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Legal update - Inland Revenue's focus on certain employee share schemes

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Inland Revenue has recently released Revenue Alert RA 15/01 (Alert). The Alert signals Inland Revenue's increased focus on certain employee share schemes, especially those which in Inland Revenue's view have the legal form of share scheme but the economic effect of an option scheme.

Reason for the increased focus

The increased focus is due to the difference in the tax treatment between share schemes and option schemes.

When a company issues shares to employees, the employee is taxed on any benefit received from the issue of the shares (ie the difference between the market value of the shares at the time they are issued and the price paid by the employee). By contrast, where an option is granted to an employee to purchase shares in the future, the benefit is not treated as being received for tax purposes until the option is exercised. When the option is exercised, the employee is taxed on the difference between the market value of the shares on the exercise date and the option/exercise price paid by the employee.

A consequence of an option scheme is that where the value of the shares has increased, the delay between acquiring and exercising options can result in a higher tax liability than if shares had been issued when the employee first entered the arrangement. Of course it follows that if the value of the shares decreases then the employee can elect not to exercise the option and their loss is limited to the option price paid (if any).

Types of schemes Inland Revenue will focus on

Inland Revenue has expressed concern with employee share schemes that deliver the economic effect of share options to employees, but have the legal form of the share issuance programme to take advantage of the more favourable tax treatment.

Two specific examples have been given by the Commissioner in the Alert.

Shares held on trust which the employee can elect to reject

In the first example, an employee purchases shares at market value which are then held on trust for three years. The purchase of the shares is funded by way of a limited recourse loan from the employer. The employee does not receive any voting, dividend, or other participation rights from the shares while they are held on trust.

After the three year period expires, the shares vest and the loan must be repaid. However, at this time the employee may choose to reject the vesting of the shares. If the shares are rejected then the loan will be satisfied by the transfer of the beneficial ownership in the shares from the trust back to the employer.

Reclassification of shares

The second example involves a scheme in which shares are reclassified after purchase.

In this scheme, the employee is able to purchase class B shares in the company at market value. The shares vest immediately. Because these class B shares do not contain any dividend or voting rights; only the right to be reclassified to ordinary shares, their market value is substantially lower than the market value of ordinary shares.

After a specified period of time, the class B shares held by the employee are reclassified by the company into ordinary shares.

Our observations

It is important to note that the Alert is not binding on Inland Revenue nor does it prevent Inland Revenue from investigating schemes other than the two examples provided. However, it is equally important to note that the Alert is simply Inland Revenue's current view and it does not mean that a court would necessarily agree with Inland Revenue's interpretation of the two examples provided.

That said, the Alert provides a useful insight into the types of arrangements that Inland Revenue is likely to focus on in the near future.

In our view, some of the characteristics in the examples in the Alert may be included in employee share schemes for sound commercial reasons. For example, an employer may wish to restrict employee voting rights for commercially sensible administrative reasons.

The presence of some of these characteristics should not automatically mean that a scheme is deemed to be a tax avoidance arrangement. Conversely, a scheme which does not include any of these features will not necessarily be without risk either. Each scheme needs to be assessed on a case by case basis.

Despite these uncertainties, the Alert highlights that the economic substance of the share scheme will be part of Inland Revenue's future analysis of employee share schemes. Employee share schemes which have been engineered to have an economic result which does not align with the legal form of the scheme will potentially be targeted by Inland Revenue.

Next steps

As employee share schemes typically operate for a number of years, the possibility exists that the law or the approach of regulators (such as Inland Revenue) may change during the lifetime of any scheme. As such we recommend that employee share schemes obtain regular 'legal health checks' to ensure that they continue to operate as expected and are fully compliant with all current laws and the approach of regulators.

If you would like a legal health check to be undertaken for your employee share scheme then please contact any one of our experts below.

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