Shares meet their Waterloo

An unintended interaction between transfer pricing and a welcome statutory corporation tax relief for share options has thrown the whole area of transfer pricing of share plans into confusion. William Franklin and Gareth Green

Share plan practitioners used to regard transfer pricing as a topic they could largely ignore and vice versa for transfer pricing practitioners. This started to change in 2001 with the 'Waterloo' case, which was the code name given to a special commissioners decision in favour of the UK Inland Revenue involving a large UK multinational.

In Waterloo, the multinational had arranged for employees of foreign subsidiaries to receive share options through an employee benefit trust (EBT). The EBT was financed by an interest free loan from the parent company and shares were sourced mainly through purchases on the market. Such arrangements are often used by companies to provide maximum flexibility in the operation of their share plans.

In a ground-breaking decision, the commissioners decided that the entire arrangement formed a single business facility – the provision by the parent company to a subsidiary of participation in a share plan for the benefit of the employees of the subsidiary, and that the subsidiary needed to make an 'arm's length' payment for the provision of that facility. From the Revenue's perspective, Waterloo has much wider significance than just share plans as it takes transfer pricing beyond the level of the simple transaction entered into by two parties.

However, as far as share plans were concerned, the Waterloo decision left unanswered a number of important practical questions such as the exact scope of the decision and how an 'arm's length' charge for the facility should be determined.

Guidelines

As there was no appeal beyond the special commissioners by the taxpayer, the Revenue set about constructing a set of guidelines for the operation of transfer pricing and share plans on the basis of the incidental comments by the commissioners and the very limited guidance relevant to share plans within the existing OECD guidelines. From these rather flimsy foundations the first guidance in *Tax Bulletin 63* was published in 2002. This was followed in the summer of 2004 by changes to the *International Manual, Draft Guidance Notes* on UK-UK transfer pricing and other comments made by the Revenue to enquirers.

Tax Bulletin 63 suggested that the arm's length value of the payment could be quantified using an option pricing model such as Black Scholes

to produce charges similar but not necessarily identical to the charges now required by IFRS 2 or FRS 20, *Share-based Payment*.

The bulletin also indicated that the Waterloo principle should be applied retrospectively at least as far as open years for corporation tax were concerned. However, in respect of future years it appeared to offer a relatively straightforward means of restoring the status quo. It confirmed the Revenue's acceptance that there is a 'capital exemption'. That is, if shares were sourced by new issue then this was a capital transaction from the perspective of the parent, and therefore not taxable income. From a transfer pricing perspective, this therefore did not require an arm's length charge in the accounts or adjustment to the tax computation. Many UK companies with international operations concluded that, if share awards to employees of foreign subsidiaries were sourced by new issue shares, then overseas share plan arrangements would be outside the scope of transfer pricing because of this capital exemption.

Within some quarters of the Revenue, we understand, there had always been misgivings about the capital exemption. Last year the Revenue let it be known that in its view it only applied when all of a company's share plan arrangements were sourced by new issue, not just the awards for foreign employees.

As in practice most of the larger international groups source shares through a mixture of market purchase and new issue, this interpretation by the Revenue would mean the capital exemption would not be available for most companies. To make matters worse, for transactions from April 2004 the scope of transfer pricing was extended to UK-UK transactions, unless a company qualified for the general exemption from transfer pricing for small and medium-sized enterprises.

The extension of transfer pricing to UK to UK transactions was not intended to generate additional corporation tax. If there was a supply of goods or services between two UK companies within the same group and transfer pricing rules required an adjustment to the price for UK tax purposes, any resulting increase in the taxable profits of one group member should ordinarily be offset by a compensating adjustment in the other group company, with the effect that the overall tax paid by the group should remain the same.

Therefore, at first sight, the extension of transfer pricing to UK to UK transactions should have been no more than an administrative nuisance. If the employees of subsidiary 'S' were granted options by parent company 'P', an arm's length payment by S to P would be required which would create additional taxable income in P and an equivalent expense in S. However, for share plans the position was more complex because of the interaction with a specific relief for share plans introduced in the 2003 Finance Act.

Concern for small companies

Previously, larger groups had often been able to obtain corporation tax relief in respect of the gains made by their option holders, ie, the 'spread'. This was achieved through a fairly complex web of offshore trusts and inter group loans and agreements which became known as 'tax symmetry arrangements'. The government became concerned that smaller companies that could not afford to set up the symmetry arrangements were being denied a tax relief available to large companies. In an imaginative move they removed the need for symmetry arrangements by introducing a statutory corporation relief for option gains, which is contained in Sch 23 of the 2003 Finance Act.

The sting in the tail of this new statutory relief was that if a company was potentially eligible for the relief it would not receive it until the accounting period in which the options were exercised and in the meantime no other relief was allowed for the 'cost of providing shares'.

Therefore the key issue is whether the transfer pricing payment by S to P is a 'cost of providing shares'. If it is, then the payment creates taxable income in the parent but the corresponding expense in the subsidiary would not qualify for corporation tax relief and the group's overall corporation tax payable would increase.

The Revenue had not intended this harmful effect of the interaction of UK-UK transfer pricing and Sch 23, Finance Act 2003 to arise, and its initial response was to try and interpret the legislation in such a way that the restriction did not apply. However, this approach was only partially successful as a restriction on the relief still arose when options were granted at a discount and satisfied by new issue – the normal situation for SAYE options.

However, the Revenue subsequently decided that this interpretation of Sch 23 was incorrect. As a result, the Revenue announced in December 2004 that all its existing guidance on share plans and transfer pricing was time limited and that companies should not rely on them for accounting periods beginning on or after 1 January 2005.

In a vacuum

So far there has been little indication from the Revenue as to the form of the new post 1 January 2005 regime other than an acknowledgement that it is having difficulty in devising it. This leaves companies in a vacuum unable to make rational decisions going forward about their share sourcing arrangements.

However, it is understandable the Revenue is having difficulties. Not only does it have the problem of the interaction with Sch 23, but it also has to take account of the new share-based payment accounting regime of IFRS 2/FRS 20, while preserving the single facility principle of its victory in the Waterloo case. Faced with the growing impatience of UK corporations for coherent guidance, the Revenue officials who are trying to reconcile the various conflicting pressures without harming share plans might well reflect on the wisdom of the victor of the original battle of Waterloo (the Duke of Wellington) who observed that 'next to a battle lost, the greatest misery is a battle gained'.

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