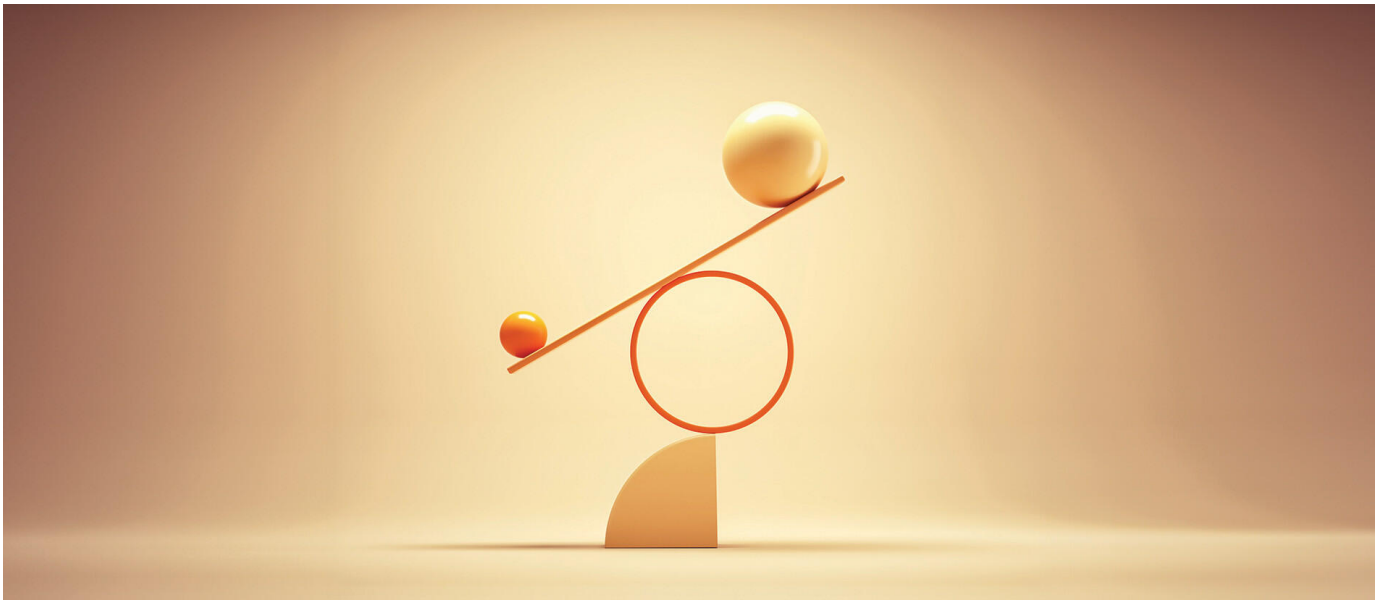
Employment related securities: absurd results of the deeming provision

Employment Tax



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We consider the Supreme Court's ruling on employment related securities in the case of *Vermilion* and the potentially absurd results brought about by the deeming provision.

Key Points

What is the issue?

We consider the implications of the Supreme Court's ruling in the case of *Vermilion Holdings Ltd* on 'employment related securities' and the application of a deeming provision which aims to provide clarity by conclusively treating certain securities or options as employment related. The court noted that it could sometimes produce absurd results.

What does it mean for me?

We suggest a two-step plan for reviewing the tax aspects of shares and shareholdings: determine if the deeming provision applies; and then whether the exclusions in ITEPA 2003 s 471(3) apply, particularly the exemption for family or personal relationships.

What can I take away?

The exemption for family or personal relationships needs further investigation, as it can lead to strange results, including a situation where a share-for-share exchange could be deemed as acquiring ERS despite there being no tax avoidance motive.

HMRC has updated its Employment Related Securities manuals on the ‘deeming provision’, almost a year to the day after the Supreme Court passed its judgment in the case of *Vermilion Holdings Ltd v HMRC* [2023] UKSC37*.*

To recap, the *Vermilion* case centred on the meaning of ‘employment related securities’ (ERS), in relation to replacement share options and the application of a deeming provision, a so-called ‘bright line’ test within the legislation. Bright line tests aim to provide total clarity in circumstances where there is a high degree of legal uncertainty.

The idea of a deeming provision in the context of ERS rules is quite sensible on the face of it: it removes any need to find a causal link as to whether a share award is employment related or not.

The provision in Income Tax (Earnings and Pensions) Act (ITEPA) 2003 s 471 (which is mirrored in s 421B) decrees that if you are a director or an employee and your employer (or a person connected to your employer) provides you with the right or opportunity to acquire securities, that right or opportunity is conclusively treated as having been made available by reason of your employment (with a few caveats set out below).

Note that the same deeming provisions apply whether you are looking at securities (s 421B) or securities options (s 471).

The *Vermilion* case

The facts of the *Vermilion* case remain of interest not only to the many consultants who have exchanged their services for share options when advising on start-ups over the years but also to many shareholders and their advisers.

A company (Vermilion) originally granted share options to an accountancy consultancy company (Quest) in lieu of fees. The director of Quest eventually became a director of Vermilion and, during restructuring, Quest's share options were replaced with a different share option plan. The question before the court was whether the replacement options were employment related.

The Supreme Court confirmed that they were due to the operation of the deeming provision in s 471: they linked the director and his company to the employer's actions.

The courts note that there will be situations where a deeming provision produces an absurd result. (See Keith Gordon's article 'Vermilion Holdings: how a deeming provision works in the context of ERS' (December 2023) for their thoughts.)

