NI contribution - Class 1B - payable in circumstances where a PSA has been agreed, from April 1999.[38]

C. Share options: 'approved' and 'unapproved' schemes

Many companies reward their employees by granting them share options, as a complement to their earnings. A 'share option' gives an employee the right to purchase company shares at the then-current share price at some stage in the future, usually by a specified date. The rationale for using this form of remuneration is that it gives employees a personal stake in the company's future performance: an increase in the company's share price will enable employees to buy shares in their own company for less than they are actually worth.

There are two points at which the grant of a share option may give rise to a tax liability: first, when the employee realises their option, and buys their portion of cut-price shares. The benefit that this option represents is liable to income tax, in the same way as a cash bonus. Second, should the employee sell their shares at a later stage, realising a capital gain, they would be liable to capital gains tax on that gain.

The tax treatment of share options was substantially reformed under provisions in the *Finance Act 1996*.[39] In brief, two 'approved' share option schemes were introduced. Under the SAYE Sharesave scheme (the all-employee scheme), or the Company Share Option Plan (CSOP) (under which selected employees may be granted options over shares worth up to £30,000), gains arising from the exercise of options under these schemes are free of tax and NI.

Companies are quite free to operate schemes which do not meet these criteria – so-called 'unapproved' share option schemes – though employees are not granted any tax relief on this type of remuneration. The gains are usually made through the exercise of the share option but can also be made, for example, when the employee is offered cash to cancel the option.[40]

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36 under s 110 of the *Finance Act 1996*

37 *Proposed Changes to Align NICs with Inland Revenue Treatment of Tax under PAYE*, 1996 DEP 3/2743

38 specifically s 53 of the *Social Security Act 1998*

39 specifically ss 111-120 of the *Finance Act 1996*

40 for details see Inland Revenue, *Share acquisitions by directors and employees IR16*, March 1997 This is available on the Revenue's internet site at: www.inlandrevenue.gov.uk/pdfs/ir16.htm

In the March 1999 Budget the Chancellor announced that the Government would be consulting on a new all-employee share ownership scheme – the Enterprise Management Incentive (EMI) – to be introduced in 2000:

> Shareholding by employees builds a stronger sense of partnership with industry, as employees feel they have more of a stake in how their companies perform. There is evidence that companies who offer share ownership schemes benefit from increased productivity. For the first time employees will be able to buy shares in their company out of their pre-tax salary. Overall, this will be the most tax advantaged all-employee share scheme introduced in the UK. This new and innovative scheme is an important step forward towards my long-term target of doubling the number of companies which offer an all-employee share scheme. Its flexible and tax efficient features should prove attractive to both employers and employees alike. The new scheme meets the objectives set out in the Pre-Budget Report, by promoting long-term shareholding by employees and widespread employee share ownership.[41]

To this end, the Inland Revenue published an outline of the scheme in a technical note,[42] and established an advisory group to assist in the development of the new scheme composed of tax practitioners, business people and other experts.[43] Legislation to introduce the new EMI was included in the *Finance Act 2000*.[44] An outline of the scheme was given in a Budget press notice:

- Employers can give employees up to £3,000 of shares each year free of tax and National Insurance, and
- Some or all of these shares can be awarded to employees for reaching performance targets
- Employees will be able to buy partnership shares out of their pre-tax salary, up to a maximum of £1,500 a year, free of tax and National Insurance
- Employers can match partnership shares by giving employees up to 2 free shares for each partnership share they buy.[45]

Generally responses to the EMI have been very positive.[46] Further refinements in the design of the EMI were announced in the *Pre-Budget Report* in November 2000.[47]

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41 HM Treasury Budget press notice HMT 11, 9 March 1999

42 This is available on the Revenue's site at: www.inlandrevenue.gov.uk/consult/tnnss.htm

43 Inland Revenue press notice, 30 March 1999

44 specifically s 62 and schedule 14 of the *Finance Act 2000*. These provisions were scrutinised at the Committee stage of the Bill on 6 & 8 June 2000 (Standing Committee H cc 506-565).

45 Inland Revenue Budget press notice REV3, 21 March 2000 Guidance on the EMI is provided on the Revenue's site at: www.inlandrevenue.gov.uk/shareschemes/emi.htm

46 for example, "Small becomes even more beautiful", *Financial Times*, 6 September 2000

47 Cm 4917 November 2000 p 47

D. NICs: coverage of shares & share options

In December 1996 regulations were laid to amend the rules relating to the tax treatment of an employer's provision of own company shares and share options:

> **Mr. Duncan Smith:** To ask the Secretary of State for Social Security what plans he has to act against avoidance of national insurance contributions.
>
> **Mr. Heald:** We are committed to acting against exploitation of the national insurance system by employers who undermine the contributory principle by avoiding paying their proper share of contributions on the earnings they pay to their employees.
>
> I have today laid regulations (SI 1996/3031) which tighten the rules for contributions where employers pay their staff in shares and share options. Earnings paid in the form of shares provided under schemes not approved by the Inland Revenue and using shares or options for shares which are capable of being traded on a recognised investment exchange as defined in the Financial Services Act 1986, or which are provided in circumstances where "trading arrangements" exist within the meaning of the Finance Act 1994, will be subject to national insurance contributions.
>
> They will be treated in the same way as income provided in cash or in the form of other non-cash assets such as gold bullion and diamonds. The regulations will come into effect from midnight tonight. Shares acquired under options granted before midnight today will not be affected. These provisions are expected to save NICs of about £30 million annually.[48]

In July 1997 the Government proposed that the NICs treatment of employee share options should be reformed, "in a way which will help business administer the existing charge":

> The options affected are those granted outside the Inland Revenue approved share schemes, which are listed or for which 'trading arrangements exist'. The NICs treatment of share options will be brought close to the tax position by removing the current NICs charge when the option is granted and charging NICs on the gain when the option is exercised. The measure is expected to raise approximately £20 million each year over the longer term.[49]

The then Social Security Minister, Harriet Harman, made this announcement, at the Second Reading of the *Social Security Bill 1997-98* on 22 July 1997:

> Three further changes in the national insurance scheme that are not currently included in the Bill will be introduced in the form of Government amendments … The third new amendment relating to national insurance contributions will align

[48] HC Deb 4 December 1996 cc 715-716W
[49] Department of Social Security press notice 97/127, 22 July 1997

> tax and national insurance rules with regard to company share options. Given the relatively short time that has elapsed since the general election, we have not been able to work through the details of those measures in time for them to be introduced, but we shall be tabling amendments in time to allow full discussion in Committee and with outside organisations.[50]

This provision was introduced at the Committee stage of the Bill, by the then Social Security Minister John Denham, on 20 November 1997:

> **Clause 49**
> **Payments treated as remuneration and earnings**
>
> **The Parliamentary Under-Secretary of State for Social Security** (Mr. John Denham): We propose that clause 49 should not stand part of the Bill, and that it should be replaced by new clause 7. New clause 7 repeats the measures already in clause 49, which tackle avoidance of national insurance contributions using non-monetary payments under restrictive undertakings. It also introduces a new measure, treating as earnings for national insurance purposes the taxable gain on exercise of a share option in an unapproved share scheme. This enables the national insurance treatment of share options to be brought closer into line with income tax.
>
> Although they are quite different in character, the measures for restrictive undertakings and share options are grouped together in a new clause because both measures require amendments to subsection (4) of section 4 of the Social Security Contributions and Benefits Act 1992. That subsection treats as earnings for national insurance purposes payments that would not ordinarily fall within the definition of earnings for the purposes of the Contributions and Benefits Act ...
>
> The new clause would introduce changes to the national insurance treatment of options on non-approved shares. The changes will put right problems with existing regulations. Under the regulations that were introduced by the previous Administration in November 1996, payments to employees, by way of certain non-approved shares and options, were brought for the first time into earnings for national insurance and pay-as-you-earn. The shares brought into pay-as-you-earn and contributions were those that are tradeable, and options over those shares. Shares and options of that type were quite readily exchangeable for cash, and prior to the regulations they were used widely to avoid national insurance.
>
> The proposals for share options in this new clause would raise some additional revenue from some employers, but that is not their primary aim. The Government have listened to criticism of the current regulations and propose to overhaul the charge to ensure greater fairness and to make the charge easier for business to administer. No new types of share scheme will be brought into national insurance.

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[50] HC Deb 22 July 1997 c 790

> The starting point for our overhaul of the share options provision is sub-paragraph (1) of new clause 7. This introduces a new measure to treat as earnings any gain taxable under section 135 of the Income and Corporation Taxes Act 1988. Currently, contributions on share options are based on the undervalue - the amount by which the sum paid by the employee is less than the market value of the shares - at the time that the option is granted.
>
> We will replace that charge with national insurance on the taxable gain when the share option is exercised. That will enable the national insurance treatment of share options to be brought closer to the income tax position. In bringing forward the new clause and in drafting the regulations that will follow, we are keen to work with business to ensure successful implementation.
>
> **Mr. Flight:** The present rules for option schemes allow exemptions up to a certain modest amount, under which gains on options are taxed as capital gains. Thereafter, they are subject to income tax. I cannot remember the precise details of the rules, but I seem to recall that all options schemes come under the legislation covering income tax. Is the clause in line with the rules governing income tax and capital gains tax arising from options schemes? I assume that national insurance does not cover the modest amounts involved in capital gains, and that it does cover amounts to be treated as income.
>
> **Mr. Denham:** It would be better for me to answer the hon. Gentleman's question in writing. The aim of the clause is to bring the national insurance treatment of share options closer to the income tax treatment, as I hope that the hon. Gentleman understands. We are keen to work with businesses to ensure the successful implementation of the measures. Officials have listened to what specialist lawyers and accountants have had to say, and they have met with business representatives to discuss this highly technical legal matter. We shall discuss with business how best to operate the change.[51]

Following this, at the time of the March 1998 Budget, a number of measures were announced to require employers to charge income tax under PAYE on assets they paid their employees, which could be easily converted into cash. Although it is not illegal to pay an employee in a non-cash form, it can involve a significant deferral of the time at which tax is paid, and schemes often have no commercial purpose *other* than to defer tax. Such schemes have involved payment in gold bars, bismuth, hay, trade debts and reversionary interests in offshore trusts.[52]

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[51] Standing Committee B 20 November 1997 cc 453-455 The new clause itself was added to the Bill on 25 November 1997 (Standing Committee B c 472).

[52] Legislation to this effect is set out in ss 64-69 of the *Finance Act 1998*. It was debated at the Committee stage of the Bill on 2 June 1998 (Standing Committee E cc 366-369).

