Untangling UK share option transfer pricing

Several developments over the last few years have undoubtedly transformed the UK transfer pricing treatment of employee share options, but they leave an unclear picture. Gareth Green, of transfer pricing boutique, Transfer Pricing Solutions Ltd, and William Franklin, share schemes specialist at UK law firm, Pinsents, have been collaborating to work out what it all means.

Many parent companies operate share option schemes in which employees of subsidiaries are allowed to participate. If those subsidiaries are in a different country (or indeed in the same country, if, like the UK from 1 April 2004, transfer pricing rules apply domestically), then transfer pricing issues inevitably arise. The parent company is partially remunerating the subsidiaries' employees, and at arm's length it would be likely to expect fair reward for rendering this benefit.

This article will examine the issues of:

- whether the parent is taxable on any payment by the subsidiary;
- if taxable, *when* is the parent taxable (and when should the subsidiary claim a deduction);
- what is the arm's length price.

Our focus will be on UK parents with overseas subsidiaries, and UK subsidiaries with overseas parents. Many of the points will also be relevant for other countries and, indeed, for transactions within a UK group, but these are not specifically considered.

Share options are not the only form of share-based remuneration. Many of the points made will apply equally to other share-based compensation, though we will restrict ourselves to considering share options. It is also beyond the scope of this article to consider the taxation of the employees.

No less than seven factors need to be taken into account:

a) New financial standards which stipulate the accounting treatment of employee share options.
b) A new statutory entitlement to a deduction for the employer.
c) A 2001 legal case on transfer pricing, known as Waterloo.
d) Inland Revenue policy statements on employee share option transfer pricing, in their Tax Bulletins and internal manuals.
e) New UK transfer pricing rules that remove the former exemption for UK-UK transactions.

A Short Guide to Employee Share Options

A share option is a right to acquire shares at a price (the "exercise price") determined when the option is originally granted. If the market value of the share exceeds the exercise price, the optionholder has the opportunity to make a gain equivalent to the difference, which is often referred to as the spread.

In some cases the right may be exercised and shares acquired immediately. But it is more common for there to be a period, usually called the vesting period, before an option becomes 'vested' and can be exercised. There is often a period following vesting within which the option must be exercised, otherwise it lapses.

Granting such options to employees is a common form of remuneration. Increasingly, options are granted to employees subject to performance targets which have to be satisfied during the vesting period before the option can be exercised. These targets can take a variety of forms. If they are linked to the share price they are known as market conditions. However there are many other potential performance targets based on say profit or EPS or personal objectives which are not market-based.

Often when options are exercised, new shares are issued. In these cases the rights of existing shareholders are diluted and options satisfied by new issue shares are described as dilutive options. Alternatively a company might satisfy options in a non-dilutive way by providing existing shares which are acquired on the market either as treasury shares or through the vehicle of an Employee Benefit Trust.

	IFRS 2	Inland Revenue transfer pricing policy	UK statutory deduction rules
Basis for measurement	Black-Scholes option pricing model	Black-Scholes option pricing model, OR Revenue's deemed loan model	Exercise spread
Non-market conditions	Adjust, if not met	No adjustment	Reflected in spread
Timing	Debit and credit accrued over period from grant to exercise	Income and expense accrued vesting over period from grant to vesting	Deduction upon exercise of the option
Treatment for parent	Capital: no income in P&L.	Capital, if only new shares are issued: not taxable. Otherwise, treated as revenue: taxable income.	No specific statute.
Treatment for subsidiary	Revenue: expense in P&L.	Revenue: tax deductible, but only for part of the charge when based on Revenue's deemed loan model.	Revenue: tax deductible.

f) Inland Revenue guidance on the interaction of (d) and (e) with (b).
g) OECD guidance on this topic, including their study "Employee Stock Option Plans: Impact on Transfer Pricing", published on 3 September 2004.

