Share plans during the sales process

Tax voice



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Fiona Bell considers the due diligence process – is there a problem, how much and who is responsible?

Participants in share plans, usually employees, will frequently be incentivised to achieve targets in return for the opportunity to share in the profits on a sale.

During a sale process both the buyer and sellers will be looking to see whether any profit is taxable as a capital gain, typically the responsibility of the selling employee, or an income taxable gain, which may fall on the buyer to administer, or a combination. There is the further issue of whether any corporation tax deduction will

be allowable under chapter 12 Corporation Tax Act 2009 but that is not covered in this article.

During a sales process, a detailed review of the set up and operation of any of the four tax advantaged plans (plus employee shareholder status shares which may still be held) is essential to be satisfied that the intended tax reliefs are available.

Further, many of the owners may also be directors or employees so that their shareholdings could come under scrutiny to see if an anticipated capital gain could be redesignated as subject to employment taxes.

Is there a problem?

Employment-related securities

For sales of private company, it is quite common that all the shares are employment related securities (**ERS**) or a securities option and within the scope of Part 7 (**Part 7**) Income Tax (Earnings and Pensions) Act 2003 (**ITEPA**). It is also worth considering if there are any other securities that can fall within this scope such as loan agreements, interests in warrants, unit trusts or similar instruments falling within the statutory definition (section 420 ITEPA).

Deeming provision

Persons who acquire securities by reason of their own or another's employment fall within the ERS legislation (sections 421B(1) and 471(1) ITEPA). In addition, employees who hold shares made available by their employer or a person connected with their employer (e.g. a majority shareholder) are deemed to have acquired their shares as an employee (sections 421B(3) and 471(3) and (4)). Directors are treated as employees for these purposes (section 5 ITEPA). Former employees/directors generally remain liable but for Chapters 2-4A Part 7, the liability ends on death and also 7 years after ceasing to be a relevant employee (section 421B(7).

A limited exemption to the deeming provision arises where securities are made available by an individual (not a trust or corporate) and it is in the normal course of the domestic or personal relationships (section 421B(3) and 471(3)). This exemption is often thought to have wider application: 'I've known and worked with him for 30 years so I gave him some shares' can be thought to be sufficient but in practice this

argument does not tend to be acceptable to HMRC on the basis, perhaps, that the donor of the shares only made the gift because of the work relationship, though if the donor was generously passing over gifts of shares at the same time to a selection of old university pals outside the business but known for 30 years there could be a stronger argument.

Family gifts are not automatically outside the deeming rule. A grant of an option over shares to a daughter employed in the business at the same time as grants to employees may not benefit from the exemption but if the award is larger and a comparable gift is made, perhaps to a son outside of the business (say help with buying a house) the situation may be less clear. The analysis will be completely fact sensitive. The Employment Related Securities Manual sets out some examples (ERSM20220). If there is uncertainty about the problem, HMRC will normally respond to a non-statutory clearance on the point, if there is time to do this during a sale process.

Employees, consultants and directors

Employees and directors are therefore within the scope of ERS but what about consultants and contractors? Putting aside the potential argument that a consultant or contractor is mis-designated and is really an employee, if they are a director or employee of a personal service company, shares held or acquired on an option exercise by the individual may be ERS with respect the employee/director relationship with their personal service company. Buyers will be concerned to ensure this liability does not become the responsibility of the company/group they are buying.

Chargeable events

Part 7 creates a range of chargeable events. Here is a quick run through of the main ones:

Restricted shares (Chapter 2 Part 7): Unless shares are quoted on a stock exchange, it is rare for them to be free of restrictions under the articles of association (e.g. the Model Articles (ref) contain a standard provision allowing directors to refuse to register shares), under shareholder agreements (typically restrictions on transfer or drag rights to oblige a sale along with a majority) or in the individual share subscription agreement. Without a section 431 election (see below)

chargeable events include the disposal of the shares, the removal or variation of the restrictions on those shares, which can be created by the removal or variation of the rights attaching to other shares.

Convertible securities (Chapter 3 Part 7): The conversion of shares, e.g. from B ordinary shares to A ordinary shares immediately before a sale creates a chargeable event. This can often be treated as the removal of a restriction, which might be covered by a section 431 election, but if not will trigger a separate chargeable event.