At the same time, the Government also announced three separate proposals on the tax treatment of remuneration in shares, relating to remuneration in shares subject to forfeiture, remuneration in convertible shares, and *share options*.[53]

An extract from the relevant press notice dealing with the latter is reproduced below:

> **Share Options**
>
> 14. Under normal tax rules, when an employee is granted an option over shares, he or she pays no income tax at the time of grant, but instead pays income tax when the option is exercised and the shares acquired. It is at this latter stage that the employee receives the benefit of the option.
>
> 15. However, when share options are granted that can be exercised more than seven years after the date of grant, there is a charge to income tax if the option price is less than the market value of the shares. This "seven year rule" is to prevent options with a high value being granted and left unexercised for very long periods.
>
> 16. Many companies offer share options that can be exercised three to ten years after grant. In many cases the intention is to offer these options at the market value of the shares, but changes in the share price over the short period between setting up the arrangement and the date of grant, can bring them into the income tax charge. Although very little income tax is usually paid at this stage, determining the precise amount of that tax can be a significant administrative task.
>
> 17. The Chancellor proposes to extend the "seven year rule", so that there is an income tax charge on the grant only of options that can be exercised more than ten years later. This will take most options outside the income tax charge on grant, reducing the administrative burden on business, while continuing to protect the Exchequer. This change will apply to share options awarded on or after 6 April 1998.
>
> 18. Share options granted and exercised in accordance with the rules of an approved share option scheme will continue to be eligible for exemption from income tax and will be unaffected by these proposals.[54]

The Government's plans to bring NI rules in line with these tax changes were announced on 31 March 1998:

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[53] Legislation to this effect is set out in ss 49-54 of the *Finance Act 1998*. It was debated at the Committee stage of the Bill on 21 May 1998 (Standing Committee E cc 374-379).

[54] Inland Revenue Budget press notice IR36, *Remuneration in shares subject to forfeiture or conversion*, 17 March 1998

Ms Buck: To ask the Secretary of State for Social Security when changes in the Budget relating to employee share schemes will be reflected in National Insurance contribution rules

Mr. Denham: We are proposing two changes to National Insurance contribution rules which will bring them closer to the income tax rules in relation to shares and share options. This will make for greater clarity for employers and help reduce the administrative burden the system places on them.

First, we intend to bring forward at Report stage in the House of Lords a new clause for inclusion in the Social Security Bill. That clause will change the National Insurance treatment of shares that are subject to the risk of forfeiture or that are convertible. The change will align the treatment of these shares under National Insurance legislation with the tax legislation announced by my right hon. Friend, the Chancellor of the Exchequer in his Budget.

Alignment of National Insurance with the income tax rules will bring forward some important changes to make the National Insurance on shares and options easier for business to administer while guarding against their use in avoidance schemes. The new clause will be tabled as soon as possible. It will mirror the proposed income tax treatment of remuneration in shares subject to forfeiture or conversion. To keep to a minimum the period over which the tax and National Insurance positions differ the clause will apply to shares awarded from the date on which it is tabled. We expect that to be before the end of the current Committee stage in the House of Lords.

The second change we propose is to match my right hon. Friend, the Chancellor's extension of the "seven year rule" for share options when we align the National Insurance treatment of share options with the income tax position. Under the current income tax arrangements the award of an option over shares is taxed at the time of grant rather than exercise only where the options can be exercised more than seven years later. My right hon. Friend, the Chancellor has announced his intention to extend that limit to ten years. We intend to mirror this in future National Insurance legislation.

When the relevant regulations made under clause 50 of the Social Security Bill come into force they will replace the National Insurance liability on grant of options with a liability on exercise, except in the case of options which can be exercised more than ten years later. This would take the great majority of options outside liability for National Insurance on grant, thus reducing the administrative burden on business while continuing to protect the Exchequer. Inland Revenue approved own-company share schemes remain excluded from liability for National Insurance contributions.[55]

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55 HC Deb 31 March 1998 cc 483-4W

Further details on the changes to be made to the NI treatment of share options were given in a press notice at this time, from which the following is taken:

> **SHARE OPTIONS**
>
> **The current income tax rules:** Under normal tax rules when an employee is granted an option over shares, he or she pays no income tax at the time of grant, but instead pays income tax when the option is exercised and shares acquired. It is at this latter stage that the employee receives the benefit of the option. However, when share options are granted which can be exercised more than seven years after the date of grant, there is a charge to income tax if the option price is less than the market value of the shares. This "seven year rule" is to prevent options with a high value being granted and left unexercised for very long periods.
>
> **Proposed changes to the tax rules:** The Chancellor of the Exchequer announced on 17 March that he proposes to extend the "seven year rule" so that there will be a tax charge on the grant of an option only if the option is exercisable more than ten years later.
>
> **Current NI rules:** The current NI rules differ from those for income tax. NI liability arises on the grant of an option and not on exercise.
>
> **Proposed changes to the NI rules:** Under plans announced in July 1997, the Government intends to bring the NI treatment of options further into line with income tax. Clause 50 of the Social Security Bill will enable the NI rules to be aligned with the income tax rules so that there will normally be a NI liability on exercise rather than grant. The Government planned to mirror the "seven year rule" for tax in National Insurance. Instead it will mirror the new "ten year rule".
>
> **Inland Revenue Approved schemes:** These schemes will remain excluded from National Insurance liability. Approved schemes are intended to encourage employee share ownership.[56]

The necessary amendments to the Social Security Bill *1997-98*, which was still before the Lords, were announced by the Government’s spokesman Lord Haskel on 30 March 1998,[57] and debated on 20 April 1998 when Lord Haskel set out their purpose:

> At Committee stage in this House, we said that we intended to introduce amendments at Report to change the national insurance treatment of employee-acquired shares which are subject to risk of forfeiture or conversion. These measures are needed to keep national insurance in step with income tax changes announced in another place by my right honourable friend the Chancellor of the

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[56] Contributions Agency press notice CA12/98, *Government announces changes to national insurance rules on earnings paid in shares and share options*, 1 April 1998

[57] HL Deb 30 March 1998 cc 71-73

> Exchequer in his Budget. These changes affect a small number of payments made in the form of shares outside Inland Revenue approved employee share schemes. When we debated this matter during Report on 2nd April, the noble Lord, Lord Higgins, raised the matter of Commons' privilege. He also raised it earlier today. My noble friend Lady Hollis, when responding to Amendment No. 1, replied to that point and it is not therefore necessary for me to repeat the arguments.[58]
>
> Perhaps I can move straight to the amendments. The amendments deal with the national insurance treatment of non-approved schemes involving restricted shares and convertible shares which are not able to be used in Inland Revenue approved schemes. I will not detain the House with a detailed account of those schemes, though I shall be happy to say more if noble Lords find that helpful. The Finance Bill inserts new Sections 140A to 140H into the Income and Corporation Taxes Act 1988.
>
> Those sections change the income tax treatment of shares carrying a risk of forfeiture and of convertible shares. The inserts will help businesses by giving them legislative certainty about the tax position. Similar changes are needed so that business will also have legislative certainty for national insurance purposes. The amendments do precisely that. The new amendments to mirror those Budget income tax changes are placed in Clause 50 because they also require an amendment to Section 4 of the Social Security Contributions and Benefits Act 1992 which treats certain kinds of payments as earnings for national insurance.
>
> Amendment No. 36 provides for regulations to match the income tax changes. There will be a direct read across to the relevant tax provisions when they are introduced. Amendment No. 37 is a minor change which simply provides greater clarity by inserting the full title of the Income and Corporation Taxes Act 1988. Amendment No. 38 provides that the regulations made under Clause 50 shall come into effect after the passing of the Finance Act 1998, but will have effect in relation to this type of share acquired on or after 6th April. We intend to use the regulations to provide for liability in respect of shares acquired on or after the date that the amendment was introduced; that is, 9th April 1998. This is important because it will enable business to apply the same regime for tax and national insurance as early as possible. Amendments Nos. 110 and 111 amend Clause 84 so that this measure comes into force following Royal Assent.
>
> We believe that these arrangements provide the most practical way to mirror in national insurance legislation the income tax changes in the Finance Bill. They will ensure that business is not faced with the burden of administering two different sets of rules over an extended period. I beg to move.

In the subsequent debate Lord Higgins, speaking for the Opposition, pointed out that no employee affected by this measure would be entitled to any further benefits by paying more NICs:

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[58] HL Deb 2 April 1998 cc 397-399

> What the amendments together with the proposals in the Finance Bill do is to remove the income tax charge when the shares are given to someone and impose it when, for want of a better expression, they are cashed in. As has rightly been pointed out, that means that a possible way of avoiding taxation is prevented. I make no complaint about that. However, it brings out another point. This is said to be a national insurance contribution, but the charges that will be imposed as a result of the amendments impose a contribution on people for which they will get absolutely nothing. The fact that they are paying the contribution will in no way entitle them to any increased benefits.
>
> That brings through once again my fundamental point that national insurance contributions are now pure and simply a tax. I do not want to delay the House, but I wish to raise one point which was made by the noble Baroness in her opening remarks this afternoon. She said that it would not be possible to make any of these changes with regard to national insurance contributions in the Finance Bill. If it is now the case, as I believe it is, that national insurance contributions are a tax, I am not clear what the basis is for the noble Baroness's assertion that this could not be done in the Finance Bill ...
>
> **Lord Goodhart:** My Lords, I agree with the noble Lord, Lord Higgins, that the distinction between tax and national insurance contributions has now for all practical purposes been eliminated ….
>
> **Lord Haskel:** My Lords, perhaps I may point out to the noble Lords, Lord Higgins and Lord Goodhart, that national insurance and income tax are entirely separate. National insurance is what it says. One gets benefits from national insurance by being insured. Income tax is what it says. It is a tax ...
>
> **Lord Higgins:** … The fact is that the additional contributions which will be collected as a result of the amendments in no way give any additional benefits.
>
> **Lord Haskel:** My Lords, I take the noble Lord's point. We are dealing with it in this way because it is a national insurance matter and we have to deal with it in national insurance legislation. All employees pay national insurance charges on earnings. After a certain level the effect on benefits is non-existent. I think I have dealt with the points that the noble Lord raised.[59]

John Denham summarised the purpose of the amendments when the Bill passed back to the Commons on 13 May 1998:

> The amendments enable us to mirror, in national insurance, changes to the income tax treatment of shares carrying a risk of forfeiture and of convertible shares, as announced by my right hon. Friend the Chancellor of the Exchequer in his Budget. The amendments provide for regulations to treat as earnings any amount on which the earner is chargeable to income tax under the provisions of

[59] HL Deb 20 April 1998 cc 998-1001

> sections 140A to 140H of the Income and Corporation Taxes Act 1988. That would allow for regulations to treat as earnings, for national insurance, gains derived from share ownership taxable under provisions to be introduced in the Finance Bill. The Finance Bill changes give business legislative certainty about the tax position.
>
> Similar changes are needed for national insurance purposes. Part of our aim of modernising national insurance is that, where it is sensible to do so, national insurance rules should be aligned with income tax rules. It is important that national insurance rules keep in step with changes to income tax so that business is not faced with the burden of administering two sets of rules for the same type of remuneration. The amendments provide the most practical way in which to mirror in national insurance legislation the income tax changes in the Finance Bill, and I commend them to the House.[60]

The relevant legislation is now contained in section 50 of the *Social Security Act 1998*, and in two sets of regulations laid under this provision: the *Social Security (Contributions) Amendment (No.3) Regulations* SI 1998/2211; and the *Social Security Contributions, Statutory Maternity Pay and Statutory Sick Pay (Miscellaneous Amendments) Regulations* SI 1999/567.[61] Only the first of these SIs was debated by the House, on 17 November 1998 in the Fourth Standing Committee on Delegated Legislation; this instrument dealt with NICs rules covering shares subject to forfeiture or conversion, rather than an award of share options.

