Traps for the unwary

Employment Tax

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Sue Wilson and Rob Goodley say caution is needed when undertaking company reorganisations where employee shareholders are present

Key Points

What is the issue?

Employee shareholder (ES) status provides a potentially generous tax regime, but the capital gains tax exemption applicable to ES shares can be lost in unexpected circumstances

What does it mean for me?

Care should be taken when reorganising the share capital of a company in which there are ES shares

What can I take away?

Seemingly benign changes to a company’s share capital structure can have a surprisingly adverse effect on an employee shareholders’ tax position. Before making any changes to a company’s share capital, shareholders and their advisers should consider the alternative methods for achieving their commercial aim and how employee shareholders are likely to be impacted by these

On 1 September 2013, the concept of ‘employee shareholder’ was introduced into UK employment law, together with an associated capital gains tax (CGT) exemption and some limited income tax relief. The new arrangements were described as a ‘three way deal’ by Chancellor George Osborne at the Conservative Party conference in October 2012, where he went on to say:

‘You the company: give your employees shares in the business. You the employee: replace your old rights of unfair dismissal and redundancy with new rights of ownership. And what will the government do? We’ll charge no CGT at all on the profit you make on your shares.’

A useful summary of the ES regime was set out by Naomi Nesbit and Matt Hall in their article ‘What a gift!’ in the May issue of *Tax Adviser*. The purpose of this article is to highlight some specific issues which arise from the drafting of the CGT exemption in TCGA 1992 ss 236B to 236G, which is of course the real ‘carrot’ for employees when agreeing to become an employee shareholder.

We have set out a few scenarios where a company might follow familiar tried and tested approaches in the expectation of tax neutral outcomes to show how they may affect employee shareholders. In all of the scenarios, the reader should assume that there is no value shift between shareholders as a result of the reorganisational steps.

Limiting the application of the CGT exemption

A key issue faced by the draftsmen of the ES shares legislation was how to ensure that the relief does not survive 'exit events', for want of a better term.

Takeover of an ES company

Suppose that the CEO of a start-up technology company, 'Techco', becomes an employee shareholder of that business, acquiring a shareholding worth £10,000. The business grows exponentially and, after two years, is purchased by a larger competitor. As part of the deal, the CEO is required to reinvest half of her £200,000 proceeds.

As is common in this situation, the CEO's reinvestment is achieved by a rollover of her shares (ie the shares of Techco that the CEO does not sell for cash are exchanged for shares of the acquirer).

In this scenario, we understand that the policy intention is that the CEO should enjoy the CGT exemption on the £200,000 of value that has been created to date, but not any future growth on the £100,000 that she reinvests.

This is where the drafter of the ES shares legislation has implemented the 'exit events' block: TCGA 1992 s 236F disapplies the provisions of TCGA 1992 ss 127 and 135. These provisions essentially state that if a company reorganises its share capital (s 127), or if a shareholder exchanges shares in one company for shares of another (s 135), then this should normally be considered a tax neutral event, rather than a disposal of the original shareholding and the acquisition of a new one.

Generally speaking, TCGA 1992s 236F will apply as intended where this is an actual 'exit event'. However, what happens if there is a share for share exchange as part of a group reorganisation?

New holding company

Let us suppose that soon after Techco issues shares to the CEO, the shareholders decide to separate the trading activity into a new company by introducing a holding company via a share for share exchange with 'mirrored' share rights. Because s 135 is disapplied under the ES legislation, this is clearly a disposal of the ES shares – and the end of the exemption on the CEO's ES shares. Unlike almost all other situations involving normal or tax-advantaged share arrangements, a mirrored share structure with identical shares and shareholders is not protected under the ES legislation.

Reorganisations

Turning to the reorganisation rules in s 127, the tax neutral reorganisation provisions are incredibly useful pieces of legislation in many commercial situations and tax advisers will often rely on these provisions without further consideration, given their intuitive logic. Undertaking a company reorganisation without these provisions means that tax advisers need to return to first principles: has there been an actual disposal of the original shares and an acquisition of a new shareholding? This can lead to some rather bizarre results, as the following scenarios illustrate.

