Employee shareholder exits: capital or income?

Employment Tax | OMB | Large Corporate

May 2026



22 April 2026

There are several ways to facilitate an employee shareholder exit, each with significant tax considerations, so planning an effective solution can be complex.

Key Points

What is the issue?
There are a range of ways to facilitate an employee shareholder exit but each carries different tax consequences, particularly in relation to employment-related securities, capital gains tax and income treatment.

What does it mean to me?
The chosen exit route can significantly affect the tax outcome for both employer and employee. HMRC scrutiny, especially around buy-backs and transactions in

securities, means that achieving CGT treatment is not always straightforward.

What can I take away?
Planning for employee exits at the outset, understanding how the various mechanisms operate, and taking early advice are key to ensuring a tax-efficient and commercially effective outcome while managing HMRC risk.

There are many commercial reasons why an employer would want a departing employee shareholder to give up their shares. There may no longer be any need to incentivise them, it may be inappropriate for them to continue sharing in the growth of the business while no longer contributing to it, and there may also be concerns around commercial sensitivity, given that shareholders may receive confidential information.

The employee may want an exit route that delivers value which is subject to capital gains tax (CGT) rather than being treated as income (either as employment income or a distribution). While this is not always achievable, the employer may be willing to prioritise CGT treatment provided it aligns with their commercial objectives. This article explores the various options available to facilitate the acquisition or cancellation of a leaver's shares.

Establishing a share incentive plan

When setting up a share scheme, it is essential to plan for the exit of employee shareholders. The articles of association (Articles) or shareholder agreements for the scheme will typically distinguish between different categories of leaver (for example, so-called 'good' and 'bad' leavers) and set out the pricing mechanisms that apply in each case.

However, it is equally important to consider the actual method by which leavers will dispose of their shares, ideally allowing for flexibility in how this is achieved. Addressing this at the outset is important from a tax perspective and helps to clarify expectations, reducing the risk of disputes with departing employees.

Employment-related securities

Regardless of the method of exit, a key consideration is the tax treatment of the leaver's shares under the employment-related securities (ERS) rules in Part 7 of the Income Tax (Earnings and Pensions) Act (ITEPA) 2003.

The ERS rules can give rise to employment income tax charges in two main situations on a disposal of a leaver's shares:

1. under ITEPA 2003 Part 7 Chapter 2, where the shares were originally acquired for less than unrestricted market value and no election was made under ITEPA 2003 s 431 (an s 431 election); and
2. under ITEPA 2003 Part 7 Chapter 3D, where the employee receives consideration for the disposal in excess of the tax market value of the shares.

On the second point, HMRC usually expects the tax market value of a leaver's shares to include appropriate discounts for minority interests and non-liquidity. A sale at pro-rata value may therefore be treated as a disposal at an overvalue, giving rise to an employment tax charge.

How these ERS charges interact with the tax treatment of the different exit methods is described below, as the outcome will depend on the structure adopted. Where they do apply, they will increase the base cost for CGT purposes by the amount subject to employment income tax, ensuring that the leaver is not taxed twice.

Methods for employee shareholder exits

There are various methods that can be used to facilitate shareholder exits, as set out below.

Purchase of own shares

A purchase of own shares is often the go-to option for the exit of minority shareholders. However, for CGT treatment to apply, strict conditions must be met and the buyback must be reported to HMRC.

A purchase of own shares by a UK non-quoted company is both an income distribution and a CGT disposal, with income treatment taking priority by virtue of the Taxation of Chargeable Gains Act (TCGA) 1992 s 39. Under this provision, consideration is excluded from the CGT computation where it has been subject to

income tax.

The definition of ‘distribution’ for income tax purposes cross-refers to Corporation Tax Act (CTA) 2010 Part 23. Essentially, the buyback is treated as a distribution to the extent that it is not a repayment of capital or is otherwise than for new consideration (case B of CTA 2010 s 1000).