[60] HC Deb 13 May 1998 c 417
[61] for a technical summary of the rules see *Tolley's NICs 2000-01*, para 28.26 1(b)

III The March 2000 Budget

A. Share options and high-technology companies

At the time of the March 2000 Budget, the Government acknowledged that some companies were being adversely affected by the extension of secondary Class 1 contributions to share options.[62] Under accountancy rules companies are required to make a provision in their accounts for the anticipated NICs liability on share options, based on the market price of the shares on the date that they prepare the accounts. Employers expressed concern that their exposure to an unpredictable NIC liability could put at risk their investment strategies and even make some technically insolvent. This has been of particular concern for small companies with limited cash flow and volatile share prices.

The Government invited views on how this problem might be tackled, and in particular, whether it should introduce legislation to allow for voluntary agreements to be drawn up between employer and employee that all or part of the employer's NICs liability would be met by the employee:

> NICs and unapproved share option gains
>
> NICs are charged on gains arising when share options are exercised outside an Inland Revenue approved scheme and the shares are readily convertible into cash. Many e-commerce and high tech companies offer their employees substantial share options as part of their remuneration package. While employers can plan for NICs on regular pay, it is much less easy for them to plan for NICs on share options, particularly where the share price is volatile. Employers have expressed concern that their exposure to unpredictable NICs liability in these circumstances could put at risk their investment strategies, damage their future growth by deterring investors and even make them insolvent.
>
> *At present, employers would be statutorily barred from asking their employees to reimburse their NICs liability, even where share prices have risen substantially and employees have realised large share option gains but the employing company does not yet have a track record of profitability.*
>
> The Government has received suggestions that employers' exposure to these difficulties could be resolved, for example by allowing a voluntary agreement between employer and employee that:
>
> - All the employer's NICs liability on unapproved share option gains will be met by the employee,
> - Part of the employer's liability on these gains, or the excess above a predetermined amount, will be met by the employee, or

[62] HM Treasury, *Budget 2000*, HC 346 March 2000 p 47

> - The employer's NICs liability is to be met by the employee but, by mutual agreement, the employer could take on the statutory liability at the time it is incurred.
>
> All three suggestions would give employers, particularly those with high growth potential, much more certainty about their exposure to NICs liability. The Government is attracted to improving flexibility in this area for business and is considering legislation.
>
> It is also implementing a number of changes which particularly help employees in high growth companies. These include Enterprise Management Incentives, to attract "hard to recruit" people in companies with high growth potential, and the reform of CGT, benefiting all employees holding shares in their employer. Any views on these suggestions should be sent to the Financial Secretary Stephen Timms, (NICs and Share Options), HM Treasury, Treasury Chambers, Parliament Street, London SW1P 3AG.[63]

This issue was the subject of some press comment following the 2000 Budget; an example is reproduced below:

> The government believes it is close to resolving a row with high-technology companies over national insurance charges on share option schemes. A potential solution is emerging in talks between the Treasury and companies that could be included in legislation and implemented this spring. It involves shifting responsibility for paying employers' national insurance to employees who exercise the options, as long as they agree. A solution would remove a serious embarrassment for Tony Blair's government in its effort to make Britain a leader in electronic commerce. The issue has united internet start-ups and technology corporations in protest. Cisco Systems, the US internet hardware group, has warned it may create 4,000 jobs in mainland Europe rather than the UK if an answer is not found.
>
> The row is about non-Inland Revenue approved share option schemes, commonly used by technology companies to supplement salaries and attract staff. A year ago Gordon Brown, Chancellor, made these liable to employers' national insurance, currently 12.2 per cent, on the difference between the price they were granted at and the market price. Companies have no control over when employees exercise the options or their share price, so they face a huge bill at a time when - in the case of start ups - they have no profit record.[64] This creates cash-flow problems, puts investment at risk and threatens to make some companies insolvent. Stephen

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[63] Inland Revenue Budget press notice REV3, 21 March 2000

[64] Whereas the employee's earnings are subject to a cap (the upper earnings limit, set at £27,820 for 2000-01) above which no NICs are payable by the employee, there is no similar earnings cap on secondary NICs (normally borne by the employer). This was removed in 1985 by the previous Administration to offset the cost of reducing the NICs burden for the lower paid. As a consequence this represents an 'open-ended' charge on the employer whenever the employee exercises their options.

> Timms, Treasury Minister, told the Commons yesterday: 'I am in discussions with the firms affected on how best to resolve (the issue).'[65]
>
> The talks are considering several ideas, but shifting the onus to employees is attractive to the government because it could resolve the problem without creating a general tax avoidance loophole. At present employers are statutorily barred from asking employees to reimburse their insurance liability, even when share prices have risen sharply and staff have realised large share option gains but the company is not in profit. The proposed solution would permit voluntary agreements to be reached for employees to meet part or all of their employer's liability. It would be included in the Child Support, Pensions and Social Security Bill, currently going through Parliament. Officials say the talks have been going well enough to make them optimistic.[66]

An editorial published in the *Financial Times* at this time argued that the proposal to allow employees to pay the employers' NIC in these circumstances was "a messy compromise, but probably the best available":

> The government had no choice but to close the tax loophole opened by the use of telephone number share options for senior employees. But it has stumbled into difficulties by failing to think out the consequences. A year ago Gordon Brown announced that capital gains from non-approved share option schemes would be treated as income for tax purposes. The chancellor said that in addition to income tax, options gains would attract employers' NICs.
>
> The top rates of income tax and capital gains tax are both 40 per cent, so this meant an additional charge of 12.5 per cent. This was a fair cop. Companies should not be able to avoid NIC by paying employees with paper rather than in cash. The government has rightly offered tax breaks for approved share option schemes, subject to limits - extended in the March Budget. It could not provide an open-ended opportunity to avoid NIC.
>
> But the Treasury failed to realise that it was placing an open-ended obligation on companies. Their liability for NIC would rise with their share prices. In the recent fevered market for new technology stocks some companies faced the possibility of a crippling NIC bill while they were still making losses. After consultations, the Treasury seems ready to change the law to allow employees to pay the employers' NIC. It would be open to the company to increase the value of the option so that the extra charge would still be paid effectively by the dilution of shareholders' interests, rather than out of cashflow.
>
> This is a messy compromise, but probably the best available. It does, however, highlight several confusions and difficulties. The first is that the distinction

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[65] HC Deb 6 April 2000 c 1139 In the event the Financial Secretary and officials met with around 50 companies and representative bodies, and received over 20 written representations (Inland Revenue press notice 96/00, 19 May 2000).

[66] "Deal 'near' over national insurance charges on high-tech share options", *Financial Times*, 7 April 2000

> between national insurance and income tax is becoming untenable. It is unimportant who pays it, since after-tax incomes will adjust to different regimes. Second, a top effective income tax rate of 52.5 per cent may create genuine difficulties for international companies in sectors such as computer software, where the best talent may migrate to lower tax countries.
>
> Third, the practice of awarding huge share options may be unfair to shareholders and give a misleading idea of the company's success in adding value. This last issue was masked by the rapid rise in share prices that made stock options appear almost costless. But in the long run, share prices must reflect real returns that account for the full cost of employees. Whether workers are paid in options or money, shareholders must ultimately foot the bill. Mr Brown's move is the Treasury's way to recognise that underlying reality.[67]

In its response to the Financial Secretary, the Chartered Institute of Taxation noted that the consensus among companies it had consulted was that the NI liability on the exercise of share options should be abolished:

> We believe that the current NI rules for share options penalises successful companies and that it is important that this is changed as soon as possible. If nothing is done about the position quickly, or if the measures do not fully address the issues, we believe that companies operating in the United Kingdom will be at a disadvantage compared with overseas companies, such as companies in France, Germany, Japan and the United States.
>
> There is already evidence that companies are considering whether the United Kingdom is the best location in which to operate. We are also aware of situations where companies are being deterred from setting up in the United Kingdom specifically because of the NI cost of share options. If the proposals set out in REV3 are implemented, we do not believe that the issue will disappear. Passing the employer's NI liability on to employees is not an attractive option for most employers since it will make it harder to recruit and retain key employees …
>
> Our members have discussed the proposals with a large number of companies. In one meeting shortly after the Budget, an informal survey was carried out on the issue of share options and NI. Of more than 300 people attending the meeting, an overwhelming majority believed that something should be done. When asked whether the employer's NI liability should be passed to employees, only one person out of those attending thought that this was a good idea …
>
> The main alternative that is favoured by virtually all companies in the abolition of the NI liability on the exercise of share options. This would bring the UK into line with many European countries that do not apply social security to the exercise of share options, operate an equivalent of the upper earnings limit for employer's social security or allow unlimited "qualified" options to be granted.

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[67] "Leader: No option for tax avoidance", *Financial Times*, 13 April 2000

> You will recall that at one of the meetings that you attended with the Inland Revenue, the Treasury and various companies this was the favoured approach. You will also remember that several of the companies stated that, because of the employer's NI liability, they were granting, or intended to grant, fewer options to employees than would be the case if there were no NI liability. One of the companies at the meeting handed out a schedule illustrating the position with real numbers and demonstrated that granting fewer options to employees would actually lose the Government more money than was raised in NI on the exercise of the options.[68]

The Tax Faculty of the Institute of Chartered Accountants of England & Wales (ICAEW) was similarly critical:

> It is unacceptable that companies which are successful and who have enabled their employees to participate in the success that they have helped bring about should be subject to what amounts to an unpredictable penalty simply because an employee has triggered a deemed tax charge.
>
> The problem here is the desire to levy tax in the form of NIC on a transaction entered into by someone other than the person liable to pay the tax, which means that the person liable for the tax, namely the employer, has no proceeds arising from that transaction to finance the impost. There is a fundamental difference between charging an employer because somebody else takes a course of action, which is the case here, and asking an employer to calculate a deduction and recover it from an employee with the employee having available some sale proceeds from which to bear the 'deduction'.
>
> Levying a tax charge on the employer in these circumstances is contrary to the ten tenets proposed in our discussion document 'Towards a Better Tax System'…[69] By way of illustration, it is neither certain (as employers will be unable to anticipate the tax consequences with reasonable certainty in advance of granting the options), nor fair and reasonable nor competitive and if the charge is introduced other than by way of primary legislation is unlikely to be properly scrutinised by Parliament. This situation is similar to other situations that are outside the control of an employer, for example non-cash vouchers provided by third parties which is also only now being addressed after the results of consultation and the advice of the Social Security Advisory Committee were ignored repeatedly by the DSS.
>
> The alternative proposals attempt to address the issue and whilst in theory they provide a means of levying NIC in respect of options that are yet to be granted, as

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[68] CIOT, *National Insurance and share options*, 19 April 2000 This forms appendix 10 to the Institute's collated representations on the Finance Bill 2000, published in October 2000. It is available on the Institute's internet site at: http://tax.org.uk/misc/financebill00CRIRR.htm

