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Analysis

# CT deductions for cash cancelled or net-settled share options

## Speed read

HMRC have published new guidance in their *Business Income Manual* at BIM44410–BIM44414 on the availability of corporation tax relief for cash cancelled or net-settled employee share options. Whilst this is welcome in confirming that 'general principles' corporation tax relief is potentially available where specific statutory relief is not, in some scenarios HMRC's view on the timing of corporation tax relief may cause practical difficulties for some companies. Further, an understanding of whether an award is an 'option' is fundamental to applying the corporation tax rules correctly.

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In many cases, where an employee acquires shares under an 'option', statutory corporation tax relief under CTA 2009 Part 12 (Part 12) is available for the employer in respect of the gain (i.e. the difference between the market value of the shares when they are acquired and any acquisition price paid) provided certain conditions are met.

For these purposes, an 'option' includes any right to acquire shares (CTA 2009 s 1005). Therefore, depending on the specific terms of the relevant share plan, awards that are described, for example, as restricted stock units (RSUs), deferred share bonuses, or long-term incentive plan (LTIP) awards – as well as 'conventional' market value employee share options – could be 'options'.

Where the conditions for corporation tax relief under Part 12 are not met – for example, where an option is cash cancelled – a 'general principles' corporation tax deduction (i.e. relief for amounts recognised for accounting purposes) may be available instead, but this is more complex and potentially less generous.

### What is net-settlement?

'Net settlement' describes an arrangement whereby the company only issues or transfers shares equal to the net gain after payroll withholding that an employee realises on the vesting or exercise of an award. Many companies choose to do this to manage the shareholder dilution which can occur with employee share plans. In that sense, 'net-settlement' is similar to, but distinct from, satisfying an option using 'cashless exercise' by issuing or transferring shares equal in value to the gain (i.e., the difference between the option exercise or 'strike' price and the market value of the shares acquired) on exercise.

One of the key requirements for claiming a Part 12 deduction is that the employee acquires a beneficial interest in the relevant shares (CTA 2009 ss 1003(2), 1007(1)(c) and 1015(1)(d)). This test is not met to the extent that share awards are cash cancelled. For example, if an employee is awarded an RSU over 1,000 shares which vests when the shares have a market value of £10 each, 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%, it could be 'net-settled' by the employing group:

- making a cash payment of £4,700 to settle the tax and employee NICs (which is withheld to settle the PAYE tax and NICs rather than transferred to the employee); and
- issuing 530 shares to the employee (worth £5,300).

The corporation tax deduction under Part 12 is limited to £5,300. This is because the employee does not acquire a beneficial interest in the 470 shares underlying the part of the award that is cash cancelled.

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Net settlement can be contrasted with 'sell to cover' arrangements where, using the example above, 530 shares are delivered to the employee and the employer arranges for the remaining 470 shares to be sold to cover the tax on behalf of the employee, normally in the market via a broker. 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 so the Part 12 deduction available is £10,000.

Although some net settlements or sales to cover are easily identified, many companies have more complex arrangements, particularly where employee benefit trusts are used as part of the settlement arrangements. The statutory requirement is that the employee acquires a beneficial interest in the shares underlying their award. It is not a requirement that the employee actually receives delivery of all of the shares, holds the beneficial interest for any particular period, or that there is an external sale of shares in the market. Close analysis of the underlying arrangement is always required to identify net settlement.

Further, other facts can mean that concluding that a company does net settle is preferable, even though this limits any corporation tax deduction under Part 12. If a settlement arrangement involves an employee acquiring a momentary beneficial interest in shares and immediately passing these back to the issuing company, the implied disposal can have adverse tax results for the employee, for example being taxed as a distribution.

### The importance of accounting

In summary, under the accounting standards for share-based payments (e.g. IFRS 2), P&L debits determined by reference to the fair value of an award at the relevant date are recognised

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over the expected vesting period. For example, where an RSU was granted in March 2020 and vested in March 2023, for a company with a calendar year end, there will be accounting debits in the years ended 31 December 2020, 2021, 2022 and 2023.

Determining the precise accounting debits can be complex and fact specific, particularly where group accounting is in play. Intra-group recharges may also need to be accounted for where a group share scheme is operated, although these should not be relevant to the availability of corporation tax deductions if they only impact the balance sheet rather than create P&L debits.

Where net settlement does occur, some companies have taken a corporation tax deduction for an element of the accounting debits corresponding to the portion of an award delivered in cash. The newly published guidance is therefore welcome in confirming that HMRC agrees that this kind of general principles deduction is potentially available. As explained below, there was previously some debate on this point due to the breadth of the rules restricting relief for matters dealt with under Part 12.

### CTA 2009 ss 1038 and 1038A

An otherwise available general principles deduction can be denied or delayed by specific legislation.

