CHAPTER 39

UNAPPROVED SHARE SCHEMES - RESTRICTED SECURITIES

39.1 Introduction

Where an employee acquires shares in his employer company for an amount less than the market value of the shares at that point, there will usually be a charge to income tax under s.62 ITEPA 2003.

There are exceptions for HMRC approved share incentive schemes such as Share Incentive Plans (SIPs), or for HMRC approved share option schemes such as SAYE Schemes, Company Share Option Plans (CSOPs) and Enterprise Management Incentive Schemes (EMIs).

Under such HMRC approved schemes, tax advantages are available to either eliminate or reduce a charge to tax when the shares are transferred to the employee.

No such advantages accrue under unapproved share schemes. Under an unapproved share scheme, there will typically be a charge to income tax on the transfer of shares, calculated as follows:

Value of shares at date of acquisition	X
Less: amount paid by employee for the shares	(X)
Employment income	X

As we have seen previously, the amount treated as employment income above will be subject to PAYE and Class 1 NICs if the shares are readily convertible assets (for example, if the shares are in a quoted company or arrangements are in place for the shares to be sold).

The amount charged to income tax is reduced by the employer's Class 1 NIC liability where this is met by the employee.

The above principles can also apply to a "one-off" issue of shares to a single employee or to a selected group of employees – there does not have to be a formal "scheme" in place for the rules on unapproved share schemes to apply.

The charge to income tax is based on the value of the shares at the date of acquisition by the employee. Therefore an employer could reduce the charge by putting certain arrangements in place to depress artificially the market value of the shares. These could include:

a) making the shares subject to forfeiture on the happening of certain events; or

b) placing certain restrictions on the shares to depress their value; or

c) making the shares convertible such that extra value can be injected into the shares at a later date; or

d) taking certain non-commercial actions so as to inject extra value into the shares.

As a result, anti avoidance provisions apply where an employee receives "employment related securities" which are subject to restrictions which alter their value. We will look at these provisions over the course of this chapter.

39.2 Employment related securities

Throughout this chapter we are only concerned with "**employment related securities"**. The definition of an employment related security is very wide and will be difficult to avoid. An employment related security is defined as a right or opportunity to acquire securities made available **by the employer** (or a person connected to him), unless: ITEPA 2003, s.421B

(a) the right is made available from an individual; and

(b) it is made in the normal course of the domestic family or personal relationships of that person.

Therefore, in practice, the acquisition of shares or securities by an employee by reason of his employment will, in the vast majority of instances, be subject to the rules for employment related securities.

There could be an exception in instances where, for example, a father is managing director and controlling shareholder of a family company and the company issue shares to his son. If the issue of shares is because of their personal relationship (as opposed to being a reward for service), the exception will apply. HMRC take a "common sense" view and will look at each case on its merits.

39.3 "Restricted securities"

"Restricted securities" are shares which are either subject to forfeiture on the occurrence of certain events or which have restrictions placed upon them relating to when (or to whom) they may be sold. ITEPA 2003, s.423

Restricted securities are commonly seen in **management buy-outs** where the investors are keen to control who can own shares in the company. The management team will acquire the shares on the buy-out but will have to **forfeit them in certain circumstances** - most commonly this will be if they leave the company.

Where shares are awarded to employees and those shares have restrictions placed upon them, special rules are in place to determine:

1. the tax charge (if any) on the **initial acquisition** of the shares; and

2. the tax charge (if any) when the **restrictions on the shares are lifted**.

39.4 Shares subject to forfeiture

Shares can be awarded to employees **on the condition that they will be forfeited** on the happening of a certain event.

Most commonly the event causing the shares to be forfeited will be the **employee leaving the company** within a certain period of time after acquiring the shares. Forfeiture restrictions are therefore often placed on shares by the employer as a means of **retaining the services of the employee** for a specified period of time after the shares are awarded.

Where shares are forfeited by an employee, the shares will either be cancelled or bought back by the company for an amount which is less than their market value.

Shares subject to forfeiture will therefore have a depressed market value at the date they are initially awarded. The value of the shares awarded to the employee will therefore **rise when the threat of forfeiture is lifted**. As a result, a charge to tax can arise when the restriction (in this case the risk of forfeiture) no longer applies.

