PRE-EMPTION RIGHTS, ITEPA PART 7, CHAPTERS 1 TO 3 AND CURRENT REVENUE POLICY AND PRACTICE

Christopher Lallemand[1]

FA 2003, Schedule 22 rewrote the rules into the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") applying to employee acquisition of shares outside approved share incentive schemes, and widened the definition of 'shares' to 'securities'. The intention appears to have been to draft the rules flexibly enough to catch schemes seeking to avoid income tax or National Insurance, but not to make any practical difference to straightforward cases.

There has been discussion between practitioners and Inland Revenue as to the impact of pre-emption rights on applying the legislation. The minutes of the Inland Revenue shares valuation fiscal forum of October 12th 2004 include the note that "A general discussion then took place regarding transfer restrictions in Articles of Association and the extent to which they impact on value. A consensus view was not established."

This article considers pre-emption rights in this context, looking at relevant parts of the legislation and Inland Revenue guidance.

---

1 Christopher Lallemand FCA, CTA has recently joined Stream Business Consulting LLP and can be contacted be email: chrislall@aol.com. The views expressed are his own. The author is grateful to Jenny Nelder of Bruce Sutherland & Co for comments made during the preparation of this article. The article has been written on the assumption that the proposals announced in the Inland Revenue technical note issued on 2nd December 2004 will be introduced by legislation.

Pre-emption rights

Pre-emption rights[2] enable company shareholders to protect themselves from aspects of the transfer of wealth and/or control. The Companies Act 1985 ("CA85"), sections 89 to 96 describe the terms by which a company may allot equity securities. The requirement is that issues for cash be allotted only once an offer of the shares has been made to all other relevant shareholders in proportion to the nominal value of their original shareholdings. The existing shareholders thus have the opportunity to maintain their proportionate holding. Regarding share transfers, sections 182 and 183 of CA85 require a proper instrument of transfer be delivered to the company before that transfer can be registered.

The Companies Act permits public companies to waive pre-emption rights by passing a special resolution. Such a waiver must specify the proportion of shares to which the waiver applies and can last for a period of up to 5 years before requiring renewal.

Private companies are permitted to exclude sections 89(1), 90(1) to (5), or 90(6) (referring to the requirement to offer the allotment of new shares to existing shareholders and specifying certain communication requirements) from their articles. Many private companies do so and include other requirements concerning pre-emption and share transfers.

The interests of minority and majority shareholders may not coincide on crucial occasions, and rights may be included in the articles or a shareholders' agreement to deal with this. 'Tag along' rights are used to avoid the risk of the majority selling their shares to an outsider leaving the minority locked in with an unknown majority controller, by requiring the majority to include the minority stake in that share sale. 'Drag along' rights are used to avoid the risk that the minority cause a proposed sale to be blocked due to the prospective purchaser being unable or unwilling to purchase the minority shareholding. They bind the minority to accept an offer approved by the majority (perhaps in a different way from section 429 of the Companies Act).

Institutional shareholders in the UK are also influenced by the 'pre-emption group' guidelines. The guidelines (which are not enforceable by law) state that the maximum waiver of pre-emption rights concerning new share issues for cash should cover no more than 5% of the company's shares in issue in any one year and 7.5% in a rolling 3-year period, and that any discount for a non-pre-emptive issue should not exceed 5%.

2 Butterworths Company Law Book 2004, Joint Ventures and Shareholder Agreements, Simmons & Simmons, 2000

In other countries, such as the US, pre-emption rights may be required according to the state law. Most states permit companies to pay shareholders for waiving their pre-emption rights, but US stock exchange rules may require shareholder approval for share issues that result in a change of control, or that exceed 20% of issued shares or voting rights.

