

Giving shares to employees

(Lecture P1185 – 18.54 minutes)

Basic provisions

Businesses often consider offering shares to their employees as remuneration and reward. This can be by way of an option to acquire shares, either through one of the approved schemes or an unapproved scheme. The employee is given an option to acquire shares in the company at a specified price in the future. The treatment will depend on the nature of the scheme. Directors are often key employees and will be offered these types of incentives. Where these notes refer to employees, the provisions equally apply to directors.

However, there can be other circumstances in which employees can find themselves as shareholders without having received those shares through an option scheme, normally simply by being awarded shares by the employer.

Any shares acquired by an employee by virtue of their employment are called 'employment related securities' and are subject to a vast tranche of anti-avoidance legislation mainly due to the creative way in which shares and share schemes were used to mitigate tax and National Insurance Contributions in the late 1990s. This means the rules are complex and employers may find themselves having to deal with difficult issues even where what they are doing is not motivated by a desire to avoid tax.

General principles

This legislation does not apply just to shares, but to all securities as defined by s.420 ITEPA 2003. This encompasses shares, loan stock and other debentures, futures, units in collective investment schemes and instruments conferring rights over securities. It also includes rights under phantom share schemes although these are really just cash bonus schemes and so normally not dealt with under these rules.

The legislation can only apply to securities acquired by reason of the employment (s.421B ITEPA 2003); this can include former or prospective employments. However, any right or opportunity to acquire securities given by the employer is treated as by virtue of the employment unless the person offering the right or opportunity is an individual and is made in the course of normal domestic or personal relationships. HMRC have become much stricter on this particular point. For example, they had previously accepted that employees undertaking MBOs via a new company vehicle were obtaining shares in that vehicle as entrepreneurs and not by virtue of their employment. This is no longer acceptable; it has made the structuring of such transactions difficult.

Considering the exclusion of shares transferred by reason of domestic relationships, the important point to note is that this only applies where the transferor is an individual so the company cannot issue new shares to the employee; they must receive the shares from the individual with whom they have the domestic relationship.

ERS (employment related securities) are taxed under the general principles relating to employment income, falling within s.62 ITEPA 2003. This means that any ERS received for which the employee pays less than market value will be taxed on the difference as employment income. This principle was established in the case of *Salmon v Weight*.

It would be useful if the regime relating to ERS was as simple as that! Since the basic tax charge is calculated as being the difference between the market value and the price paid, it would be in the interests of employers to minimise the market value to mitigate the tax payable by the employee. This can be done in various ways and legislation has been put in place to counter all of the common devices to reduce value. It is this legislation which causes such significant problems when considering the taxation of ERS. It should be noted that the legislation detailed below operates in addition to any tax charge which arises under general principles i.e. it does not supersede a general charge under s.62 ITEPA 2003 on acquisition of securities except in particular circumstances.

Anti-avoidance legislation

The basic principles relating to ERS are then enhanced by the stringent anti-avoidance legislation often generically referred to as the 'Schedule 22' provisions although these are now found in Part 7 of ITEPA 2003. If the securities have certain properties, there are ongoing tax consequences. In basic terms, where the legislation applies, increases in value after issue of the shares may be liable to tax as employment income rather than being taxed under the often more beneficial capital gains tax code. An employee often assumes that they will get capital gains treatment of gains on shares but are then caught by employment income rules creating a considerable unexpected cost.

The legislation catches the following situations:

- Restricted securities;
- Convertible securities;
- Shares which have been artificially suppressed in value;
- Shares which are artificially enhanced in value;
- Shares acquired at less than market value (not caught by general legislation);
- Securities disposed of for more than market value;
- Post-acquisition benefits received in relation to ERS;
- Restricted securities.

One of the easiest ways to reduce the market value of securities is to restrict the rights on the shares or make them subject to forfeiture in particular circumstances. Although many such restrictions will be for commercial reasons, for example to retrieve shares from employees who leave their employer, many were used for tax avoidance purposes. This led to the introduction of stringent anti-avoidance legislation on any shares which fall within the definitions of restricted securities.

Securities are defined in s420 Income Tax (Earnings and Pensions Act) ITEPA 2003. Restricted securities are then defined in s423 ITEPA 2003.

There are three types of restrictions which will bring an ERS within these provisions but only if the restriction reduces their market value. The three types are as follows:

1. there will be a transfer, reversion or forfeiture of the ERS on the operation or non-operation of a specific event and the person will not be entitled to compensation at least equal to their market value at that time;
2. there are restrictions on the freedom of the person holding the ERS to dispose of those ERS or retain the proceeds of the sale; or
3. there are any provisions under which disposal or retention of the ERS may result in a disadvantage to the holder, the employee or any person connected with them.

