Tax Representation

Tax Faculty

TAXREP 29/04

FORM 42 EMPLOYMENT RELATED SECURITIES: REPORTING REQUIREMENTS

Memorandum submitted in July 2004 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in relation to queries on Form 42

CONTENTS

FORM 42 EMPLOYMENT RELATED SECURITIES: REPORTING REQUIREMENTS

INTRODUCTION

1. Schedule 22 of the Finance Act 2003 set out a new regime for the taxation of employee share schemes. The new regime included new reporting requirements in respect of share transactions by employees and future or ex-employees. Details of share transactions need to be disclosed on new Form 42. We are concerned that this new requirement imposes an onerous burdens on businesses and needs to be modified.

WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 125,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).

4. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

GENERAL COMMENTS

5. We acknowledge that the previous reporting regime was poor and that a more rigorous regime was desirable to the Revenue. However, the new rules have gone too far in the opposite direction. There has been no adequate explanation of why the information is required nor of what the Revenue is going to do with it.

6. Our understanding from the Finance Bill 2003 debates is that section 421J was intended by Parliament as an information power for the purposes of Schedule 22. The Form 42 seems to require reporting of things that are clearly not within Schedule 22 and therefore go beyond the intention of Parliament. We can understand that the Revenue require reporting of transactions that fall within Schedule 22, or that would do so but for the fact that the company has formed an opinion that the shares have been issued at full value and on normal terms. Our

concerns are that the form also appears to require the reporting of transactions that are clearly not within Schedule 22.

7. We believe that there is no requirement under the legislation for taxpayers to report such transactions and that the form should make clear that it relates only to the Schedule 22 regime. It is this requirement to report transactions outside that regime that gives rise to a huge regulatory burden.

8. We are also most concerned at the way the reporting regime enacted in Schedule 22, Finance Act 2003 is being implemented. It is of concern that the 16 page Form 42 replaces a simple 2 page form and needs to be completed in respect of a much wider series of transactions. This is particularly an issue for those cases where there is no share scheme but merely shares that are issued or transferred in connection with a newly incorporated company.

9. Prior to 23 June 2004, the Share Scheme team handled all publicity in respect of Form 42 and pronouncements were only available on its section of the Inland Revenue's website rather than the general news page. Furthermore, the publication 'Share Focus' containing the team's guidance is not usually sent to general tax practitioners, most of whom will not anyway have considered it relevant unless any of their small incorporated clients were using share schemes.

10. The Revenue's interpretation of the scope of the reporting regime gives rise to an additional regulatory burden that appears at odds with the Government's aspirations to cut the burdens on small businesses.

11. Whilst we welcome the recently announced extension of the filing deadline to 6 September 2004, we are not sure that this is long enough given the work involved. We request that the deadline is moved to the end of the year so that taxpayers, their agents, and Revenue offices have the opportunity to approach this work in a considered manner.

12. The Revenue's expectations of the application of the new reporting requirements had not been explained in that the Working Together publication, which is sent to all agents, nor had it been discussed through that forum which is a natural place to discuss operational issues. If the content of this had been discussed with both the Operations Consultative Committee and Working Together, we would have hoped that a more practical, shorter, version could have been made available. Also user testing should have enabled the download problems of the past few weeks to be avoided.

SPECIFIC COMMENTS

Extension of share scheme reporting requirements to other occasions of share acquisitions

13. We are concerned that the extension of the share scheme reporting requirements to other occasions of share acquisitions was not the intention of Parliament.

14. Dawn Primarolo said during debates on the Finance Bill 2003:

"Schedule 22 provides a coherent, consistent and fair way forward for all those involved in share schemes. There is tax value when it is untouched and accessible by reason of employment. There are major avoidance schemes that need to be blocked". (Hansard, SCB, 22.5.2003, col 252).

15. And later

"A point to emphasise here is that the rules introduced by Schedule 22 seek to tax value obtained by reason of employment" (Hansard SCB 22.5.2003, col 256).

