



The Restricted Securities Regime



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The Restricted Securities Regime

What is a “Restricted Security”?

A restricted security is typically a share in a private company that is owned by an employee (or associate of an employee) that is subject to restrictions on the owner's rights to or under that share.

These restrictions will usually be set out in the Articles of Association of the company or could be in a Shareholders' or Investment Agreement. An example of a common restriction would be a requirement to sell shares once the employee leaves the employment of the company for an amount which could be less than the market value of the share at this time.

In the above example, a restriction on the ability to retain shares will affect the value of the share and so it is likely the share will be classed as a “restricted security”. It is important to note that not all shares that have restricted rights will be classed as “restricted securities”. Shares which are part of a class of share which have restrictions (which are not expected to dissolve over time) are unlikely to be restricted. As an example, a share in a non-voting class of shares will not necessarily be restricted, but if certain holders of voting shares are restricted from voting in certain circumstances, these shares are likely to be restricted.

Many types of securities can be restricted securities, and these include (in addition to shares) debentures, bonds, units in a collective investment scheme, insurance contracts, warrants and even interests in the above. The securities must, however, be employment related and for the purposes of this fact sheet, purchased after 16 April 2003.

The Rationale of the Restricted Securities Regime

This tax legislation was introduced in 2003 to address a perceived tax avoidance abuse; shares were being issued with restrictions which substantially depressed their then market value. This meant that an income tax charge on the shares could be avoided. The restrictions, following issue of shares, were then lifted resulting in an increase in value which was subject to capital gains tax at a

much lower rate than applies to income receipts.

To combat this abuse the legislation provides that a proportion of the sales proceeds be subject to income tax instead of capital gains. The income tax is charged on that proportion of the future sale proceeds as is equal to equal to the percentage discount on the shares originally acquired as against the unrestricted market value of the shares (i.e. the value of the shares without any restrictions).

An example is set out below:-

If shares were acquired with an unrestricted market value of 10p each and the effect of restrictions meant the shares were worth 8p each, the discount would be 20%. On the sale of these shares (or lifting of restrictions) income tax would be payable at 20% of the value of the shares under the Restricted Securities Regime.

Dis-applying the Restricted Securities Regime

Employer and employee can agree to dis-apply the Restricted Securities Regime by electing to pay income tax upfront on the unrestricted value of the shares, ignoring any restrictions placed on such shares for the purposes of valuation.

This can be done by both parties signing an irrevocable election (section 431(1) Income Tax (Earnings and Pensions) Act 2003) either before the shares are acquired or within 14 days of these shares being acquired.

Benefits for the employee of making an election

Even if there is a discount, the assumption would usually be that the value of the shares increases over time, so paying income tax (and NICs if relevant) on the discount now is better than paying income tax (and NICs if relevant) on the equivalent proportion of the (higher) value when the shareholder sells (or the restrictions are lifted).

Risks for the employee

- The employee will be liable to income tax if the unrestricted market value is greater than the price paid for

the shares.

- Even if tax is paid on acquiring the shares, the employee may not keep them meaning that income tax has been paid on benefits that have not been received.

- The value of the shares may not increase as expected.

- The employee may pay more tax because of the election than would have been paid without it.

- The employee has to fund the tax upfront rather than from sale proceeds (although a restricted securities charge can arise on the lifting of restrictions and not just on a sale).

Benefits for the company of making an election

- The election crystallises the tax position at the time shares are issued and is administratively simpler than managing complex restricted securities tax liabilities.

- NICs are only payable if the shares are “readily convertible assets” – if no exit is in prospect at the time of acquisition and the company is not under the control of another company, shares in a private company are unlikely to be “readily convertible assets”, but they will be if the restricted securities tax charge arises on a sale (because they are deemed to be readily convertible assets in such circumstances.) The election can therefore reduce the relevant NIC liabilities.

- Employer's NIC will only be payable if the shares are readily convertible assets which is less likely to be the case at the time the shares are acquired than at the time of a sale.

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