Unfortunately, these factors are not entirely coherent. As is illustrated by the summary table above, they give different answers in certain respects. Matters are further complicated by the failure of factor (a) to address the use of share option schemes within corporate groups and the fact that factors (d) and (f) do not take into account factor (a). The purpose of this article is to suggest how to navigate through this web of interacting factors.

Financial reporting standards

The accounting treatment of share options is important in this context because, as in many countries, the profit and loss account of a UK taxpayer forms the starting point for determining its taxable income. Unless an adjustment is required or permitted by tax legislation, financial reporting standards will therefore determine taxable income. They also increasingly represent an attempt to reflect the substance of the underlying transaction, and therefore may guide us in forming views on the appropriate tax and transfer pricing treatment.

It is therefore important to take into account the International Accounting Standard IFRS 2, Share Based Payment, released by the International Accounting Standards Board (IASB) in February 2004. Because quoted companies based in the European Union are required to adopt International Accounting Standards for 2005 many multinationals will be directly adopting the use of IFRSs in their published accounts. Others will indirectly do so, as many countries are revising their own local standards to be consistent with IFRSs. For instance, in the UK, FRS 20 has been closely modelled on IFRS 2 and will apply to companies that do not adopt IFRS 2. It is also anticipated that in the USA a similar standard known as FAS 123 will finally overcome resistance and become mandatory during 2005.

The accounting treatment required by IFRS 2 is that the P&L should be debited to reflect the remuneration of the employees, whether or not the option scheme is dilutive. This will have a major effect on the reported profitability of companies which previously have reflected no accounting expense on dilutive schemes, on the grounds that there is no 'cost' to the firm from issuing new shares. The corresponding credit entry is to a capital reserve, again regardless of whether the scheme is dilutive.

The quantum of the debit and credit must be determined using the Black-Scholes option pricing model or one of its derivatives, as at the time the option is granted. This is spread over the period from grant to vesting.

No adjustment may be made for movements in the price of the underlying shares after grant date. If the share price at exercise is lower than the exercise price, the option will not be exercised, but this does not mean there should be an adjustment to the amount already debited to the P&L. The logic is that the employee would still have ascribed a value to the option when it was granted, notwithstanding that it subsequently became worthless. (An analogy would be that most people would ascribe a value to being given a lottery ticket, notwithstanding that it subsequently turns out not to win any prize, at which point it becomes valueless.)

Adjustments are, however, made over the vesting period to take into account increased or decreased likelihood of the options vesting, if vesting is subject to non-market conditions (such as meeting certain performance targets).

Somewhat surprisingly, IFRS 2 only considers the treatment where a company operates a share option scheme for its own employees. Discussions with the IASB indicate that, although they have not published their views, they have considered the implications where (as is common) such schemes are open to employees of subsidiary companies.

If we now consider how to apply the IFRS 2 rules to an intragroup situation, there seems no justification not to make the same entries. However, the debit and credit must in this case be split. The debit to P&L will be made by the employer: the subsidiary. The credit to capital will be made by the operator of the option scheme: the parent. We understand the IASB considers that the missing credit for the employer should be to a capital contribution account within the capital and reserves part of the subsidiary's balance sheet, and the missing debit for the parent should be to an "investment in subsidiary" asset account in the parent's balance sheet. Intercompany receivables and payables should not be set up.

If any payment is made by the subsidiary to the parent, we suggest that this should reduce the "investment in subsidiary" in the parent's balance sheet and reduce the subsidiary's capital contribution account. (The other side of each double entry would of course be to cash or intercompany accounts.)

Therefore, IFRS 2 will mean that share option schemes which previously gave rise to no expense in the employer's P&L will now do so. Conversely, the parent company operating the option scheme will show no income in the P&L, even if the subsidiary pays for the benefit of having its employees participate in the scheme. As will be seen below, this is potentially significant for the transfer pricing treatment.