16. And further

"The new rules target only non-commercial, artificial manipulation which often involves substantial cash bonuses. Schedule 22 deals with employment-related securities".

17. It seems clear from these quotes that the intention of Parliament was that Schedule 22 should apply only where the shares involve "non-commercial, artificial manipulation" and accordingly no part of the Schedule should apply to straight forward share transactions that do not give rise to potential charges under the Schedule. However, the reporting requirements of Form 42 appear to extend the ambit of Schedule 22 (ie new s 421J) to create a regulatory burden related to transactions that are not only clearly outside the intention of Parliament, but which have no tax consequences either.

18. We also note that the Treasury's Explanatory Finance Bill Notes to s 421J states "This section derives from section 432 and 433 ITEPA 2003 in respect of the duty to provide information. It also gives the Revenue power to require a return from employers and others of employee benefits associated with securities". We believe that taxpayers are entitled to rely on this Treasury explanation, which seems to make it clear that the section is concerned only with situations where there is an employee benefit or potentially such a benefit.

Requirement to submit a return in the absence of a reportable event

19. Section 421J(3) ITEPA 2003 requires a responsible person to provide the Revenue before 7 July following the tax year with particulars of any reportable events that took place in the previous year.

20. Section 421J(4) enables the Revenue by notice to require any person to give such particulars of such reportable events as are required by the notice which take place in the period specified in the notice "or if no reportable event in relation to which that person is a responsible person has taken place in that period, to state that fact".

21. s 421J(10) enables the Revenue to specify the form in which particulars must be provided.

22. Following our analysis of this legislation we believe that:

- if a reportable event has taken place in 2003/04 a responsible person must complete a form 42 under s 421J(3);
- if no reportable event has taken place and the Revenue do not issue a form 42 to the responsible person there is no requirement to complete a form 42;
- if no reportable event has taken place but the Revenue issue a form 42 to that responsible person he is required under s 421J(4) and (10) to state that fact in the form specified by the Revenue, ie by ticking the box on page 16 of the form 42 and signing the declaration

We would be grateful for confirmation that our understanding of the rules is correct.

What constitutes a reportable event?

23. There are a number of circumstances which may give rise to a reportable event.

24. An acquisition of shares or securities "pursuant to a right or opportunity available by reason of the employment of the person who acquires the securities" is a reportable event (s 421K(3)).

25. However, if the acquisition is not "in connection with" the employment s 421J does not apply; because s 427(1) says that Part 7 of the Act (which includes s 421J) "contains special rules about cases where securities...are acquired in connection with an employment". Whether an acquisition is in connection with an employment is a question of fact. It seems to us to be different from "by reason of the employment." Certainly s 421B(3) cannot apply.

26. Accordingly we do not believe that there is an obligation to report share issues of ordinary shares which do not give rise to an employee benefit as we do not consider that such a transaction constitutes a reportable event. We believe that s 421K(3)(a) has to be interpreted in accordance with the context in which it is used. If these transactions are removed from the reporting requirements, this will remove much of the unnecessary complexity and ensure that transactions only need to be reported if they are likely to have tax consequences.

Further queries in relation to the definition of a reportable event

27. If a company is owned by three Directors who are also employees and one of the Directors wishes to leave the company, it is not unusual for the shares either to be bought back by the company or for these shares to be bought by the remaining shareholders (in accordance with the pre-emption rights). Is this a circumstance which is reportable? On the face of it, the company is merely re-organising its affairs when one of the shareholders/Directors wishes to cease their involvement with the business. If there is no tax charge, we do not think that such a transaction should be reportable

28. If an existing Director decides to make a gift of some of his shares, say 10%, to an employee or fellow Director for no other reason but that he likes the person, is this a reportable event? In cases like this, there would be no consideration and a holdover election would be signed under section 165, TCGA 1992.

29. If someone has subscribed for some shares to help in a business start up in, say, May 2003, and then some 10 months later in March 2004 this person becomes either a Director or employee of the company due to a change in circumstances not envisaged at the time of the original investment, is the original share issue reportable in respect of this individual?

