

Taxline and VATline Q & A

Taxline 0845 356 0006 VATline 0845 356 0007

Q: My client is the sole shareholder and director of a property investment company. He would like to transfer 10% of his shares to Joe, one of his key employees. However he does not want Joe to have the shares for two years but after that he would like to transfer them to him at today's value. What do you suggest?

A: There are a number of issues here. If an individual transfers shares at undervalue to another individual, this is treated as a deemed disposal at market value at the date of the gift (s17 TCGA 1992). Therefore, if your client gifts his shares in two years' time, he would be subject to capital gains tax on any gain made with the proceeds being the market value at the date of the gift. He will therefore be taxed on proceeds he has not received.

The employee would be subject to income tax on the difference between the market value of the shares at the time of receipt and the amount paid.

Consider the following example:

- The shares cost £1,000 and have already been held for six months
- The shares are currently worth £10,000
- The shares are estimated to be worth £30,000 in two years when the shareholder would like to give the shares to the employee
- The shareholder and employee are assumed to be higher rate taxpayers and the shares are not 'readily convertible assets'

The capital gain made by your client on the transfer at undervalue of the shares would be:

	£
Proceeds:	30,000
Cost:	(1,000)
	£29,000

Capital gains tax payable: £11,600 (£29,000 x 40%)

The income tax payable by the employee on acquisition would be:

Income tax: £8,000 ((£30,000 - £10,000) @ 40%)

Corporation tax deduction: £6,000 (£20,000 @ 30%)

HMRC gets: £13,600

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Alternatively, your client could consider granting an option to the employee to acquire the shares in two years, with the exercise price being the market value at the date of grant.

There would be no tax charge to the shareholder on the grant of the option. Furthermore, as a result of s144ZA TCGA 1992, the market value rule does not apply to the shareholder's disposal and, instead, the proceeds on the disposal will be the exercise price. Assuming the shares are to increase in value, the shareholder will therefore be taxed on a lower capital gain on the disposal.

Taking the above example, assuming an exercise price of £10,000, the tax position would be as follows:

No tax payable by the shareholder or the employee on the grant of the option.

The capital gain made by your client on the exercise of the option by the employee would be:

	£
Proceeds:	10,000
Cost:	(1,000)
	£9,000

Capital gains tax payable: £3,600 (£9,000 @ 40%)

The income tax payable by the employee on acquisition would be:

Income tax: £8,000 (£20,000 @ 40%) (as before)

Corporation tax deduction: £6,000 (£20,000 @ 30%) (as before)

HMRC gets: £5,600

In this example, tax planning has saved £8,000.