3.3.8 Exemption for "normal" transactions

ITEPA 2003, s. 429 prevents a chargeable event from being treated as having occurred where a number of key tests are met, which can be summarised as follows:

- All of the shares of the same class are affected by the same restrictions.
- The same event triggers the same lifting or variation of restrictions or disposal of the shares for all of the persons holding shares of that class.
- Either the company is treated as "employee-controlled" by persons holding that class of shares or the majority of the shares were not employment-related securities.
- There was no tax avoidance motive underlying the arrangements.

The term "employee-controlled" is defined in s. 421H and describes a company whose employees collectively could exercise control of the company and where those employees exercise that control because they own a particular class of shares.

The purpose of this exception is to prevent tax charges from arising on transactions that are part of the ordinary life-cycle of a company and that are unconnected with providing rewards to employees.

Example – restricted securities – exempt transactions

At the time of its sale to Chai Corp, Tea Ltd has two classes of shares in issue: 200,000 ordinary shares and 25,000 B shares.

The ordinary shares have voting rights and are held by Vaughn Capital Partners, a private equity house. The B shares do not confer voting rights and are held by the employees.

Because the holder of the ordinary shares controls the company, its sale to Chai Corp will not be an exempt transaction: even though the sale to Chai Corp is an event that affects all of the shareholders, the company is not treated as employee-controlled for the purposes of s. 421H, because the B shares do not confer voting rights on the employees, let alone control over the company.

If Vaughn Capital Partners had owned the majority of the B shares, the transaction would have been exempt, as the majority of the B shares would not have been employment-related securities.

As was the case elsewhere in ITEPA 2003, Pt. 7, the anti-avoidance provision in s. 429 was inserted with effect from 4 December 2004, as a number of weaknesses had been identified in the tax regime by advisers and ingenious steps had been taken to exploit those weaknesses.

Examples of the type of planning that was adopted were the subject of the judgment in the twin cases of *UBS AG* and *DB Group Services (UK) Ltd*. Although the cases differ slightly in detail, the broad thrust of the planning was very similar:

- Each company incorporated a company (a special purpose vehicle or SPV) in an offshore jurisdiction.
- Cash contributions were paid into the SPVs, which were then invested.
- The SPVs had no other purpose or activity other than holding the investments.
- Shares in the SPVs were issued to employees of UBS and DB.
- The terms of the share issuance were that such that they had to be surrendered if certain conditions were not met. In other words, a forfeiture condition applied to the SPV shares. The forfeiture condition lasted less than five years.
- It was arranged that the shares held by the employees had voting control of the SPVs.
- The employees' investments in the SPVs could then be liquidated at a future date, with the intention that the employees would enjoy capital treatment.

The analysis of these transactions under the original version of s. 429 was that the acquisition of the shares in the SPVs did not give rise to a tax charge on the employees, as the shares were forfeitable securities within the scope of s. 425.Then, at the time that the risk of forfeiture lifted, the SPVs were employee-controlled by virtue of the particular classes of shares held by the employees, with the result that the lifting of the forfeiture condition did not give rise to a tax charge either. Needless to say, this analysis would fail under the law as currently enacted: the arrangements were transparently intended to avoid tax and would be caught by the anti-avoidance provisions now contained in sections 429 and 431B.

The approach adopted by the Supreme Court was to consider the material reality of the transactions: in reality, there was very little chance that the forfeiture conditions could be invoked. On the basis that there was no real risk of forfeiture, and that the forfeiture conditions had no commercial or business purpose, the SPV shares could not be treated as forfeitable securities and the special regime in s. 425 could not apply. In short, the employees were taxed on the full market value of the SPV shares when they received them.

The decision in *UBS AG* and *DB Group Services (UK) Ltd* was reviewed and applied by the Upper Tribunal in *Cyclops Electronics*. In that case, the tribunal appeared to go somewhat further than the Supreme Court, by simply asserting that a restriction can only be taken into account for the purposes of ITEPA 2003, Pt. 7, Ch. 2 if there is a business or commercial purpose underlying it: the commercial reality of the operation of the restriction was not relevant. It remains to be seen whether the approach taken in *Cyclops* will be followed more generally by the tribunals or whether it will be rejected as too extreme an approach to these provisions.

Cases: *UBS AG v HMRC, and DB Group Services (UK) Ltd v HMRC* [2016] UKSC 13; *Cyclops Electronics Ltd and another v HMRC* [2018] UKUT 7 (TCC)

3.3.9 Effect of elections

The legislation provides for a regime of elections, allowing employers and employees to modify the tax treatment of securities under ITEPA 2003, Pt. 7, Ch. 2.