Cash-settled options

It is worth pointing out that the above comments relate to options under which the employee will receive shares. There is different treatment for options that will be settled in cash, but if such 'phantom options' are used, the cash would usually be paid to the employee by the employer, with no active involvement by the parent company. Transfer pricing issues seem unlikely to arise unless the cash payments to the employee are made by the parent.

Impact on cost sharing schemes

It is not within the scope of this article to examine the current controversy, which is particularly heated in the US, over the question of whether a cost sharing agreement should share the 'costs' of employee share options in cases where no cost has been reflected in the employer's financial statements. However, we note in passing that the implementation of IFRS 2 around the world and the proposed mandatory application of FAS 123 in the USA is likely to mean that this ceases to be a common transfer pricing issue, as companies will be required to include in their P&L's the cost of remunerating their staff in this way.

Inland Revenue transfer pricing policy

The Waterloo case concerned a UK parent that allowed the employees of overseas subsidiaries to participate in its share option scheme, which operated via a trust. The trust granted the share options, and bought shares on the market using interest-free loans from the parent. If necessary, the parent issued new shares to the trust. The subsidiaries made no payment in return for having their employees remunerated in this way.

The case is of little direct relevance now, as it related to years prior to 1998, when the current UK transfer pricing legislation was introduced. The Special Commissioners adopted an inventive application of the phrase "business facility" in the old legislation, to allow them to conclude the parent should be deemed to have received an arm's length payment from the subsidiary. Although this phrase no longer appears, the new legislation was specifically worded to ensure that interlinked series of transactions are caught, so it seems likely that the parent would still have suffered deemed income under the new rules. The main relevance of

Waterloo now is that it prompted the Inland Revenue to set out their policy on transfer pricing treatment of intragroup share options. They assert that it is based on Waterloo, although most of the policy has, at best, only tenuous basis in the limited Waterloo judgement.

The policy was initially set out in Tax Bulletin 63, published in February 2003. It has subsequently been refined and extended in the Inland Revenue's International Tax Manual (INTM 464140).

UK subsidiaries

Although Waterloo concerned a UK parent, these policy statements focus more on UK subsidiaries of overseas groups. Arguably, this was caused by the booming stockmarkets in the late 1990s and very early 2000s, which meant that options being exercised in those years often had a large spread. Many share option schemes require no payment by the subsidiary when the option is granted; if and when the option has vested and the employee exercises it, the subsidiary must pay an amount equal to the spread. The Inland Revenue were therefore seeing substantial tax deductions being claimed by some UK subsidiaries, in circumstances where, had those subsidiaries chosen to hedge the options when they were granted, the cost of remunerating their employees could have been much lower.

The policy statements seem to have been designed to stop this. They seek to explain why, in the Inland Revenue's view, the arm's length price should be based on the (actual or hypothetical) hedging cost, and why the spread will rarely meet the arm's length test. Their rationale is based upon the assertion that any prudent business would seek to hedge in some way the exposure to the expected share price increases.

They support this assertion with the observation that it is difficult to find groups that wait until options are exercised before buying shares in the market, thereby exposing themselves to increases in the share price. Based on the experience of many share schemes experts, the Inland Revenue cannot have looked very hard, as there are many groups that do not externally hedge. Although the OECD's September 2004 study, "Employee Stock Option Plans: Impact on Transfer Pricing", does not set out to be prescriptive, it is notable that the OECD did not appear to find itself able to share the Inland Revenue's view on this.

Nevertheless, this is the Inland Revenue's staunch position. Even if the group in question does not hedge its exposure, the Inland Revenue argue that this does not necessarily mean that an individual subsidiary would, on a stand alone basis, have chosen not to hedge.

The Inland Revenue argue that the exposure could have been hedged either by buying a matching option on the market, or by buying an appropriate amount of the underlying shares and holding them until the options are exercised or they lapse. Accordingly, they are willing to allow taxpayers the choice of two methods to calculate the arm's length price. The first is to use option pricing models such as Black-Scholes. The second method is to calculate the costs of buying and holding the shares, including the interest on loans to fund the acquisitions.