Acquisition of shares at less than market value (Chapter 3C Part 7): This treats the under value as notional loan with an annual charge and so potential for many years of underpayment if this has been missed but often the appropriate event falls under Chapter 5 below since it is the acquisition of ERS pursuant to a right or opportunity to acquire the ERS.

Disposal of shares at more than market value (Chapter 3D Part 7): Are shares to be sold in the current transaction, or is there evidence that shares were sold in the past at more than the market value? Market value has the meaning in section 272 and following Taxation of Chargeable Gains Act 1992. This article is not the place to analyse that in detail but a common situation is where a majority director/shareholder sells shares to employees for a price closer to the majority value of the shares without any discount for minority interest. In that situation, the director may have disposed of the shares at an over value creating an employment tax liability. *Grays Timber Products Limited v Revenue and Customs Commissioners* [2010] UKSC 4 considers this matter further and analysis may be required to identify if any over-value is due to inherent share rights or taking on additional responsibilities under the share purchase agreement.
Post-acquisition benefit (Chapter 4 Part 7): This is a broad provision bringing in a range of possible events where a person receives a benefit in connection with ERS. On a sale this might include a situation where one shareholder receives a larger share of the sale proceeds (perhaps a higher per share price).

Exercise of an option (Chapter 5 Part 7): If the option does not qualify for relief (an unapproved option) from the start the position is clear. However, if the option purports to be a company share option plan (CSOP – schedule 4 ITEPA), share save option (SAYE – schedule 3 ITEPA) or enterprise management incentive (EMI – schedule 5 ITEPA) then,

- were the options correctly granted according to the qualifying requirements?
- did the paperwork comply with the statutory requirements and HMRC interpretation (e.g. for EMI options?
- were the restrictions on the shares properly summarised and did the employee give the working time declaration within the time limits)?
- was the plan properly registered with HMRC, were EMI awards notified within 92 days or was there a reasonable excuse application?
- were annual returns made (particularly relevant for CSOP and SAYE, and Share Incentive Plans (see Schedule 2 ITEPA, albeit SIPs don't involve options)?
- have there been any amendments to the options, e.g. changes to allow options to be exercised or vest early, or to allow cashless exercise that were not permitted under the rules as these might create additional rights not within the scope of the relief?
- were there changes to share rights through the articles affecting the qualifying status after the option grant?
- does the option exercise benefit in whole or part from employment tax relief, e.g. for a CSOP exercise within 3 years does it meet the tests in section 524, particularly sub-section (2E) ITEPA and for EMI options, was the option granted at a discount from the market value creating a partial employment tax liability?

Outside of Part 7, where there are internationally mobile employees, even if they are not resident at the time of the award or at the time of the sale, if the employee with ERS had been resident at some stage, Chapter 5A ITEPA may apply so that part of the gain is apportioned to be taxable in the UK.

Section 431 Election and NIC Election

There is a common belief that a section 431 election and/or an NIC election will solve all the problems related to restricted shares. Unfortunately, this election is not a universal 'good' but if the valid elections exist then the company may have some protections.

The section 431 election will generally ignore the valuation impact of all restrictions on securities meaning that the values on acquisition are taken to be the unrestricted market value. This might increase tax liabilities when shares are acquired but prevent a restricted securities charges on subsequent event. Points to consider are:

- was the election signed by the employee and employer within 14 days from the date of acquisition?
- was the election limited, e.g. only covering certain of the restrictions?
- did it contain the correct detail, e.g. the right number of shares and employer?
- does there need to be a section 431 election, e.g. EMI options have a deemed election (section 431A ITEPA) but most advisers require it anyway. If shares are acquired immediately before a disposal, will there be an increase in value that requires an election?
- non-UK residents cannot complete a section 431 election so if shares or share rights were awarded while non-resident, a valid election cannot be made to cover a disposal when a UK resident?
- on an exchange of securities (e.g. a share for share exchange) a section 431 election does not apply to the new securities but a valid election will continue to apply (section 430A(6) and (7)), which means it is necessary to match the elections with the original acquisition?