The value of pre-emption rights

The monetary value of pre-emption rights for new issues can be determined by the terms of fund raising, and the value would increase with the size of fund raising and the discount of the issue below market price. Option pricing models can also be used to value rights, as they offer a choice regarding purchase, so that if (prior to the issue) the offer price falls below market price there is the option not to subscribe. The value of pre-emption rights can also be considered in terms of control. The ability to maintain voting rights of a particular holding has a value related to the value of those voting rights, in addition to the ability to maintain one's share of the anticipated future company earnings which might be lost when new shareholders subscribe at below market prices.

Pre-emption rights can provide an impartial method by which shares are allocated between competing shareholder purchasers to avoid arguments over who will purchase. They can also provide a measure of protection to existing shareholders from the introduction of an unwanted prospective purchaser (e.g. a competitor). Value detracting characteristics of pre-emption rights could include constraints on widening the shareholder base and tapping new sources of finance for smaller companies with less liquid markets for their capital, and the requirement to sell at a potentially lower price to existing shareholders than could be obtained elsewhere.

The impact of pre-emption rights in assisting public companies to raise new capital in the UK is the subject of a recent review by the dti[3]. According to this review, studies in the US have highlighted instances where removal of pre-emption rights is associated with share price increases[4]. The final report comments that while the requirement to follow pre-emption requirements in the US might have been seen in that market as burdensome, the greater use in the US

---

3 DTI – Pre-emption rights: Final Report. A study by Paul Myners into the impact of shareholders' pre-emption rights on a public company's ability to raise new capital (February 2005, URN 05/679)

4 DTI - The impact of pre-emption rights on a pu8blic company's ability to raise new capital – an invitation to comment from Paul Myners (3rd November 2004).

of the legal claim for breach of fiduciary duty against abusive capital issues acts as an effective alternative protection mechanism.

While recognising that pre-emption rights in the UK are valuable, the final report recommends some changes to improve a public company's ability to react quickly to market conditions to raise required capital, particularly in the R&D and biotech sectors. These include a more flexible interpretation of the 'pre-emption group' guidelines, and a modernization of the company law time limits affecting pre-emption rights.

Restrictions on transfer of shares have been shown to have a significant depreciatory effect on the value of shares for estate duty purposes, for example – *Salvesen's Trustees v IRC* (1930) 9 ATC 43[5]. The articles of that company provided that the company could, by extraordinary resolution at any time, resolve that any shareholder, other than a director or a person holding more than 10% of the shares of the company, be required to transfer his shares. This would have resulted in a significant discount for interests of 10% or less. The courts have also held in estate duty cases that restrictions on rights of transfer in company articles are to be taken into account when valuing the shares from the perspective of a hypothetical purchaser (*IRC v Lynall* (1971) 47 TC 375).

Employment securities and the restricted and convertible securities sections of ITEPA

Employment related securities defined in ITEPA, s421B are securities or an interest in securities made available by reason of employment (whether current, former or prospective). The exception to this rule is where the person acquiring the shares is an individual and the right to acquire is by reason of normal family, domestic or personal relationships. Shares cease to be employment related securities immediately before the death of an employee, and seven years after the first date after the acquisition on which the employee ceases to be employed by the employer or the company issuing the securities, or a person connected with either of these entities.

Securities to which Chapters 2 and 3 of the legislation apply include shares, debentures, warrants, certificates and other instruments conferring rights in respect of securities held by persons other than those to whom the rights are conferred, units in a collective investment scheme, futures, rights under contracts

5 Practical share valuation, Nigel Eastaway, Harry Booth and Keith Eamer (Butterworths, 1998)

for difference, and (with effect from 2nd December 2004[6]) rights under certain contracts of insurance (ITEPA, s420).

Pre-emption rights and restricted securities:

Section 423 describes "restricted securities" for the purposes of the Chapter 2 charging provisions. One of the definitions is that employment related securities are restricted securities or restricted interest securities if:

(a) there is any contract, agreement, arrangement or condition under which the freedom, of the person by whom the employment related securities are held, to dispose of the employment related securities is restricted, or there is a restriction on any other right, and

(b) the market value of those employment related securities is less than it would be but for the restriction.

