Cripps

Section 431 election – what is it and should I sign it?

In short, you are at risk of an income tax liability if you sell shares which you acquired by reason of, or which are in some way connected to, your employment. However, if you have made a Section 431 election (named after a section of the Income Tax (Earnings and Pensions) Act 2003) then, on a later sale of the shares, any taxable gain made on the sale should be taxed at capital gains tax rates (which are generally lower) than income tax rates.

If you are issued shares as a result of the sale of a company in which you are employed then you fall within the scope of special tax rules known as "employment-related securities" (ERS Rules).

Restricted shares

One of the main targets of the ERS Rules are restricted shares. Typically, the restrictions relate to voting rights, entitlement to dividends and transfer rights. For example, employees are commonly issued shares which carry equal voting, income and return of capital rights but they can't be transferred without consent. The effect of the restrictions is to lower the value of shares.

For tax purposes, restricted shares have two values. Firstly, the shares have an actual market value. This is the amount the shares are actually worth. Secondly, the shares have what is known as an unrestricted market value, being what the shares would actually be worth if there were no restrictions attaching to them.

If you are issued shares at less than their actual market value, then the difference between what you paid for them and their actual market value is treated as taxable income. More importantly, if the shares are restricted securities then, in very broad terms, unless you paid the full unrestricted market value at the time they were issued to you (which is unlikely), then part of the growth in value of the shares may fall to be taxed as income rather than capital when you sell them.

How do you avoid the tax trap?

To avoid a charge under the ERS Rules, you can elect to make a Section 431 Election so that any discount between the actual market value and unrestricted market value of the shares is taxed at the point the shares are issued to you. Yes, you may have to pay slightly more tax upfront because you will pay income tax on the difference between the price you paid for the shares and their unrestricted market value. However, on a sale of the shares your overall tax bill should be substantially less because more of the sale proceeds are taxed as capital rather than income.

To be valid, the Section 431 Election must be signed by you and the company within 14 days of you being issued shares. Once the election has been made, the document does not need to be sent to HMRC but must be stored so that it can be produced if HMRC ever asks to see it. The company is required to file a return with HMRC reporting the issue of shares and it should state on the return whether an election was made.

Benefits and risks of a Section 431 election

By making a Section 431 Election you are protecting your tax position on a later sale of shares. Without an election, any future growth in value could be taxed as income, not capital. The downside, of course, is that if the shares were to fall in value then you could end up paying more tax by making an election, but as a calculated gamble that the shares will rise in value it's generally a good thing to sign an election.

The tax rules applying to employment-related securities are complex and need careful consideration, and specialist tax advice should always be sought to ensure the best possible outcome.

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