A NIC election transfers the liability for the employer's secondary Class 1 NIC liability to the employee in respect of certain charges (see paragraphs 3A and 3B Schedule 1 Social Security Contributions and Benefits Act 1992). Sellers may seek to rely on an election but while HMRC has a standard form, it is only effective if HMRC has given its approval to both the form and the related arrangements. Alternatively, an agreement or indemnity by the employee to cover the contributions, usually alongside an authority for the tax liabilities to be deducted from sale proceeds, will not dislodge the responsibility of the employer to make the contribution but the employee will be required to reimburse the employer under the terms of the agreement.

How much?

An overlooked or slightly late tax return might create a £100 penalty or there could be £1m of gains on shares of a non-resident. In a sale process, some tax implications might not be considered material by a buyer so it is important to be able to quantify a potential liability.

In many cases gains can be easy to quantify, e.g. an option is being exercised for £5,000 and the shares will be sold for £20,000.

The much more difficult situation is when shares were acquired, or options granted, long before any transaction and without a formal valuation at the time and/or HMRC agreement. In the context of the time and cost constraints of a transaction, information may not be available to make a definitive assessment as part of a due diligence process. HMRC will no longer agree post transaction values but where EMI values have not been agreed prior to an option grant, HMRC will consider a valuation subsequently and up to the time of the next annual return.

Where there is no valid section 431 election, there is potential for a liability to arise but this will not normally be the full amount of the gain. In broad terms, the chargeable amount will mirror the difference between the actual market value and the unrestricted market value. For example, if Xavier acquired restricted shares in USA Parent Inc for $20,000 paying the actual (restricted) market value and sells the shares 2 years later for $30,000 he makes a profit of $10,000. If the restrictions depressed the value by, say 20%, the element subject to the restricted securities charge on sale will be $2,000. If there is a valid agreement or election to transfer the NIC liability combined with an agreement to deduct the sums due from the sale proceeds, the employer will bear no cost beyond the need to deal with the administration of the PAYE.

If shares (or other securities) convert during a pre-sale reconstruction, the chargeable amount is based on the value uplift due to the conversion. If the right to convert accrues over time, the actual uplift on the event might be small but the legislation (section 441 ITEPA) measures the chargeable amount as the value of the shares as converted, less the value of the shares as though they did not have the conversion rights (and deducting any consideration paid for the conversion). The time and cost in assessing the share values without conversion rights will typically hamper an effective quantification of the liability.

Who is responsible?

This is the key point in a transaction. If the parties and their representatives can identify this then they can negotiate where the liability falls and the indemnities or warranties that are appropriate.

The timing of the event might affect the responsibility. For example, the parties may agree tax liabilities arising before the transaction, say the exercise of an option, are attributable to the sellers.

On a sale, the shares are usually readily convertible assets (section 702 ITEPA) so that PAYE will be a concern for the buyer (section 698 ITEPA).

Where the liabilities are historic, such as historic share awards, the position will be less clear and will need to be considered as will section 222 ITEPA and checks could then be required to identify if the employee has made good any PAYE liability. It is possible the employees were responsible for declaring this via their self-assessment tax returns.

What else?

Broader issues will include:

- Loans to buy shares from an employer or third parties such as shareholders, employee trusts with potential annual Form P11D reporting of beneficial loan, consideration of loans to participations and if Part 7A ITEPA applies.
- Transfers of shares to/from an employee trust and stamp duties, capital gains tax or inheritance tax liabilities arising as a result.
- The impact of company reorganisations prior to the sale on shareholdings of employees and directors.

Summary

A detailed review prior to a transaction requires a full knowledge of the facts. Key points to check will include:

- Which current, former and prospective employees (and their relatives) hold or have held shares, how and when they came by them and whether tax reporting and payment obligations were completed at the time?
- How were historic transactions financed and were shares paid for in full?
- Does the documentation comply with the qualifying requirements of the tax advantaged plans (EMI, SIP, CSOP, and any employee shareholder status shares) and if relevant the section 431 and NIC elections?
- Could there be a PAYE liability where the responsibility falls on the employer, and is that before or after the transaction?
- What values have been assessed and/or agreed with HMRC?