[69] Further details of the Faculty's work in this area are published on its internet site: www.taxfac.co.uk/facultypublications/index.cfm?selectedtype=25&cfid=133954&cftoken=11465550

> these could be made conditional on the employee indemnifying the employer for the NIC charge, they will still leave employers vulnerable as they would have to rely on the goodwill of employees. An employer cannot force his employees to contribute to the NIC charge unless the employees agree to amend the terms of their contracts of employment or the option agreements, which for options yet to be granted is unlikely to engender good employer/employee relations and for options granted from April 1999 to date is unlikely to be worth employers even considering.
>
> Therefore, whilst what is being proposed appears at first sight to be of some help it is in practice unlikely to be workable. The Government should either make the tax charge transparent by imposing it directly on the employee or, preferably, abolish the NIC charge, it seemingly having been introduced on the false premise of aligning tax and NIC.[70]

On 19 May 2000 the Government announced that legislation would be introduced as soon as possible to tackle this problem: first, to allow an employer's NICs on options to be recovered from or transferred to the employee, following agreement between the company and the employee; second, to allow employees to set the employer's NI paid by them as a result of this change against their liability to income tax on the share option. Details were given in a press notice issued at the time:

> 1. The main change would remove the current statutory bar which prevents employers and employees coming to an agreement under which the employee can pay the employer's National Insurance Contributions ('NICs') but only in respect of share option gains. The employer and employee will be able to come to a voluntary agreement under which the employee could agree to fund all or part of the employer's NICs. Alternatively, the employer and employee will be able to make a joint election under which the liability for all or part of the employer's NICs is transferred to the employee. An election will take effect after the Inland Revenue have approved the form of the election and the arrangements made for securing that any liability transferred by the election is paid.
>
> 2. The change will enable employers and employees to come to an agreement or make an election in relation to any unapproved share option granted on or after 6 April 1999 where a gain has not yet arisen.
>
> 3. This change should help companies with very volatile share prices that offer their employees substantial share options as part of their remuneration package. Recovering the employer's NICs from the employee or transferring the charge to the employee should solve the accounting difficulties faced by companies. These arise because of the need for companies to put a provision in their accounts for a NICs liability that is unpredictable since it depends on the company's share price at the time when the employee decides to exercise his or her option. It also helps

[70] *NIC on unapproved share options TAXREP 15/00*, April 2000 This is published on the Faculty's internet site at: www.taxfac.co.uk/facultypublications/documents/10-240-1.doc

> smaller start-up companies which may have limited cash flow by putting the company in funds to pay their NICs charge or by moving the payment of the NICs charge to the employee.
>
> 4. In a separate measure, a new tax relief will be introduced which will allow employees to set off any NICs they pay, under an election or under an agreement to recover NICs, in calculating the income tax charge arising on the share option gains.
>
> 5. The Government does not want employers to be able to transfer their wider National Insurance liabilities to their employees. The legislation will therefore also confirm the existing general statutory bar on doing so, and extend it to Class 1A (on benefits in kind) and Class 1B (on PAYE Settlement Agreements), both of which are only payable by employers.[71]

In one respect these proposals included one further concession: namely, allowing employees to offset NICs paid under this type of agreement against income tax. In its press notice, the Government pointed out that this would cut the overall headline rate of tax on share option gains, bringing it into line with the tax take on options in the USA:

> Many other EU countries impose social security taxes similar to NICs in the UK. They also charge social security taxes on taxable gains on the exercise of share options. The rates vary between countries depending on their tax structure. Some EU countries have higher initial social security rates that the UK. An employer's overall bill in these other countries may be less than the UK when an employee receives high levels of remuneration, because the liability in the UK is uncapped. The position in the US is similar to the UK in that social security taxes are payable by the employer on share option gains made by employees. Although the main social security tax chargeable at 7.65% is capped at earnings of $72,600, the 1.45% Medicare charge, which is also payable by both employers and employees, is uncapped.
>
> The UK has one of the lowest top rates of income tax (40%) in the world. Giving an employee a deduction for the NICs charge in computing their income tax will reduce the overall headline rate of tax on share option gains from 52.2% to 47.32%.[72] This compares favourably with the top rates of tax in many EU countries and is similar to what is paid in the US when state income taxes are taken into account as well. For example, France, Germany, the Netherlands, Spain and Sweden all have top income tax rates in excess of 47.32%. In the US an employee living in California pays a top rate of over 45% and one living in New York City would pay over 46%.[73]

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71 Inland Revenue press notice 96/00, 19 May 2000

72 ie, 12.2% x (100 – 40)% = 7.32% A higher rate taxpayer would be charged tax on the option at 40% + 7.32%. The other fraction of the employers NIC is met by the Revenue, in the form of tax relief granted the employee (ie, 4.88%).

73 *ibid.*

According to the *Financial Times*, reactions to the proposals were mixed:

> Leigh Wood, chief operating officer of NTL, the cable company, said yesterday: "We are pleased that the government has listened. This will enable us to continue with one of the widest stock option programmes to employees in the country." But Stephen Allott, president and chief financial officer of Micromuse, the US software company, said the proposals, while better than the original ones, were a "penalty on success". He was "very sad that we will not have a regime in the UK that will attract the talent necessary to found the next Cisco here." He had spoken to 50 companies, of which only one was happy with the Treasury's proposals. However, the Treasury said its proposals provided a practical solution that did not create a tax loophole through which any large bonuses could pass. Two-thirds of respondents had indicated they could use the scheme.[74]

The *Sunday Times* quoted Tim Conway, policy director at the Computer Software and Services Association (CSSA), as being critical of the proposal: "This is not the solution because it is putting the onus back in the arms of industry … The problem is that the Treasury is not thinking ahead. The move will drive a wedge between employer and employee and will be an administrative nightmare."[75] Writing in *The Tax Journal* in June 2000, Amanda Flint (director at KPMG) argued that few employees would be happy to make a voluntary agreement with their employer to assume liability for employer NICs on their options:

> It is hard to see why they would be prepared to accept such an arrangement unless there was a quid pro quo such as a grant of further options or other consideration. If these proposals result in the grant of additional options over newly issued shares to employees, the cost of employers' NIC is moved not from employer to employee but from employer to shareholders in the form of additional dilution.
>
> As a result the proposed solution looks as if it will satisfy few interested parties. Companies would prefer not to be paying NIC at all on options and view it as being counter to the incentive effect behind the grant of options to employees. If the Inland Revenue's concern is that options were used not as incentives but as NIC avoidance schemes, this could have been addressed by other means, for example, the introduction of a purposive test with an appropriate penalty attached. The additional NICs charge on employees increases the inclination to sell all the shares acquired on the exercise of options as the tax burden is even higher. Many companies would also like to see the tax and NIC point shifted to the disposal of shares when holders are able to realise proceeds to pay the tax due. This would also give an incentive to employees to hold shares for longer — one of the Government's stated objectives for employee share schemes.[76]

[74] "Move to soften impact of NI on share schemes", *Financial Times*, 20 May 2000

[75] "Employers seek complete rethink on NI charges", *Sunday Times*, 28 May 2000

[76] "NIC and options", *Tax Journal*, 19 June 2000

B. Agreements and elections to transfer employer NICs

The Government introduced two new clauses at the Lords' Committee stage of the *Child Support, Pensions & Social Security Bill* on 22 May 2000, to implement the changes proposed in its press notice issued on 19 May.[77] Speaking for the Government on this occasion, Baroness Hollis summarised the purpose of these provisions as follows:

> Since 6th April 1999, gains made by employees when they exercise share options granted after 5th April 1999 are subject to Class 1 NICs, unless the share options are awarded and exercised under an Inland Revenue approved scheme or the shares acquired are not readily convertible into cash. The Committee may be aware that under accountancy rules companies are required to make a provision in their accounts for the anticipated NICs liability on share options based on the market price of the shares on the date that they prepare the accounts.
>
> Many companies have informed us that while they can plan for NICs on regular pay, it is more difficult for them to plan for NICs on share option gains, particularly where the share price is volatile, as it is in the high growth sector of the economy, such as the new Internet companies. The exposure to so unpredictable a NICs liability could put at risk these companies' investment strategies and even make some companies technically insolvent. The unpredictability of accounting provisions is a severe worry to employers.
>
> As a result, a number of these companies are now questioning their investment plans for the UK and have told us that they might consider moving jobs elsewhere. Class 1 NICs consist of a primary contribution, which is payable by the employee and a secondary contribution which is payable by the secondary contributor, which, in most circumstances, is the employer. Current social security legislation provides a statutory bar to prevent employers from recovering any part of their secondary Class 1 liability from the employee. This amendment strengthens that protection for the employee but at the same time introduces an exception for NICs arising on share option gains.
>
> The amendment does three things. First, it allows employers and employees to reach an agreement that a secondary contributor (usually the employer) may recover some or all of the secondary NICs in respect of rights to acquire shares from the employee. Secondly, and as an alternative, the employer may make an application for approval of an election to the Board of the Inland Revenue. If approval is obtained, the employer and employee can jointly elect to transfer all or some of the liability to pay the secondary NICs on the share option gain to the employee.
>
> Elections can be made only after the Inland Revenue has given its approval to the form of the election and the accompanying arrangements for securing that the NICs liability transferred to the employee is paid. We shall introduce the ability

[77] HL Deb 22 May 2000 cc 618-629

> to transfer the liability to the employee to overcome accounting difficulties for companies that report in the United States which would otherwise arise if the employer simply recovered the NICs. This flexibility has been provided in response to requests made to us during the consultation period.
>
> Thirdly, the proposed amendment strengthens the existing statutory bar that prevents the employer recovering any part of the secondary NIC in respect of all forms of earnings (subject to the new exception for share options). It extends protection to the employee by ensuring that the person liable to pay the Class 1A NICs (on benefits in kind) or Class 1B (on pay-as-you-earn settlement agreements) cannot recover his liability from the employee.
>
> I emphasise that this amendment seeks to put in place a solution that a number of companies have requested and we are meeting those requests. I should also add that the Government have consulted widely on the solution and it is clear that many of the companies that we have spoken to will welcome it. I can assure the Committee that the employer may only transfer or recover his liability from the employee if the employee so agrees.
>
> The merits of the solution are such that it completely eliminates the unpredictability of the charge to the company and it moves the liability to the person with funds to pay for it. We believe that it is needed to attract business and jobs to the UK and to help UK companies compete in the global market. It goes towards meeting the Government's aim of a fairer national insurance system by ensuring that NICs are paid on share options and not treated more favourably than other kinds of remuneration.[78]

These new clauses were the subject of a short debate on the second day of Bill's Report stage on 27 June 2000.[79] On this occasion, Lord Goodhart moved an amendment to deal with two specific complaints some e-commerce companies had made about these provisions, and to raise the issue for general discussion; amongst other things he proposed moving the NIC charge to the date of grant. Part of his speech is reproduced below:

> It is, I think, agreed by firms in the e-commerce world that the government amendments in Clauses 78 and 82 are an improvement on the status quo. But there are two serious complaints. First, the amendments provide no relief from the unexpectedly large liabilities for secondary contributions incurred by those granting options since 6th April 1999. Those liabilities are unexpectedly large as a result of the enormous increase in the value of e-commerce shares and, therefore, the value of options which have occurred after April 1999; and although it has declined from its peak earlier this year, it is still a long way above what it was in April 1999.