There are exceptions to these rules. Shares will not fall within these provisions if:

- shares are unpaid or partly paid and will be subject to forfeiture if the calls are not met; or
- the individual must dispose of the securities where employment is ended because of misconduct.

UNLESS the main purpose (or one of the main purposes) of the issue of the ERS was the avoidance of tax or National Insurance Contributions (NICs).

Where there are ERS which are restricted securities, there is no charge on acquisition under s62 ITEPA 2003 if the restriction is the type under the first heading shown above and they will cease to be restricted securities within five years of acquisition. This arises because of s425 ITEPA 2003.

It is possible to elect to disapply this under s425(3) ITEPA 2003 i.e. to have the tax charge remain in place. There are a number of conditions that need to be fulfilled. It will be seen later why it might be advantageous to do this.

There is a charge to tax in relation to restricted securities on the occurrence of a chargeable event. The following are chargeable events:

- The shares ceasing to be restricted;
- Variations being made to the shares without them ceasing to be restricted securities; and
- Shares being disposed of for consideration whilst still being restricted.

There is no charge under the rules if all of the following apply:

- The ERS are shares in a company of a particular class;
- The provision (by virtue of which the ERS are restricted securities) applies to all the company's shares of the same class;
- The event which affects the ERS has not been done as part of a scheme or arrangement the main purpose (or one of the main purposes) of which is the avoidance of income tax or NICs;

- All the company's shares of the class (other than the ERS) are affected by an event similar to that which is a chargeable event in relation to the ERS; and
- EITHER the company is employee controlled by virtue of holdings of shares of that class OR the majority of the company's shares of the class are not ERS.

The legislation tells us that the formula for calculating the tax charge on the happening of a chargeable event is:

$$\text{UMV} \times (\text{IUP} - \text{PCP} - \text{OP}) - \text{CE}$$

- UMV is the unrestricted market value
- IUP is the initial untaxed proportion
- PCP is the previously chargeable proportion
- OP is the outstanding proportion
- CE is the amount paid.

The rationale behind this is discussed below – it is not as complicated as it looks!

It is useful to understand the rationale behind this formula. The charge on initial acquisition of the shares is based on the market value of the restricted shares which takes into account the restrictions attaching to the shares. If they had no restrictions the market value would be higher. This higher value is known as the IUMV – initial unrestricted market value.

As restrictions are lifted the actual market value (AMV) of the shares moves closer to the unrestricted market value (UMV). The proportionate increase in AMV is taxed at that time using the above formula.

There are tax elections which the employer and employee can make:

- An election to ignore the restricted securities rules and take the unrestricted market value into account on acquisition of the shares (s431 ITEPA 2003); and
- An election to ignore the future outstanding restrictions on a subsequent chargeable event (where not all restrictions are lifted) (s430 ITEPA 2003).

Where the main purpose of the issue of ERS is for the avoidance of tax or NICs, then the election under the first heading above is treated as being made automatically so the charge on acquisition will always be made by reference to the unrestricted market value.

Why might such an election be made? This is probably best illustrated by an example.

Example 1

a) Restricted shares are acquired with a market value of £7. The unrestricted market value at that date is £10. £7 is paid for the shares.

What is the tax charge on acquisition?

MV at acquisition (restricted)	7
Less: amount paid	(7)
Taxable	=

If an election under s431 is made to ignore the restricted securities rules:

MV at acquisition (the IUMV)	10
Less: amount paid	(7)
Taxable	<u>3</u>

There will be no further tax charges as the unrestricted market value has been used.

b) A chargeable event occurs at which time AMV = 12 and UMV = 15. What is the charge assuming no s431 election was made?

Applying the formula: $UMV \times (IUP - PCP - OP) - CE$:

$$15 \times \left\{ \frac{10 - 7}{10} - 0 - \frac{15 - 12}{15} \right\} = 1.5 \text{ charged}$$

If an s430 election is made:

$$15 \times \left\{ \frac{10 - 7}{10} - 0 - 0 \right\} = 4.5 \text{ charged}$$

c) A second chargeable event occurs when AMV = 15 and UMV = 16.

