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EMPLOYEE INCENTIVES – RESTRICTED SECURITIES REGIME

An employee who acquires an interest in shares in his employing company may be receiving a benefit that is properly viewed as part of his remuneration package and ought therefore be taxed as such.

The restricted securities regime is a particular aspect of the law governing the taxation of employee securities. It was introduced to counteract certain tax avoidance schemes. In very simple terms, the value of securities could be deliberately reduced by imposing restrictions at the time of acquisition, which is when the securities would be subject to income tax. The restrictions could then be lifted, increasing the value to the employee, at a time when no income tax (only capital gains tax, at a much lower rate) would arise.

The main aim of the restricted securities regime is therefore to impose income tax on any untaxed value of 'restricted securities' owned by any employee or director, when the restrictions are lifted or the shares are sold. Unfortunately the legislation is not restricted to cases of tax avoidance and can have effects where no tax avoidance is intended.

WHEN THE REGIME APPLIES

Employees or directors may acquire shares that are subject to restrictions that reduce their market value. Shares will be restricted securities, broadly speaking, if there is a restriction on the holder's right to dispose of or retain the shares or on any other right conferred by the shares, and the restriction reduces the market value of the shares. An example of a common restriction that may reduce share value would be a requirement to sell the shares at cost when the employee leaves employment.

WHAT 'RESTRICTIONS' MEANS

Restrictions of any nature are covered by these provisions if their effect is to depress the market value of the shares. These will include restrictions such as requiring the consent of an investor to any transfer, lock-ins, suspension of voting rights on departure and forfeiture if performance conditions are not met. It does not matter where the restrictions are contained – eg they may be in the company's articles of association, or in a shareholders' agreement, or anywhere else.

However, not all shares that have restricted rights are restricted securities for the purposes of the legislation. Shares with intrinsic restrictions which are not expected to be lifted, for example, a class of non-voting shares, will not necessarily be restricted. In contrast, if certain holders of shares are restricted from voting their shares in certain circumstances, these are likely to be restricted securities for the purposes of the legislation.

HOW THE REGIME WORKS

If at the time the shareholder acquires the shares he or she pays less than the shares' actual market value (and for these purposes, market value takes into account the effect of the restrictions) then he or she will have to pay income tax up front, under general tax principles, on the difference between the amount paid for the shares and the restricted market value.

However, if at the time the shareholder acquires the shares he or she pays less than their unrestricted market value (ie the value disregarding the effect of the restrictions), then the restricted securities regime will come into play. So, when the shareholder sells the shares or the relevant restrictions are lifted (for example, through the passage of time or because the articles are altered to remove them), the shareholder will have an additional income tax charge on a proportion of the value of the shares at that time. The taxable proportion is generally equal to the proportion of the discount to unrestricted market value the shareholder benefited from at the time he or she acquired the shares.

Where the shares are listed, or are otherwise subject to trading arrangements, or are in a subsidiary, a charge to both employers' and employee's national insurance contributions may also arise, and the income tax liability may be that of the company under the PAYE regime.

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So, if the market value of a share without restrictions was £1 and the shareholder paid the actual market value, taking into account the effect of the restrictions, of 75p, the discount would be 25%.

When the shares were sold income tax (and NIC if payable – see above) would be paid on 25% of the value (unrestricted market value, ie what it would be without restrictions) of those shares. So, if a shareholder sold the shares for £5 there would be income tax on £1.25 (25% x £5) per share.

ASCERTAINING THE UNRESTRICTED MARKET VALUE FOR THE SHARES

It is usually assumed that someone would pay more for a share that is not subject to the types of restrictions described above than they would pay for a share that is subject to them: the more onerous the restrictions, the greater the impact on value. However, it can be difficult to establish what, if any, impact on value the restrictions have.

Except in the context of HMRC approved, EMI, or employee shareholder schemes, it is not usually possible to agree share valuations with HMRC before shares are acquired. With other share incentives it can be difficult to be certain what the unrestricted market value of the shares is.

ELECTING TO DISAPPLY THE RESTRICTED SECURITIES REGIME

Given that the regime can result in substantial tax being paid on the lifting of restrictions or sale of the shares, HMRC has given employees the opportunity to elect out of the restricted securities legislation and to pay income tax on the unrestricted value of the shares, ignoring any restrictions placed on the shares.

The employer and employee can agree that the restricted securities regime should not apply to an acquisition of shares and the employee could, as a result, avoid an income tax charge on any share gain. This is done by employer and employee signing a joint irrevocable election under section 431(1) Income Tax (Earnings and Pensions) Act 2003 either before, or within 14 days after, the shares are issued to the employee.

The effect of the election is that the restrictions are disregarded in valuing the restricted securities and the income tax charge on acquisition is calculated on the unrestricted market value. This can increase the tax charge on acquisition of the shares, but will avoid a later, possibly much larger, charge upon removal of the restriction or on sale of the shares. If an election is made, income tax (and NICs if payable – see above) would be paid at the time of acquisition on the amount (if any) by which the price paid is less than the unrestricted market value of the shares. If there is no discount then there should be no tax to pay and when the shares are eventually sold the gain would be subject to capital gains tax only.