CTA 2009 s 1038A disallows any corporation tax deduction that would otherwise be available in relation to an option, or any matter connected with an option, unless and until:

- the underlying shares are acquired; or
- an amount otherwise counts as employment income in relation to the option.

Although this provision is part of Part 12, it applies where a share option is acquired by reason of employment, irrespective of whether the requirements to obtain Part 12 relief are met.

Where an income tax chargeable event occurs without the relevant underlying shares being acquired (e.g. where the option is net-settled or cash cancelled in full), s 1038A(7) 'switches off' s 1038A to the extent that the employee receives cash that counts as employment income.

When shares are acquired that qualify for statutory corporation tax relief under Part 12 (even if the relief is calculated as nil), CTA 2009 s 1038 stops any other deduction being given for 'any matter connected with the provision of the shares' or 'in a case in which the shares are acquired pursuant to an option ... any matter connected with the option'.

This prohibition covers matters connected with the provision of the shares actually acquired (and if relevant the underlying option), whereas the debits under consideration in relation to the cash cancelled or net-settled part of an award are more straightforwardly understood as connected with what was *not* acquired. Moreover, the accounting debits in question strictly represent the consumption of employees' services rather than the cost of providing shares or options.

Nonetheless, given the breadth of the drafting in these exclusivity provisions, it is welcome that the HMRC guidance accepts that this legislation will not prevent a deduction for the net-settled portion of an option.

### Quantum of a general principles deduction

HMRC's view on the quantum of a general principles deduction for employee share options is as expected: the starting point is to look to available accounting debits to the extent they represent the 'cashed out' part of the award, but with an effective 'cap' equal to the amount charged to income tax (on the basis that s 1038A prevents a deduction for any amounts not charged to income tax).

Where an award is cash cancelled a company might expect a full corporation tax deduction for the cash payment made to the employee. It is therefore important to understand that this is not necessarily the case. Assuming the revenue not capital and wholly and exclusively tests can be surmounted, the actual deduction is based on the maximum of the P&L debits and the cash payment charged to income tax. Care therefore needs to be taken as to precisely how the cash cancellation arrangement is structured and accounted for. The timing of the available deduction also needs to be considered, as noted below.

### Timing of corporation tax deductions

Where corporation tax relief is available under Part 12, the legislation prescribes that the relief is available for the accounting period in which the employee acquires shares.

With a general principles deduction, however, the starting point is that any relief is available when the accounting debits are taken. In its recently published guidance, HMRC's view is that, up to the point a share option is net-settled or cash cancelled, s 1038A denies a general principles deduction for any accounting debits related to the option. At the point the award is cash cancelled or net-settled, s 1038A no longer denies a deduction.

> HMRC's guidance on the timing of general principles CT relief for share options is likely to create an administrative burden and practical difficulty for companies

It would therefore appear that any company wishing to obtain general principles relief should go back and take deductions across all the accounting periods where the historical P&L debits sit. As noted in the example above, for an RSU granted in March 2020 and vesting March 2023, there would typically be historical P&L debits spread across accounting periods ended 31 December 2020, 2021, 2022 and 2023.

HMRC's guidance on the timing of general principles corporation tax relief for share options is likely to create an administrative burden and practical difficulty for companies, particularly as tax returns can normally only be amended within two years of the end of the relevant accounting period. In other cases where the legislation can require the liability for a potentially closed period to be retrospectively changed as a result of subsequent events (e.g. TCGA 1992 s 144), HMRC have published guidance confirming how this can be given effect to administratively. No equivalent guidance has yet been provided in relation to the administrative aspects here, so in the short term at least this is likely to be a key area of practical uncertainty for businesses.

### CTA 2009 ss 1288 and 1290

CTA 2009 s 1288 delays a deduction that would otherwise be available for remuneration that is charged in the accounts but is not paid within nine months of the end of the accounting period. Instead, a deduction is allowed in the accounting period in which the remuneration is actually paid.

Prior to the recently published HMRC guidance, some companies may have taken the position that CTA 2009 s 1288 is relevant to the timing of a general principles corporation tax deduction for a cash cancelled or net-settled award on the basis that, in summary, as their specific share plans were drafted, no 'money's worth' was received (and so no

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remuneration 'paid') on grant of the award, and remuneration was received only when the cash cancellation or net-settlement payment was made. Continuing the above example of an RSU granted in March 2020 and vesting in March 2023, under that analysis s 1288 would defer corporation tax relief for any accounting debits taken in accounting periods ended 31 December 2020 and 2021 to the accounting period of vest (i.e. 31 December 2023). Accounting debits taken in 2022 would remain in that accounting period (because the March 2023 vest is less than nine months from the end of the 31 December 2022). But at least the corporation tax return for the year ended 31 December 2022 will usually still be open at that time.