Some exceptions to this are described at s424. Where either or both of the following apply, however, the employment related securities (or interest in securities) are not regarded as restricted: (a) where the securities may be forfeited for non payment of calls (payment not being restricted), (b) where there is a requirement to sell the securities as a result of ceasing to be employed due to misconduct. With effect from 2nd December 2004 the exception for redeemable securities that was previously available has been removed, and a further proviso requires that the exceptions do not apply when used as part of an arrangement to avoid tax or NICs.

S427 describes chargeable events for restricted securities as the lifting or variation of restrictions, and the disposal for consideration of the securities, but a specific exemption from charge is available at s429. The exemption applies if:

1. the employment-related securities are all shares of one class,

2. the restriction applies to all shares of that class,

3. all the shares of that class (other than the employment-related securities) are affected by an event similar to that which is a chargeable event and

6 Inland Revenue Technical Note: Avoidance and employment related securities – proposals to amend Part 7 of ITEPA 2003, issued 2nd December 2004

4. the company is either:

   (a) employee-controlled by virtue of that class of shares, or

   (b) the majority of the company's shares of that class are not employment-related securities.

The exemption is subject to the condition that avoidance of tax or NICs was not the main purpose, or one of the main purposes, of the arrangements under which the right or opportunity to acquire the employment-related securities was made available or (with effect from 2 December 2004) at any subsequent time. The condition, requiring all shares to be affected by a similar event, means that the s429 exemption would apply only on a situation like a take-over, and not for example on a single disposal by an individual minority shareholder.

When a chargeable event occurs, there is a charge based on the value attributable to the removal of the restriction where no excepting election has been made and where full (unrestricted) market value was not paid for the security at acquisition. Section 428 sets out the formula for charge as follows:

UMV × (IUP-PCP-OP) – CE

UMV = market value of the employment related security immediately after the chargeable event, but for any restriction

IUP = (IUMV-DA)/IUMV

Where:

IUMV= market value of the employment related security at the time of acquisition, but for any restriction (i.e. initial unrestricted market value), and

DA = the deductible amount, which is the amount paid for the employment related security on acquisition (or treated as paid either through earnings or employment income or via replacement of an existing security).

PCP is the aggregate of the application of the formula IUP-PCP-OP on each previous chargeable event since acquisition (this would be nil if there had been no previous chargeable event).

OP is (UMV-AMV)/UMV, where UMV is as above, and AMV is actual market value of the employment related security immediately after the chargeable event.

CE is the total of any expenses incurred with lifting or varying the restrictions, or on disposal of the employment related security.

Thus where the ratio between UMV and AMV at the time of a chargeable event is the same as the ratio between IUMV and DA at acquisition, then there will be no charge. For example, suppose IUMV = 100 and DA = 95, and UMV = 200 and AMV = 190, with CE and PCP both being nil. The formula then becomes:

$200 \times (0.05 - 0 - 0.05) - 0 = 0$

As pre-emption rights can restrict freedom to dispose of securities it would seem they can cause shares to be within the restricted securities legislation, and a charge could arise if the rights operated to pass value into the securities. If the pre-emption rights affect the unrestricted market value in the same way, both when the securities are acquired and later when a chargeable event arises, however, then the formula for the tax charge excludes that particular portion of the value from charge.

It is possible to make an election under s431 to assess the restricted securities' charge in full at the point of acquisition of securities, after which the restricted securities legislation (sections 425 to 430) no longer applies. This requires an election by both employee and employer within 14 days of the acquisition date. The prescribed form can be found via the link on the IR website from the FAQ 2(i). The election under s431(1) assesses the charge by excluding all restrictions in valuing the share on acquisition, while an election under s432(2) excludes only one or a selection of restrictions. The election does not have to be filed with the Inland Revenue and can cover all restrictions or only a selection.

