

Overview of employment-related restricted shares

April 2025



What is a 'restricted share'?

Restricted shares are shares which are subject to any of the following 'restrictions':

- automatic transfer, reversion or forfeiture at a price less than market value as a result of pre-defined events occurring
- restriction on the ability to dispose of the shares or their sale proceeds
- restriction on the ability to retain the shares or their sale proceeds
- restriction on any right conferred by the shares
- any disadvantage to the shareholder (or certain other people) caused by the disposal or retention of or exercise of rights in relation to the shares,

and as a consequence, the market value of the shares is lower than it would have been without such restriction.

There are some exceptions to this rule however. A requirement to sell or transfer shares as a consequence of an employee ceasing employment due to misconduct is expressly carved out from being a restriction,

ie if there is a requirement for the individual to transfer their shares if they are dismissed for misconduct. However, this would not catch a performance-related dismissal or a resignation. Similarly, a requirement to forfeit unpaid or partly paid shares on non-payment of a call is not a restriction for these purposes.

The provisions setting out the restrictions applicable to a share can be set out in any document relating to the shares or the person holding the shares, including the stock option plan, Articles of Association, bye-laws, or any contract. In practice, restrictions are most often found in restricted share agreements (with restrictions often being lifted after a certain period of time or when certain conditions are met); or in the Articles of Association and/or shareholders' agreement of private companies (or both).

What is the effect of acquiring 'restricted shares'?

The acquisition of a 'restricted share' modifies the tax treatment of the shares in certain situations.

On acquisition

If the shares have a 'restriction' that falls within the first bullet above and such restriction lasts less than five years, the income tax charge will be zero. This is true even if there are other restrictions in place.

This rule does not apply where the shares are acquired by exercising a share option, or where the charge to tax arises under the convertible securities regime or because the shares are acquired at an undervalue (primarily relevant to nil and partly paid shares).

Otherwise, acquiring restricted securities does not affect the tax charge at acquisition.

Lifting restrictions, end of restrictions, variation of restrictions and disposal of shares for consideration

A tax charge may arise if the shares:

- cease to be restricted
- have their restrictions varied or lifted, or
- are disposed of for consideration.

Such tax charge will arise on each occurrence of such an event (eg a variation of restrictions, followed by a lifting of one restriction but no

others, followed by a disposal of the shares can result in three different tax charges).

The tax charge is calculated by reference to a formula and is based on the proportion by which the value of the shares is depressed by the presence of restrictions. It takes into account any consideration for the shares and certain income tax charges that may have arisen previously (including under the restricted shares regime). The tax charge applies regardless of how the shares were originally acquired and will attract income tax and possibly National Insurance contributions, rather than the potentially more favourable capital gains tax regime. In the case of restricted stock that vests according to a monthly vesting schedule, this may result in monthly income tax and possibly National Insurance contribution charges.

As restricted shares may be transferable securities for the purposes of the Financial Services and Markets Act 2000, the UK Prospectus Regulation and the Prospectus Regulation Rules, a relevant exemption is needed from the requirement to issue a prospectus. The most useful exemption is where the offer of

restricted shares is made to fewer than 150 persons in the UK at any time.

Example

Alex purchases shares in Employco Limited for £8. The market value of the shares is £8. However, the shares are subject to forfeiture in certain leaver situations. If these restrictions were not present, the market value of the shares would be £10.

A year later, Employco Limited is sold to a third party purchaser, at a price of £20 per share. The restrictions on the shares have not changed, and Alex had not sold any shares previously.

The restrictions caused a 20% discount to the unrestricted market value. This means that on the sale, £4 per share is subject to income tax and National Insurance contributions.

The gain for CGT purposes will take this income tax charge into account, meaning that the base cost will be £12; and the gain will therefore be £8 rather than £12 for CGT purposes.

Section 431 election

To avoid the income tax treatment of restricted shares on disposal, the employee can enter into an election under section 431 of the Income Tax (Earnings and Pensions) Act 2003, whereby the employee elects to pay income tax on the acquisition of the shares as though they were not restricted.

This does increase the tax charge on acquisition but all further gains in the value of the shares should be subject to capital gains tax (as long as none of the anti-avoidance conditions or another tax regime applicable to the shares (eg sale at an overvalue) applies). Therefore, in the above example, there would be income tax due on acquisition on the £2 discount to the unrestricted market value but no charge to income tax on the sale.

A section 431 election must be entered into no later than 14 days after the acquisition of the shares. It is possible for a section 431 election to be made in advance of the acquisition of shares.

In the event that a section 431 election is not signed, it may still be possible to avoid a tax charge as described above if the unrestricted market value of the shares was paid on acquisition – in this situation, although the tax charge still technically arises, the taxable amount equals zero.

Sale of shares

If a section 431 election has not been signed (and no similar election has been signed), the tax treatment on sale will be as discussed above (see What is the effect of acquiring 'restricted shares?').

If a section 431 election has been signed in respect of all restrictions (and/or unrestricted market value was paid at acquisition), there should be no income tax on the sale of shares. There should be a charge to capital gains tax on the difference between the sale proceeds and the unrestricted market value of the shares on acquisition.

The employee can use the capital gains tax annual allowance (£3,000 for the tax year 2025/26) so that only gains in excess of this amount will then be subject to capital gains tax. Capital gains tax is payable at the

rate of 24% for higher rate and additional rate taxpayers (40% and 45%). If an employee pays income tax at the basic rate (20%) and his income and gains do not exceed the higher rate threshold, capital gains tax will be payable at the flat rate of 18%.

If an employee has at least 5% of the voting rights and 5% of the ordinary share capital of the company and holds the shares for at least two years then the employee might be eligible for business asset disposal relief which allows an effective rate of 14% (increasing to 18% in April 2026) for gains up to a lifetime limit of £1 million. In reality this relief may be of limited use for employee option holders.

Employer liabilities

If at the relevant time the shares are readily convertible assets (the shares are listed or there are trading arrangements in place or they are shares in a company which is a subsidiary of another unlisted company), employer Class 1 National Insurance contributions will be payable on any difference between the acquisition price and the market value of the shares (which will be the unrestricted market value if a section 431 election was entered into).

This employer liability cannot be passed on to the employee at acquisition (as is the case for the exercise of an option).

The employer must withhold the employee's income tax liability and employee's National Insurance charges liability via PAYE if, at the time of acquisition, the shares are readily convertible assets.

If the employee does not make good the income tax liability within 90 days of the end of the tax year, there can be a 'tax on tax' charge for the employee.

If a section 431 election was not entered into, and there is a tax charge later, employer Class 1 National Insurance contributions will be payable on the taxable amount if: (i) the shares are readily convertible assets; or (ii) there is a disposal for cash or readily convertible assets. This employer liability can be passed on to the employee, though it is not market practice to do so.

Reporting obligations for employer

The acquisition of the restricted shares, and any disposal or other chargeable events must be reported by 6 July following the end of the relevant tax year to HMRC using their Employment Related Securities online system.



A super team, would highly recommend

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