# Employee Share Schemes

## Equity Reward for Private Companies

1st Edition

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# Part 2: Taxation of employee securities

# 3. Acquisition of securities

## 3.1 Introduction to share awards

In essence, when an employee receives securities, any difference between the value that he or she receives in the shares and the price paid to acquire them will be treated as taxable employment income and will be subject to tax under one of the provisions of ITEPA 2003.

How the tax would be collected is discussed in **Chapter 7** below and the position of the employer company is set out in **Chapter 6**.

In the absence of the special regime of charges in ITEPA 2003, Pt. 7, an award of shares to an employee would constitute "money's worth" in the hands of the employee, which would fall to be taxed as general earnings under ITEPA 2003, Pt. 3, Chapter 1. (The ITEPA 2003 provisions, now found at s. 62(3), are an enactment of the 1935 House of Lords decision in *Weight v Salmon*.)

This means that the employee would normally be treated as having received taxable employment income on the date that he or she received the shares that had been awarded. The value subject to tax would be based on the money's worth received by the employee, as set out above in **Chapter 2**, this valuation standard is different to that developed for the purposes of TCGA 1992, Part VIII, as the information that can be taken into account for such a valuation is less restrictive than the usual CGT valuation standard, which is used throughout ITEPA 2003, Pt. 7.

These rules exist in parallel with ITEPA 2003, Pt. 7, which introduces modifications to the tax regime; often a single transaction can be apparently within the scope of a number of different taxing provisions, although in reality the rules have to be read together as forming a unified system and often the "common law" tax charge under ITEPA 2003, Pt. 3, Chapter 1 will only be visible if there is a material difference in the "money's worth" and TCGA 1992, Part VIII valuations.

**Case:** *Weight v Salmon* (1935) 19 TC 174

## 3.2 Acquiring securities – looking at the deal

In order to work out how an award of securities should be taxed there are two essential elements that need to be considered:

- The status of the securities themselves – are the securities convertible into other securities? Are there any restrictions on the rights of the securities?
- The terms of the offer of securities to the employee – does the employee have to pay anything to acquire the securities? Will the employee have to pay something for the securities now or in the future? Does the employee receive the securities now, or in the future? Do the terms of the offer to the employee impose additional restrictions on his or her rights to enjoy the securities?

These questions go back to the principle set out in **Chapter 1**:

- at what point does the employee receive value?
- how do we measure that value?
- and to what extent can the employee be said to have given consideration for the value that he or she has received?

If the securities' rights or the terms of the offer place a restriction on the employee's rights over the securities, then the employee can be seen to have received only a proportion of the value of the securities; the provisions of the restricted securities regime will need to be considered to establish how much value is treated as taxable employment income and when it will come into charge (discussed in detail at **3.3** below).

Where an employee receives securities, which are convertible into securities of another description, then that employee cannot be said to have received the whole benefit of the securities until they have undergone their conversion into the other type of securities. For this reason, the rules on convertible securities in ITEPA 2003, Pt. 7, Chapter 3 have the effect of disregarding the securities' conversion rights when they are acquired, deferring the bulk of the tax charge until the point that the employee receives value, when the conversion event takes place. These rules are discussed in detail in the next chapter.

If the deal is such that the employee has a right to acquire securities at a point in the future, then the rules on securities options in ITEPA 2003, Pt. 7, Chapter 5 will apply (see **3.5** below).

Finally, if an employee has agreed to pay something for the shares at a date in the future, or if the shares are not fully paid up when they are issued to the employee, the "normal" rules in Part 3, Chapter 1 would treat the promise to pay in the future as good consideration that would reduce or eliminate the tax charge on acquisition. The additional rules in Part 7, Chapter 3, discussed in full at **3.4** below, set out how to deal with this sort of transaction and the modifications that are needed to the basic regime.

## 3.3 Restricted securities

### *3.3.1 Before FA 2003*

Before FA 2003 there had been two disjointed tax regimes in place that dealt with the situation where shares granted to employees were subject to a risk of forfeiture (the "conditional shares" regime) or subject to restrictions on their rights.

Although both regimes remain technically in force, they only apply to shares that were acquired by reason of employment before 16 April 2003 and, in consequence, are increasingly rarely encountered in practice.

These rules deferred tax charges, in whole or in part, from the date that the shares were acquired by the employee to the date the shares were disposed of or the employee otherwise came to a full enjoyment of the share rights.

In the case of the rules on conditional shares, the regime applied where an employee could be forced to dispose of his or her shares and brought the whole value of the shares into charge as taxable employment income at the point that the shares were sold or they ceased to be conditional. This could leave employees, who believed that their profits on selling their shares were capital and subject to tax at a maximum rate as low as 10%, suffering PAYE and NIC charges at far higher rates.

The rules were, on the whole, poorly understood by advisers and were seen to have unfair and perverse results for employees.

### *3.3.2 Finance Act 2003: restricted securities*

In order to remedy some of the unfairness that was perceived to exist in the old rules, as well as to combat tax avoidance using securities, new rules were introduced in FA 2003. The new rules applied to all shares acquired on or after 16 April 2003 and came fully into force on 1 September 2003.

The rules on restricted securities are set out in ITEPA 2003, Pt. 7, Chapter 2 and their rationale is to defer tax charges until the point that an employee enjoys the value from his or her shares or other securities.

The principle underlying the rules is that where an employee acquires shares that are subject to a restriction that reduces their market value, then the value brought into tax when the shares acquired will be reduced to reflect the restrictions; when the restrictions are lifted or the shares are sold, then there will be a further tax charge to reflect the value "freed up" by the lifting of the restrictions.

There is an inherent problem in the drafting of the legislation, because it fails to take into account the impact of the change from a "money's worth" valuation of employees' shares to the TCGA 1992, Part VIII value: if a restriction is inherent in the shares' rights, it will be fully taken into account in valuing the shares, as a third party purchaser of those shares would be subject to the restriction; if a restriction is not an inherent share right, it will not be reflected in the valuation at all, because the hypothetical third party purchaser envisaged by the legislation and case law would not be treated as being bound by any restrictions that did not attach to the shares directly. This point is explored in more detail in **Chapter 2** above.

The profession and HMRC have tacitly come to a compromise, entertaining the polite fiction that the market value of shares can be affected in the ways envisaged by the legislation, and the courts have given a degree of support to this premise. Whether the courts would continue to entertain this view if the point were to be directly litigated is questionable, but the author suspects that it is not in the interests of taxpayers or HMRC to pursue the point to a court capable of decisively ruling on it and that the polite fiction will continue for so long as the legislation remains in force.

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