The Inland Revenue policy on deductions is therefore broadly consistent with IFRS 2, although IFRS 2 requires Black-Scholes, whereas the Inland Revenue will accept the use of other similar models or the "buying shares on the market" basis. This means the quantum of the accounting debit may be different from the tax return figure. As regards timing, the Inland Revenue suggest that the deduction should be spread over the vesting period, which is also consistent with IFRS 2.

Ironically, these policy statements coincided with the stockmarket bust, since when many employee share options have been 'underwater', so a transfer price equal to the spread would result in a deduction of zero, whereas using the hedging cost does at least give the UK subsidiary a deduction. However, the Inland Revenue are applying their policy in relation to all "open" years, back as far as 1997, or earlier if a transfer pricing enquiry (whether or not in relation to share options) is still ongoing.

It is important to note that Inland Revenue policy is not binding on the taxpayer; it is merely a statement of their position. The situation is, in the view of the authors, not as clear cut as the Inland Revenue assert, and it is open to UK taxpayers to take a different position if they consider it appropriate. However, it is clear (subject to the new statutory deduction rules below) that any deduction based on the spread would, if higher than the hedging costs, likely face considerable resistance from the Revenue.

UK parents

The Inland Revenue are far less consistent with IFRS 2 when it comes to the position of the parent. They concede that where the parent is supporting its share option scheme by issuing new shares in return for a payment equal to the market value of the shares at that point, "it is difficult to see how the receipt could be anything other than capital in this simplified structure" and, as capital, not taxable.

Where the parent buys shares on the market, however, the Inland Revenue insist that any payment (actual, or deemed under the transfer pricing rules) from the subsidiary under the scheme is revenue in nature, and is therefore taxable income for the parent. The strength of this argument is doubtful, and is now further undermined by the fact that under IFRS 2 the accounting entries in the parent proposed by the IASB in groups are capital in nature. Of course, accounting treatment does not always correspond with economic reality, but in this case we believe this is exactly what the drafters of IFRS 2 were trying to reflect.

If, as is common, the scheme uses a mix of new shares and market-purchase, the Inland Revenue consider that all receipts under the scheme are "indivisibly on revenue account and taxable as income". The rationale, such as it is, appears to be that the new shares are in that case merely part of the means by which the options scheme is made available to the subsidiary, so they somehow lose their capital nature. This seems more like wishful thinking and bravado, rather than a compelling, thought out argument.

The obvious response is for the parent to play no part in the market purchase of shares. If the parent's only role is to issue new shares to a subsidiary or trust, and receive in return, a payment equal to the market value of the shares at that time, many would consider it axiomatic that this is a capital transaction. However, it would appear that the Inland Revenue may insist even this is a revenue receipt. Careful design of the scheme would be advisable.

We understand the Revenue are currently reviewing their existing policy to take account, among other things, of IFRS 2, and it is to be hoped that the Inland Revenue will accept that capital treatment is appropriate for the parent, whether or not the scheme is dilutive. However, it seems equally likely that the new policy will argue that even pure new issues are on revenue account.

On the plus side, after nailing their colours to the mast in favour of using hedging to set the arm's length price, the Inland Revenue cannot insist on taxing the UK parent based on the exercise spread. They will not, however, accept income less than either of the hedging methods would give, even if the parent has received no payment.

Statutory deduction

With effect for accounting periods starting on or after 1 January 2003, Schedule 23 of the Finance Act 2003 has introduced the right to a statutory deduction for UK employers in respect of the cost of providing shares (including share options) to employees. This only affects the employer, not the operator of the option scheme (if it is not the employer). Prior to that a statutory relief was only available in respect of certain "save as you earn" employee option schemes and more general corporation tax relief for share options required the implementation of a complex matrix of trusts, loans and intercompany agreements.

