

When isn't a share 'employment-related'?

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1. The purpose of this talk is to identify circumstances in which shares (and share options) held by an employee do not count as 'employment-related securities' for the purposes of Part 6 ITEPA03.
2. The importance of this is that capital gains on shares falling within those provisions can be charged to income tax instead of capital gains tax (and so at a higher tax rate), and attract national insurance contributions, and the income tax and NICs can be within the PAYE regime (requiring grossing up, or reimbursement by the employee).
3. The basic proposition is to tax value an employee receives from / by reason of his / her employment. Looked at from the opposite direction, value that is received for other reasons – for example because of changes in 'normal' market value – should not be within this legislation.
4. Thus, within the category of 'ERS', further limits apply to ascertain what is taxed as income:
 - restricted securities: securities providing for transfer, reversion or forfeiture (other than for unpaid calls, or bad leaver provisions) so that the market value of the securities is reduced (Chapter 2 of Part 7);
 - convertible securities: securities carrying rights for the holder to convert them into securities of some other description (Chapter 3 of Part 7);

- securities with artificially depressed or enhanced market value: for example, where the value has been reduced / increased in order to avoid tax or NICs, or intra-group transactions not on arm's length terms (Chapters 3A and 3B of Part 7);
 - securities acquired for less than market value: this includes securities where the agreed price is market value, but payment of any part of it is delayed. Income tax is charged on the basis of a notional employer loan, in the amount of the shortfall (Chapter 3C of Part 7);
 - securities disposed of for more than their market value (Chapter 3D of Part 7);
 - Post-acquisition benefits from securities: this is intended to be a catch-all provision, but its scope is unclear.
5. The charges arise on the occurrence of specific transactions, termed by the legislation 'chargeable events'. These are:
- restricted securities: the lifting or variation of any restrictions, or the disposal of the shares for consideration;
 - convertible securities: the conversion or disposal of the securities, the surrender of the right to convert, or the receipt of any consideration in connection with the entitlement to convert;
 - securities with artificially depressed or enhanced market value: the acquisition of the securities, or their valuation at the end of any tax year;
 - securities acquired for less than market value: tax is charged on the basis of an ongoing loan;
 - securities disposed of for more than their market value: their disposal;
 - Post-acquisition benefits from securities: the receipt of any benefits.

6. But this paper focusses on when shares (or share options) count as ‘employment-related securities’ within the meaning of section 421B (section 471) ITEPA03.

7. Section 421B provides *inter alia*:

‘(1) Subject as follows (and to any provision contained in Chapters 2 to 4A) those Chapters apply to securities, or an interest in securities, acquired by a person where the right or opportunity to acquire the securities or interest is available by reason of an employment of that person or any other person.

(2) For the purposes of subsection (1)—

(a) securities are, or an interest in securities is, acquired at the time when the person acquiring the securities or interest becomes beneficially entitled to those securities or that interest (and not, if different, the time when the securities are, or interest is, conveyed or transferred), and

(b) “employment” includes a former or prospective employment.

(3) A right or opportunity to acquire securities or an interest in securities made available by a person’s employer, or by a person connected with a person’s employer, is to be regarded for the purposes of subsection (1) as available by reason of an employment of that person unless—

(a) the person by whom the right or opportunity is made available is an individual, and

(b) the right or opportunity is made available in the normal course of the domestic, family or personal relationships of that person.’

8. Section 471 makes corresponding provision in relation to options to acquire securities.

9. The first point is what specifically the tests are. It is not enough, in particular, that shares are issued by the employer. The question is always as to the right or opportunity to acquire them. Of course, there is a big overlap. Where an employer

issues securities directly to an employee, it is likely (but not always) that the right or opportunity to acquire those shares has been 'made available by' the employer. However, if, for example, another shareholder gives the employee shares, or the employee buys the shares from another shareholder, then the right or opportunity is not 'made available by' the employer. Nor is the right or opportunity acquired 'by reason of an employment' of the recipient. So the shares are not within the regime.

10. On the other hand, if an employer buys shares in a listed company and then gives those shares to its employees as part of their remuneration, the fact that those shares are not in the employer does not preclude them from being 'ERS'. The opportunity to acquire the shares is available by reason of the recipient's employment, and the shares are therefore ERS.
11. This is the issue in the ongoing case of *Vermilion v. HMRC* [2021] STC 1874. Simplifying the facts, a consultant was granted share options in a company as part of his fee. A year later, he agreed to become a director as part of a rescue funding exercise, and to reduce his option entitlement. Instead of amending the option agreement, the existing options were cancelled and new ones issued. HMRC keep arguing that the fact that the company granted the new options is in itself enough to mean that the right or opportunity to acquire them was made available by the company (the employer). That must be wrong. On the facts, the reason he could get the new options was only because he had the old ones. If anyone 'made available' the right or opportunity to acquire the new options, it was either the man himself, by agreeing to give up the old ones, or the new investors, by allowing him to keep some of his existing options. Either way, the fact that the company issued the new options is not sufficient. The Court of

Session agreed the options were not within the regime; HMRC have appealed to the Supreme Court, and the appeal will be held in February 2023.