The tax charge depends on whether there can be a forfeiture at less than market value either:

a) **where 5 years or more have elapsed** from the date the shares are awarded; or

b) **before 5 years have elapsed** from the date the shares are awarded.

a) <u>Shares subject to forfeiture 5 years or more after the award</u>

If the shares are subject to being forfeited at less than market value **5 years or more following the award, there is a charge to tax** at the time of issue. ITEPA 2003, s. 425

The charge is as follows:

Value of shares at date of award ("restricted value")	X
Less: amount paid by employee for the shares	(X)
Employment income	X

A further charge will arise under s.426 ITEPA 2003 when the **restriction is lifted**. ITEPA 2003, s. 426

This further charge is based on the formula in s.428 ITEPA 2003. The formula in the legislation contains a number of steps but, in the majority of cases, this can be simplified to the following: ITEPA 2003, S.428

$$UMV \times \frac{IUMV - DA}{IUMV}$$

where:

"UMV" =	the market value of the shares at the date the risk of forfeiture is lifted
"IUMV" =	"unrestricted" value of the shares at the date of award
"DA" =	the amount paid by the employee for the shares plus the amount charged as employment income on the initial award

Illustration 1

In May 2005, Jockey Ltd awarded Karen (an employee) 10,000 shares in Jockey Ltd for 50p per share. The unrestricted market value of the shares in May 2005 was £1.50.

However, the shares are subject to being forfeited in return for 75p per share if Karen leaves Jockey Ltd within six years of the award. This amount is assumed to be the restricted market value in May 2005.

Karen remained in employment and the forfeiture risk was duly lifted in May 2011 when the shares are worth £2.80.

Solution

There is a charge on the initial award of the shares in 2005/06 as the shares were at risk of forfeiture more than 5 years after the award.

The charge will be:

	£
Value of shares at date of award - "restricted value" (10,000 x 75p)	7,500
Less: amount paid by employee for the shares (10,000 x 50p)	(5,000)
Employment income (10,000 x 25p)	2,500

A further charge will arise in May 2011 (2011/12) when the risk is lifted, based on the formula:

$$UMV \times \frac{IUMV - DA}{IUMV}$$

where:

"UMV" =	the market value of the shares at the date the risk of forfeiture is lifted (£2.80)
"IUMV" =	is the "unrestricted" value of the shares at the date of award (£1.50)
"DA" =	is the amount paid for the shares (50p) plus the employment income on award (25p)

The charge will be:

$$10{,}000 \times £2.80 \times \frac{(1.50 - 0.75)}{1.50} \qquad \underline{£14{,}000}$$

b) Shares subject to forfeiture within 5 years of award

If the shares are subject to being forfeited at less than market value within **5 years of being awarded, there will be** **no charge** **to tax** at the time of issue. ITEPA 2003, s. 425

When the **restriction is lifted** (ie, at the point at which the threat of forfeiture has been removed), there is then a **charge to tax calculated, as before, using the formula in S.428.** ITEPA 2003, s. 426

$$UMV \times \frac{IUMV - DA}{IUMV}$$

where:

"UMV" =	the market value of the shares at the date the risk of forfeiture is lifted
"IUMV" =	the "unrestricted" value of the shares at the date of award
"DA" =	the amount paid for the shares. In this case the employment income on award is nil

Illustration 2

In June 2008, Chatsworth Ltd awarded Frank (an employee) 6,000 shares in Chatsworth Ltd. The market value of the shares in June 2008 was £2.50. Frank paid £1 per share (ie £6,000) for the shares.

The shares are subject to being forfeited in return for £1.20 per share if Frank leaves Chatsworth Ltd within three years of the award.

Frank remained in employment and the forfeiture risk was duly lifted in June 2011 when the shares are worth £4.75.

Solution

There is no charge in respect of the initial award of the shares in 2008/09 as the shares were at risk of forfeiture within 5 years.

A charge will arise in 2011/12 when the risk is lifted. The charge will be based on the formula:

$$\text{UMV} \times \frac{\text{IUMV} - \text{DA}}{\text{IUMV}}$$

where:

"UMV" =	the market value of the shares at the date the risk of forfeiture is lifted (£4.75).
"IUMV" =	the "unrestricted" value of the shares at the date of award (£2.50).
"DA" =	the amount paid for the shares (£1.00).

The charge will be:

$$6{,}000 \times £4.75 \times \frac{(2.50 - 1.00)}{2.50} \qquad \underline{£17{,}100}$$

If Frank resigns within 3 years (ie before the risk of forfeiture is lifted), his shares are forfeited in return for £1.20 per share. A charge to income tax will arise at this point. The charge is calculated using the formula in S428 except the proceeds (in this case £1.20) are substituted for UMV.