Bonus issue of shares

Let us return to Techco and rewind the clock to when the CEO first received her £10,000 worth of shares in the company.

Let us suppose that, at that time, the company had just one class of share in issue, which after the CEO received her shares were held as follows:

Table 1		
Founder	96	£1 ordinary shares
CEO	4	£1 ordinary shares

Shortly afterwards, the founder shareholder decides that he would like to give the CFO of the business a small equity interest of around 0.2%. This will be less than the value of one share, so Techco undertakes a nine for one bonus issue of shares, and then issues two shares to the CFO. The company shareholdings then become:

Table 2		
Founder	960	£1 ordinary shares
CEO	40	£1 ordinary shares

CEO	1	£1 ordinary shares

Ordinarily, TCGA 1992 s 127 would apply to the nine for one bonus issue, and so the CEO’s 40 shares would ‘stand in the shoes’ of the original four shares that she held. However, as the CEO is an employee shareholder, TCGA 1992 s 127 does not apply to the shares that she holds. Therefore, while her original four shares retain their ES status, the 36 new shares that she has been issued were not acquired by her pursuant to an ES agreement. Therefore, they do not qualify for the CGT exemption.

In simple terms, 90% of the value of the CEO’s CGT exemption has been lost as a direct result of the bonus issue of shares.

Share split

Let us suppose that the facts are the same as in the bonus issues scenario, but instead of carrying out a nine for one bonus issue, Techco decides to perform a 10 for one share split. The shareholding details after the share split and after making the share award to the CFO are as follows:

Table 3		
Founder	960	£0.10 ordinary shares
CEO	40	£0.10 ordinary shares
CEO	2	£0.10 ordinary shares

Again, the TCGA 1992 s 127 provisions do not apply to the shares held by the CEO. The question then becomes: has the CEO disposed of her shares and/or acquired new shares

From a company law perspective, the share split does not change the total amount of ordinary share capital of Techco (it is £100 both before and after the share split);

and it does not change the CEO’s share of voting rights or economic rights, etc. On that basis, one could conclude that the CEO has not disposed of one asset and acquired another: it is just that her original asset has been cut up into 10 pieces. However, this is certainly not clear cut – it could be argued that the original shares have been disposed of in full and a completely new shareholding acquired.

If the former is correct, the CGT exemption is preserved. If the latter is correct, the exemption is crystallised in full and any future growth is not exempt (the base cost being the value at the date of the share split). We understand that HMRC consider this to be a legal question rather than a tax question.

Questions to ask

The ES CGT exemption applies to the ‘first disposal’ of an ES share. So, when undertaking a company reorganisation where some of the shareholders are employee shareholders, two things need to be considered:

1. Will the reorganisation result in employee shareholders disposing of some or all of their shares? If so, the CGT exemption will be crystallised on the shares that are disposed of.
2. Will the reorganisation result in employee shareholders acquiring new shares? If so, the CGT exemption will not apply to the newly acquired shares, as they were not acquired pursuant to an ES agreement.

The logic of the rules may need to be tested in any number of more complex scenarios.

External investment

A company starts with a single class of shares including some ES shares. Sometime later, an incoming investor acquires convertible preferred shares. In order to protect its investment, the investor insists upon a number of restrictions (such as leaver and transfer restrictions) being placed on the original shares.

Have the employee shareholders made a disposal of their ES shares? Initially you may think not, because they hold the same number and class of shares both before and after the reorganisation. However, some fundamental changes have been made to those shares, so could HMRC argue that they are now a new asset?

The answer to this question is: possibly. As discussed in *Unilever (UK) Holdings Ltd v Smith* (Inspector of Taxes) [2002] EWCA Civ 1787, the degree to which shares rights are changed will determine whether or not there has been a disposal. However, where the line is drawn for these purposes is unclear, and so a degree of judgment is required.

Summary

In summary, shareholders and their advisers should tread very carefully when undertaking company reorganisations where employee shareholders are present. If the ES status survives over the longer term, it is to be hoped that legislators may turn their attention to the anomalies to ensure that employee shareholders are protected where there is a technical disposal, but no economic changes.