Taxation of Restricted Shares
The new regime

By Professor John Ward and Dara Burke

Where individuals receive shares or securities in the course of their employment, the valuation of that benefit under general principles is beset with uncertainty. In addition, there is a growing body of statutory rules governing the tax treatment of share awards, most recently including F(No 2)A 2008, s12 dealing with the tax treatment of 'restricted shares'. This article is designed to provide a brief overview of the scope of the general charging provisions and how these interact with this latest legislative development.

The General Charging Provisions

Where shares are acquired by an employee, then he will be potentially liable to income tax on general principles under Schedule E by virtue of TCA 1997 s112 if such shares represent a perquisite or profit arising from his employment (*Weight v Salmon* 19 TC 174). The taxable amount of the benefit will consist of the value of the shares less any consideration paid by the employee. A similar analysis is likely to apply to foreign employments taxable under Schedule D Case III (i.e. those with non-Irish duties).

However, it is the issue of valuation which can prove problematic. In the leading UK Schedule E case of *Wilkins v Rogerson* (39 TC 344) the value of a perquisite (in that case, a made-to-measure suit provided directly to the employee) was held to be "its money value in the (employee's) hands, that is to say, what he could get for it if he sold it as soon as he received it".

From this it might appear that where substantive restrictions apply to the disposal of shares, then the amount for which they could be sold immediately must by definition be zero. This, however, was not the approach taken in the earlier case of *Ede v Wilson and Cornwall* (26TC 381) where the employee had agreed not to sell quoted shares without the permission of his employer, so long as he remained in employment. It was held that although "in the hands of the [taxpayer] the shares may not have the same value as would shares to which there was no such clog or tie", they nevertheless constituted taxable money's worth because they were "capable of being turned into money from their own nature". In *Abbot v Philbin* 39 TC 82, the House of Lords side-stepped this contradiction by holding that a non-assignable share option was still capable of being turned into cash immediately by indirect means such as a sale of the beneficial interest or by pledging it as security for a loan. However, this would seem to imply that if there were a bar on any form of such indirect means of realisation being adopted by the employee, then the convertible value of the security should arguably be zero.

In *Tax Briefing 31*, the Revenue Commissioners expressed their view that if shares were received by employees with a prohibition on sale, such a restriction did not affect the market value of such shares but might affect the taxable amount of the benefit enjoyed by the employee. They did not elaborate upon the legislative basis for their observations. In practice, the Revenue Commissioners operated a sliding scale under which they reduced the taxable benefit in question by reference to the number of years during which the shares could be disposed of where there was an absolute prohibition on direct and indirect forms of disposal and various other conditions were met. The Revenue intended that this practice (with some minor modifications) should be effectively incorporated into the law following enactment of F (No 2) A 2008, s12 (see below). However, as discussed further below, the drafting of the relevant provisions leaves something to be desired.

The position remained open in relation to the correct valuation of shares which were subject to contractual restrictions on disposal, but which did not satisfy the terms of the Revenue Commissioners' practice. However, a taxpayer who sought to invoke the decision in *Ede v Cornwall* and look for a discounted value for their shares might well have achieved a pyrrhic victory. This is because the anti-avoidance provisions of TCA 1997, s122A would have treated the difference between (a) the open

market value of the shares as computed for CGT purposes under TCA 1997, s548 and (b) the amount taxed under Schedule E (or if appropriate Schedule D Case III) as a preferential loan. It is considered that the better view is that the objective basis of valuation prescribed by TCA 1997, s548 would not normally take into account any contractual restrictions in respect of shares which were personal to the individual employee. It should be noted however that HMRC in the UK apparently take a different view (though note the UK Special Commissioners' decision in *Company A v HMRC* (SPC 00602)). Further discussion of these complications fall outside the scope of the present article.

Definition of Restricted Shares

TCA 1997, s128D inserted by F (No 2) A 2008, s12 now provides a statutory code from 20 November 2008 onwards in relation to the grant of restricted shares to directors or employees ('employees' hereafter) received in their capacity as such. The rules apply whether the employment is taxable either under Schedule E or under Schedule D III (i.e. in the case of a foreign employment with non-Irish duties). The shares must be in the employer company or in a company which controls the employer company. 'Control' for these purposes bears its extended meaning in TCA 1997, s432. These provisions also apply automatically to shares granted on the exercise of an option which is taxable under TCA 1997, s128. There are exclusions for shares received under Profit Sharing Schemes, ESOTs, Approved Savings-Related Share Option Schemes and Approved Share Option Schemes.

Restricted Shares are defined as shares or stock where: (i) there is a written contract or agreement in place under the terms of which the employee generally cannot assign, charge, pledge as security for a loan or other debt, transfer, or generally otherwise dispose of the shares for a specified period of not less than one year (the 'specified period'); (ii) the contract or agreement is in place for genuine commercial purposes and does not form part of a scheme or arrangement of which the main purpose or one of the main purposes is the avoidance of tax; (iii) during the specified period, the shares are held in a trust established by the employer for the benefit of employees or held under such other arrangements as the Revenue Commissioners may allow (e.g. a secure stockbroker account).

However, in the case of condition (i), there are exceptions for disposals arising from: (a) the death of the employee; (b) share exchange transactions qualifying for CGT 'paper for paper' rollover relief under TCA 1997, s584;(c) transactions entered under a compromise, arrangement or scheme applicable to all the shares of the same class or (d) a sale following a general offer made to holders of shares of the same class conditional on the purchaser acquiring control (again as defined by TCA 1997, s432) of the company in question.