Assuming no s431 or s430 elections were made on past events:

$$16 \times \left\{ \frac{3}{10} - \frac{1.5}{15} - \frac{16 - 15}{16} \right\} = 2.2$$

If an s430 election is made:

$$16 \times \left\{ \frac{3}{10} - \frac{1.5}{15} - 0 \right\} = 3.2$$

d) A third chargeable event occurs when AMV = UMV = 20 when all restrictions are lifted.

Assuming no previous elections:

$$20 \times \left\{ \frac{3}{10} - \left(\frac{1.5}{15} + \frac{2.2}{16} \right) - 0 \right\} = 1.25$$

In summary:

	S431 election	S430 election after event 1	S430 election after event 2	No election
On acquisition	3	-	-	-
After event 1	-	4.5	1.5	1.5
After event 2	-	-	3.2	2.2
After event 3	-	-	-	1.25
Total tax charge	3	4.5	4.7	4.95

The elections have resulted in earlier charges to tax but less charge overall. If the share value has decreased over time then the election would have resulted in a higher charge.

The advantage of the s431 election is to give certainty of the charge on acquisition and if the share values increase dramatically, the difference in overall tax payable can be significant. It is important to acknowledge, however, that the tax charge would not be repaid if the value of the shares goes down and clients must realise that risk.

In reality, it is fairly standard to put a s431 election in place and the difference in value is often nothing like as extreme as is suggested in examples such as that above.

Convertible shares

Convertible securities are those which have a right of conversion into other shares or securities. The right to convert does not have to be exercisable only by the employee but the right of conversion must exist at the time of acquisition by the employee.

The legislation operates in a similar way to the restricted securities provisions. The initial tax charge is based on the market value as if the shares were not convertible unless the main purpose for the arrangements is the avoidance of tax in which case the right to convert is not ignored.

There is then a tax charge on a later chargeable event. These chargeable events are:

- Conversion of securities;
- Disposal of securities whilst they are still convertible;
- Release of entitlement to convert.

The formula for the taxable amount is as complicated as that for restricted securities but is rarely encountered in practice. Basically, it brings into charge to income tax the uplift in value which the individual gets on conversion or on disposal. If there is a release of entitlement to convert, any amount received is taxed as income.

Shares with artificially enhanced market value

The major catch-all piece of legislation relating to securities that have an artificially enhanced market value has been very widely drawn and would have caught many of the abuses that were used in the past as tax-saving measures in connection with employee shares.

This is a rather nasty provision as it potentially charges tax on an annual basis in respect of artificial increases of 10 per cent or more per annum in the value of securities. A considerable amount of monitoring will therefore be required on the part of a company whose shares are rapidly increasing in value.

There will be a danger, on occasion, that HMRC will seek a tax charge under this provision because they see the share value of a fast-growing business as increasing other than by genuine commercial means. However, this should not be the case unless there is some element of artificiality, for example the use of non-arm's length transactions (whether intra-group or with non-corporate shareholders); eliminating or devaluing some shares to enhance the value of others; or the use of alphabet shares.

Where there is an increase of more than 10% over the charging period (which will normally be the tax year) then a tax charge will arise on the difference between the market value and market value if non-commercial increases were disregarded. You ignore the effect of any restrictions on the valuation but then restrict the tax charge based on the restrictions (on the basis that this will come into charge under the restricted securities provisions at some point so does not need to be taxed here).

Shares with artificially depressed market value

This legislation is specifically designed to catch or deter the avoidance of tax using depreciatory transactions. It has been drawn up in order to deter the issue of securities to employees that have an artificially depressed market value, i.e. one achieved by means other than those having genuine commercial purposes. Once those factors ceased to apply, the value of the shares would be enhanced, potentially free of income tax charges.

This legislation was also extended to cover situations where securities are disposed of or cancelled.

Charges can also arise at 5 April if there has been a post-acquisition depreciatory transaction relating to restricted securities at any point during the previous seven tax years.

As in the case of securities with artificially enhanced market values, it may often be a matter of judgment as to whether a transaction falls within this legislation. Regrettably, HMRC have no procedure for offering advance clearances.

A charge on acquisition applies where the market value of the employment-related securities at the time of acquisition has been reduced by at least 10 per cent as a result of 'things done otherwise than for genuine commercial purposes within the period of seven years ending with the date of acquisition'. In these circumstances, the employee will be treated as receiving employment income for the tax year in which the acquisition occurs. The taxable amount is the market value at the time of acquisition assuming the actions that have suppressed the value did not happen less the actual market value at the time of acquisition.