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78 *op.cit.* cc 624-625 The Department issued a regulatory impact assessment of this change, following the Committee stage of the Bill (DSS, *National insurance contributions and share option gains: facilitating recovery of employers national insurance contributions from employment*, 26 May 2000 [RIA 00/87]).

79 HL Deb 27 June 2000 cc 879-888

> The second complaint by those companies was that the effect of the transfer of liabilities for secondary contributions from employers to employees is to create an effective tax rate of 47 per cent on gains, even taking into account the fact that, for tax purposes, the secondary contributions will be allowed as expenses against tax before the tax liability is computed. So there is an effective tax rate of 47 per cent, taking income tax and NICs together. In the view of those companies, that is likely to discourage the mobile and very expert workforce required in businesses of that kind from taking jobs in the United Kingdom, and it may lead some of the companies to move their operations abroad. The companies are highly mobile. They can, of course, set up in virtually any part of the world that they choose.
>
> The amendment seeks to deal with both those problems. It proposes that the NIC liabilities are to be charged on the value of the option rights when the option is granted and not when it is exercised. That will leave the liability for secondary contributions with the employer, but on a much smaller amount and on a more easily ascertainable basis, not on an open-ended basis as to the ultimate liability.
>
> The amendment proposes, secondly, that the new basis of calculation will be made retrospective, subject to a liability to pay interest. It seems in principle fair to charge the NICs on the option value at the date of the grant because that is the value of the remuneration package when it is paid, and it seems that it is perfectly legitimate to treat the subsequent increase in value of an option as something in the nature of a capital gain, on which NICs are not charged.
>
> It is obvious that an option has a value, even if the option is to buy shares at a price at, or even above, the level at which those shares stand at the date when the option is granted. It is a one-way bet: if it is not in your interest to exercise the option, you do not have to; if it is, you can exercise it. The amendment also preserves the liability for secondary contributions on the employer, which seems to us to be the place where it belongs.
>
> I have to say that I was subsequently approached by another company, NTL, which is also in the IT business and which prefers the Government's formula to the formula in my amendment. So it is clear that there is no consensus in the world of high-tech. It may be that the issue could be solved by giving a right to elect to pay either on the value of the option at the date of the grant or to transfer the liability to the employee and base it on the gain on the exercise of the option.[80]

Speaking for the Government, Baroness Hollis opposed the amendment – and, in the light of the Baroness' offer that officials might elucidate certain technical issues for Lords Goodhart and Higgins, in a meeting prior to Third Reading – Lord Goodhart withdrew it. That part of the Baroness' response to the debate, dealing with the Government's objections to the amendment, is reproduced below:

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[80] *op.cit.* cc 880-881

As I mentioned to the House earlier, social security legislation currently provides a statutory bar to prevent employers from recovering any part of their Class 1 liability from the employee. The first effect of this amendment would be to ensure that Class 1A (NICs liability on benefits in kind) and Class 1B (NICs liability on PAYE voluntary settlement agreements) would remain excluded from this statutory bar. I am sure that I can count on support from all sides of the House: that we do not want to leave the employee exposed in this manner.

The second effect of this amendment would be to move the NICs charge from the exercise of unapproved options to the "intrinsic" value of the options at the date of grant. This would mean that employees and employers would have to pay NICs regardless of whether the options are eventually exercised or if the value of the shares were to fall. So NICs would have to be paid purely on the expectation of a realisation of value and not a tangible gain in value; the NICs payable would not reflect the gain that the employee actually made. Many high growth companies have told us that they grant share options because they are unable to offer competitive cash salaries, particularly when they start up in business. This amendment would mean that these companies would face an NICs charge when they grant options to employees--at the time when they are least likely to be able to pay.

We see a number of difficulties with the noble Lord's proposals. First, employees would be required to pay NICs at the time they receive the option. This could mean that they have to pay at a time when they have insufficient cash to meet their liabilities. Currently, employees can sell some of their shares when they exercise their options to meet their liabilities. Secondly, we would go back to the position that existed for NICs pre 6th April 1999, and so take the NICs charge back out of alignment with the income tax charge through PAYE. This will mean that PAYE and NICs will have to operate on two different figures. Employers said at the time that this caused considerable administrative problems.

Thirdly, the amendment will increase administrative costs for employers and the Inland Revenue, due to the added complexity of accurately valuing options over shares at the time of grant--and there is considerable difficulty in identifying a method that would allow this to be done accurately. Employers would be required to operate a valuation model such as that provided in the Black Scholes Model. These models do not always easily apply themselves to high growth and unquoted companies. It will mean that options will have to be valued at grant for NICs purposes and again at exercise for income tax purposes--in other words, what happens when one disjoins them. Currently a valuation for income tax through PAYE is also acceptable for NICs.

Fourthly, the position that existed prior to 6th April 1999 will re-open an avoidance route that was used by companies, particularly in the City, to pay large bonuses to directors, and other highly paid employees, free of NICs. Any proposal to scale back the current NICs charge and charge it at grant brings with it the opportunity for new forms of avoidance. Fifthly, the effect of this amendment would be that employees and employers who are paid in cash would pay more NICs than employees and employers where share options form an

> integral part of the remuneration package. The Government believe that that is unfair. I thought the noble Lord, Lord Goodhart, too, felt this was unfair, given his remarks at Committee stage.
>
> Sixthly, the effect of this amendment would reduce income to the National Insurance Fund. The amount is difficult to predict because it is based on the volatility of the share price, but our provisional estimate is that it is likely to cost the National Insurance Fund in the region of £350 million a year. This could also result in a move away from bonuses paid in cash to share options and some substitution of cash pay with share options. If this were to happen the loss to the National Insurance Fund could be multi-millions. This could also affect employees' entitlement to contributions-based, earnings-related and work-related payments such as statutory sick pay or statutory maternity pay.[81]

Following its Third Reading in the Lords on 19 July, the Bill returned to the Commons on 24 July for scrutiny of amendments made during its passage through the Lords. On this occasion Minister of State at the DSS, Jeff Rooker, summarised the purpose of these amendments as follows:

> We are dealing with the clauses that relate to national insurance contributions. I have taken on the role of a Treasury Minister because these clauses are in the Bill because they cannot technically go into a Finance Bill … The House will be aware that following the Budget statement in March, my hon. Friend the Financial Secretary engaged in a period of consultation with companies to find a technical solution to the problem that had arisen in relation to national insurance contributions on share option gains. I shall not go into the whys and wherefores, but an amicable solution has been reached for all concerned. I commend it to the House.[82]

No further comment was made at the time, and the amendments were agreed without any further change.[83] At this time the *Financial Times* reported that one particular US software company had announced the new rules would not prevent it reconsidering future investment, initially planned for a site in the UK – though reportedly the Treasury had responded that there was no question of reopening the issue, given that the plan had already been amended to meet business concerns.[84]

In a technical analysis of these provisions, one commentator raised doubts about the 'voluntary' nature of any agreement to reclaim employer NICs from employees:

> Although the agreement or election between the employee and the employer must be 'voluntary', the extent to which in practice the employee can take an option

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81 *op.cit.* cc 885-886 Following completion of the Report stage, these provisions constituted clauses 78 & 82 of the Bill [HL Bill 92].

82 HC Deb 24 July 2000 cc 822-823

83 They now form ss 77 & 81 of the *Child Support, Pensions & Social Security Act 2000.*

84 "Options levy may threaten US group expansion", *Financial Times*, 20 July 2000

> without assuming the secondary NIC liability, if this is what the employer so desires, is somewhat debatable. If the availability of share options depends on the employee meeting the secondary NIC bill, most employees would take the view that the price was one worth paying, notwithstanding that the value of the 'incentive' is somewhat reduced. After all a smaller slice of the pie is better than none at all.

She went on to point out that these changes would encourage both employers and employees to reconsider the undoubted attractions of approved share option schemes – in particular the Enterprise Management Incentive:

> There is however an alternative. Revenue approved schemes do exist and where possible, shares and share options should be provided within the confines of these schemes so as to enjoy, the associated tax and NIC advantages. In particular, the availability of the enterprise management incentives scheme, (FA 20001 s. 62 and Sch. 14) enables small companies (gross assets riot exceeding £15m) to reward up to 15 key employees with share options worth up to £100,000 at the time of grant. No tax arises on the grant of the option nor usually any tax or NIC liability on exercise. With no secondary NIC liability, the question of who should suffer it is somewhat redundant.[85]

On 9 October 2000 the Government laid regulations to provide the supporting legislation to enable employers to make elections:

> The new regulations, which follow new legislation introduced in the summer, provides the process to enable employers to seek approval so that they may make an election with their employees, which transfers the liability for employer's National Insurance contributions from the employer to the employee. This will solve accounting difficulties and also help smaller start-up companies with limited cash flow.
>
> Financial Secretary Stephen Timms said: "I am very grateful to those companies and their representatives whose contributions have helped develop the process under which share option elections can be made. Allowing employers and employees to make an election to transfer the National Insurance charge provides a technical solution by completely eliminating the unpredictability of the charge. I am also pleased that many companies have already made applications to use this solution."[86]

The regulations came into force from 10 October 2000.[87] The Revenue has published guidance on the operation of these rules;[88] this is reproduced in Part V of this paper.