Company formation agents

30. We are pleased to note that the Revenue response to Frequently Asked Question 1(v) states:

'Shares acquired by the company formation agent (initial subscriber shares) will not be employment-related securities and no report is required'.

31. However, we would like to know on what basis the Revenue consider that company formation agents do not have to complete form 42. Clearly if there is a statutory requirement to make a return the Revenue are not entitled to waive that statutory requirement for individual taxpayers. We do not ourselves believe that there is a requirement on company formation agents because when such a person acquires a subscriber's shares he clearly does not do so by virtue of the fact that he is going to become a director of the company until he finds a purchaser for it.

32. This seems to us no different to an entrepreneur who sets up a company acquiring shares. He equally clearly does not acquire his shares because he intends to become a director. He acquires them because he intends to set up a business and has chosen a limited company as the format in which he wishes to carry on that business

Subscriber shares

33. *In the following paragraphs we have used simple examples to demonstrate the situations under consideration.*

34. *Janet and John have just set up a new husband and wife company. They are both directors and have issued themselves shares and intend to remunerate themselves using dividends.*

35. We do not consider that the issue of shares to Janet and John who have just set up a new husband and wife company is a reportable event. The opportunity to acquire the shares is pursuant to the agreement between them, either as shareholders or as entrepreneurs; it is not pursuant to a right or opportunity available by reason of the employment. Furthermore, we do not think that it is pursuant to a right or opportunity made available by the employer, ie the company, so s 421B(3) does not apply to the initial subscription for shares. We therefore that in this respect the Revenue guidance is wrong and should be amended.

36. *After a couple of months, Janet and John each subscribe for further shares at par value so that their respective interests reflect the proportionate ownership rights that they want to have in the business.*

37. Again, we do not accept that in the case of a family company the share issue will have been provided by reason of the employment. Having established a required level of working capital, it will be the owners of a company that must contribute adequate funding with which to begin operating, not the employees.

38. *After a period of time, it is clear that Janet is spending more time in the business than the couple had planned and they decide that this justifies issuing her with more shares.*

39. Janet and John have become person's connected with the employer, so s 421B(3) will deem the right or opportunity to be provided by reason of the employment. This is therefore a reportable event. Would this still be reportable if the shares are issued at market value

40. *Janet later gives shares to John*

41. If the gift (or a sale, perhaps as part of a divorce) was in a personal capacity, it would not be a reportable event. If John has acquired more shares 'by reason of his employment' this will be reportable. The circumstances of each case would determine whether the transfer is reportable.

42. *Janet and John later give shares to their children*

43. Once again, we draw a distinction between shares acquired as a consequence of a family relationship and shares acquired by reason of employment. We understand that s 421B(3) provides that this will not normally be a reportable event but we would welcome clarification.

44. We would also welcome confirmation that in a situation where one spouse transfers shares to the other as a gift and 'Nil' is entered in the box as the proceeds, the Revenue will not seek to impose an income tax and national insurance charge, rather than it being dealt with as a CGT disposal and acquisition. The transfer will not have been made by reason of the employment, but will have been made in a personal capacity. Given that family companies fairly regularly pass shares between spouses and sons or daughters in succession, this could create considerable difficulty.

Company reorganisations

Share splits

45. Please confirm that this does not constitute a reportable event for the purposes of s 421K, ITEPA 2003.

Bonus issue

46. Please confirm that this does not constitute a reportable event for the purposes of s 421K, ITEPA 2003.

Share options

47. Further to s 420(5)(e) ITEPA 2003, these are not securities for the purposes of Form 42 requirements. Presumably there will only be a reportable event when the options are later exercised.

Elections under s 431(1)

48. Schedule 3a of Form 42 makes no reference to prior elections. Some taxpayers may have made s 431(1) ITEPA 2003 elections on incorporation to guard against any subsequent income tax charge on events in the future. They will have paid income tax on the value for their shares when they were acquired as if they were unrestricted securities, so that the income tax rules relating to restricted securities do not apply. With conventional share schemes this will be more of an issue for 2004/05 and subsequent years. We should like confirmation that if you make a s 431(1) election, subsequent events do not have to be reported because s 431(1) disapplies s 425-430, so there is no s 427 chargeable event to report.