If a depreciative value is ascribed to pre-emption rights or restrictions on transfer (which appears to be the view of the Inland Revenue for minority holdings – see below on discussion of market value), it appears there will always be an ITEPA charge under a s431(1) election where the amount paid for the shares is equal to or less than its value with pre-emption rights and transfer restrictions. Where pre-emption rights will have the same influence throughout the life of a security, a s431(2) election that did not exclude those rights from the valuation calculation, would therefore seem to ensure that no charge would occur due to pre-emption rights (assuming the operation of those rights on the securities did not change).

As indicated in the discussion on pre-emption rights, different people can place different values on pre-emption rights, which may change according to business conditions and/or levels of holding. In relation to the value ascribed to pre-emption rights it is interesting to consider the situation of a minority employee shareholder in a private company who increases his shareholding for an arm's length price. As his shareholding increases, his voting control could increase and the value of his overall holding may increase. Any value discount attributable to pre-emption rights on the value of original holding could have decreased thus potentially causing a charge on the shares within the ITEPA restricted securities legislation.

One could argue that a portion of the purchase price of the new holding related to an amount equal to the increase in value of the original holding due to the increased level of holding arising from the combined purchases (i.e. a component of 'CE' in the ITEPA, s428 formula). Where the shareholder had paid a full market price for the shares at acquisition on each occasion (so that IUMV and DA are equal), then the mechanics of the s428 formula mean there is no charge. The examples in the frequently asked questions and the non-binding agreements with the British Venture Capital Association (see below) where full market price has been paid, do seem to indicate that no employment charge would arise in these circumstances where there are normal pre-emption rights and transfer restrictions.

Pre-emption rights and convertible securities:

One of the chargeable events under Chapter 2 is the lifting or variation of the restrictions. A change in the application of pre-emption rights may occur without those rights being altered if the rights apply in different ways to certain shareholdings. If the pre-emption rights are altered or varied by changing the articles, however, then it could be argued the securities have been converted to a different type of security. In this instance Chapter 3 of ITEPA Part 7 would apply.

Section 436(c) indicates that the securities are convertible securities if a contract, agreement, arrangement or condition makes provision for the conversion of the securities (otherwise than by the holder) into securities of a different description. One of the chargeable events under Chapter 3 (s439(3a)) is the conversion of employment related securities into securities of a different description in circumstances in which an associated person is beneficially entitled to those converted securities.

Where the market value of the shares with new rights is higher than before, there will be a tax charge unless the shares meet the exemption conditions of section 443 (which are similar to those in s429). There may also be a charge on an increase in value at disposal, and there is no election to have the charge assessed in full on the acquisition of the convertible security.

One might also consider a hypothetical situation such as the *Salvesen's Trustees v IRC* (1930) 9 ATC 43 with their potentially restrictive transfer condition resulting in penal transfer provisions. A set of circumstances could arise where value is passed to non-director, employee shareholders previously holding less than 10% in such a way that what might otherwise have been income is transferred in the form of an increase in value of shares. The potential transfer restriction has not been removed here, but the shareholders have been taken out of risk from application of that restriction. On the assumption that the capital gains tax value shifting provisions did not apply, ITEPA, Part 7, Chapter 2 could apply. Alternatively if the articles are amended to remove the restrictive provision, ITEPA, Part 7, Chapter 3 could apply.

Whether transfer conditions are included in articles or a separate shareholders' agreement may be a further factor in determining whether Chapter 2 or Chapter 3 would apply on an alteration of those conditions.

Market Value

Market value for the purposes of the employment related securities legislation uses the capital gains tax valuation test (ITEPA, s421) which in the case of unquoted shares and securities, provides that the market value calculations assume all the information a prudent prospective purchaser might require is available as if he were purchasing from a willing vendor in an arm's length sale.

A discussion of the apparent inconsistency of applying this test with the view that pre-emption rights are restrictions on securities appears in the January 2005 issue of *Tax Adviser*[7]. The article comments that the experience to date of a number of practitioners indicates that in cases where the discount applying to a minority holding is around 70% – 80%, Inland Revenue Shares Valuation is suggesting that 20/70ths or 20/80ths of that discount relates to restrictions on transfer. The specifics of each case would, however, need to be considered individually.