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[85] "A sting in the tail", *Tax Adviser*, September 2000 The author is Sarah Bradford, a freelance tax author.
[86] Inland Revenue press notice 154/00, 9 October 2000
[87] SI 2000/2744, with equivalent provision for Northern Ireland under SI 2000/2743. Consequential amendments were made in SI 2000/2742.
[88] This is available on its internet site at: www.inlandrevenue.gov.uk/shareschemes/emp_nics.htm

C. Consequential changes in income tax

On 19 May 2000 the Government announced that it would introduce legislation to allow an employer's NICs on options to be recovered from or transferred to the employee, following agreement between companies and their employees. In addition it proposed to introduce a new tax relief to allow employees to set off any NICs they pay, under an election or under an agreement to recover NICs, against income tax.[89]

To this end a new clause was introduced at the Committee stage of the Finance Bill on 29 June. The Financial Secretary Stephen Timms, set out the purpose of the new clause:

> The new clause provides tax relief to employees and builds on measures introduced in the Child Support, Pensions and Social Security Bill in another place earlier this week … [It] gives employees tax relief when they bear the cost of the employer's national insurance contribution on share option gains. The relief is tied to two circumstances in which an employer and an employee can agree that the employee will bear the costs …
>
> Companies with employees will receive a deduction from the corporation tax on their profits for the secondary national insurance contributions that they pay as part of the costs of employment. If the liability is transferred to the employee or the money is recovered from the employee, no corporation tax deduction will be offered. Therefore, it is only fair that the employee who bears the cost should benefit from a tax relief for it. The new clause supplies that relief by allowing a deduction from the amount of the share option gain that would be chargeable to tax. We have included safeguards to prevent an employee from receiving the relief when he has not paid the national insurance contributions within 60 days of the end of the tax year. That is a generous time scale compared with the normal time limit for accounting for national insurance to the Inland Revenue.
>
> Many employees will sell some shares to release funds to meet their liabilities when they make gains on their share options. We have included a measure that will allow employers to calculate the PAYE by taking the new relief into account, so the employee will receive the tax relief during the year through PAYE, rather than having to wait for a tax refund through the self-assessment tax return after the end of the year.
>
> The changes will help us to continue to attract businesses and jobs to the United Kingdom and will help companies to compete. The changes fully take into account the importance of share options for employers and employees, particularly in the new economy, and remove barriers to using share options in recruiting and retaining employees. They also meet our aim of a fairer tax and national insurance system, by ensuring that tax relief is given to whoever bears the cost of national insurance contributions on share options.[90]

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[89] Inland Revenue press notice 96/00, 19 May 2000

[90] Standing Committee H 29 June 2000 cc 1019-1021

Speaking for the Opposition, Oliver Letwin MP welcomed the fact that the Government had responded to representation on this issue, but suggested that it would have been preferable to reverse the decision to extend NICs to share options:

> In our view, the right way of proceeding would have been to undo the original mistake of putting NICs on employee share options, then forget the whole thing. None of us sees the merit in a bizarre and restricted 47.3 per cent. marginal tax rate … The measure has been introduced because the Government's first proposal, as the Financial Secretary fairly admitted, would have had a catastrophic effect on a range of high-tech companies setting up.[91]

Speaking for the Liberal Democrats, Edward Davey MP suggested that the introduction of a marginal tax rate of 47.3% for employees realising gains on share options would have serious implications for the ability of high-technology companies to attract employees:

> The basic concerns of industry remain. It is dealing with internationally mobile labour. One reads in the specialist press that various firms in California are stuffed full of employees from Europe, who want to become involved in high-tech industry and achieve the best remuneration that they can. Given the tax regimes that pertain in this country and mainland Europe, they are attracted to the US. It is not simply because there is a well-performing high-tech industry in California, because we all know that Europe has its own well-performing high-tech industries. The issue that is driving many of them to California is the comparative tax rates.[92]

In responding to the debate, the Financial Secretary noted that a range of factors would be at stake in a company's decision on its location:

> A couple of weeks ago, I attended a conference for European high-growth firms, at which there were 400 or 500 people from all over the EU. It was evident that the view everywhere else in the EU was that the UK was the best place by a considerable margin in which to establish and to grow such a firm. I had an interesting discussion with a French entrepreneur who had decided to establish a dot.com enterprise and who felt that he could choose any location in the world, although he felt that France was not an appropriate location due to the environment there. In the end, his choice was between the UK and the US. He chose to come to the UK, partly because of the difficulties of finding staff in the US because of the tightness of its labour market. From a recruitment point of view, he felt that he would be significantly better off. That perhaps makes the point that it is necessary to consider a range of issues facing companies, not simply one issue, when thinking about international competition.[93]

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[91] *op.cit.* c 1021
[92] *op.cit.* c 1023
[93] *op.cit.* c 1026

Nonetheless Mr Timms underlined that the decision to introduce this concession had been guided by concerns that requiring employees to pay a tax rate of over 50% would have a damaging effect on incentives, and put the UK at a disadvantage with other countries, particularly the United States of America:

> It was apparent in my discussions with many companies that the 50 per cent. level was psychologically significant. One or two companies said that if they ended up with a rate above 50 per cent. it would be disastrous, but a rate slightly below that figure would be fine. As a result of the new clause, the rate will be significantly below 50 per cent., which will help many firms …
>
> The top income tax rate in the major EU countries-France, Germany, the Netherlands, Spain and Sweden-is more than 47.3 per cent. In the US, an employee living in California pays a top rate of more than 45 per cent., and someone living in New York City would pay more than 46 per cent …
>
> In general, the US taxes such gains in exactly the same way as the UK. The gain made to the date of exercise is chargeable to income tax, and gains made subsequent to that and before the date of sale are chargeable to capital gains tax. On unapproved US options, the gain made to the date of exercise is liable to income tax, with a top rate of 39.6 per cent.-plus state taxes, and plus the employer's Medicare liability, which is comparable to employer's NICs although at a lower level. The subsequent gain on sale of those shares is liable to income tax if the shares are held for less than a year … and 20 per cent. capital gains tax if held for more than a year. In the UK, if the shares are held for more than four years, the rate of capital gains tax will apply at 10 per cent.
>
> The arrangements for approved options are rather different. I believe that, in full comparison with the US, once the changes are made our rates will be competitive with those faced by many employees in the US … There is an alternative regime for approved options in the US, as there is in the UK, and … the terms of the approved scheme are more generous in the US than in the UK, although the enterprise management incentive introduced by the Bill is more generous.[94]

The issue was raised a second time at the Report stage of the Bill, when the Opposition put down an amendment with the aim of reversing this measure, by cutting the marginal tax rate for higher rate taxpayers in these circumstances to 40%.[95] In the event the amendment was rejected, and this provision incorporated in the *Finance Act 2000*.[96]

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94 *op.cit.* c 1025, cc 1029-1033

95 HC Deb 19 July 2000 cc 401-413

96 specifically section 56 of the *Finance Act 2000*

IV The *Social Security Contributions (Share Options) Bill*

In October 2000 it was reported that the Government were considering further changes concerning the treatment of unapproved share options for NIC purposes:

> A delegation of finance directors from some of America's largest computer companies are to meet Chancellor Gordon Brown next month to vent their spleen over the UK's tax system. The meeting represents the first sign that the Treasury is preparing to offer concessions on the deeply unpopular introduction of national insurance on share options … It is understood that finance directors from Cisco, Oracle, Sun Microsystems and JDS Uniphase were invited earlier this month by Treasury Finance Secretary Stephen Timms to meet the Chancellor.
>
> In a packed meeting at Cisco's offices in San Jose, Mr Timms told the executives that national insurance on share options was still a "live issue" and urged the delegates to meet his boss. It is understood that one idea under consideration is to give the IT companies facing a hefty tax burden relief in the "gap period" - the time before the new tax rules were changed in April. Flanked by Diane Hay, the assistant director of the Inland Revenue, and Christopher Martin, his private secretary, Mr Timms said that giving the finance directors some "face time" with the Chancellor might help in finding a solution. Sources close to the Treasury revealed the timing of the meetings could be critical. Mr Brown is understood to be considering announcing a further period of industry consultation on the effects of national insurance in his November pre -Budget statement. One idea being banded around the Treasury is to relax the rules on "approved" share option schemes - situations where companies and employees are exempt from the tax.
>
> At present, companies can issue up to £30,000 worth of share options per employee without paying the 12.2 per cent levy. Instead, capital gains tax is paid on the shares. It is understood that the Treasury is considering raising the threshold, which could be included in the next Finance Act, due in the summer of 2001.[97]

In his Pre-Budget Statement on 8 November 2000 the Chancellor announced two proposals to encourage investment in e-commerce (*emphasis added*):

> To help smaller high risk and e-commerce companies recruit and retain the staff they need, we propose to expand tax relief for share options and to make Britain the most attractive environment for e-commerce. In future, all employees can benefit from our enterprise incentive scheme - up to a company limit of £2½ million worth of share options. *For the period to May 2000, I propose to make provision for companies to limit and settle their liability for national insurance contributions on share options.*[98]

[97] "Treasury rethinks share tax", *Independent*, 15 October 2000

[98] HC Deb 8 November 2000 c 317

Further details were given in the *Pre-Budget Report*:

> Having addressed the concern over share options issued after 19 May 2000, new legislation will be introduced to cover share options issued between 6 April 1999 and 19 May 2000. Under these rules, companies will have the option of removing all uncertainty through settling their NICs liabilities on those options based on market values at the time of this Pre-Budget Report. This will remove future growth from the charge to employer's National Insurance. Together with the option of transferring liability to the employee, this will solve the difficulties for those high growth firms.[99]

The statement does not appear to have attracted much attention in the press; one example is reproduced below:

> TREASURY attempts to reduce the national insurance burden on share options received one cheer from high-technology entrepreneurs, who said the reforms did not go far enough. Yesterday's pre-Budget statement took action to solve problems caused when NI contributions are levied on share options. This has been a particular concern for many high-tech firms, who make heavy use of share options to top up salaries. Gordon Brown unveiled changes that aimed, he said, "to help smaller high-risk and e-commerce companies recruit and retain the staff they need". However, Mr Brown was criticised for not taking a radically simpler approach. Mike Lynch, chief executive of software group Autonomy, said: "There's no doubt that the Government is trying to do the right thing. The problem is that they tinker, tinker, tinker and don't sort out the fundamental issue which is that options should be treated as a capital gain and not be hit with NI."…
>
> Mr Brown also offered to reform the Enterprise Management Incentive, a tax-free share scheme aimed at start-up companies, in the next Budget. The existing cap preventing more than 15 employees per company taking part in the scheme has now been lifted. In future, any number of staff can benefit, to a maximum scheme value of £2.5m, although there is a limit of £100,000 per employee. Robin Saxby, chairman and chief executive of microchip designer ARM Holdings, said: "These measures are helpful, but don't fix all problems. I don't see anything here to help out established high-tech businesses, who are as important to the economy as start-ups."[100]

On 21 December 2000 the Financial Secretary Stephen Timms announced the publication of the *Social Security Contributions (Share Options) Bill 2000-01*; a summary of the Bill was given in a press notice from which the following is taken:

> Under the proposed new legislation employers will be able to settle the NIC liability arising on options granted during that period by using the share price on 7 November to calculate the gain on which NIC will arise …

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[99] Cm 4917 November 2000 p 47

[100] "Share options changes bring muffled cheer", *Daily Telegraph*, 9 November 2000

> Upon Royal Assent the Bill will allow companies to settle the NIC liability arising on options granted between 6 April 1999 and 19 May 2000 (which remained unexercised on 8 November) provided that notification and any appropriate payment is made to the Inland Revenue within 60 days of the Bill coming into force. Where such notification is received the employer will pay a special employer only contribution based on 12.2% of the deemed gain calculated using the share price on 7 November 2000 and no employee contribution will be payable on the actual gain. Companies who do not send notification and any necessary payment will remain subject to the existing rules and will be liable to pay Class 1 NIC on the actual share option gain.
>
> Companies who have granted employee share options during the period 6 April 1999 and 19 May 2000 and who wish to take advantage of this measure should send their name and address to the address below: Shares Scheme Team Capital and Savings Room 138 New Wing Somerset House Strand London WC2R 1LB Or by E Mailing to: Shareschemes@ir.gsi.gov.uk
>
> The legislation is subject to the Parliamentary process and as such may change. However, to ease administration for employers, where a gain is made before Royal Assent of the Bill, employers may calculate and pay the employer's NIC charge on the deemed gain using the share price on the 7 November 2000, rather than using the existing Class 1 rules.
>
> Those employers who wish to make use of this administrative easement will still be required to send in the appropriate notification when the legislation comes into force otherwise Class 1 NIC will remain due and interest and penalties on any underpayments and under recording will be applied accordingly. In the event that the legislation has not come into force by the end of November 2001 any balance of Class 1 NIC should be paid by the end of January 2002 to avoid interest and penalties arising.[101]

A Regulatory Impact Assessment on the Bill was agreed on 28 November 2000;[102] for ease of reference, it is reproduced below:

> **Introduction**
>
> Since 6 April 1999 National Insurance Contributions are charged on gains arising when share options are exercised, assigned or released outside an Inland Revenue approved scheme if the shares are readily convertible into cash. While employers can plan for NICs on regular pay, it is not as easy for them to plan for NICs on share options, particularly where the share price is volatile.
>
> Under accountancy rules companies are required to make a provision in their accounts for the anticipated NIC liability on share options based on the market

[101] Inland Revenue press notice 189/00, 21 December 2000

[102] Copies of the RIA can be obtained from Hasmukh Dodia at Capital & Savings, Room 138, New Wing, Somerset House, Strand, London, WC2R 1LB (Bill 8 – EN para 39-40).

price of the shares on the date that they prepare the accounts. Employers have expressed concern that their exposure to an unpredictable NIC liability could put at risk their investment strategies and even make some technically insolvent.