The charge will be:

$$6{,}000 \times £1.20 \times \frac{(2.50 - 1.00)}{2.50} \qquad \underline{£4{,}320}$$

This principle also applies in cases where the risk of forfeit lasts for 5 years or more.

39.5 Shares subject to forfeiture within 5 years – election to disapply exemption

As we have seen, if shares are awarded to an employee and the shares are subject to forfeiture within 5 years of being awarded, there is **no charge to tax at the date of the initial award**.

Instead there is a charge to tax when the **risk of forfeiture is removed**. This charge is based on the market value of the shares at the date the restriction is lifted. This was covered in illustration 2.

However, in this case, the employer and employee can **jointly elect** within 14 days of the award of the shares for the **exemption on acquisition not to apply**. The election is irrevocable. There is no requirement to send the election to HMRC, but it must be kept on file by the company in case of an enquiry. ITEPA 2003, s. 425(3)

Once an election is made, **a charge to tax will arise on the initial award** of the shares, in the same way as if the restriction lasted more than five years.

If the shares are later forfeited (or sold for less than their restricted market value) there is no possibility of recovering the tax paid on the initial award.

There is also a charge under s.426 (based on the formula in s.428) **when the restriction is subsequently lifted**.

The effect of the election is to compute the amount taxed as employment income in the same way as if the risk of forfeit lasts for 5 years or more from the award of the shares. As we will see, the election can reduce the overall tax charge.

Illustration 3

Returning to illustration 2 above.

In June 2008, Chatsworth Ltd awarded Frank (an employee) 6,000 shares in Chatsworth Ltd for £1 per share. The market value of the shares in June 2008 was £2.50.

The shares are subject to being forfeited in return for £1.20 per share if Frank leaves Chatsworth Ltd within three years of the award. This is also assumed to be the restricted market value in June 2008.

Frank remained in employment and the forfeiture risk was duly lifted in June 2011 when the shares are worth £4.75.

(i) No election under s.425(3)

No charge arises on the initial award of the shares in 2008/09 as the shares were at risk of forfeiture within 5 years.

A charge will arise in 2011/12 when the risk is lifted. The charge will be:

$$6{,}000 \times £4.75 \times \frac{(2.50 - 1.00)}{2.50} \qquad \underline{£17{,}100}$$

(as per illustration 2)

(ii) Election under s.425(3)

A charge now arises on the initial award of the shares in 2008/09 as follows:

	£
Value of shares at date of award ("restricted value")	
6,000 x £1.20	7,200
Less: amount paid by employee for the shares	
6,000 x £1	(6,000)
Employment income	1,200

A further charge arises when the risk of forfeiture is lifted (June 2011), based on the formula in s.428:

$$\text{UMV} \times \frac{\text{IUMV} - \text{DA}}{\text{IUMV}}$$

Where:

"UMV" =	the market value of the shares at the date the risk of forfeiture is lifted (£4.75)
"IUMV" =	the "unrestricted" value of the shares at the award (£2.50)
"DA" =	the amount paid for the shares (£1.00) plus the employment income on award (20p)

The charge will be:

$$6{,}000 \times £4.75 \times \frac{(2.50 - 1.20)}{2.50} \qquad \underline{£14{,}820}$$

Summary

	£
Total amount charged without election	17,100
Total amount charged with election £(1,200 + 14,820)	(16,020)
Reduction in employment income	£1,080

In this instance, an election would have been beneficial (even taking into account the cash-flow disadvantage of having to pay some tax in the year of the initial award).

S.425(3) elections will be advantageous where the employee remains in employment (and therefore does not forfeit the shares) and the shares increase in value between the date of the award and the date that the restrictions are lifted.

However, an election can have the effect of increasing the tax liability where either:

i. the shares are forfeited (as the tax paid on the initial award will not be refunded); or
ii. the shares fall in value between the date of the award and the date that the restrictions are lifted.

Bearing in mind that an election must be made within 14 days of the initial award if it is to take effect, both employer and employee are "guessing" at the eventual outcome. A "wait-and-see" approach is not therefore possible!

39.6 Shares subject to other restrictions

Shares may be awarded by an employer to an employee subject to restrictions other than a risk of forfeiture.

A common example of this is that shares are awarded to an employee, but the employee is **restricted as to either when or to whom the shares can be sold**. For instance, shares can be awarded to an employee but with the condition that they cannot be sold for a certain period of time. This restriction will obviously depress the value of the shares at the time of the award.