A two-step plan

Post *Vermilion*, we have a clear two step plan:

1. When reviewing the tax aspects of shares and shareholdings, the first step for ERS is to see if the deeming provision applies.
2. The next step is to consider whether the exclusions set out in ITEPA 2003 s 471(3) apply.
3. 'A right or opportunity to acquire securities or an interest in securities made available by a person's employer, or by a person connected with a person's employer, is to be regarded … as available by reason of an employment of that person unless:
   a) the person by whom the right or opportunity is made available is an individual; and
   b) the right or opportunity is made available in the normal course of the domestic, family or personal relationships of that person.

We have yet to see this exemption tested in relation to ERS and its wording is not as clear as it might be. These phrases could be open to different forms of interpretation.

However, in its manuals HMRC takes the more nuanced view that the carve out will typically apply to allow succession planning, setting out the example of a family company. (See the box above: ***'By reason of employment': exception for family or personal relationships***.)

HMRC is quite guarded in suggesting that the exemption would only apply to a share transfer – the legislation does not say that.

As noted, there is no deeming provision when it comes to the exemption. This means that when deciding whether we can apply the exemption, we need to be highly invested in understanding the full facts and circumstances which led to the share award.

By reason of employment: exception for family or personal relationships

Employment-Related Securities and Options Manual ERSM20220:

'It would clearly apply if a father, on reaching retirement, hands over all the shares in his family company to his son and daughter simply because they are his children, even if they are both also employees of the family company.

'However, it is a question of fact, and it is possible for the employment, rather than the family relationship, to be the reason for the gift, and where that is the case the shares will be employment-related securities.

'This may well be the case where large numbers of employees were given shares and they included a son and a daughter of the proprietor. Personal relationships can also include friendships and it is not unknown for a proprietor to pass on his business to a long-time employee with whom he has developed close personal ties. The principal question to be asked is whether an employer is trying to reward or provide an incentive to an employee in passing over such shares to him/her, or whether the reason is more personal than an employer/employee relationship.'

Some strange results…

HMRC's example about exemptions for family or personal relationships has been toned down over the years.

My personal theory is that the exemption in ITEPA 2003 s 471(3) (a)-(b) requires more serious investigation because this is the 'get out of jail card' in so many cases involving small companies, at least.

My long-held view is that if you are a director or shareholder and you direct the allotment shares to yourself, the exemption applies. I can't think of anything more personal than my relationship with myself! Reading around, over the years this seems to be a controversial point amongst some advisers. Even if one does not go so far, ignoring the exemption can still create some absurd results.

Example 1: Employment related and non-employment related shares

Janice, the sole shareholder and sole director of a company, acquired a single £1 ordinary share on incorporation. HMRC (in Employment Related Securities Manual ERSM140040) tells us that these are ERS but there is no ERS reporting requirement if amongst other things:

- the shares are not acquired by reason of or in connection with another employment (whether that is the only employment or one of a number of employments); and
- the shares are acquired by a person who is a director or prospective director of the company, or who has a personal family relationship with the director and the right or opportunity is made available in the normal course of the domestic, family or personal relationship of that person.

As Janice will be a director, her shares are now deemed to be ERS and she cannot now meet the first bullet point above (possibly HMRC's manual needs updating here). Applying the friends and family exemption takes her out of ERS reporting. That makes far more sense.

As trade commences, Janice soon realises that having a single share was a mistake. She resolves to increase the share capital by subdividing her share into 100 shares of 1p. Now she can gift half of her shares to her wife, Joyti, who will also become a

director of the company. As she is both a best friend and family, the exemption applies and Joyti's shares are not ERS.

As we can see, if we apply the deeming provision without the exemption we have a company with 100 shares saddled with a rather pointless ongoing ERS reporting obligation. The company now is a deemed employer too. It should also register an unapproved share scheme via PAYE online and it will potentially face penalties if it ignores that. This is a lot to take on board and there is not even a remote possibility of an income tax charge in relation to the securities themselves. Did parliament really intend that?

Example 2: A share for share exchange between friends

Matt, a director, and his longstanding friend Molly run a couple of small companies, and they decide to pool their resources to form a group. They execute a cashless share for share exchange to add a new Holdco following the reorganization rules in the Taxation of Chargeable Gains Act (TGCA) 1992 ss 135-137. They are both directors of their new Holdco. Tax clearance was applied for at the time under TCGA 1992 s 138 and Income Tax Act 2007 s 701 for the individuals. There is clearly no tax avoidance motive and HMRC grants advanced clearance.

But hold on! As a result of the exchange, if we apply the deeming provision without any exemption, the two shareholders, as directors of their new Holdco, are deemed to have acquired ERS.

Again, the knock-on effect of this is surely the 'absurd' result that we must avoid. Just as with Example 1, there is no tax avoidance motive and indeed no other employees. Advisers wanting a 'belt and braces' approach will also suggest that they make a s 431 market value election, as the shares are surely restricted securities.

As a result of ignoring the potential to claim the exemption, we have a situation in which a vast amount of otherwise productive time by working people is wasted on form filling. And once that obligation commences, it is with that employer until the offending ERS are disposed of. Surely, we have better fish to fry!

One could argue that it would take more time to prove the exemption applies. Well, if so, this is an absurd result too.

My examples are of fairly typical scenarios that we see regularly in owner-managed businesses. No one really wants to be the test case for the ‘friends and family’ exemption and HMRC is nervous about illustrating it. There were 14 years between the decision in *Gray’s Timber Products v HMRC* [2010] UKSC 4*,* which was the first ever case to examine ‘the complication of the provisions’ in ITEPA 2003 Part 7, and the unanimous verdict given in *Vermilion*. Is it time to revise your firm’s policy on ERS now?

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