Residence exclusion

49. There is no reference in S421K to S421E (residence exclusion). For instance, as it stands, S421K(3)(a) requires the report of all securities options granted anywhere in the world. This is clearly not what is intended, but the Revenue has said nothing publicly on the matter. We have been left to infer that options are only reportable if there is a UK connection. This should be clarified for the future.

Public subscriptions

50. If the Revenue's interpretation of section 421J is correct then it appears that a public share issue to which employees happen to apply will be a reportable event even though section 421F contains a specific exclusion to prevent such an event triggering a charge under Schedule 22. We believe that this demonstrates that section 421J must be limited to events within Schedule 22.

51. The Paymaster General gave the following assurance on this point during last year's debates.

"Where shares are acquired as part of a public offer, the rules provide that they are not employment related. Amendment No 25 [an Opposition amendment] is designed to take account of public offers where certain provisions are made and to ensure that in such cases the shares do not become employment related. However, provided that the employees in such circumstances pay the same price for the shares as other members of the public - so they are not receiving a preferential price because they are employees - the shares will be accepted as being within a public offer. There is therefore no need for the amendment. It is quite clear what happens in such circumstances". (Hansard, Standing Cttee B, 22.5.2003, col 264)

We would welcome clarification that such an acquisition is not a reportable event.

Administrative points

Use of Form 42

52. We are pleased to note in the Revenue's frequently asked question Q1(y) published on 23 June 2004that although Form 42 is the form prescribed for making a return, the responsible person may use his own form, spreadsheet or letter provided that this gives the required details.

All-employee unapproved arrangements operated by large companies

53. Apart from husband wife companies and small family businesses, the new reporting rules result in a heavy administrative burden for large companies operating completely innocuous all-employee unapproved arrangements, such as share purchase plans. The taxable benefit for each employee is not particularly large, but, depending on the arrangements, with dividends and purchase discounts tax may arise in a number of ways, for instance, under Chapters 3C, 4, or 5. Moreover, very small differences between the cost of employees purchasing shares out of savings and the market value of shares on the date of receipt need to be shown on the return. There is no flexibility in the new arrangements.

Other practical matters

54. Box 8 asks whether PAYE/NIC has been operated. In the case of all newly incorporated small companies, we would expect the answer to be no.

55. On page 16 of the form, the name of the company and corporation tax and PAYE reference are again requested - that is a duplication of the information which has been asked for earlier in the form and these should be deleted.

56. The end of the form requires, apparently, a signature by either a Company Secretary or acting Secretary. This is most unusual as virtually all other corporation tax returns or forms can be signed by a Director or an authorised officer. Is this restriction intentional?

57. On the form (looking at 2.d, for example) does only one restriction apply or do all the restrictions have to apply. i.e. "The securities may be forfeit at some future time" and "There is a restriction etc" Should this be "And" be "or"?

58. It has been said that the Revenue needs information about certain non-chargeable events because the employer may be entitled to a tax deduction. There is also the question of providing information to employees to help them complete their tax returns. It is possible that the information will eventually find its way onto the employee's file in the Revenue. If this results in a S9A enquiry because the Revenue wants to challenge the valuations, the employee may be caught cold and will be aggrieved. We believe that employees should be entitled to a copy of returns made of their share benefits whether or not there are taxable amounts to show on personal tax returns

Which Revenue offices will process these forms?

59. We would like further consideration to be given to whether in future these returns should be issued and processed by Employee Share Schemes, or by local districts. The latter would be preferable because whatever agreements the employer reaches with the local inspector on the taxation of share plans may more easily be reflected in the return, particularly if the return allows for comments. Returns processed by Employee Share Schemes will presumably be rejected if not totally in accordance with the rules.

