

Open Market Considerations Determine Tax Liability

Although there has, over the years, been a plethora of employee share schemes, with varying tax benefits and treatments accruing to them, disputes over the tax treatment on the disposal of such shares are comparatively rare.

Recently, however, such a dispute reached the Supreme Court. It involved a director of a timber company who was allocated a 6 per cent shareholding in the company. The company was later sold to the Jewson group. As a result of the director's subscription agreement, he became entitled to a payment of more than £1.4 million, when a 6 per cent shareholding was worth, on a proportionate basis, more than £1 million less.

HM Revenue and Customs argued that in circumstances such as these, the difference between the two sums was a taxable benefit in kind and thus subject to Income Tax (IT), not Capital Gains Tax (CGT). This made a massive difference to the tax liability of the director: not only did the sale not qualify for the annual relief for CGT, but it was also subject to National Insurance Contributions (NICs). The NICs would be mainly a liability of the company which had been sold, but the directors had entered into an agreement with Jewson to meet tax liabilities arising on the company as a result of the sale, so, in effect, the liability fell on them.

The question turned on the definition of market value in the relevant legislation. Should the shares be valued as the other shares were (i.e. ignoring the director's special rights)? If not, then if the special rights of the shares held by the director were to be considered, should the rights attaching to the shares be regarded as worthless to a purchaser and thus ignored in the valuation?

In the view of the Supreme Court, Jewson did not have any interest in the relative rights of the different shareholders of the company when it purchased it and thus those rights could not affect the open market value of the shares. The director's rights were not assignable and were therefore personal rights of no value to the purchaser. When valuing shares for such purposes, the 'open market' valuation is to be based on a hypothetical purchaser's position immediately after the completion of the notional transaction.

Accordingly, the difference was taxable under the IT rules, not the CGT rules.

When disposing of shares in a company, the impact of taxation and the guarantees given to the purchasers of the shares need to be carefully considered. If you are contemplating selling your company, we can advise you on all contractual and tax matters.

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