

Practice guide

Corporation tax deductions for share plans

Speed read

Under CTA 2009 Part 12, a statutory deduction potentially applies to all forms of employee share awards, although different chapters of Part 12 apply to stand-alone share acquisitions and securities options. There is longstanding uncertainty about the correct taxing provision in ITEPA 2003 for restricted share units (RSU) style awards, which can have implications for claiming a statutory corporation tax deduction. With effect for share acquisitions on or after 6 April 2015, additional statutory deductions may be claimed for internationally mobile employees. Net settlement of an award can limit the available statutory deduction. Part 12 relief is limited to the acquisition of shares, so any other deductions, such as interest and administration costs, must be claimed under general principles.



Lorna Jordan

KPMG

Lorna Jordan is a director in KPMG's people services team. She has more than 20 years'

experience of advising global companies across all industry sectors on their international incentive plans. Lorna specialises in the tax, regulatory and compliance issues around rewarding and incentivising employees. Email: lorna.jordan@kpmg.co.uk; tel: 0118 373 1442.



Alison Hughes

KPMG

Alison Hughes is a senior manager in KPMG's people services team. She advises

clients on the tax, regulatory and design aspects of employee equity and cash incentive arrangements, acting for a wide range of global, listed, private equity backed and unlisted companies across all sectors. Email: alison.hughes2@kpmg.co.uk; tel: 020 7311 2626.

Although statutory corporation tax relief for share plans has been available since 2003 (older readers may still think of this as 'Schedule 23 relief'), companies can still encounter practical issues when applying the provisions. We will consider some areas that can give rise to difficulties, as follows:

- claiming relief for restricted share units (RSUs) on the correct basis;
- how the rules apply to internationally mobile employees;
- net settlement; and
- the extent to which CTA 2009 ss 1038 and 1038A can deny a general principles deduction.

Recap of the legislation

Under CTA 2009 Part 12, a statutory deduction potentially applies to all forms of employee share awards (e.g. share options, RSUs, long term incentive plans and employee stock purchase plans). This includes shares obtained under HMRC tax advantaged plans, although there are special rules for share incentive plans in CTA 2009 Part 11.

Different chapters of Part 12 apply to stand-alone share acquisitions, securities options and certain events subsequent to the acquisition of restricted shares or securities that convert into shares. Although not considered further within this article, very broadly, the rules for restricted shares and convertible securities seek to give a corporation tax deduction that matches the post-acquisition income tax charges arising under ITEPA 2003 Part 7 Chapters 2 and 3 for employees.

We focus here on the relief for stand-alone share acquisitions and securities options. The requirements in both cases are the same, but the times differ for when some of the tests are applied. The main requirements are as follows:

- An individual must have an employment with a company that is within the charge to UK corporation tax.
- The individual must acquire the shares or the option because of the relevant employment. This is a factual test – there is no deeming provision as there is for income tax purposes under ITEPA 2003 Part 7.
- The shares subject to the award must be fully paid-up, non-redeemable ordinary shares.
- The shares must be in a company that is not under the control of another company unless, broadly, either company's shares are listed on a recognised stock exchange – so private equity backed companies can have trouble qualifying.
- The shares acquired must be in the individual's employing company or, broadly, a 51% parent company or a consortium company.
- There must be a taxable event for income tax purposes (although there does not need to be an actual tax charge so, for example, it does not matter if the individual is non-resident).

For option exercises or other share acquisitions (assuming the shares are neither restricted nor convertible), the amount of the deduction is the market value of the shares on acquisition, less any amount paid to acquire the shares and/or the option. The statutory deduction is available irrespective of any UK company accounting charge, and any other deduction for the cost of providing the shares is then disallowed; i.e. accounting charges are added back other than for incidental costs.

The relief is generally available to the employer company. In the context of securities options, CTA 2009 s 1015(1)(c) means this should be interpreted as the employer when the option was granted (although CTA 2009 s 1024 can transfer the relief for securities options to a new employer on certain business transfers).

RSU awards

The uncertainty about the correct taxing provision in ITEPA 2003 for RSU style awards (i.e. a conditional right to receive free shares on a future vesting date if performance and/or employment conditions are met) is longstanding. Although FA 2016 introduction of ITEPA 2003 s 418(1A) made it clear that the securities option rules in Part 7 Chapter 5 take priority over the general earnings rules in s 62, an employer's right to cash settle can still mean a particular RSU should be taxed as general earnings and not as a securities option. In practice, the plan documentation should be reviewed to determine the correct taxing provision.

This has a number of income tax, NICs and CGT implications for internationally mobile employees and is also relevant for claiming a statutory corporation tax

Example 1: Taxing RSU awards

Mr A was in the UK at the grant of an RSU on 1 March 2015. He subsequently moved to the US as a permanent transfer and is employed by a US company when the RSU vests on 1 March 2018.

If the RSU was a securities option, there was a full UK statutory corporation tax deduction in the accounting period in which 1 March 2018 falls (based on the value of the vested shares) as Mr A meets the test of acquiring the securities option by reason of a UK employment.