Certifying market value

60. There is a question as to what is the market value of securities when they are acquired. In the case of a newly incorporated small company, normally one would expect the market value of the shares is likely to be close to, or equal to, par value. No-one is likely to want to buy a company with just share capital on the Balance sheet for the amount originally subscribed. Will it be necessary in these circumstances to have to agree a value with share valuation division.

61. Indeed, it may be that the market value of a new company is less than the amount subscribed for the shares. Does this mean there is a loss? Does this mean that this can be offset against earned income? [What is our view on the issue?]

62. Most of the small limited companies have a pre emption clause in the Articles. It will be difficult to value the shares on the basis of their unrestricted market value when the restriction is never likely to be lifted.

63. We are also concerned that it will be difficult to certify market value, particularly for shares subsequently issued or in cases where a trade is subsequently transferred into the company and the adviser is only acting as the incorporation agent.

National Insurance numbers

64. As part of the information requested on line 2A, the form asks for the employee's name and national insurance number. It is not unknown for individuals not to have a national insurance number. They may be foreign nationals who have only recently come to the UK and they may not be in employment. We understand that forms without a national insurance number may be rejected. We would welcome clarification that the form will not be rejected where employers use their best endeavours to obtain this information.

65. Furthermore, please could the Revenue clarify that where employees who do not have a real NINO use a temporary NINO, in the format "TN date of birth M or F", this will be acceptable.

Technology

66. The current form does not allow any database similar to that used for Forms P11D per the employers' CD ROM so that it could be mail merged. We request that the Revenue gives serious consideration to combining the technology for this

information? Furthermore we should like to clarify the position regarding PAYE reference numbers. We are of the view that this should only be incorporation number as some companies may never have a PAYE reference number.

Interaction of securities options taxable under Chapter 5 and restricted securities taxable under Chapter 2

67. A further point concerns the lack of a interaction between the rules for the taxation of securities options under Chapter 5 and the restricted securities taxable under Chapter 2. If you have a securities option on which dividend equivalents are payable (not uncommon with LTIPs), the Revenue view is that the securities option is a security in its own right. But it does not cease to be a securities option as well. It is unclear whether the award should be reported at 1a or at 2c. There is no need to report at 2c if the 'security' is restricted for a period of less than five years, although it could be reported at 1a with a disclosure. The Revenue needs to provide more guidance on this issue, otherwise reporting practice will be inconsistent from year to year, as between award and vest, and employers will end up confusing themselves as well as the Revenue.

Reporting by small newly formed companies

68. We recognise that the Revenue may insist upon retaining this new regulatory burden despite our view that there are no legitimate grounds for so doing. If this is the case then the Tax Faculty would be supportive of a 'two form' process to replace the single Form 42, which as discussed earlier is too long and over complex. Combining some of this with the CT41G would be a sensible approach given the new powers on that form included in the Finance Bill 2003. Wee would also welcome improved guidance notes on the form.

Definition of 'employee'

69. If only the husband is a Director and the wife is Company Secretary, should both of their shareholdings be entered. It may be that the Company Secretary receives no remuneration whatsoever - is that person still looked upon as holding shares by virtue of employment?

70. Where a new company is set up with subscriber shares and the company is under the EIS regime, it is necessary and normal for Directors to be appointed who may or may not also be employees after the shares have been issued. In these circumstances, they are normally getting their shares as investor's/ business angels and it is only subsequently that they are then being appointed as a Director/employee. Are shares issued in this way also reportable?

71. What is the position where shares have been issued and somebody becomes a non-Executive Director? Is the share issue to be deemed to be in connection with an employment [regardless of timescales]? Under company law they would receive directors fees not emoluments.

72. Please will you confirm what the position is when a company is acquired in exchange for shares and the shareholder remains a director? We would appreciate

general clarification on this point particularly as there may be restrictions on selling the shares for a certain period of time (for example, if listed). This issue potentially affects which box in form 42 is used, if applicable, and whether joint elections should be signed.

AM
9.7.04