7 Share Valuation Issues, Jenny Nelder, Tax Adviser January 2005

A Review of Frequently Asked Questions[8] included on the Inland Revenue Share Scheme website

While not specifically referring to pre-emption rights, question 1(h) indicates that just because a share is classed as an employment related security does not mean that there will be an ITEPA tax charge. The securities would have to be used to pass value before that happens. In most cases this is unlikely and the security holder should benefit from CGT treatment on normal commercial growth in value (which includes a big jump in value due to a take over).

At question 1(k) the Revenue have indicated that personal restrictions on shares would be taken into account in determining the CGT definition of market value for the purposes of the securities legislation. Question 1(m) confirms that 'market value' will take into account personal rights and restrictions and not just those rights and restrictions attaching to the shares, and this value rationale will be applied consistently through Chapters 1 to 5 of ITEPA, Part 7. These two questions appear to indicate that pre-emption rights and restrictions on transfer will be taken into account in determining market value, though it is not clear that market value without restrictions for the purpose of a section 431 election will include pre-emption rights.

Non-binding memoranda of understanding dated 25th July 2003 between the Revenue and the British Venture Capital Association, on the tax treatment of (i) carried interest in Venture Capital and Private Equity Limited Partnerships and (ii) managers' equity investments in venture capital and private equity-backed companies, give examples of circumstances where an income tax charge would and would not arise. In both examples there is a requirement that the employees are fully remunerated via salary and bonuses. The examples appear to include certain pre-emptive right restrictions (vesting and general transfer restrictions in the carried interest example, and tag along/drag along rights in the managers' shares example) which do not cause an employment tax charge in the circumstances given.

Question 2(bb) indicates that where an employee holding shares in a quoted company is subject to restrictions due to stock exchange 'close period' rules, they will not seek to argue solely for the reason of the close period rules that the shares are restricted shares within the meaning of s423(1).

Question 2(ff) discusses the calculation of 'OP' in the s428 formula for calculating the tax charge (the difference immediately after the chargeable event between the unrestricted market value and the actual market value, divided by the

8 www.inlandrevenue.gov.uk/shareschemes/

unrestricted market value). In the circumstance where the restriction in place at acquisition remains (and has not wasted in value), then if the security is sold at a later date with that same restriction under pre-emptive conditions to a director, or else to a third party, then the acquirer will be acquiring the share with the restriction and there should be no charge.

At question 3(d) the comment is made that there could be restricted securities which convert into a different type of security and both Chapters 2 and 3 could apply. Assurance is given that where Chapter 2 has been applied the Revenue would not seek to apply Chapter 3 to charge the gain twice unless there is evidence of avoidance, and in any event the gain would not be taxed twice. Question 3(e) discusses 'flowering' shares which could be classified as either convertible securities or restricted securities. Where either Chapter 2 or Chapter 3 could apply the Revenue expect the application of Chapter 2 to be preferred by the employee, because of the greater flexibility provided by elections and a more 'front-loaded' charge. Where this choice has been made, the Revenue will not seek to insist on an alternative charge, provided a consistent approach is adopted and there is no avoidance of tax or NIC by manipulation of arrangements or values.

Share valuation assurance

While there is no formal scheme for post transaction valuation checks for employment income purposes by Shares Valuation, where requested they will do so. It is not Inland Revenue policy to comment on valuations in advance of transactions, but some informal arrangements do exist where proposed offers to employees are considered and the number of employees is sufficiently large.

Conclusion

The issue of transfer restrictions in articles of association and the extent to which they impact on value can present complex valuation issues. It does not seem possible to give generally applicable guidance on when to apply different parts of the legislation, other than to suggest the consideration of the legislation to each set of circumstances. Where the assurance is required the first discussions should be with the assigned inspector.