If the RSU was not a securities option, there was no UK statutory corporation tax deduction as Mr A did not meet the test of acquiring the shares by reason of a UK employment (as he was employed by a US company when the RSU vested and the shares were acquired). There may be a general principles deduction based on the accounting costs recognised in the original UK employer, but this will potentially be a lower amount than the statutory deduction.

For income tax purposes, it would be appropriate to take the view that the shares were acquired because of both the UK and US employments in place over the vesting period. However, although CTA 2009 s 1002(2) provides that employment includes a former or prospective employment, because there appears to be no scope under CTA 2009 s 1010 to take a limited statutory deduction for the UK sourced portion of the vesting gain, we do not consider that it is normally correct to interpret the Part 12 legislation on the basis that shares were acquired by reason of both employments. That said, this is not free from doubt as it could be argued that 'the shares' in s 1010 refers to the shares acquired by reason of the former UK employment only and not the subsequent US employment.

deduction. If an RSU is a securities option, the various tests above under CTA 2009 Part 12 Chapter 3 need to be applied at the point the option is granted. Otherwise, this will be regarded as an award of shares and the various tests under Chapter 2 need to be applied at the point the shares are acquired (i.e. vest). In our experience, this is an issue that is often overlooked and is illustrated in example 1.

Internationally mobile employees

With effect for share acquisitions on or after 6 April 2015, rules introduced by FA 2014 allow additional statutory deductions to be claimed for internationally mobile employees. There were two key changes:

1. Employees seconded to the UK

Where a person has an employment with a non-UK resident company not within the charge to UK corporation tax, but in performing the duties of that employment 'works in the UK for' a company (the 'host employer') that is within the charge to UK corporation tax, a deduction may be available to the host employer under CTA 2009 s 1007A or, for a securities option, s 1015B. The amount of the deduction is limited to the total amount of employment income that is charged to tax under ITEPA 2003. Previously, there was no deduction for assignees seconded to the UK as they did not meet the tests of acquiring the option or shares because of employment with a company that is within the charge to UK corporation tax. As an aside, we note that an employer will often only know the amount on which payroll withholding was operated and not the final

Example 2: Internationally mobile employees

Miss B was in the US at grant of an RSU on 1 March 2015. She subsequently moved to the UK as a permanent transfer and she is still in the UK when the RSU vests on 1 March 2018.

If the RSU is a securities option, there is a partial statutory deduction in the accounting period into which 1 March 2018 falls based on the UK sourced portion of the gain that is charged to income tax under CTA 2009 s 1015A, as Miss B is then employed by a UK company. Under the rules in force before Finance Act 2014, there would not have been any statutory deduction as she did not meet the test of acquiring the securities option by reason of a UK employment.

Alternatively, if the RSU is not a securities option, there is a full UK statutory corporation tax deduction in the accounting period into which 1 March 2018 falls (based on the value of the vested shares) as she meets the test of acquiring the shares by reason of a UK employment.

If the facts had been identical except that the move was from the UK to the US, the outcome would remain as noted in example 1; i.e. a full statutory deduction if the RSU was a securities option and no statutory deduction if the RSU was not a securities option.

amount charged to income tax, which could be lower after, for example, claiming relief for overseas workdays via the personal tax return. This creates a practical problem.

2. Inbound transfers with existing options

Under CTA 2009 s 1015A, a deduction limited to the total amount of employment income that is charged to tax under ITEPA 2003 is available if:

- an employee is granted an option because of an employment with a non-UK resident company not within the charge to corporation tax;
- at the point the shares are acquired, he or she has an employment with a company that is within the charge to corporation tax; and
- he or she has a UK income tax charge because part of the option gain is UK source.

In contrast to s 1015A(1)(a), s 1015A(1)(c) specifically says 'has' a UK employment (rather than 'has or had'), so the position is unclear for employees who have a UK income tax charge because they worked in the UK for part of the vesting period but are no longer in the UK when the income tax charge arises (i.e. the UK is an intervening country).

The effect of the FA 2014 changes for statutory corporation tax relief and internationally mobile employees seems to be positive because, as shown in example 2, it introduces scope for additional corporation tax deductions without limiting the scope for the previously existing deductions.

In practice, however, a UK company will need to think carefully about how the rules for taking a statutory deduction in relation to internationally mobile employees interact with other provisions, particularly if it is paying a recharge to an overseas parent in return for the seconded employee (as this amount is often based on the remuneration costs for the individual, including share plan participation).

Further, in our experience, even though the rules for internationally mobile employees have been in force since April 2015, some companies do not seek such Part 12

deductions because the data to support them is not readily available.

Net settlement

One of the key requirements for claiming a statutory deduction is that the employee must acquire a beneficial interest in the relevant shares (CTA 2009 ss 1003(2), 1007(1)(c) and 1015(1)(d)).