If such restricted shares are awarded, a charge to tax under s.62 ITEPA 2003 will arise **at the time the shares are issued**, calculated as follows:

Value of shares at date of award ("restricted value")	X
Less: amount paid by employee for the shares	(X)
Employment income	X

A further charge will arise when the **restriction is lifted**, based on the formula in s.428 ITEPA 2003: ITEPA 2003, s. 426

$$UMV \times \frac{IUMV - DA}{IUMV}$$

where:

"UMV" =	the market value of the shares at the date the restriction is lifted
"IUMV" =	the "unrestricted" value of the shares at the date of award
"DA" =	the amount paid for the shares plus the employment income on award

You will see therefore that the rules for shares subject to **other** restrictions are the same as those for shares subject to forfeit after 5 years or more.

Illustration 4

Yvonne works for Carib Ltd. On 5 January 2008 she is given (free of charge), 5,000 shares in Carib Ltd. The shares were valued at £10 each in January 2008.

However, a condition of the offer is that Yvonne is prohibited from selling the shares until 6 January 2011. The effect of this restriction is to depress the value of Yvonne's shares as at January 2008 to £8 per share.

Yvonne waits until 7 January 2011 at which point she sells her shares for £12.50 each.

Solution

Yvonne has restricted shares, so a charge to tax on acquisition (January 2008) will arise as follows:

	£
Value of shares at date of award ("restricted value")	
5,000 x £8	40,000
Less: amount paid by employee for the shares	(NIL)
Employment income	40,000

A further charge arises when the restriction is lifted (January 2011), based on the formula in s.428:

$$UMV \times \frac{IUMV - DA}{IUMV}$$

Where:

"UMV" =	the market value of the shares at the date the restriction is lifted (£12.50)
"IUMV" =	the "unrestricted" value of the shares at the date of award (£10)
"DA" =	the amount paid for the shares (nil) plus the employment income on award (£8.00)

The charge will be:

$$5{,}000 \times £12.50 \times \frac{(10 - 8)}{10} \qquad \underline{£12{,}500}$$

39.7 More than one restriction

So far we have dealt with restricted securities which are only subject to one restriction. We have looked at shares which are subject to forfeiture or shares which have other restrictions such as restrictions relating to when they can be disposed of.

However, we also need to deal with the situation where the employment related securities are **subject to more than one restriction**. For example, an employee could be given shares which are subject to forfeiture if the employee leaves the employment within 3 years and which cannot be sold within 5 years of the date of the award.

We need to be able to calculate the tax charge on acquisition (if any) and when each of the restrictions is lifted. We deal with these situations by building upon the rules we have already looked at.

There is **no change** in the way we calculate the charge on the actual award of the shares. So, if the shares are subject to a forfeiture restriction which will be lifted within 5 years, there is still no charge at the date of award. This is even though the shares may continue to be restricted securities after this date by virtue of some other restriction. ITEPA 2003, s. 425

In any other case, the charge on award will be calculated as normal i.e.

	£
Value of shares at date of award (restricted value)	X
Less:	
Amount paid by employee for the shares	(X)
Employment income	£X

There will be a charge to tax when the first restriction is lifted. As usual, this is calculated using the formula in s.428 ITEPA 2003, but this time we need to consider the **full version of the formula** contained in the legislation which is:

ITEPA 2003, s. 428

UMV x (IUP – PCP – OP)

where:

"UMV"	is the unrestricted market value of the shares ignoring any remaining restrictions
"IUP"	is the proportion of the initial value which has not been charged to tax
"PCP"	is the proportion charged on a previous event
"OP"	is the proportion of share value still subject to restrictions.

The same formula will be used to calculate any subsequent amounts charged under s.428.

Illustration 5

Jed was awarded 10,000 shares in ATL Ltd by ATL Ltd (his employing company), in June 2007. Jed paid 20p per share. The unrestricted market value of the shares in June 2007 was £2 per share.

However, the shares are subject to forfeiture if Jed leaves ATL Ltd within 3 years of the date of award. In addition, the shares cannot be sold within 6 year of the date of the award. As a result of these restrictions, the actual market value of the shares at the date of award is 50p per share.

Jed remains employed by ATL Ltd so the forfeiture restriction is lifted in June 2010. At this point, the restricted value of the shares is £1.20 per share (as a result of the sale restriction) and the unrestricted value is £3 per share.

Finally, the sale restriction is lifted in June 2013, when the market value of the shares is £4 per share.