Legislation was introduced in July 2000 to allow employees to bear the employer's NIC when they make a gain on their share options. However, some companies have said that they cannot make such agreements with their employees if an option has already been awarded. Many employers have said therefore that the uncertainty and unpredictability of the options granted between 6 April 1999 and 19 May 2000 continue to affect their businesses.

Ministers have decided to help companies that awarded options between the 6 April and the 19 May 2000. Employers will be able to limit their exposure to NIC by opting to pay NIC by reference to the gain attributable to the growth in company share price up to 7 November 2000. Under this arrangement the NICs will be payable within 60 days of the new legislation being introduced.

Purpose and intended effect of the measures

The intention is to introduce new legislation specifically to cover share options granted from 6 April 1999 to the 19 May 2000 inclusive. This period is commonly referred to as the "gap period". This new measure is to enable the employer to opt to calculate the employer's NIC due on the options granted during the gap period and remit a payment of the NIC due within 60 days of Royal Assent of the legislation.

Risks

In absence of this measure, the risk to business is that they can become technically insolvent or seriously prejudice their borrowing capacity and credit worthiness. The risk to the (National Insurance Fund) NIF is that the likely number of businesses who take advantage of the measure could be higher than the proportion estimated [see below] and therefore the cost to the NIF would increase.

Benefits

The benefits to the employer of this measure is that overall it will reduce financial risk:

- They will effectively be able to cap their NIC liability by reference to the share price on 7 November 2000. No further NIC will be due if the share price subsequently rises.
- This will remove uncertainty for the employer. The value of this cannot be quantified readily, but in principle it is reflected in the increase in credit worthiness which is seen as the increased borrowing limits available to the business because of crystallisation of liability.
- Upon payment and notification to the Revenue they will be able to remove the corresponding NIC provision from their accounts.
- They will not need to add to the provision in their accounts further in subsequent reporting periods, thus avoiding further charges against their profits.

- Companies have reported that where a NIC provision causes them to miss a performance target, the response of the market would have been damaging in the short to medium term.

The measure provides an option for the employer to effectively cap the NIC liability on the gap options by reference to the share price on the 7 November 2000. If the share price subsequently rises, falls or indeed if the option is not exercised there is to be no refund or recalculation. Employers will therefore need to consider whether settlement would be right for them.

Employees who have been granted options in the period covered by this measure will benefit because once their employer opts to pay the NIC charge no further employee or employer NIC will be due on exercise of the option.

Those employees who have agreed or elected to pay the employer's NIC in respect of these options will also be able to benefit if their employer opts to take advantage of the measure and pay the NIC himself. And, the employee will be able to similarly cap the liability that they have agreed to take on.

Consultation
There has been informal consultation on the subject of options granted during the gap period between May and October 2000 where the views of over 50 companies have been expressed. Those companies, both large and small, have approached the Government and the Inland Revenue asking for help in resolving the difficulties arising from NIC liability on the gap options.

Compliance costs for business
Since the measure only provides a single opportunity for the employer to make a payment of NICs in respect of specific options the compliance costs will be minimal. Any work produced will not be recurring and will be limited to the returns received in the period provided for in the legislation.

The intended measure only affects those options granted during the gap period that remained unexercised on the 7 November 2000.

This is a voluntary measure. Employers will need to consider whether settling the NIC in this manner is right for them. For some this decision will be easy:

- Where the share price on the 7 November 2000 is below that of the exercise price the employer can effectively opt to pay no NIC provided that the appropriate notification is sent to the Inland Revenue within the required period.
- Where the shares under option are not readily convertible assets on the 7 November 2000 the employer will again effectively be able to opt to pay no NIC. This will help some companies who are unlisted on the 7 November 2000.

Employers (who do not fall into the preceding paragraph) who have granted options during the gap period will need to consider whether they expect their share price to rise or fall from that on the 7 November 2000. They will need to make a judgement as to whether the benefits that early settlement will offer will

outweigh any risk that the share price might fall. Employers will have from the 8 November 2000 to 60 days after the legislation comes into force to decide whether this is right for them. Any costs, involved in following the provision, should be limited to the information requirement and be one-off. Notification would consist of a list of the options from the employer for which they wish to settle with determination of market price following normal Revenue practice.

Those employers who wish to settle the NICs will need to identify the employees who received options during the gap period information, which in most cases will be already captured for other purposes. The measure gives employers the flexibility to choose which options they wish to include in the settlement or of course they can include all options granted during that period.

Once the employer has decided which options he wishes to include in the settlement, he must prepare a notification, calculate the NIC due and send these to the Inland Revenue within 60 days of the legislation coming into force. A central point of collection of payments and returns specific to this measure will be used to ease administration for employers.

The employer will not be required to obtain Inland Revenue approval or make complicated returns so there should be minimum impact on their business in terms of time and resources.

The cost to employers of seeking professional guidance to consider this measure, and if they wish to settle, to prepare and make the additional return is estimated to be equivalent to a one-off cost in the region of £5 to £10 million, net of future discounted savings from not having to adjust their provisions. These costs will be outweighed by the benefits of certainty over future liability and the savings companies will make by not paying NICs on the actual share option gains that they have included in the settlement.

In future years those companies that settle the liability will make administrative savings after settlement because they will no longer need to accrue for and report on the NIC provision in their balance sheets and profit and loss accounts.

Other costs and effects

It is estimated that around 2,000 companies may have offered share options in the gap period to some 50,000 employees. The following costs assume that 2/3rds of the companies will take advantage of the measure. It is estimated that the employers who opt to settle their NIC will save an estimated £160m in employers NIC over the next 5 years. As settlement of the NIC is required within 60 days of Royal Assent the NIC received is estimated to be higher in the first year but with lower NIC receipts in later years.

This measure is anticipated to effect receipts to the National Insurance Fund as follows:

2001/2	2002/3	2003/4	2004/5	2005/6
£200m	-£230m	-£80m	-£30m	-£15m

Effect on employee
Those opting to settle their NIC will be opting to pay a Class 1A charge, which is an employer only contribution. There is the potential therefore, that some employees may pay less employee's NIC as a result. However, it is considered that only a small number of employees who received unapproved share options during the gap period are earning under the Upper Earnings Level (and consequently eligible to pay any employee NIC) and may therefore be affected. Share options are paid in addition to regular salary on which the employee will pay employee's NIC. Therefore, the likelihood that entitlement to basic pension entitlement will be lost is minimal. The number of employees likely to be adversely affected by this measure is expected to be very small and it is not possible to make reliable estimates.

Impact on small business
Ministers and the Inland Revenue have had a period of informal consultation where they have met with small businesses and trade organisations. Representations to Ministers and officials strongly indicated a need for a specific measure to deal with the gap issue where the impact on small companies of the NIC provision was causing particular difficulties.

The intention of this measure is to help all businesses that are having difficulty with the unpredictable NIC charge that will follow a share option gain. It is likely that those businesses involved in the high-tech industry, where there are many small, but growing companies, where equity remuneration is favoured will benefit significantly from this measure.

Small businesses not involved in equity remuneration will be unaffected by the measure, but in a few cases it may be argued that start-up business without share options may have to consider their remuneration practices to retain staff.

Monitoring and evaluation
Due to the time limitation of the measure it is perceived there will be no need for ongoing monitoring of the effects of the measure. A central point, to which the employer will submit a return will capture the data showing how many employers have taken advantage of the measure, NIC collected and the number of employees affected.

Summary and recommendation
This measure will allow the employer to elect to pay the NICs on the share options granted in the gap period but not exercised before 8 November 2000 by reference to the share price on the 7 November 2000. The measure is in response to requests from employers and will help them to remove the NIC provision and uncertainty from their balance sheet once the NIC has been paid. It will also save NIC costs in relation to any further upward movement of share prices.

V Appendix: Inland Revenue guidance on NICs & employee share options

This appendix reproduces information published by the Inland Revenue on its internet site;[103] first, a series of Frequently Asked Questions; and second, details on the operation of agreements between employer and employee to allow the employer to recover the secondary NICs on share options.

A. Frequently Asked Questions

What were companies concerned about?
Before April 1999 NICs was payable on the grant of share options, but only if the options were granted at a discount. Any charge was limited to the discount. However, these old rules were unfair because the charge did not reflect the gain made when the option was exercised nor that it might never be exercised.

In 1999 the law was changed to make NICs payable on the gain made when the option is exercised, assigned or released. As a result, the NICs charge was on the same basis as the PAYE tax charge. This change was part of the Governments policy for tax and NICs alignment.

However, some companies expressed concern that the secondary NICs charge is unpredictable, and that this would cause problems in drawing up their accounts. Under accountancy rules, they are required to make a provision in their accounts for the anticipated NICs liability on share options, based on the market price of the shares on the date that they prepare the accounts. Employers expressed concern that their exposure to an unpredictable NIC liability could put at risk their investment strategies and even make some technically insolvent. This has been of particular concern for small companies with limited cash flow and volatile share prices.

What will the provisions in the Child Support, Pensions and Social Security Act do?
The new provisions in the Child Support, Pensions and Social Security Act:-

- Extend the statutory bar preventing employers recovering NICs from employees in respect of Class 1A and Class 1B NICs;
- Allow the employer to recover the whole or part of any secondary NICs payable in respect of a unapproved share option gain from the employee (subject to the agreement of the employee);
- Where a joint election has been made by the employer and the employee which has Inland Revenue approval, the amendment allows the whole or part of the employer's secondary NICs liability to be transferred to the employee.

How does this change help companies?
This change provides a technical solution to the problem by eliminating the unpredictability for employers, and should also solve the cash flow problem for small companies by allowing the person who has the funds to pay the secondary NICs: i.e. the employee.

