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SHARES FOR EMPLOYEES
CORPORATION TAX RELIEF FOR THE COMPANY

CHRIS CHAPPLE
chris.chapple@bdo.co.uk

BY CHRIS CHAPPLE
Tax partner with BDO LLP

In May 2017 the First-tier Tax Tribunal (FTT) ruled that a company was entitled to a corporation tax deduction on the grant of options over the company's shares by the trustees of its employee benefit trust (EBT) to company employees, based on accounting debits made in accordance with International Reporting Standard 2. As well as looking at that decision, it may be helpful to remind readers of the different ways in which companies can obtain corporation tax relief on the grant and exercise of share options, and on employee share acquisitions, even where the company has not incurred expenditure and is not directly involved in the transaction.

OVERVIEW

There are four main ways in which companies can obtain corporation tax relief on the grant and/or exercise of share options:

01. Statutory deductions under specific tax-advantaged share option scheme rules

02. Other statutory relief for employee share acquisitions

03. A deduction under general principles for providing non-qualifying shares to employees

04. A deduction under general rule for accounting debits made in accordance with recognised financial standards.

We will outline the position for each type of relief, noting points to watch.

1 STATUTORY DEDUCTIONS UNDER SPECIFIC TAX-ADVANTAGED SHARE OPTION SCHEME RULES

CTA 2009 provides statutory relief for:

- The costs of setting up a:
  - share incentive plan (SIP) (S 987)
  - SAYE option scheme or CSOP scheme (S 999)
  - employee share ownership trust (S 1000)
- The running expenses of a SIP (S 988)
- Contributions to the trustees of a SIP trust to enable them to acquire shares in the company or a parent company (S 989)
- A deduction equal to the market value of free or matching shares awarded to employees under a SIP (S 994)
- Additional expense in providing partnership shares (S 995)

It should be noted that some of these deductions are subject to withdrawal if the relevant scheme is not operated in accordance with HMRC rules.

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2 OTHER STATUTORY RELIEF FOR EMPLOYEE SHARE ACQUISITIONS

Statutory relief is available to a company under Ss 1001-1038 CTA 2009 where:

a. An employee or another person acquires shares because of the employee's employment by the company

b. An employee or another person obtains an option to acquire shares because of the employee's employment by the company, and shares are acquired pursuant to the option.

It is important to note that:

- Any relief available under the above rules relating to SIPs takes priority to these general reliefs
- Relief will be available under these rules not only in respect of shares provided directly by the company but also for acquisitions not directly involving the company – for example, where an employee is gifted shares by another employee or by an EBT.

The main conditions are summarised below.

a. Acquisition of shares because of a person's employment by a company

The shares must be fully paid-up non-redeemable ordinary shares in the employing company (or a group or associated company) that are:

- shares in a company that is not under the control of another company; or
- shares listed on a recognised stock exchange, or
- shares in a company that is under the control of a listed company.

The company must be within the charge to corporation tax, and the employee must be subject to an income tax charge in relation to the acquisition of the shares (or would be subject to income tax if UK-resident, and the employment duties had been performed in the UK).

The allowable deduction for the employing company, for the accounting period in which the shares are acquired, will be the market value of the shares when they are acquired, less the amount or value of any consideration given by any person for the shares.

Special rules apply to restricted or convertible shares.

EXAMPLE 1

John, a director and majority shareholder of an unquoted UK company, gifts Mary, an employee of the company,1,000 ordinary shares with a market value of £5,000. John had acquired the shares at a cost of £1,000, and the gift is not for family or personal reasons but purely due to Mary's employment.

John will have realised a chargeable gain of £4,000, Mary will be subject to income tax on £5,000, and the company will be entitled to a corporation tax deduction of £5,000.

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b. Exercise of an option to acquire shares obtained because of a person's employment by a company

The shares must be fully paid-up non-redeemable ordinary shares in the employing company (or a group or associated company) that are:

- shares in a company that is not under the control of another company; or
- shares listed on a recognised stock exchange, or
- shares in a company that is under the control of a listed company.

The company must be within the charge to corporation tax, and the employee must be subject to an income tax charge in relation to the acquisition of the shares (or would be subject to income tax if UK-resident, and the employment duties had been performed in the UK, or unless exempted from a charge because the shares are acquired under an HMRC-approved CSOP, SAYE or EMI share option scheme.)

The allowable deduction for the company, for the accounting period in which the shares are acquired, will be the market value of the shares when they are acquired, less the amount or value of any consideration given by any person for the option or the acquisition of the shares.

Special rules apply to restricted or convertible shares, and in relation to takeovers or transfers of businesses.