Solution

As the forfeiture restrictions will be lifted within 5 years, there is no charge on the acquisition of the shares, even though the sale restriction is in place for 6 years.

The first charge will arise when the forfeiture restriction is lifted (June 2010). We calculate the charge using our formula:

UMV x (IUP – PCP – OP)

UMV is the market value of the shares at the date the restriction is lifted, ignoring any other restrictions i.e. £3.

IUP is the proportion of the initial value which has not been charged to tax. The initial unrestricted market value was £2 per share but Jed contributed 20p per share. So £1.80 of the £2 has not been charged to tax, giving an IUP of 0.9 i.e. £1.80/£2.00.

PCP is the previously charged portion which in this case is nil as this is the first chargeable event under s.428.

OP is the proportion of the share value still subject to restrictions. The unrestricted market value when the forfeiture restriction is lifted is £3 per share and the restricted value is £1.20, so £1.80 is the amount relating to the restriction, giving a value for OP of 0.6 i.e.

$$\frac{£3 - £1.20}{£3} = 0.6$$

We now have all the figures we need to calculate the tax charge:

10,000 x £3 x (0.9 – 0 – 0.6) = £9,000

A second charge will arise when the sale restriction is lifted in June 2013, calculated using the same formula.

UMV will be the market value of the shares, which is £4 per share.

IUP does not change and therefore remains at 0.9.

PCP is no longer nil, as there was a charge when the forfeiture restriction was lifted. The initial uncharged portion was 0.9 and the outstanding portion still subject to restrictions after the first restriction was lifted was 0.6, so the previously charged portion is 0.3.

OP is nil, as there is now no amount still subject to restrictions. Therefore the income charged to tax will be:

10,000 x £4 x (0.9 – 0.3 – 0) = £24,000.

39.8 Capital Gains Tax

For capital gains tax purposes, the shares have a "base cost" as follows: TCGA 1992, S.119A

	£
Amounts paid for the shares	X
Add: amounts taxed as employment income	X
CGT base cost	X

In illustration 4 above, Yvonne sold her 5,000 shares for £12.50 each in January 2011. She was not required to pay for the shares but had been charged to income tax on £40,000 when they were acquired and on £12,500 when the restriction was lifted. Yvonne would therefore make a capital gain of:

	£	£
Sales proceeds (5,000 x £12.50)		62,500
Amounts paid for the shares	NIL	
Add: amounts taxed as employment income £(40,000 + 12,500)	52,500	
CGT base cost		(52,500)
Capital gain (before annual exemption)		10,000

39.9 Election to disapply the restricted charges

It is possible for the employee and employer to make a joint **election to ignore** the impact of **all restrictions, including risk of forfeiture**.

ITEPA 2003, s. 431(1)

In this case the only income tax charge will be based on the **unrestricted** market value of the shares at the time of their acquisition, i.e.

Unrestricted value of shares at date of award	X
Less: amount paid by employee for the shares	(X)
Employment income	X

If such an election is made, there is no income tax charge when the restriction comes to an end.

The time limit for making this election is **14 days from the receipt of the shares**. The election is **irrevocable** once made. Again there is no requirement to send the election to HMRC (but it must be kept on file by the company in case of an enquiry).

The effect of an election is that all future increases in value from the date of award will be subject to capital gains tax. However, if the shares are disposed of for less than the unrestricted market value, any income tax paid on the initial award cannot be recovered.

Illustration 6

Returning to illustration 4.

Yvonne works for Carib Ltd. On 5 January 2008 she is given (free of charge), 5,000 shares in Carib Ltd. The shares were valued at £10 each in January 2008.

However, a condition of the offer is that Yvonne is prohibited from selling the shares until 6 January 2011. The effect of this restriction is to depress the share value as at January 2008 to £8 per share.

Yvonne and Carib Ltd make a joint election under s.431 ITEPA 2003.

Yvonne waits until 7 January 2011 at which point she sells her shares for £12.50 each.

Solution

Yvonne has restricted shares and a s.431 election is made, so a charge to tax on acquisition (January 2008) will arise as follows:

	£
Unrestricted value of shares at date of award (5,000 x £10)	50,000
Less: amount paid by employee for the shares	(NIL)
Employment income	50,000

No further charge arises when the restriction is lifted (January 2011).

