Employee share plans
UK corporation tax deductions and the impact of net settlement

In the UK many companies meet the conditions to claim a specific statutory corporate tax deduction for employee share plans. The impact of net settlement can present challenges in claiming this statutory corporate tax deduction. We are seeing increased HMRC activity in this area so companies will want to review their existing processes to ensure they are maximising the deduction available.

The issue of net settlement and claiming tax deductions in the UK

The issue

- There is a specific provision in the UK which gives many companies a statutory right to corporation tax relief for employee share acquisitions if certain conditions are met. One of the key conditions that must be met is that employees acquire shares.
- The process of net settlement results in employees acquiring less shares as part of the overall value of their award, which reduces the amount that can be claimed under the statutory deduction provisions.

The statutory relief regime

- The statutory relief is generally based on the value of shares when employees receive them, and so can be of significant value to companies, both in terms of current year tax deductions and deferred tax asset recognition.
- There is no company cost necessary to claim the relief.
- In general we would expect that a UK listed company or a UK subsidiary of a non UK listed company would meet the relevant conditions. Some unlisted companies will qualify too. The exact application of the relief can vary from company to company.
- If a company doesn't meet the conditions to claim a deduction using the statutory regime, it may be able to claim some level of tax relief through applying alternative UK tax rules.

What is net settlement?

- Net settlement is the term commonly associated with the process where a company settles an employee share award partly in shares and partly in cash.
- Net settling is attractive because it results in a company needing to use less shares to satisfy employee share awards (lower dilution), and can reduce the transaction costs associated with employee share plans.
- Under net settlement, the employee acquires shares net of the employee tax portion of the share award, and the company pays cash directly to the UK tax authorities (HMRC) for the balance of the award value, to cover the employment taxes due.
- As an example:
  - Employee pays taxes at 47%.
  - Employee granted a share award which has a value of £100 at vesting.
  - Employee receives shares worth £53 and the company pays tax of £47 direct to HMRC.
- Net settlement is becoming increasingly common amongst US listed companies, and, with a recent change to international accounting rules, is now likely to be more attractive in other territories including the UK.
- So while there are many positive aspects to net settlement, the resulting UK corporate tax deductions may be lower than expected.

How does the specific statutory deduction regime interact with net settlement?

One of the key conditions to claim the statutory deduction is that employees must actually acquire shares, and if a company net settles then the employee acquires less shares than they otherwise would, and the statutory deduction may be lower as a result.

The rules relating to accounting for employee share plans and net settlement can be complex, resulting in challenges identifying and supporting a tax deduction claim and deferred tax recognition for any proportion of an employee share award paid in cash under a net settlement process.

HMRC are alert to the increasing use of net settlement and that some companies may be inadvertently claiming the incorrect amount under the statutory deduction regime. This has resulted in significant settlements as part of some HMRC enquiries.

The reasons tax teams find net settlement challenging

- UK tax teams are often unaware of the precise detail around how their overseas parent settles employee share awards.
- Internal systems, processes and reporting sometimes do not distinguish between employee share awards that are fully share settled and those that are net settled.
- Similarly, employee share plan administrators often use reporting systems that do not distinguish between employee share awards that are fully share settled and those that are net settled.
- The UK corporate tax deduction rules are misinterpreted, resulting in a deduction being claimed on an incorrect basis.
- Intuitively, tax funded by the company from its cash reserves is believed to be fully deductible when this is not the case.

The table below gives an example of how significantly net settlement can impact a company's statutory share plan deductions – Even though the economic result for the employee is the same.

Position if not net settled

- Employee is granted an award over 100 shares.
- At vesting shares are worth 10 each.
- Employee pays tax and UK social security at a combined rate of 47%, on the total of 1,000 at vesting.
- Employee acquires 100 shares.
- Tax of 470 is then funded through a sale of 47 shares on behalf of the employee (typically managed by a share plan administrator), with sale proceeds remitted by the company to HMRC.
- Company claims a statutory deduction of 1,000.

Position if net settling

- Employee is granted an award over 100 shares.
- At vesting shares are worth 10 each.
- Employee pays tax and NIC at a combined rate of 47%, on the total of 1,000 at vesting.
- Employee acquires 53 shares.
- Tax of 470 is funded by the company by direct payment to HMRC from its cash reserves.
- Company can claim a statutory deduction of 530.
- Any further deduction for the tax paid by the company is subject to the specific accounting and fact pattern of the company.

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How are we supporting our clients?

- Assessing if the specific employee share plan settlement process may lead to reduced statutory deductions being available, and impact on current and deferred tax.
- Identifying and testing alternative ways that tax deductions may be claimed for net settled awards.
- Changes to processes and reporting to capture the data required to optimise tax deduction claims and recognise deferred tax assets.
- Support with any required remediation and negotiations with HMRC.
- Consider what impact net settlement may have on your Deferred Tax Asset, and whether any adjustment may be required.