However, we understand that in HMRC's view remuneration is 'paid' at the point an option is granted, even where all or part of that option is ultimately cash-settled (so s 1288 is never engaged). Although there is some case law support for the proposition that the tax point for an option would be grant absent specific legislation, in a different historical context HMRC have drawn a distinction between an option that is binding as a matter of contract law (i.e. granted as a deed or for consideration if English law is the relevant governing law) and an option that is not a 'legal option'. HMRC do not appear to be making this distinction in the context of the new corporation tax guidance.

CTA 2009 s 1290 is a further provision that delays a corporation tax deduction for employee benefit contributions until qualifying benefits or expenses are paid out. Whilst arrangements must always be considered on their own facts, this provision will not usually help to move earlier accounting debits into the year in which awards are net-settled because the Supreme Court held in *HMRC v NCL Investments Ltd and another* [2022] STC 599 that, on the facts of that case, the grant of an option did not constitute an employee benefit contribution.

### Awards that are not 'options'

It's important to appreciate that HMRC's recently published guidance applies only to share awards that are 'options' within the meaning of CTA 2009 s 1005.

As noted above, in broad terms the definition of an 'option' for these purposes includes any right to acquire shares. The income tax definition (ITEPA 2003 s 420(8)) includes other types of security as well as shares, but the key to both definitions is that the employee has a right to acquire shares.

Accordingly, where the grantor can, at its discretion, satisfy an award by delivering cash rather than shares it is not clear that the award is necessarily an option (see HMRC's *Employment Related Securities Manual* at ERSM110025 and ERSM110020).

The corporation tax consequence of an award being an 'option' is that any Part 12 deduction is available under Part 12 Chapter 3, which broadly means that many of the relevant statutory tests should be applied at the date the option is granted. As noted above, the additional corporation tax consequence is that s 1038A applies to affect the timing and cap the quantum of a general principles deduction for a net-settled or cash cancelled award.

If a share award falls outside the definition of an 'option' (for example, an RSU where the employer may choose to settle the award in cash or shares), the corporation tax consequence is that any Part 12 deduction is available under Part 12 Chapter 2, which broadly means that the relevant statutory tests should be applied when the employee acquires the beneficial interest in the shares.

As noted above, the additional corporation tax consequence is that s 1038A does not apply if the award is not an 'option'. HMRC have indicated to KPMG that where an award is not an 'option', so the acquisition of the underlying shares is taxed as general earnings under ITEPA 2003 s 62 for income tax purposes, CTA 2009 s 1288 is relevant to the timing of a general principles corporation tax deduction for net-settled or cash cancelled awards. As outlined above, this would mean that for share awards falling outside the definition of an option, relief for the accounting debits would be deferred into the year of vest or the year of vest and the prior year.

Having the timing and, potentially, the quantum of corporation tax relief differing according to whether an award is analysed as an option or not has the potential to be confusing for all involved and could potentially lead to compliance errors, particularly as determining the correct taxing provision for a share award is not always clear-cut.

We understand HMRC is not prepared to read s 1288 with the benefit of hindsight as to how the award was actually settled and to separate out the share settled and cash settled parts and determine the date the remuneration was paid on that basis, even in cases where there was an expectation of net-settlement at the date of grant.

## HMRC's recently published guidance applies only to share awards that are 'options' within CTA 2009 s 1005

In our experience, HMRC appear to prefer an 'option' analysis and consider that most RSU and similar awards should be treated as securities options for income tax purposes. We are aware that some companies currently treat awards as 'options' for tax purposes even if the plan documents contain a power for the employer to cash settle if the practical expectation is that awards will be share settled (and HMRC have previously indicated that they will not normally challenge that position). However, arguably, this is not strictly technically correct. Companies who wish to obtain closer alignment between the timing of any Part 12 deduction and general principles deduction for the net-settled part of an award (i.e. companies who wish to apply s 1288) might revisit their analysis of the correct taxing provision. Care should be taken as certain other tax and social security consequences, particularly affecting internationally mobile employees, hinge on the analysis of whether an award is an option, and any change to an established practice might be examined, and potentially challenged, by HMRC.

Companies who are unsure how their awards have historically been analysed should check their online annual employer share plan returns due by 6 July each year (formerly known as form 42). The section of the return in which an award is reported differs according to whether an award is treated as an option or not. Note further that HMRC requires specific reporting in this form where an option is net-settled.

### Conclusion

Overall, the new HMRC guidance confirming that a general principles deduction for a net-settled or cash cancelled award is available is welcome. However, companies will need to consider what steps they should take if their current approach to the timing or quantum of any general principles deductions they claim for cash cancelled or net-settled share awards does not align with HMRC's recently published position. ■

- Corporation tax deductions for share plans (L Jordan & A Hughes, 1.3.19)