The capital gain on sale will be:

	£	£
Sales proceeds (5,000 x £12.50)		62,500
Amounts paid for the shares	NIL	
Add: amounts taxed as employment income	50,000	
CGT base cost		(50,000)
Capital gain (before annual exemption)		12,500

The effect of the election is to turn more of Yvonne's profit into capital gain (which is beneficial given that the CGT rate is 18% if the gain falls within the basic rate band or 28%).

39.10 Convertible securities

ITEPA 2003, s.435

There is further anti-avoidance legislation to prevent an employer giving "low value" shares to an employee **which can then be converted** to "higher value" shares at a later date.

Where securities are acquired by reason of employment by an employee on terms that allow them to be converted to another class of shares, **2 charges** to income tax may arise:

1. firstly **when the shares are initially acquired** and,
2. secondly, **when the shares are converted**.

1) Tax charge on acquisition

When the convertible securities are initially acquired, a charge to tax will arise under s.62 ITEPA 2003 as follows: ITEPA 2003, s. 437

Market value of shares at date of award	X
Less: amount paid by employee for the shares	(X)
Employment income	X

The "market value" above is determined as if the securities were not convertible (ie, the initial charge to tax is based on the "depressed" value of the shares).

2) "Post acquisition" tax charge

A charge to tax may later arise if there is either: ITEPA 2003, s. 438

(a) a conversion of the securities into securities of a different description; or
(b) a disposal for consideration at a time when the securities are still convertible.

The chargeable amount is calculated by comparing the value of the securities after conversion with the value of the securities before conversion, i.e.

Market value of shares after conversion	X
Less: market value of shares before conversion	(X)
Employment income	X

Illustration 7

Debbie is given 1,000 shares in Gallagher Ltd (her employer company) in March 2008. The shares were then worth £8,000. The shares do not carry either voting rights or a right to a dividend, but will be converted to full ordinary voting shares (with dividend rights) if Debbie is still employed by Gallagher Ltd in March 2011.

The shares are still worth £8,000 prior to conversion and will be worth £14,000 when converted.

Income tax charges

1) On acquisition (March 2008):

MV at award (non convertible value)	£8,000

2) On conversion (March 2011):

	£
Market value of shares after conversion	14,000
Less: market value of shares before conversion	(8,000)
Employment income	6,000

39.11 Notional loans on partly paid shares

ITEPA 2003, s.446Q to s.446W

A "notional loan" will be treated as arising where employment related securities are acquired by an employee for consideration, and there is a **delay in the employee paying the consideration**.

In essence, the employee is treated as having "borrowed" the unpaid amount from the employer and a **taxable benefit will arise** on the amount "borrowed" based on HMRC's official rate of interest. No taxable benefit will arise where the notional loan (aggregated with any other outstanding loans) is less than £5,000 throughout the tax year.

The notional loan will be treated as discharged where the shares are sold or where the employee's obligation to pay is released. ITEPA 2003, s. 446U

If the notional loan is written off, a charge to income tax will arise in the year the loan is treated as discharged.

Where the notional loan is discharged by payment of the amounts outstanding or by death of the employee, no charge will arise (other than the usual notional loan benefit up to the date of repayment based on the HMRC interest rate).

Illustration 8

Mickey is given 8,000 partly-paid £1 ordinary shares in Cadillac Ltd (his employing company) on 1 June 2009. A fully paid share is worth £2.50 and Mickey will be required to pay £1 in respect of each share when the company calls for it.

Mickey sells the shares for £3 per share on 1 June 2011. At this point the call (ie, the amount owed to Cadillac Ltd for the shares) is still outstanding.

A charge to income tax will arise in 2009/10 when Mickey is given the shares. Fully paid shares are worth £2.50 per share. Therefore shares with a call of £1 will be worth £1.50.

	£
Value of shares at date of award (8,000 x 1.50)	12,000
Less: amount paid by employee for the shares	(NIL)
Employment income	12,000

In addition, a notional loan will be created, equal to the outstanding call of £8,000. Assuming an official rate of interest of 4% this gives the following charges:

2009/10

8,000 x £1 = £8,000 x 4% x 10/12	£267

2010/11

£8,000 x 4%	£320

2011/12

£8,000 x 4% x 2/12	£53

When the shares are sold, the loan is treated as written off and Mickey will be charged to income tax on the full £8,000.