The four types of election are as follows:

- s. 425 – disapplies the forfeitable securities rules when securities are acquired;
- s. 430 – disapplies the effect of the remaining restrictions on shares after a chargeable event has taken place;
- s. 431(1) – disapplies the whole of the restricted securities regime when securities are acquired; and

- s. 431(2) – disapplies the effect of some restrictions when securities are acquired.

There is a comparatively short timescale for making these elections:

- elections under sections 425, 431(1) and 431(2) must be made within 14 days of the date on which the securities are acquired; and
- elections under s. 430 have to be made within 14 days of a chargeable event.

The elections must be made jointly by both the employee and employer company. There is no obligation to file them with HMRC, but they must be available for inspection.

In practice, elections under s. 425 are rarely, if ever, used. If an employee and employer wish to make the acquisition date the tax point for the acquisition of forfeitable securities then the likelihood is that they will wish to disapply the whole of the restricted securities regime, in which case an election under s. 431(1) would be more appropriate.

The circumstances in which elections under s. 431(2) might be used are limited; the only commercially sensible reason for disapplying some, but not all, of the restrictions attaching to securities might be where forfeitable securities have other restrictions applying to them and the parties are keen to take advantage of the forfeitable securities rules without wishing to worry about the tax effect of the other restrictions on the shares.

Elections under s. 430 are also comparatively rare, as the first chargeable event relating to an employee's securities is likely to be their sale. The main situation where a s. 430 election would be of use would be where forfeitable securities have been given to an employee and the forfeiture condition has lifted, but there are still outstanding restrictions on the shares.

The most frequently encountered election is the election to opt out of the restricted securities regime completely, set out in ITEPA 2003, s. 431(1).

Example – elections

Tea Ltd makes a further award of shares to Martin, which are conditional on his meeting a performance target – if he does not meet the performance target by the third anniversary of grant, he will be obliged to sell the shares back to the company at par.

This is a forfeiture condition and it falls within the scope of ITEPA 2003, s. 425 because it has a lifespan of less than five years.

The shares are of the same class as those comprised in Martin's other share awards and carry the same restrictions.

If Martin and the company do nothing, then Martin will not be taxed when he receives the shares; instead, Martin will be treated as having received taxable employment income equal to the shares' restricted value when the forfeiture condition lifts and then there would be a further tax charge under the restricted securities rules when Martin sold the shares.

If Martin and the company make a s. 425 election, then Martin would be taxed on the shares' restricted value when he receives them, and would then suffer a charge under the restricted securities rules when he sells; Martin would not be refunded the tax that he suffered if he does not meet the performance conditions and is forced to sell the shares back at par – at best he would have realised a CGT loss.

Martin and the company could make a s. 431(2) election to ignore all of the restrictions on the shares other than the forfeiture condition – this would mean that Martin would not have an up-front tax charge: if the performance conditions are satisfied, Martin will pay tax on the UMV of the shares at that point and will not be subject to further tax charges under the restricted securities regime when he sells the shares; if the performance condition is not met, then the shares will be forfeit and Martin will not have suffered a "dry" tax charge. The same result would arise if Martin did nothing when the shares were awarded to him, but he and the company made a s. 430 election when the performance condition was achieved.

Finally, if Martin and the company made a s. 431(1) election when he acquired the shares, then neither the restricted securities rules nor the forfeitable shares rules would apply: Martin would pay income tax on the whole unrestricted value of the shares when he acquired them and would have no further exposure to the rules on restricted securities; however, he would run the risk that he paid tax in respect of shares that he subsequently loses.

Where an employee acquires shares through one of the tax-advantaged share schemes set out in statute (which are discussed in more detail beginning at **Chapter 12** below) they may be deemed to have made s. 431(1) elections when their awards crystallise under ITEPA 2003, s. 431A – these rules are dealt with in more detail below.

If securities have been acquired as part of a tax avoidance scheme, then ITEPA 2003, s. 431B deems that a s. 431(1) election will have been made.

With the exception of the forfeitable securities rules, most employers see the restricted securities regime as an unnecessary complication that could hinder future transactions; it is very rare for a well-advised employer to wish to risk the potential future compliance obligations that arise from the restricted securities regime, and employers will usually make employee share awards dependent on the employee entering into a s. 431(1) election.

Elections are usually high up on the list of documents requested by purchasers of companies in due diligence processes; if elections have not been made or there are questions about their validity, the effect on due diligence processes can be entirely disproportionate to the tax at risk.

Although many employers are willing to take advantage of the forfeitable securities regime, most employers see the restricted securities regime as a risk and trap for the badly advised.