For example, an employee is made an award of 1,000 shares which vests when the shares have a market value of £10 per share and the entire amount that counts as employment income (i.e. £10,000) is subject to payroll withholding at a marginal tax and employee NIC rate of 47%. In this case, it could be 'net settled' by the employing group:

- making a deemed cash payment of £4,700 to settle the tax and employee NIC (deemed in the sense that it is never paid to the employee but is used to settle tax and NIC); and
- issuing 530 shares to the employee (i.e. the net value of the award of £5,300 divided by £10).

Some companies (especially US parented groups) choose to net settle because it reduces the number of shares issued; i.e. less dilution. In a clear case of net settlement where only 530 shares are ever issued, the statutory corporation tax deduction is limited to £5,300; i.e. the value of the issued shares. This is because the employee never has a beneficial interest in 470 shares.

There may be some scope for claiming a general principles corporation tax deduction for the cash payment, but this is not always straightforward. In particular, as well as passing the usual revenue rather than capital, wholly and exclusively tests and being subject to the timing rules in CTA 2009 Part 20, it needs to be supported by the underlying accounting treatment; i.e. it must have been recognised as a cost in determining the accounting profit. Very broadly, with a rising share value, a general principles deduction is likely to be lower than the statutory deduction that could have been available if the relevant part of the award is treated as 'equity settled', rather than 'cash settled', for accounting purposes. This is because such accounting costs are broadly based on the original fair value of an award expensed over the vesting period and are not 'trued up' each year.

Amendments to IFRS 2 issued in June 2016 provide that if, in the absence of a net settlement feature for withholding tax obligations, the relevant share-based payment would otherwise be accounted for wholly as equity settled, the net settlement feature for withholding obligations will not, in and of itself, cause that award to be accounted for as part cash settled. This change applies to accounting periods beginning on and after 1 January 2018 (IFRS 2 para 63D). Accordingly, for accounting periods beginning on and after 1 January 2018, it is even more likely than before that any available general principles deduction will be insufficient to compensate for the additional statutory deduction that could have been obtained. This is because the 'cashed out' part of an award is accounted for as equity, rather than cash, settled.

A net settlement arrangement can be contrasted with a 'sell to cover' arrangement where, using the example above, 530 shares are delivered to the employee and the employer arranges for the remaining 470 shares to be sold in the market to cover the tax. In both cases, the employee is only ever delivered 530 out of the vested 1,000 shares. However, in the latter case the employee becomes beneficial owner of 1,000 shares (as 470 existing shares are sold by a broker to

cover the tax, as well as the 530 delivered to the employee), so the statutory deduction available is £10,000.

Although a plain vanilla net settlement or sell to cover can be easily identified, in reality many companies have a more complex hybrid arrangement, particularly where employee benefit trusts are used as part of the settlement arrangements. It is important to note the statutory requirement is that the employee acquires a beneficial interest in the full number of shares underlying his or her award. It is *not* a requirement that the employee actually receives all of the shares, holds that beneficial interest for any period or that there is an external sale of shares in the market. Close analysis of the underlying arrangement is always required and recommended.

Extent of CTA 2009 ss 1038 and 1038A

Part 12 relief is limited to the acquisition of shares. Any other deductions for the share plans (e.g. interest and administration costs) must be claimed under general principles or, in the case of set-up costs, under the special rules on set-up costs applicable to certain tax-advantaged share option plans. Part 12 relief is also limited to share settled plans, so that a potential deduction for cash settled awards would need to be claimed under general principles. CTA 2009 s 1038 is a broad provision intended to stop a general principles deduction also arising where the statutory rules are in play. Section 1038A is a further, somewhat overlapping, provision introduced for accounting periods ending on or after 20 March 2013 to counter attempts to claim deductions on general principles in respect of accounting charges in respect of underwater share options that were never exercised. (The underwater option position prior to March 2013 is currently being litigated via the case of *NCL Investments Ltd v HMRC* [2017] UKFTT 495 (TC) but that is another story.)

Because of the breadth of the drafting, which denies a deduction for 'any matter connected with the provision of shares' or 'with the option', we have seen some HMRC inspectors try to claim that this prevents deductions for ancillary costs related to a share plan such as share plan hedging costs or even employer NIC. In our view, such arguments should generally be resisted as, taking a purposive view of the legislation, s 1038 is intended to prevent overlapping statutory and general principles deductions. It is not intended to remove a deduction for something ancillary that would have arisen on general principles long before the specific rules for obtaining a corporation tax deduction for share plans were first introduced and not reflected in the statutory relief now provided.

What next?

Historically, even where deductions claimed are substantial, many companies have not seen HMRC raise detailed enquiries on Part 12 deductions. However, more recently, we have seen some evidence of increased HMRC scrutiny of corporation tax deductions for share plans in relation to net settlement arrangements, as well as reviewing the online share reporting against the corporation tax computations and raising enquiries. As it can take some time to gather and analyse relevant data (often requiring liaison between the internal share schemes team and the central tax and accounting teams), we recommend that companies proactively review the basis on which they are claiming corporation tax relief for share plans, rather than be on the back foot should HMRC raise an enquiry. ■