Securities acquired for less than market value

On the face of it, this legislation seems strange as there is a basic charge under s62 ITEPA 2003 if someone acquires shares for less than market value. However, this legislation at Chapter 3C is aimed at two scenarios:

1. Where a non-UK resident employee acquires shares in circumstances where there is no UK tax charge (although this is less common since 6 April 2015) or
2. Where an employee agrees to pay or subscribe full market value for the shares but the acquisition or subscription price is left outstanding.

The tax charge is based on an assumption that the amount not taxed is a notional loan and therefore that a notional loan benefit arises each year for which the amount is outstanding. If there is no payment of the 'loan' when the shares are sold (which might have been the case with non-resident individuals) there is a supplementary tax charge when the notional loan is deemed to have been discharged.

It should also be noted that the notional loan rule does not apply if the main purpose of the arrangements is the avoidance of tax or National Insurance contributions in which case the amount of the notional loan is employment income in the year of acquisition.

Shares disposed of for more than market value

Where ERS are sold for a consideration that exceeds their market value, there may be a charge under Chapter 3D. Market value is taken to be the same definition as applies for capital gains purposes.

The taxable amount is the disposal consideration less the market value of the time of disposal less any expenses of disposal. This clearly converts a capital gain into income tax and will particularly tax situations where an employee is guaranteed a minimum sale price by their employer.

The case of *Gray's Timber Products Ltd v R&C Commrs* considered this point.

The company's managing director, on taking up his position, had subscribed for shares in the company's holding company. That holding represented five per cent of the issued ordinary shares. The director and the majority shareholders then entered into a subscription and shareholders' agreement which provided, amongst other things, that, in the event of a change in control, the other parties to the subscription agreement were to procure that the director's original shareholding be purchased on terms which would give him an enhanced payment, in addition to the return of his original investment, disproportionately greater than the amounts received by other shareholders or his percentage of the equity shares. Thereafter the entire share capital of the holding company was sold to an unconnected third party. The total consideration paid was £5,903,219, of which a total of £1,451,172 was paid to the director.

HMRC contended that those shares, as employment-related securities, and sold as part of the sale of the whole share capital of the holding company, were sold for more than their market value. Consequently, they contended that the sale occasioned a charge to income tax. By contrast, the company maintained that the shares in question were sold for their market value, so that the whole of the consideration received by the director fell to be brought into computation of his capital gain on the disposal.

The special commissioner concluded that the director's disposal of his shares was taxable as income as he had disposed of his shares for more than their market value. The market value of each and every £1 ordinary share was calculated simply by taking the total paid by the outside purchaser, namely £5,903,219, and dividing that figure by the number of ordinary shares issued. The company appealed but lost (by a majority) in the Court of Session (*Gray's Timber Products Ltd v R & C Commrs* [2009] BTC 589). When, as in the present case, there had been an arm's length disposal of a whole class of shares, the market value of individual shares, and of holdings of such shares, falling within that class, would normally be obtained by dividing up the total consideration paid by the number of shares sold. When personal arrangements relating to an individual shareholder, whose shareholding fell to be treated as employment-related securities, resulted in that shareholder receiving what amounted to a disproportionate proportion of the total consideration paid by the purchaser of the whole class of shares, then the provisions came into play. There was no dispute that the director had received a disproportionately greater amount for his shares in the equity share capital of the company than its other shareholders did.

The subscription agreement foresaw that as a possibility which had materialised. Accordingly, it resulted in the application of the relevant legislation.

The company lost again in the Supreme Court (Grays Timber Products Ltd v R & C Commrs [2010] BTC 112). In estimating the market value, attention had to be focused on the asset that needed to be valued. In this case it was the rights attached to the shares acquired by the purchaser, no more and no less. In the present case, the valuation did not have to take account of the actual sale of G's shares at a special price enhanced for reasons of G's special position as managing director. There was no escape from the conclusion that the enhanced payment that G received was caught by these provisions.

Post-acquisition benefits

There is a final piece of legislation that needs to be considered – s447 ITEPA 2003 which charges an employee who 'receives a benefit in connection with employment-related securities'. The benefit is then charged to income tax in the year it is received. It does not apply if the benefit is otherwise chargeable to income tax unless something has been done which effects the ERS as part of a scheme the main purpose of which is to avoid tax or National Insurance contributions.

An example might be a company paying dividends as part of scheme to replace remuneration in order to reduce tax liabilities. Chapter 4 could be applied in that case, notwithstanding that dividends would be taxable. Another example where the legislation might apply in general terms might be amending the company's articles to improve the rights of certain shares leading to an increase in value.

Contributed by Ros Martin