Calculation of taxable benefit

Where the section applies, the value of the shares must be taken in the first instance as the open market value of the shares as computed under TCA 1997 s548 without any regard to the restrictions on disposal (as already noted, it may well be that such restrictions have no effect for TCA 1997 s548 purposes in any event). The legislation provides that the charge to income tax imposed on the deemed benefit (net of any consideration payable by the employee) is then abated by a percentage calculated as 10% x the full number of years in the specified period, up to a maximum of 6. However, this form of wording is defective. The statute provides no indication as to how the income tax attributable to the benefit is to be ascertained. A further difficulty if the new section is interpreted literally is that the approach adopted would be at complete variance with previous Revenue practice, whereas these provisions are designed to codify that practice. In fact, the Revenue's own guidance notes envisage that it is the taxable benefit which should be abated and not the tax charge itself. For present purposes it will be assumed hereafter that this is how the legislation will be applied. This distinction will also be relevant inter alia for the purposes of computing the Health Contribution and the Income Levy.

The abatement percentage can accordingly be tabulated as follows:

Number of years restriction	Rate of Abatement of Benefit
1	10%
2	20%
3	30%
4	40%
5	50%
More than 5 years	60%

Example 1

Benjamin is an employee of Thicket Limited under an Irish contract of employment. He is issued with 1,000 restricted ordinary shares in the company under a non-approved incentive scheme on 1 January 2009 which meets the Revenue conditions set out above. The restrictions apply for a specified period of four years and six months. The open market value of the shares in accordance with TCA 1997 s548 is agreed at €5,000 but Benjamin is only required to pay consideration of €1,000.

	€
Open Market Value of Shares	5,000
Less: Consideration	-1,000
Net Benefit	4,000
Less: Abatement (40%)	-1,600
Taxable Benefit under Schedule E for 2009	€2,400

If Benjamin had paid no consideration for the shares, the position would be as follows:

	€
Benefit	5,000
Less: Consideration	(---)
Less: Abatement (40%)	-2,000
Taxable Benefit under Schedule E for 2009	€3,000

Accordingly Benjamin's payment of €1,000 only reduces the taxable benefit by €600, which is not attractive from a tax perspective.

Adjustment of taxable benefit

There will be a retrospective recapture of any abatement claimed under these provisions where one of the following events occurs before the end of the specified period: (a) any of the restrictions enumerated above is removed or varied; (b) the shares are disposed of under one of the exceptions described above (on the death of the employee or a qualifying share-for-share takeover, etc.). The taxable benefit will be adjusted to reflect the actual period during which the restriction applied. The consequent adjustment of the individual's tax liability may be made at any time.

Example 2

Benjamin disposes of his shares in Thicket Limited in April 2011 following a share-for-share takeover by Forest plc which qualifies for CGT 'paper for paper' rollover relief under TCA 1997 s584.

	€
Open Market Value of Shares	5,000
Less: Consideration	-1,000
Net Benefit	4,000
Less: Adjusted Abatement (20%)	-800
Adjusted Taxable Benefit	3,200
Original Taxable benefit	-2,400
Additional Taxable Benefit 2009	€800

Interaction with CGT

The base cost of the shares for CGT purposes will include the amount of the benefit charged to income tax under these provisions, including any subsequent adjustment to the amount of the taxable benefit (the legislation in fact again erroneously refers to the tax charged on the benefit instead of the taxable benefit itself).

Example 3

Benjamin disposes of his shares in Forest plc in December 2011 for €12,000. The base cost of his shares in Thicket Limited will 'flow through' to his shareholding in Forest plc by virtue of TCA 1997 s584. The calculation of his gain for CGT purposes will be as follows:

	€
Consideration	12,000
Less: Purchase Price	-1,000
Less: Adjusted Taxable Benefit	-3,200
Chargeable Gain	€7,800

Administrative Requirements

A person (usually a company) must report relevant particulars to the Revenue where it

(i) awards restricted shares to an employee, or

(ii) the employee acquires restricted shares on the exercise of an option within TCA 1997 s128 which had previously been granted by that person, or

(iii) an event occurs which requires an adjustment to a taxable event.

The person must file the report by 31 March after the end of the relevant tax year.

Conclusion

Where it is contemplated that there will be a clog on the freedom to dispose of shares granted to an employee or director, it will normally make sense to avail of the provisions of TCA 1997, s128D which provide clarity, as well as the opportunity to substantially mitigate potential tax liabilities. It is to be hoped that the drafting of the section will be rectified in due course to give proper legal expression to its intended effect.

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Financial Services: No Return to Growth Until First Half of 2010 at the Earliest

Global financial services companies expect no return to growth until the first six months of 2010 or even later, according to recently published research by Ernst & Young.

While a third of the 125 global financial services respondents expected some expansion this year, the report found that 34% of those polled expect the return to growth to begin in the first six months of 2010, with 32% believing it would be further out.

As an indication of just how deep the recession is impacting the financial services sector, just over two thirds of those polled expect to increase the amount of time they spend on securing the future of their business.

The industry was clearly taken aback by the ferocity and depth of the downturn: 72% of respondents were surprised at the severity and 70% were surprised by the speed of the financial crisis. Only 30% had seen any improvement in their business over the last 12 months, compared to almost 50% that had not.

For the study, the Economist Intelligence Unit surveyed 569 C-suite and board level executives. Respondents were drawn from across the world and across industry sectors. Over half the executives polled worked for companies with an annual global revenue in excess of US$1 billion. The research was carried out in June 2009.