12. The second issue is founder shares.
13. HMRC say that one of the reasons for bringing in the current rules in Part 7 of ITEPA03 was to ensure that founder shares are caught.
14. But are they?
15. In a sense, it might not matter in a company with a single founder. This is because in that case, that individual can subscribe for shares at their par value, and the shares can be unrestricted and unconvertible. So no Part 7 charges will arise in any event. HMRC accept this: ERS Manual, ERSM 20240.
16. But unrestricted shares might not be commercially possible where there is more than one founder. So the question arises as to whether they are within the provisions.
17. HMRC say (ERS Manual, ERSM 20240):

‘There is no concept of “founders’ shares” in the legislation. The founder of a company who is to be a director of that company from the start acquires employment-related securities and is within the scope of the rules.’
18. But no explanation is given. The issue has not come before the tax tribunal. So it remains to be tested.
19. What HMRC seem to rest upon is the point that ‘employee’ is defined to include prospective employees. So, for example, where a person is granted shares at a time when it is anticipated / expected that s/he will become a director or employee of the company making the grant, those shares are caught.
20. But founders’ shares are in a different position. At the time the right or opportunity to acquire the shares is made available to the individual, the (future) employer does

not exist. Therefore, it cannot be the one who is making that right or opportunity available.

21. It is indeed not even clear if the founder him / herself makes the right or opportunity available to him / herself, at least where the founder incorporates the company as opposed to buying it from company formation agents for example. This is because the founder becomes a member by subscribing the memorandum of association, and registering the company at Companies House with a statement of capital and initial holdings: section 16(5) and section 112 Companies Act 2006. The scenario is certainly outside the primary provision, that applies where the right or opportunity is available 'by reason of an employment of that person'. Indeed, it seems the other way around: employment by the company is made available by the founder shareholder.
22. The deeming provision, which asks whether the right or opportunity was made available by the company or a person connected with the person's employer is the grey area.
23. The right or opportunity is not made available by the company: it does not exist at the time.
24. A founder shareholder becomes connected by the issue of shares (assuming that the shares confer control of the company on the shareholder). But the right or opportunity to acquire those shares, if made available by that person, is made available before that person is connected with the company, again not least because the company does not exist at that time. The fact that the term 'employer' includes future employers does not gainsay this, because the point is that there is no connection at the time the right or opportunity is made available.

25. So my view, at least, is that founder shares remain outside the scope of the ERS provisions. But as mentioned, this is not HMRC's view, and so relying on this point is likely to lead to a tax tribunal appeal.
26. We take this a step further, to founder shares where the founder is non-UK resident. What difference does that make? So far as the basic issue of whether the shares are ERS is concerned, it makes no difference: the same arguments arise, and again, my view is that founder shares issued to a subscriber to the memorandum are not ERS.
27. But let us assume that that is wrong, and that such shares count as ERS.
28. So long as the individual remains non-UK resident and has no UK located duties, no problem arises: s/he is not liable to UK income tax, and therefore no charge under the ERS provisions in any event.
29. What if the individual becomes UK resident, or performs part of his / her duties in the UK (other than incidental ones) at some point in the period between grant and chargeable event? Chapter 5B of Part 2 ITEPA03 provides rules for apportioning the specific employment income arising on a chargeable event. So the total income is treated as accruing equally day-to-day, and is then apportioned according to residence status and, so far as while non-UK resident have been performed partly inside and partly outside the UK, on a just and reasonable basis: section 41H(8) ITEPA03.
30. Can an election be made under section 431 ITEPA03, for the market value of restricted securities on acquisition to be treated as the market value of those securities without all or any of the restrictions, and subsequent chargeable events not to give rise to any charge under the restricted securities provisions? If so, then if granted to a non-UK resident individual, the difference between those market values would escape UK

income tax. The answer is yes, but only if the non-UK resident performs some non-incident duties in the UK in the course of the year of grant: section 431(6) ITEPA03, in conjunction with sections 27 and 39 ITEPA03.

31. One final point to consider is share exchanges, or other transactions by which securities that are not ERS are exchanged or converted into new shares, in the context of foreign founders.
32. An example of an exchange is *Vermilion*, and I am not clear that the facts that the shareholder is a founder rather than a consultant, and on grant is non-UK resident, make any difference. So in a sense the best I can say is wait and see what the Supreme Court says. But that is about a year from now, and clients need advice before then.
33. First point to note is that if matters transpire the other way around – so shares that are ERS are converted or exchanged into other shares – the new shares are within the ERS regime: sections 421D and 483 ITEPA03. So there is at least a consistency in arguing that where one starts with non-ERS shares, any new shares should also be non-ERS.
34. But the legislation does not expressly say that, so it might be interpreted as meaning that the new shares have to be considered on their own: was the right or opportunity to acquire them made available by a person's employer, or person connected with the employer?
35. As mentioned, being issued by the employer is not enough. It is a highly fact-sensitive issue, and depends on a close analysis of matters of what it is that enables the employee to enjoy the benefit of the new shares: *Wicks v. Firth* [1982] 1 Ch. 335, per Oliver, L.J., at 371. But it seems to me that, if the new shares are offered on the same basis to the now employee as they are offered to any other existing shareholders, then

the new shares should not be ERS shares. This applies also *mutatis mutandis*: in other words, if the now employee's existing shares are subject to restrictions but other shareholders' shares are not, the employee's new shares will not be ERS shares provided their terms correspond to the existing shares in the same way as other shareholders' new shares correspond to the terms of their existing shares.

36. And as always, consideration of the issue at the time of the transaction, and careful documenting of it, including the reasons for them, are necessary in order to achieve the correct tax result.

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