Accordingly, it will not be a distribution to the extent that the nominal value is returned to the shareholder, which can in some rare circumstances be a large number. In addition, by virtue of CTA 2010 s 1025, HMRC accepts that where the shares were originally issued at a premium, that premium constitutes new consideration on a subsequent buyback, unless it has previously been used to pay up capital (see HMRC’s Company Taxation Manual CTM17520). In practice, this means that an income tax charge may only apply where proceeds exceed the original subscription price.

CTA 2010 s 1033 and related sections set out the conditions under which a purchase of own shares will be treated as an exempt distribution, effectively placing the disposal wholly within CGT. Some of these conditions are practical, such as a minimum five-year holding period and a requirement that the individual’s shares are reduced by at least 25%. Others are more subjective and need some consideration. These include whether the company is a trading company and whether the buyback is for the benefit of the trade (see Keith Gordon’s article ‘A company share buyback: the battle of *Boulting*’ in *Tax Adviser* February 2026).

The company may seek advanced statutory clearance from HMRC under CTA 2010 s 1044 to confirm that the buyback will be treated as an exempt distribution. However, this adds professional costs and an administrative burden each time shares are repurchased from a leaver.

Additionally, it has become evident that HMRC’s policy on the ‘benefit of the trade’ test has tightened in recent practice. HMRC appears less willing to simply accept that a buyback from a small exiting shareholder will satisfy the test, though it does seem to be more accepting where the departing shareholder is a key member of management.

We await further clearance cases to determine where HMRC’s thresholds on percentage ownership will fall in practice, and how these will differ depending on the circumstances. For the moment, businesses seeking CGT treatment for smaller

shareholdings must be warned that a robust analysis of the benefit of the trade will be required, and that there remains a risk that clearance may not be granted even where a commercial rationale exists.

Although a clearance is not strictly required, for the distribution to be exempt the buy-back must be reported to HMRC within 60 days, together with an explanation of why it is believed to be exempt (i.e. the same information that would have been included in a clearance application). Where a clearance has been obtained, the reporting is simplified as most of the detail can be provided by enclosing a copy of the clearance correspondence.

In our experience, HMRC will accept late reporting; however, the conditions for exempt treatment have not technically been met and late reports may not be accepted.

Where the company is not UK resident, the tax treatment of the purchase of own shares (i.e. whether it is capital or income) is typically determined by reference to the law of the jurisdiction in which the company is incorporated or registered. This is a principle established by case law, notably *Rae v Lazard Investment Co Ltd* (1963) 41 TC 1.

Where the buyback results in capital treatment and ERS charges are in point, PAYE income tax, together with employee and employer NIC, will apply to a proportion of the proceeds.

In contrast, where a buyback by a UK resident company is treated as a distribution, any employment income tax arising under the ERS charges is disapplied by ITEPA 2003 s 716A, although employee and employer NIC may still arise.

Do nothing

In some cases, the employer may be less concerned that departing employees are retaining their shares, and therefore have put no formal arrangements in place for a buyout.

This is more likely where the company is listed, and therefore a market is available for the employee to sell their shares. Private companies that are registered with the Private Intermittent Securities and Capital Exchange System (PISCES) to enable trading in their shares might similarly adopt this approach.

Frozen return value

Where employees acquire shares on an understanding that they will be realised only on a planned exit event, the Articles may defer the realisation for leavers until that event. In such cases, the proceeds are typically capped at the value of the shares at the time of leaving, and leavers who retain their shares will usually lose the right to dividends and votes.

Tax and legal advice will be required to implement a mechanism for freezing the value of shares where this has not already been addressed. In particular, this concerns the following issues:

- If the shares convert to a different class upon leaving, it will be necessary to consider whether that conversion constitutes a reorganisation under TCGA 1992 s 126 (deferring the gain) or gives rise to a chargeable disposal of shares.
- Establish whether the value freeze, and the subsequent allocation of proceeds on an exit to all shareholders, is supported by the terms of the Articles. If subsequent sale proceeds are not allocated in accordance with their rights in the Articles, this may give rise to employment income tax for other employee shareholders under ITEPA 2003 Part 7 Chapter 3D, following the principles in *Grays Timber Products Ltd v Revenue and Customs (Scotland)* [2010] UKSC 4.

