Client Alert.

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Director and Employee Rights and the Grays Timber Case in the UK

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When structuring the share rights of employees and directors in a company or group that employs them, parties to these arrangements will be keen to ensure that any enhanced rights to payments on a share sale are structured in the correct way in order to avoid an income tax on the gain which could potentially mean 52% as opposed to a lower capital gains tax charge of up to 28%.

In the recent case of Grays Timber Products Ltd. v HMRC (Scotland) [2010] UKSC 4, specific arrangements were put in place between Grays Group and Mr Gibson, the managing director of Grays Timber Products Ltd. (“Timber Products”). In accordance with a subscription and shareholders agreement (“Agreement”), if certain conditions were met on a sale of a controlling stake in the parent company of Timber Products (“Parent”), Mr Gibson was contractually entitled to receive a disproportionate share of sale proceeds from the purchaser, greater than that realised by other shareholders. Put simply, Mr Gibson had an enhanced right to proceeds in the event of a sale as provided in the Agreement.

On the subsequent sale of the entire share capital of the Parent, the relevant conditions were satisfied and, accordingly, the purchaser paid to Mr Gibson a disproportionate share of the consideration meaning that there was a significant difference between the amount received by Mr Gibson and the amount referable to Mr Gibson’s shareholding in the Group.

The question to be decided was whether Mr Gibson would be liable for a capital gains tax charge on the full amount of his gain, or whether a portion would be subject to income tax at a higher rate. The key question before the Court was whether Mr Gibson received an amount in excess of the market value price of his shares, in which case, the excess will be subject to income tax.

The Court considered the definition of “market value” and found that it required consideration of the amount that a hypothetical purchaser would pay to acquire the rights attaching to the shares. It also considered the fact that Mr Gibson’s entitlement to receive a disproportionate share of the sale proceeds was included in the Agreement and not in the articles of association. The Court found that the market value of an employee’s or director’s shares was equal to the value of those shares in the purchaser’s hands, disregarding the individual’s personal rights to receive a disproportionate share of the sale proceeds in the Agreement. As the enhanced right to proceeds was not relevant to the purchaser and not included in the articles of association, it would not form part of the “market value” of the shares. The Court also considered the fact that the rights of Mr Gibson were not transferrable and not able to be assigned to a purchaser to give the shares additional value. Therefore, on disposal of his shareholding, Mr Gibson was held to be liable for income tax on the additional portion of the proceeds referable to his enhanced right and the portion was held to be employment related income which was subject to income tax.

The Court in its judgment was careful not to define "market value" for the purposes of Part 7 Income Tax (Earnings and Pensions) Act 2003 generally, but rather to restrict it to apply to Chapter 3D (securities disposed of for more than market value) only. Market value may be treated differently for provisions dealing with restricted securities, convertible securities and securities with artificially depressed or enhanced market values in Part 7.

The Court also expressed considerable dissatisfaction with the clarity of law in this area and the accuracy of some of HMRC's guidance on the relevant law. Consequently, we would expect that HMRC will provide further guidance in this area in order to provide further clarity.

With the significant gap between the rate of income tax and capital gains tax, this case comes as a timely reminder that extra caution should be taken in the design of arrangements for employees and directors where they are to own, or benefit from, shares in the company or group that employs them. Parties to these arrangements must ensure that any specific rights are included in the company's articles of association rather than in the shareholders' agreement and arrangements may also be made to create a specific class of share for these enhanced rights so that their value forms part of the market value of the shares of the company on a sale. There is a risk that a number of common arrangements may be caught if enhanced rights to payments are structured as rights that are particular to an individual rather than rights that attach to the shares.

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