BENEFITS FOR THE EMPLOYEE OF MAKING AN ELECTION

- The assumption is usually that the value of the shares increases over time. As such, paying income tax (and NICs if relevant) on the discount now is better than paying income tax (and NICs if relevant) on the equivalent proportion of the (higher) value when the shareholder sells (or the restrictions are lifted).
- As explained above, NICs are only payable if the shares are listed, or are otherwise subject to 'trading arrangements', or are in a subsidiary. If no exit is in prospect at the time of acquisition and the company is not under the control of another company, shares in a private company are unlikely to produce an NIC charge. An NIC charge may apply if the restricted securities tax charge arises on a sale (because, in those circumstances, the shares are likely to be deemed to be subject to trading arrangements). The election can therefore avoid possible future NIC liabilities.

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BENEFITS FOR THE COMPANY OF MAKING AN ELECTION

- The election crystallises the tax position at the time shares are issued and is administratively simpler than managing complex restricted securities tax liabilities.
- If the value of the shares increases over time, any employer's NICs payable are likely to be less if paid on the amount of the discount when shares are issued than if paid on the same proportion of the value of the shares at a later date.
- Employer's NICs will only be payable if the shares are readily convertible assets - this is less likely to be the case at the time the shares are acquired than at the time of a sale.

RISKS FOR THE EMPLOYEE

- The employee may not keep the shares, meaning he or she will have paid tax on a benefit that has not been received.
- The value of the shares may not increase as expected, meaning that tax is paid on a greater value than has been received.
- The employee has to fund the tax up-front rather than (as is likely) from sale proceeds.

It is not possible to claim a refund of income tax paid if an election is made and any of these risks materialise. However, because of the benefits outlined above, the election is often made on a precautionary basis to ensure no restricted securities charges arise later on.

From the company's point of view, the only real downside of an employee making an election is that it may have to pay employer's NICs if the shares are readily convertible assets. However, for the reasons stated above, shares in a private company are less likely to be readily convertible assets at the time when they are acquired than at the time of a future sale. Therefore, despite this potential downside, it is most often advisable that companies require their employees and directors who are acquiring shares to enter into elections to disapply the restricted securities regime. A requirement on employee and director shareholders to do this could be incorporated into the company's shareholders agreement or articles of association and any option agreements with directors or employees.

SHARE OPTIONS - DEEMED ELECTIONS

The issues outlined above will arise both on simple acquisitions of shares and when shares that are subject to restrictions are acquired on exercise of options.

In the case of unapproved options, income tax will be payable on exercise of the option on any gain that is deemed to be made at that point (ie the difference between the market value of the shares at the time of exercise, taking into account any restrictions, and the option price). As with direct acquisition of shares, the election is available to substitute the unrestricted market value of the shares as the basis of the charge.

In the case of approved share options (ordinarily including EMI), a deemed section 431 election is made when the option is exercised and the shares acquired. There are special rules for EMI shares, and there is no deemed election if income tax arises on the exercise of the option. Income tax would normally only arise on an EMI option if the option was granted at a discount to the market value of the shares at grant or if there has been a disqualifying event for EMI purposes. If income tax does arise and there is no deemed election, then the same considerations as above will apply to whether an election should be made.

There is also a deemed section 431 election for shares in research institution spin-out companies. This applies where intellectual property has been transferred from a research institution to a company and shares are acquired in that company (within certain time limits) by a researcher who is involved in the research relating to the transferred intellectual property. In this scenario the deeming can be disapplied.

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FORFEITABLE SECURITIES

Forfeitable securities (as they are known colloquially), are a special class of restricted security where the restriction will fall away within five years of their acquisition. These securities are exempt from the general charge to income tax that would otherwise arise on the acquisition of forfeitable securities. Instead an income tax charge arises on the lifting of the restrictions. However, since the value of the shares might be higher by the time the restriction are lifted, the parties can elect (at the time of, or within 14 days following, the acquisition) that the exemption from the general income tax charge on acquisition is not to apply. By completing an election, income tax (and NICs if applicable) will be charged on the difference between the price paid for the security and the full market value of the security (ie ignoring the value of the forfeiture restriction), at the time the securities are acquired. No further charge to income tax (or NICs) will arise when the forfeiture restriction is lifted, regardless of any capital growth in the value of the security, which will fall under the capital gains tax regime.

NON-DOMICILED/NOT ORDINARILY RESIDENT SHAREHOLDERS

The restricted securities regime may apply to non-domiciled and not ordinarily resident shareholders. These tax payers should obtain specialist advice.

FURTHER INFORMATION

For further information, please get in touch with your usual Penningtons Manches contact.

This factsheet is intended to provide a general summary of the law in this area rather than comprehensive guidance or legal advice. Legal advice should be sought in relation to specific circumstances. The law and practice in this note is stated as at April 2016.

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FIND OUT MORE

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