Sale to other shareholders or new management

Sometimes a sale to other shareholders is possible. For example, the shareholders' agreement or Articles may include a mechanism for offering the shares to other existing shareholders, including a parent entity. Alternatively, the employer may identify other members of management to whom they wish to offer share ownership.

As this involves an actual disposal of the shares, capital gains treatment will apply. However, if the ERS charges are in point, a proportion of the proceeds will be subject to PAYE and employee and employer NIC.

Capital reduction

Where the company has sufficient share capital, it may be possible to cancel some of the shares through a capital reduction and return capital to the leaver up to the value of those shares.

For this purpose, ‘share capital’ comprises paid-up nominal share capital, share premium, capital redemption reserve and redenomination reserve.

In practice, it will be necessary to cancel all the nominal share capital held by the employee (in order to eliminate their holding) and, if required, share capital from one of the other sources (to cover any additional amount paid to the leaver). Where the amount paid to the employee is less than the nominal share capital cancelled, any excess will be transferred to distributable reserves.

Under general principles (case B of CTA 2010 s 1000), a repayment of capital is not treated as a distribution for tax purposes. It will therefore be a CGT chargeable disposal for the leaver.

However, it is important to consider the wider provisions of Part 23 of CTA 2010, which contains anti-avoidance rules that apply in certain situations. For example, a repayment of capital can be a distribution where a bonus issue of shares occurs before or after the capital reduction, unless that bonus issue is funded from new consideration.

It is also important to consider the transactions in securities (TIS) anti-avoidance provisions, which broadly apply where a shareholder realises an income tax advantage. HMRC may seek to counteract the transaction by effectively treating the proceeds as income, on the basis that the capital reduction is being used as a means to extract value in capital form rather than by way of an income distribution.

Nevertheless, there are circumstances in which HMRC will grant TIS clearance, under Income Tax Act 2007 s 701 – for example, where the company has no distributable reserves and so, as a matter of company law, the capital reduction is the only available mechanism to cancel the leaver’s shares.

On the basis that, in the context of a purchase of own shares, an income tax charge may arise only to the extent that proceeds exceed the original subscription price (for shares issued at a premium), it can be argued that an income tax advantage from a capital reduction would arise only in the same circumstances. Hence, it should be possible to use a capital reduction to return such amounts without the TIS provisions applying, although seeking statutory clearance would be strongly recommended.

To the extent that the ERS charges apply, a proportion of the proceeds will be subject to PAYE and NIC.

Capital reductions may also be used to cancel employee shares where all rights have been forfeited, for example under bad leaver provisions. Any capital released will be credited to distributable reserves, and a capital loss would typically arise for the shareholder.

Sale to an employee benefit trust

The employer could establish an employee benefit trust (EBT) to act in a warehousing capacity to buy and sell shares with employees, essentially creating a market for leavers to dispose of their shares.

As there will be an actual disposal of shares, CGT should always apply. However, if the ERS charges apply, a proportion of the proceeds will be subject to PAYE, together with employee and employer NIC. The EBT may be funded by employer contributions, the onward sale of shares or by way of a loan. There are a number of tax and commercial considerations in relation to the establishment and operation of an EBT, and specific advice should be sought.

The same TIS considerations will need to be taken into account as those outlined above in relation to a capital reduction.

Conclusion

Employee shareholder exits require careful planning and thoughtful structuring to balance commercial objectives with tax efficiency. By anticipating leaver scenarios when establishing share plans, employers can reduce uncertainty and avoid costly disputes. The choice of exit mechanism – whether a purchase of own shares, capital reduction, sale to an EBT or fellow shareholders, or simply allowing shares to remain in issue – must be assessed in light of the ERS rules, CGT considerations, anti-avoidance provisions and, where relevant, the company’s constitutional documents.

Employers should also be mindful of the fact that HMRC scrutiny in this area continues to evolve, particularly in relation to the ‘benefit of the trade’ test and the application of the TIS provisions. Early advice and clear planning remain key to managing employee exits efficiently and mitigating tax risk for all parties involved.

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