EXAMPLE 2

The company in Example 1 grants Mary an EMI qualifying option to acquire 1,000 shares held by John, with an exercise cost of £1,000, which Mary exercises when the shares are worth £5,000.

On exercise of the option, John will have no chargeable gain, as the proceeds (the exercise price of the option) are equal to his base cost, and the company will be entitled to a corporation tax deduction of £4,000.

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3 A DEDUCTION UNDER GENERAL PRINCIPLES WHERE NON-QUALIFYING SHARES ARE PROVIDED TO EMPLOYEES

In addition to the statutory deductions, relief is available under general tax principles for the cost to a company of providing the following types of shares to employees:

- partly-paid, redeemable or preference shares
- unlisted shares in a subsidiary company (unless its parent company is listed on a recognised stock exchange and is not a close company); or
- shares in a company which is not sufficiently linked to the employing company at the date on which the employee acquires the shares, or any earlier right (share option) to acquire the shares.

The main ways in which such shares are provided to employees are:

a. Through employee benefit trusts (EBTs) to which the employer makes contributions

b. Under global share schemes for which the employer pays an intra-group recharge

a. Employee benefit trusts to which the employer makes contributions

Subject to anti-avoidance legislation and case law, a deduction may be given for employer contributions to EBTs which are not capital expenditure and which are made wholly and exclusively for the purposes of employer's trade.

The deduction is given when, and to the extent that, an employee receives benefits in the form of money or assets (including the 'non-qualifying shares') which are subject to both income tax and NICs. As 'non-qualifying shares' are deemed to be readily convertible assets, liability to income tax and NICs arises when the employee acquires the shares, so a deduction would be allowed to the company at that point, but limited to the value of the initial contributions to the EBT.

b. Under global share schemes for which the employer pays an intra-group recharge

There are two main kinds of 'group schemes' set up by the parent company of a group to provide its shares to employees of any company in the group:

- UK parent companies typically set up an employee share ownership trust through which shares in the parent company are provided to employees of group companies, funded by contributions from their employing companies.
- If the employing company is a member of a multinational group of companies the parent company may charge the employing company (an 'intra-group recharge') for allowing its employees to benefit under a global group scheme.

If a deduction is in principle allowable for an intra-group recharge, the EBT anti-avoidance legislation - see (a) above - applies to determine when it is allowable.

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4 A DEDUCTION UNDER GENERAL PRINCIPLES WHERE A PARTICULAR ACCOUNTING TREATMENT APPLIES

Under International Reporting Standard 2 (IFRS 2) and Financial Reporting Standard 102 (FRS 102), companies must account for the cost (fair value) of providing share options to employees.

A corporation tax deduction under general principles may be available if there is no possibility of obtaining corporation tax relief under the other methods described above.

THE RECENT CASE

The NCL investments Limited and Smith & Williamson Corporate Services Limited v HMRC case concerned deductions claimed against trading profits in respect of accounting debits relating to the grant of share options granted to employees by the trustees of an EBT.

HMRC agreed that that the companies calculated the IFRS2 Debits correctly, and properly allocated them to accounting periods, in accordance with IFRS. However, HMRC argued that:

- The expenses in question were not incurred wholly and exclusively for the purposes of the companies' trades, or
- The expenses were capital , or
- A deduction was prevented from being available by S 1038 CTA 2009 ('Exclusion of other deductions') or S 1290 CTA 2009 ('Employee benefit contributions').

The FTT disagreed with HMRC's contention that the IFRS 2 debits were not deductible because they were not "incurred", being merely accounting entries which did not represent a real expense, and considered that, taking a realistic view of the facts, the debits were incurred wholly and exclusively for the purposes of the companies' trades.

The FTT also considered that the debits were not capital in nature because:

- They arose because the companies' employees were remunerated with share options and the remuneration of employees has a revenue, not a capital, nature.
- They arose periodically, and were not "one off" items. They were therefore recurring costs that had a connection with the companies' earning of income (not least since the companies on-charged the debits to other members of the group, at a margin, by way of a management charge).
- As an accounting matter, they reflected the consumption of employees' services by the companies.

Finally, the FTT disagreed with HMRC's view that a deduction was prevented under Ss 1038 or 1290 CTA 2009.

The FTT therefore ruled in favour of the taxpayers on all points, and allowed their appeal.

It remains to be seen whether HMRC appeals this decision, and the extent of any wider application is unclear, as the facts of the case were very specific. It must also be noted that it relates to periods before the enactment of FA 2013 which now prevents claims for deductions in respect of IFRS 2 debits in some circumstances.