Bizarrely, the deduction under Schedule 23 is equal to the exercise spread: exactly the basis that, only a few months earlier, the Inland Revenue went to such lengths to prevent being used. Schedule 23 will apply to most UK subsidiaries participating in overseas share option schemes, with the exception of certain groups with a narrow shareholding base or which fall foul of certain pitfalls which can cause the relief to be lost.

The deduction for the exercise spread is available regardless of the actual transfer pricing of the scheme, even if the subsidiary has made no payment under the scheme. Unless the parent's country taxes the parent on the basis of the exercise spread, there will be a tax mismatch and potentially a timing mismatch. Double or less-than-single taxation may arise.

For instance, if the parent's country sees the transfer pricing the same as the Inland Revenue, it will tax the parent on the basis of the hedging cost as at the time of granting the option, which may be higher or lower than the exercise spread, depending on how the share price moves between grant and exercise date. The taxable income will arise over the vesting period, whereas the deduction in the UK will not arise unless and until the option is exercised. On the other hand, if the parent's country follows the accounting treatment under IFRS 2 for tax purposes, the parent may not be taxable at all.

The Inland Revenue released a draft guidance note following the 2004 Budget, which ostensibly deals with share option transfer pricing where the parent and subsidiary are both in the UK. (This is now subject to UK transfer pricing rules, following the removal of the former UK-UK exemption with effect from 1 April 2004.) The note explains how the Inland Revenue's transfer pricing policy on employee share options interacts with Schedule 23, and this explanation is also relevant to cases where the parent is overseas.

The position is, however, somewhat confused. The note explains that it is first necessary to apply normal transfer pricing analysis, so the Inland Revenue would expect this to result in an ostensible deduction for a UK subsidiary calculated on the basis of either of their two hedging methods. However, if Schedule 23 applies, it potentially overrides this, by prohibiting any other deduction for the "cost of providing shares". This is the case even if the option is not ultimately exercised and the Schedule 23 relief is zero. Therefore the ostensible transfer pricing deduction in the subsidiary normally has to be added back.

However, it isn't as simple as that, because problems arise in cases where the parent and subsidiary are both UK companies. The parent must still include in its UK taxable profits the arm's length price for the benefit it has provided to the subsidiary under the option plan. But Schedule 23 may deny a compensating transfer pricing adjustment to the subsidiary, if this counts as a "cost of providing shares". The result is that the intended benefit of the Schedule 23 deduction for the subsidiary is negated by the transfer pricing income for the parent (although they are unlikely to cancel out exactly, as Schedule 23 requires the deduction to be determined based on the spread, whereas this basis is specifically prohibited by the Inland Revenue for transfer pricing purposes).

The Inland Revenue had not intended this harmful effect of the interaction of UK-UK transfer pricing and Schedule 23 Finance Act 2003 to arise, and their initial response was to try and interpret the legislation in such a way that the restriction did not apply. That is, they proposed to interpret "the cost of acquiring shares" on a narrow basis, so that the UK subsidiary could claim a transfer pricing adjustment as well as the schedule 23 deduction. 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.

Another perceived drawback was that if the transfer pricing adjustment for the subsidiary is not a "cost of acquiring shares", then UK based subsidiaries of overseas parents would be able to claim double deductions, first under transfer pricing and then again under Schedule 23, without there being any corresponding taxable income in the UK (as the parent was not a UK taxpayer). This resulted in the Inland Revenue announcement in December 2004 that the draft guidance would be reviewed and companies should not rely on it being acceptable for accounting periods beginning on or after 1 January 2005.

While it is understandable that the Inland Revenue want to ensure that this time the guidance will be thoroughly thought through, the delay in issuing new guidance is becoming unacceptable.

Conclusion

The treatment of employee share options is becoming one of the most complex transfer pricing issues in the UK, partly because it is an inherently tricky area, and partly because of the interaction with accounting standards and the statutory deduction. It warrants careful review to ensure optimal treatment.

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