From a capital gains tax perspective, the chargeable gain will be:

	£	£
Sales proceeds (8,000 x £3)		24,000
Amounts paid for shares	NIL	
Add: Amounts taxed as employment income		
- on acquisition	12,000	
- on discharge of notional loan	8,000	
CGT base cost		(20,000)
Capital gain (before annual exemption)		4,000

39.12 Shares with artificially decreased/increased market value

A charge will arise where the market value of employment related securities has been increased or decreased by "**non-commercial actions**". "Non-commercial actions" include anything that is done with the main purpose of securing a tax advantage and for transactions between companies in a 51% group. ITEPA 2003, s.446A

A tax charge will arise on acquisition where: ITEPA 2003, s. 446B

- in the seven years prior to acquisition;
- anything has been done to decrease the market value of the security by more than 10%.

The charge is based on the **difference between the full market value of the security and the actual market value.** ITEPA 2003, s. 446C

Similarly where something is done to **artificially increase the value of securities by at least 10%, a charge to income tax will arise.** ITEPA 2003, s. 446L

The charge will be based on the **difference between the increased market value and the market value disregarding the artificial increase.**

Illustration 9

Paddy is an employee and shareholder of Mimi Ltd.

The directors of Mimi Ltd are employed by the holding company, MFM Holdings Ltd, which charges a management charge to Mimi Ltd each year to cover the time the directors spend on the affairs of Mimi Ltd.

In December 2010 MFM Holdings Ltd decided to suspend the management charge and make other changes to intra group payments. As a result of these changes, the shares held by Paddy increased in value from £5,000 to £5,400.

Solution

There are transactions between companies in a 51% group which have the effect of increasing the value of Paddy's shares.

The increase in value of the shares is 8%. Thus no charge will arise on Paddy in the tax year 2010/11 (unless further non-commercial actions take place before 5 April 2011 which result in a total increase in value of 10% or more).

If Paddy's shares had increased in value to (say) £6,000 (ie, by 20%), an amount of £(6,000 – 5,000) = £1,000 would be charged to tax in 2010/11.

HMRC can also apply these rules to counter schemes whereby salary is given up in return for shares giving access to a dividend stream, such that dividends are thereafter paid free of PAYE & NIC.

Illustration 10

Karl works for Eastlands Ltd as a salesman. On joining the company he subscribed £100 for 100 £1 non-voting preference "A" shares. The shares carry no rights, other than the right to a dividend to be awarded by the directors at their discretion. Karl can surrender the shares for £100 on leaving his employment. Karl is paid a basic salary of £20,000 per annum on which PAYE is withheld. Any further remuneration is based on his sales.

Eastlands Ltd wishes to remunerate Karl for his sales performance in the year ended 31 December 2010. Therefore on 15 March 2011, the directors declared a dividend of £500 per share in respect of the "A" preference shares. A dividend of £50,000 was duly paid to Karl on 31 March 2011.

There is no charge to tax on the acquisition of the shares as the amount paid by Karl will be equal to their market value. As Karl can only surrender them for £100, the value of the shares will be the £100 paid.

However, HMRC will argue that on 15 March 2011, the employer has artificially increased the value of Karl's shares by £50,000 and that amount should be taxed as employment income. Once the dividend is paid on 31 March 2011, the shares fall back to their nominal value of £100 but that decrease is disregarded. Essentially the legislation turns what seems to be a dividend into employment income.

HMRC will argue that the action taken by Eastlands Ltd is "non-commercial" as one of the main purposes of this arrangement is the avoidance of tax and NIC. £50,000 will therefore be subject to PAYE and NIC in 2010/11.

39.13 Reporting requirements

ITEPA 2003, s.421J & s.421K

A return must be made to HMRC by **7 July following the tax year** in which there is a "reportable event". The return is usually made on Form 42.

The person liable to make the return is the employer or the person from whom the shares were acquired. "Reportable events" include the acquisition of securities and a chargeable event in relation to such securities, for example:

- the lifting of restrictions; or
- the employee disposing of his shares (other than to an associated person) before the restrictions are lifted; or
- the conversion of any securities; or
- the doing of anything which gives rise to a taxable amount counting as employment income.

Details of shares acquired by employees under tax-advantaged schemes such as SAYE schemes, company share option plans and share incentive plans, do not need to be reported on Form 42. Separate report forms are provided for such schemes.

EMI schemes also have separate reporting mechanisms although where EMI options are granted in excess of the tax-approved maximum (currently £120,000) the excess options must be reported on the Form 42.

Example 1

Shane is given 15,000 shares in his employer company, McGuire Ltd, in February 2010 when the shares were worth £3 per share. The shares are subject to a risk of forfeiture at £2 per share should he resign in the next 7 years. The restricted market value in February 2010 is assumed to be £2 per share.

