A complicated gift

Employment Tax | Personal tax



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Mark McLaughlin looks at the tax ‘life’ of a restricted security in the hands of a company employee from acquisition to disposal

Key Points

What is the issue?

This article focuses on the tax treatment of an employer company’s shares in the hands of an employee, from acquisition to disposal.

What does it mean for me?

The employment-related securities legislation defines ‘restricted securities’ very widely where there is a restriction on a share resulting in the market value of the share being altered. If the market value of the share is not reduced by a restriction, it is not a restricted security.

What can I take away?

There is a general reporting requirement when shares in a company are issued to employees (including past or future employees). However, it is not necessary to report some transactions.

Many employees will be blissfully unaware of the employment-related securities (ERS) provisions, and the potential implications if they own shares in their employer company. Furthermore, some tax practitioners might be forgiven for underestimating the broad scope of the rules.

The ERS legislation occupies a sizeable chunk of legislation (ITEPA 2003 Pt 7). Entire publications have been written about ERS. There are several different categories of ERS, each with their own tax rules, such as convertible securities, and securities acquired for less than market value.

This article focuses on one category of ERS that is encountered relatively often in practice, namely restricted securities. It looks at the tax treatment of an employer company’s shares in the hands of an employee, from acquisition to disposal (all references are to ITEPA 2003 unless otherwise stated).

Setting the scene

The ERS legislation applies to directors, employees and office holders. Subject to certain narrow exemptions (see below), securities and/or options in a past, present or future employer held by an employee are deemed to stem from the employment. ‘Securities’ includes company shares, as well as (among other things) loan stock, but not cheques, bankers’ drafts, etc.

There are certain exceptions from the ERS regime. Perhaps the most common exception is for family or personal relationships; the ‘deeming’ provision is removed where the right or opportunity to benefit from a share is provided to an individual in

the ‘normal course of the domestic, family or personal relationships’ of that person (ITEPA 2003 s 421B(3)). In most cases, a ‘gift’ of shares to a family member who works in the family company will be covered by this exception, but the exception can be more difficult to prove where the individual concerned is an unrelated close friend (see HMRC’s Employment Related Securities manual at ERSM20220).

Restricted securities

The ERS legislation defines ‘restricted securities’ very widely (ITEPA 2003 s 423). Those provisions apply where there is a restriction on a share (by reason of any agreement, contract, arrangement or condition) resulting in the market value of the share being altered. If the market value of the share is not reduced by a restriction, it is not a restricted security.

There are three major types of restriction in the ERS legislation:

- Provision for transfer, reversion or forfeiture: This applies where a share runs the risk of being taken away from the employee for less than its market value in specified circumstances (e.g. the employee might have valuable shares in the company that he would be required to sell back to the company at par if he left the employment).
- Restriction on freedom to retain or sell the shares or to exercise certain share rights: This broadly applies to provisions under which the employee cannot freely keep or sell a share; or keep the proceeds of any sale; or there is provision for any other restriction (e.g. the right to vote, etc.).
- Potential disadvantages in respect of the securities: This covers provision for any other restrictions to the potential disadvantage of the employee (or certain others). For example, there may be a provision that the employee can receive dividends and vote but must always waive the dividends and vote as instructed.

It is important to establish whether the shares concerned are subject to restriction or whether the characteristics of the share are simply ‘generic’ to that class of shares in the company. If the characteristics of the share are enshrined in the Articles of the company as applying to all shares of that class, and an employee gets some of those shares, there is probably no ‘restriction’ (ERSM30310).

An income tax charge arises on restricted securities if there is a ‘chargeable event’ (ITEPA 2003 s 426). There are three categories of chargeable event (ITEPA 2003 s

427):

- the lifting of all restrictions from the securities, before they have been disposed of to an unconnected person;
- the variation of any of the restrictions, before they have been disposed of to an unconnected person; and
- the disposal of the securities to an unconnected person, before all the restrictions have been lifted.

Image

EXAMPLE 1: TIM AND HIS SHARES

Tim acquired shares in his employer's company (Acme Bibs Ltd) in May 2015 for £1,000. The shares were restricted securities, because if Tim left his employment within three years, he would be obliged to offer to sell the shares back to the company for £1,000.

Due to this restriction, the actual market value of the shares acquired is £2,400. The unrestricted market value of the shares at that time is £4,000. Tim sold his shares in Acme Bibs Ltd in June 2020 for £10,000, after holding them for five years. The tax position of these events is as follows.

May 2015: Shares bought

Shares have been bought for £1,000 that have an actual market value of £2,400. However, there is no income tax charge on the difference because the shares are subject to a forfeiture clause that will expire within five years (ITEPA 2003 s 425(1)).

May 2018: Selling restriction lifted

The lifting of selling restrictions is a chargeable event. At this stage, the unrestricted market value has risen to £8,000; and, as there are no other restrictions remaining, the actual market value of the shares is also £8,000.

Applying the formula in ITEPA 2003 s 428, the taxable amount arising on this event is calculated as follows:

UMV x (IUP – PCP – OP) – CE = Taxable amount
£8,000 x (0.75 – 0 – 0) – 0 = £6,000 chargeable to income tax

See ERSM30400 for guidance on this calculation. The abbreviations refer to:

- UMV (unrestricted market value)
- IUP (initial uncharged proportion)
- PCP (previously charged proportion)
- OP (outstanding proportion)
- CE (consideration and expenses)

In brief, the items in the brackets look at the proportion of value to be brought into charge as explained below, and CE relates to any expenses incurred by the employee on the event).