[103] www.inlandrevenue.gov.uk/shareschemes/emp_nics.htm

How will agreements to recover the secondary NIC work?
Agreements to recover the liability must be voluntary agreements between the employer and employee. It has been possible to make agreements since 19 May 2000 but they did not have legal force until the Child Support, Pensions and Social Security Bill received Royal Assent on 28 July 2000. Agreements can relate to options granted after 5 April 1999 (provided the NIC liability did not arise before 28 July 2000).

How will elections to transfer the liability work?
Employees and employers can elect to transfer the secondary NICs liability to the employee to overcome accounting difficulties in the US with a "recovery approach". Under this arrangement the employee, rather than the employer, will be liable for any secondary NICs arising on share options gains covered by the election.

In order to make an election, the employer must seek prior approval from the Inland Revenue. This approval will be given for both the form of the election and the arrangements made for securing that the liability transferred by the proposed election will be paid on time. The employer may have more than one approved election format or approved arrangement. Once approval has been obtained employees and employer may make joint elections - again, this is voluntary and so both the employee and the employer must agree to the election.

As with the agreement to recover, the election can cover an absolute amount, an amount above or below a prescribed figure or a percentage of the secondary NIC arising on the share option gain. We do not prescribe the format or content of the election. Employers can make the election an integral part of the option contract if they wish to do so.

The Inland Revenue can refuse approval if it appears that adequate arrangements to make sure that the liability will be met have not been made, or if the Inland Revenue feels that it does not have enough information to determine this.

An election continues in force until:

- it ceases to have effect in accordance with its terms;
- it is revoked jointly by both parties; or
- the approval of the election is withdrawn by the Inland Revenue in relation to options not yet granted.

Will the employee get tax relief?
Yes. There is special tax relief available for employees who meet their employer's NICs liability. This will reduce their headline rate of tax for the exercise of unapproved options from 52.2% (40% income tax + 12.2% employer's NICs) to 47.32% for a higher rate taxpayer and from 35.2% (23% income tax + 12.2% employers NIC) to 32.39%.

Will the election work under US Generally Accepted Accounting Principles?
Yes. Our advice is that an election to transfer the legal liability can be structured in a way that does not trigger a charge to a company's profit and loss account as required under the variable plan accounting provisions included in the US Generally Accepted Accounting Principles.

When did the new rules come into effect?
The NICs and Income Tax provisions came into effect when the Child Support, Pensions And Social Security Bill and the Finance Bill 2000 respectively received Royal Assent on 28 July 2000. They can apply to all unapproved share options granted on or after 6 April 1999 where a gain had not arisen before 28 July.

Can I enter into one of these arrangements now?
It has been possible to enter into a voluntary agreement that allows recovery of secondary NICs since 19 May 2000 but it would have had no legal force until Royal Assent of the Child Support, Pensions and Social Security Act on 28 July. However, an agreement could not apply to any liabilities that arose before Royal Assent of the Act on 28 July.

For a joint election you will need Inland Revenue approval. Once approval has been received an election can be made to cover any option granted to the employee after 5 April 1999, provided that the liability for secondary NICs did not arise before 19 May 2000. Companies who wish to grant options now may therefore wish to agree with the employee that the option grant is conditional on such an election being made after approval is received.

B. Allowing employees to bear the employer's national insurance arising on share option gains

Background
Changes introduced in the Child Support, Pensions and Social Security Act 2000, which gained Royal Assent on 28 July, allow employers to ask their employees to bear the employer's (secondary) NIC arising on share option gains. There are two ways in which this may be achieved.

- First, the employer and the employee may make an agreement that some or all of the employer's NIC liability can be recovered from the employee.
- Second, the employer and the employee may make a joint election to legally transfer the liability for the secondary NIC to the employee.

Agreements and elections can only be made for gains on rights to acquire shares. These usually take the form of a share option.

Method 1 - Agreement for employee to pay employer's NIC
The NIC legislation does not allow the employer to ask the employee to pay any part of his secondary (employer's) liability for NIC. However, the legislation has now been amended to provide an exception to this rule. Employers and employees may now agree that the employee will bear some or all of the employer's NIC on share option gains.

What share options can agreements cover?
Agreements are only valid if they were made on or after 19 May 2000. They can cover any share option, which has been granted to an employee, but they will not be valid for any gains that were made prior to the 28 July 2000.

Agreements can be made in respect of any share option where a NIC liability may arise on the share option gain. This includes qualifying options for the purposes of Enterprise Management Incentives

What NIC can be recovered from the employee under an agreement?
The agreement may cover some or all of the employer's NIC that may arise on share option gains. For example, an agreement may be for the employee to pay 75% of the employer's NIC liability, or any employer's liability above a certain monetary amount.

What format should the agreement take?
That is for the employer to agree with the employee.

How should the NIC be recovered from the employee?
It is for the employer and the employee to agree how the employee will reimburse the employer. Many employees sell some of their shares when they exercise the share option to meet their income tax liabilities. One way of recovering the employer's NIC from the employee may be to extend this arrangement.

How does an employee receive the income tax relief where an agreement exists?
Finance Act 2000 introduced income tax relief for the employee on the amount of the secondary NIC that he pays on the share option gain, provided that it is paid within 60 days of the end of the tax year in which the gain occurred. When the gain is made income tax will be collected through PAYE in the usual manner. Employers will be able to operate PAYE on the amount of the taxable gain reduced by the amount of any relief likely to be available.

Example

Employee exercises an unapproved share option on 1/12/00 and makes a gain of £1,000. She has agreed with her employer that she will pay all of the employer's liability for secondary NIC.

Employee earns above the employee's upper earnings limit.
Employer's NIC is 12.2% of £1,000 = £122.

Employee pays the employer £122 on 7/12/00.

Income tax is collected through PAYE.
Amount on which PAYE is operated is £1,000 - £122 = £878.

What happens if the employee does not reimburse the employer within 60 days of the end of the tax year in which the gain arose?
Employees are not entitled to income tax relief on the amount of the secondary NIC if they have not paid it within the time limit. If they have not met the deadline and PAYE has been operated on the taxable gain net of the secondary NIC amount, then the employee will be required to pay back to the Inland Revenue the income tax relief already given.

Method 2 - An election to transfer the liability for secondary NIC on share option gains to an employee
Legislation has been introduced which will enable an employer to make an application to the Inland Revenue for approval of an election to transfer the liability for secondary NIC to the employee. If approval is obtained, the employer and employee can jointly elect to transfer some or all of the secondary NIC liability arising on a share option gain to the employee. Elections can

only be made when the Inland Revenue have given notice that they are satisfied with the form of the election and that the accompanying arrangements will result in the timely payments of secondary NIC by the employee.

The ability to make an election to transfer the liability has been introduced to overcome accounting difficulties for companies that report in the US, which would otherwise arise if the employer simply recovered the secondary NIC from the employee under Method 1.

What share options can elections cover?
Once approval is received, an election can cover:

a. existing options already granted after 5 April 1999, **provided that the gain was not made before the election was made** - but see (c)
b. a specific option or options to be granted at a future date
c. existing options already granted after 5 April 1999 where the liability arose after 18th May 2000 but before the 28 July 2000, **providing an election is made covering that option before 28 October 2000.**

What NIC liability can the election transfer to the employee?
The election may cover some or all of the employer's NIC that may arise on share option gains. For example, an election may be for the employee to assume all of the employer's NIC liability, or a proportion of it, or any employer's liability above a certain monetary amount.

How does an employee receive the income tax relief where an election exists?
Finance Act 2000 introduced income tax relief for the employee on the amount of the secondary NIC that is covered by a valid election. When the gain is made income tax will be collected through PAYE in the usual manner. Employers will be able to operate PAYE on the amount of the taxable gain reduced by the amount of any tax relief likely to be available.

What form should the election take?
An election must include the following:

a. details of the share options to which it relates, or of the period within which the share options to which it relates are intended to be granted
b. a statement that the election relates to any gain on which the earner is liable to pay contributions under section 4(4)(a)( ) of the Social Security Contributions and Benefits Act 1992 and an explanation of the effect of that paragraph
c. the amount or proportion (as the case may be) of the liability for secondary contributions to be transferred
d. a statement that its purpose is to transfer the liability for the secondary contributions referred to in paragraph (c) from the secondary contributor to the earner
e. a statement as to the method by which the secondary contributor will secure that the liability for amounts of contributions, transferred under the election, is met
f. a statement as to the circumstances in which it shall cease to have effect
g. a declaration by the earner that he agrees to be bound by its terms, and
h. evidence sufficient to show that the secondary contributor agrees to be bound by its terms

Will individual elections have to be made with each employee?
Each employee will need to make an election. But the election itself may be contained in two documents, one made by the employee and the other by the secondary contributor, in which case:

- the document made by the employee must contain the matters listed in paragraph (a) to (g), and
- the document made by the secondary contributor must contain the matters listed in paragraph (a) to (f) and (h).

This will enable an employer to make a generic election.

What format must the election be made in?
The election can be a separate document or an integral part of the option contract. It may be written or in an electronic format.

Will the employee need to complete separate payroll records?
No. The employer will continue to be the responsible for:

- preparing and maintaining the deduction working sheets (DWS),
- calculating the amount of NIC, and
- preparing the end of year returns in relation to the NIC that has been transferred to the employee.

The employer should continue to include the share option gain together with any other earnings on which NIC should be deducted on the DWS. The secondary NIC should continue to be recorded on the DWS in the column showing the total employees' and employer's NIC payable. It should not be included in the column showing the employee's contributions payable.

What type of arrangements will meet with Inland Revenue approval?
To help companies, we are being very flexible about the way that the employee can meet the secondary NIC to be paid by them under the election. Examples of an arrangement that are likely to meet with Inland Revenue approval are where a trust, an investment house or the employer withholds some of the share option gain from the employee to meet the liability.

The arrangements should however demonstrate the following:

- that the arrangements will result in the timely payment of the transferred NIC
- that the employer will be aware of when a share option gain has been made (so that he can meet his responsibilities for accounting and recording the NIC)
- that the employer will receive the funds from or on behalf of the employee in sufficient time to pass these to the Collector of Taxes within 14 days of the end of the income tax month in which the share option gain was made
- that the arrangements will work regardless of which country the employee is working in when the gain is made and where the employee is no longer in the employ of the company

What information should be provided on the arrangements in order to obtain approval?
This will depend on the nature of the arrangements but in all cases we will require:

- the name, address and capacity of each party to the arrangement
- copies of any agreements relating to the arrangements
- full details of the nature of the arrangements.

How does an employer make an application for approval?
The application should include the form of election that the employer wishes to use and details of the arrangements that will be used to collect the NIC transferred from the employee. The application should be sent to:

The Employee Share Schemes Unit
Inland Revenue
New Wing, Somerset House
Strand
London
WC2R 1LB

The ESSU will pass the applications on to the appropriate person to process.

When will the regulations be available formalising this process?
Regulations came into force on 10 October:

Where can I obtain more information?
The web site will be updated to include other frequently asked questions. If you have any further queries you may ring 020 7438 7783 for assistance.