Calculate the amounts charged to income tax if:

a) Shane resigns in December 2011; or

b) the risk of forfeiture is lifted in February 2012, when the shares are worth £7.

Example 2

Ian is managing director and 100% shareholder of Stella Trading Ltd. Ian is keen to reward the contribution of his senior salesman, Liam, who has been with the company since March 1996. Ian intends to award Liam a 10% holding of newly issued shares in Stella Trading Ltd in March 2011 (to coincide with Liam's 15-year service with the company). Ian estimates that a 10% shareholding will then be worth £150,000.

Ian is keen to control who owns shares in Stella Trading Ltd and the share agreement will therefore prohibit Liam from selling his shares within 2 years of issue. The effect of the restriction will be to reduce the value of the 10% shareholding in 2011 to £120,000. The shares will be worth £180,000 in 2013.

Ian will be 50 in 2016 and is thinking of selling the company. He anticipates that his 90% holding will then be worth about £2.5m and Liam's 10% holding will be worth £250,000.

Ian would like some advice on the following:

a) What (if any) will be charged to income tax in 2011 and 2013?
b) What elections are possible to mitigate any charges?
c) Assuming Liam sells his shares in 2016 for £250,000, what is his capital gain?

Prepare the necessary computations.

Answer 1

As the forfeiture risk can last more than five years, a charge to tax under s.62 will arise at the time of issue (February 2010) as follows:

15,000 x £2 (restricted value) = £30,000.

a) If Shane resigns in December 2011, there will be a charge under s.426 as follows:

$$\text{Proceeds} \times \frac{\text{IUMV} - \text{DA}}{\text{IUMV}}$$

"IUMV" is the "unrestricted" value of the shares at the date of award (£3).
"DA" is the amount paid for the shares (nil) plus the employment income on award (£2).

The charge will be:

$$15{,}000 \times £2 \times \frac{(3 - 2)}{3} \qquad \underline{£10{,}000}$$

b) If the restriction is lifted in February 2012, a charge will arise under s.426 as below:

$$\text{UMV} \times \frac{\text{IUMV} - \text{DA}}{\text{IUMV}}$$

"UMV" is the MV of the shares at the date the restriction is lifted (£7)
"IUMV" is the "unrestricted" value of the shares at the date of award (£3)
"DA" is the amount paid for the shares (nil) plus the employment income on award (£2)

The charge will be:

$$15{,}000 \times £7 \times \frac{(3 - 2)}{3} \qquad \underline{£35{,}000}$$

Answer 2

a) Amounts charged to income tax in 2011 and 2013

Liam will have restricted shares, so a charge to tax on acquisition (March 2011) will arise as follows:

	£
Value of shares at date of award ("restricted value")	120,000
Less: amount paid by employee for the shares	(NIL)
Employment income	120,000

A further charge arises when the restriction is lifted (March 2013), based on the formula in s.428:

$$UMV \times \frac{IUMV - DA}{IUMV}$$

"UMV" is the market value of the shares at the date the restriction is lifted (£180,000)
"IUMV" is the "unrestricted" value of the shares at the date of award (£150,000)
"DA" is the amount paid for the shares (nil) plus the employment income on award (£120,000)

The charge will be:

$$£180{,}000 \times \frac{150{,}000 - 120{,}000}{150{,}000} \qquad \underline{£36{,}000}$$

b) Elections to mitigate any charges

It is possible for employee and employer to make a joint election under s.431 ITEPA to ignore the impact of all restrictions.

In this case the only income tax charge will be based on the unrestricted market value of the shares at the time of their acquisition. There is no charge when the restrictions are lifted.

The revised charge in March 2011 would be:

	£
Unrestricted value of shares at date of award	150,000
Less: amount paid by employee for the shares	(NIL)
Employment income 2010/11	150,000

No further charge arises when the restriction is lifted in 2013.

There is therefore a potential saving by making an election as the employment income is reduced by £6,000. However this advantage is slightly eroded by Liam having to pay more tax up-front in 2010/11. In addition, more CGT will be due on an eventual sale (albeit at a reduced rate).

d) Liam's capital gain on selling his shares in 2016

The amount charged to CGT will depend on whether a s.431 election was made when the shares were initially awarded:

	No election	*Election*
	£	£
Sales proceeds	250,000	250,000
Amounts paid for shares	NIL	NIL
Amounts taxed as employment income	(156,000)	(150,000)
Capital gain (before reliefs)	94,000	100,000