June 2020: Shares sold

The shares are sold for £10,000. This transaction is subject to CGT. The tax charge will be based on the consideration for sale (£10,000) less the cost of the shares and the sums chargeable to income tax during the ownership of the shares (ignoring any reliefs, incidental costs and the CGT annual exemption):

	£	£
Consideration		10,000
Less:		
Cost	1,000	
Income tax charge (May 2018)	6,000	
		(7,000)
Chargeable to CGT		3,000

The restricted securities legislation brings into charge to income tax the proportion of the value of the shares not paid for on acquisition. Another way of representing the position is to state that Tim bought shares with an unrestricted market value of £4,000 but only paid £1,000 for them. In effect, he received a discount of 75%:

	Unrestricted market value	Taxable sum	%
May 2015	4,000	nil	0
May 2018	8,000	6,000	75
Total % charged			75

The full 75% discount enjoyed by Tim has been brought into charge across his period of ownership as the restrictions have been lifted.

Image

EXAMPLE 2: TIM'S ELECTION

If Tim (see **Example 1**) had elected to ignore the restrictions on his shares when he acquired them, he would have been charged as follows:

May 2015: Shares bought
Income tax is charged on the difference between the UMV of the shares (£4,000) and the amount he pays for those shares (£1,000). Tim is therefore charged to income tax on £3,000 in that tax year.

May 2018: Selling restrictions lifted
When the restrictions on the shares are lifted in May 2018, no further income tax charge arises.

June 2020: Shares sold
Tim would be chargeable to CGT on disposal of the shares in Acme Bibs Ltd as follows:

	£	£
Consideration		10,000
Less: cost	1,000	
Income tax charge (May 2015)	3,000	
Total costs (excluding dealing costs)		(4,000)
Chargeable to CGT		6,000

Without making the election, Tim would be subject to tax on £9,000. Of this, £6,000 would be chargeable to income tax with the remaining £3,000 being chargeable to CGT.

With the election, Tim would still be subject to tax on a total of £9,000, although only £3,000 would be chargeable to income tax with the remaining £6,000 being chargeable to CGT.

Given the differential in income tax and CGT rates (and the potential for CGT reliefs and the annual exemption, etc.), the election in Tim's case would be beneficial as his total tax bill would be reduced. However, Tim would have to find the funds to pay the tax liability 'upfront' for 2015/16.

The variation of a restriction includes the removal of a restriction; in other words, if there is a security with several restrictions attached, a chargeable event will occur on each occasion that one of the restrictions ends.

The income tax charge (under ITEPA 2003 s 428) is based on a rather daunting formula. HMRC's Employment Related Securities manual includes 'simple' examples of the calculation (at ERSM30420), and 'complex' examples (at ERSM30430).

To understand the legislation and HMRC's guidance, it might be helpful to understand what the legislation is trying to do. When a restricted share has been acquired by the employee, a charge would have arisen based on money's worth.

This would have looked at any difference between what was paid for the share and its actual market value at the time of acquisition. The actual market value will reflect

any characteristics of the share at that time.

If the impact of restrictions on the market value of that share was ignored, it would be reasonable to expect that the market value would be greater; this is referred to as the unrestricted market value.

The difference between those two values (i.e. unrestricted market value and actual market value) is not ordinarily subject to tax on the acquisition of the share (although see above where an election is made). The employee therefore has a share which could potentially give extra value if those restrictions were released or varied, or if the share were sold to someone to whom the restrictions had no impact. The restricted securities provisions are aimed at taxing this potential additional value when a chargeable event occurs (see Example 1).

Election for market value

In Example 1, an irrevocable election could have been made jointly by Tim and Acme Bibs Ltd to ignore the above restriction and replace it with a tax charge based on the full value of the shares on acquisition (ITEPA 2003 s 431(1)). An election must be made no more than 14 days after the shares are acquired; however, it is not submitted to HMRC but must be retained in case it is required for later inspection.

If there is more than one restriction, an election can be made to ignore certain restrictions, but leaving others to be charged to tax on acquisition (ITEPA 2003 s 431(2)). HMRC will not normally extend the time limit for making the election; but varying a restriction can create an opportunity to make an election to deem all restrictions to have been lifted (under ITEPA 2003 s 430(1)). Examples of both election forms are available via HMRC’s Employment Related Securities manual at ERSM30450.

The above elections give the taxpayer the opportunity to identify and exclude from the above charge any specific restrictions that are anticipated to be lifted, and which would give rise to an increase in the tax bill (assuming the shares rose in value).

In certain circumstances, an election under ITEPA 2003 s 431 is deemed to have been made by employer and employee. Those circumstances are broadly where shares are acquired under a tax advantaged scheme (e.g. enterprise management incentives), or where securities are acquired as part of an avoidance scheme (see ITEPA 2003 ss 431A and 431B).

Telling HMRC

There is a general reporting requirement (in ITEPA 2003 ss 421J and 421K(3)(a)) when shares in a company are issued to employees (including past or future employees). The relevant return (i.e. HMRC's 'other' template) must be made to HMRC by 6 July following the relevant tax year.

However, it is not necessary to report some transactions; for example, where a limited company is incorporated in the UK and initial subscriber shares are acquired directly on incorporation; or on transfer from a company formation agent, etc. where certain conditions are met (see ERSM140040). Nevertheless, all shares acquired in those circumstances by officers of the company or otherwise, by reason of employment, are employment-related securities.

ERS schemes, including one-off awards or gifts of shares, should be registered with HMRC. The Gov.uk website provides links to end of year return templates, technical and guidance notes (tinyurl.com/Template-ERS).