Ask an expert

Buying back shares from employees

Q My client is in discussions with a senior employee who is leaving the company. He has a 10% stake in the business, and the company will buy the shares back in accordance with the articles, which state that the fair value of the shares is calculated without reference to a minority discount. As a minority discount would usually be applied for tax purposes, is the employee receiving an overvalue for the shares, and does the company need to withhold PAYE on the 'excess' amount?

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A This is a relatively common occurrence, and your client is right to consider the tax consequences arising from this inherent mismatch between the value required by the articles and the likely market value for tax purposes.

As the shares are employment-related securities, the definition of market value is that defined by TCGA 1992 s 272, being 'the price which those assets might reasonably be expected to fetch on a sale in an open market'. Typically, we would then expect a minority shareholding to be subject to a discount to pro-rata value. Therefore, if the company were worth £1m, the fair value of the employee's shares under the articles would be £100,000, but for tax purposes might only be, say, £30,000. Strictly, the £70,000 difference is not subject to CGT but is subject to income tax and NIC, and the company would need to withhold PAYE and NIC accordingly.

HMRC recognises that this potential anomaly exists, and a question was raised on this point at the share and assets valuation (SAV) fiscal forum, a regular meeting held between HMRC and valuation practitioners. HMRC acknowledged that the amount payable to an employee could exceed the fiscal market value of the shares, and stated that the position would depend on the facts of each case (see minutes of meeting held on 28 June 2010, at www.lexisurl.com/0VMmU).

This issue can put employers in a difficult position, particularly if relations with the departing employee are already strained. The treatment above would give the employee a very different net position, particularly if they had been expecting to claim entrepreneurs' relief (ER) on the full amount, as illustrated in the figure below.

The company will also be liable to an unexpected employer's NIC charge, presumably at 13.8%, which would cost £9,660.

We then need to look at situations where the difference between the value calculated in accordance with the articles and the value for tax purposes might not give rise to a tax charge. The first thing to consider is whether the valuation basis used in the articles is applicable for tax purposes. This might be the case where the fact that the shares receive pro-rata value on sale was factored into the valuation upon acquisition.

Alternatively, company articles may have a stated valuation basis, such as a fixed profit multiple, which does not reflect current market conditions. Therefore, it would be correct to perform the calculation for tax purposes on a more appropriate basis.

Assuming that there is a mismatch between the amount received for the shares and the market value, the company will be required to withhold PAYE and NIC on the basis of its 'best estimate' of the overvalue. In certain circumstances, HMRC will consider the value for PAYE purposes under the 'PAYE healthcheck' procedure immediately after the transaction.

However, this service is only available for simple, straightforward transactions which could be looked at within the PAYE deadline timeframe, rather than contentious, complex or high value transactions which, necessarily, would require more time to consider (see minutes of the SAV fiscal forum held on 13 September 2012, at www.lexisurl.com/vKwYq).

If a company's transaction falls into the 'straightforward' category, then the request should be submitted to SAV as soon as possible after the share purchase, clearly identifying that the valuation is for PAYE purposes. For this reason, completing the transaction as soon as possible after the 5th of the month gives as much time as possible for the value to be considered.

It should be noted that the value provided by HMRC in these circumstances is purely an informal figure for the purposes of applying PAYE and neither HMRC nor the employee are obliged to accept the original PAYE figure as the final tax liability. However, if the final figure agreed is different from the 'best estimate' agreed whether under the PAYE healthcheck procedures or not, as long as the 'best estimate' was reasonable, the company will still be regarded as having accounted for PAYE and NIC correctly. ■

Example computation

	If eligible for ER and full capital gains treatment	If eligible for full capital gains treatment	If 'excess' over market value is subject to income tax (with ER)	If 'excess' over market value is subject to income tax (no ER)
	£	£	£	£
Fair value of the shares	100,000	100,000	100,000	100,000
Market value of the shares	100,000	100,000	30,000	30,000
CGT payable	10,000	28,000	3,000	8,400
Income tax payable (at say, 45%)	Nil	Nil	31,500	31,500
NIC	Nil	Nil	1,400	1,400
Net payment received	£90,000	£72,000	£64,100	£58,700