

## **DRAFT GUIDANCE: IMPLICATIONS OF TRANSFER PRICING FOR EMPLOYEE SHARE SCHEMES OPERATED BY UK GROUPS**

**Note: This draft guidance is currently being reviewed in the light of comments received on the draft. It is anticipated that significant changes will be made to this draft, and taxpayers should not assume that the treatment outlined in the guidance can be used when applying tax rules and calculating taxable profits for accounting periods starting after 31 December 2004.**

**We appreciate there is particular concern that groups implementing the new transfer pricing rules in Finance Act 2004 should not be faced with significant increased tax in the group as a whole because there is increased taxation of the parent company but no related deduction for the subsidiary. We are seeking to develop an approach that will continue to address this issue going forward, but in a different way to the treatment set out in the draft guidance.**

### **Introduction**

Parent companies may make employee share schemes available to their subsidiaries for them to reward their employees, for example by granting options to buy shares in the parent company. Usually, group wide schemes will operate through a trust, with members of the group paying into the scheme.

Other similar arrangements are possible (eg the shares could be those of a sister company in the group rather than the parent). For simplicity, the guidance is based on the scenario above, but the principles can be applied also to other possible scenarios.

Where the parent and subsidiary are in different countries, the share schemes will already be subject to transfer pricing legislation (Section 770A and Schedule 28AA of the Income and Corporation Taxes Act 1988). There is existing practical guidance on applying transfer pricing the provision of share schemes in the International Tax Manual (Section INTM464140, available on the Internet at:

<http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM464140.htm>).

Provisions in the Finance Bill 2004 bring wholly UK schemes within the scope of Schedule 28AA and the guidance, with effect from 1 April 2004.

### **Implications of transfer pricing for UK groups' share schemes**

The implications of the extension of transfer pricing requirements to the provision of share schemes within the UK will depend on the size of the group and the current arrangements for paying for the scheme.

### Small and medium-sized enterprises (SMEs)

The extension of transfer pricing legislation to UK – UK transactions does not generally affect small and medium-sized enterprises (assessed on a group basis). So, groups in these categories which run share schemes in the UK will not need to take any action.

### Other groups

Groups should check that payments by subsidiaries for the share scheme are consistent with the guidance in INTM464140. If so, no further action is needed.

If the amounts paid are not consistent with the guidance, then the simplest way to ensure compliance may be to change the amounts paid to bring them into line with the guidance.

Otherwise, a transfer pricing adjustment will usually be needed, as if either no intra group payment is made or if the amount of any actual payment is out of line with INTM464140, then this could be expected to reduce the taxable income and tax liability of either the parent (most typically) or the subsidiary, in comparison with a tax calculation based on the arm's length result.

### **Schemes that charge subsidiaries**

Often subsidiaries pay to use the scheme for their employees. In such cases, the parent and subsidiary should check that the payments are consistent with INTM464140. If so, or if the charges are changed to make it consistent, then no further action is required.

Where the charges are too high to be consistent with INTM464140, and they are not changed, then a transfer pricing adjustment may need to be made by the subsidiary - if the high charge has the effect of reducing the subsidiary's taxable income in comparison with a charge consistent with INTM464140, then a transfer pricing adjustment should be made for the purposes of calculating the taxable income of the subsidiary.

Where the charges are too low to be consistent with INTM464140, then a transfer pricing adjustment may need to be made by the parent - if the low charges have the effect of reducing the parent's taxable income in comparison with a charge consistent with INTM464140, then a transfer pricing adjustment should be made for the purposes of calculating the taxable income of the parent.

### **Schemes that do not charge subsidiaries**

If subsidiaries do not pay for the scheme, then, either charges consistent with INTM464140 should be introduced, or a transfer pricing adjustment may need to be made by the parent - if the lack of charge has the effect of reducing the parent's taxable income in comparison with a price consistent with INTM464140, then a transfer pricing adjustment should be made for the purposes of calculating the taxable income of the parent.

### **Compensating adjustments**

In any case where a transfer pricing adjustment is made in relation to a UK – UK transactions (such as the provision of a share scheme by a UK parent to a UK subsidiary), then the other party to the transaction may make a compensating adjustment to enable them to calculate their tax liability on a consistent basis.

### **Interface between transfer pricing adjustments and Schedule 23 of Finance Act 2003**

Where a transfer pricing adjustment is made, there may be an interface with the provisions of Schedule 23 of the Finance Act 2003 for the subsidiary, as Schedule 23 introduced specific provisions for Corporation Tax relief for employing companies in respect of certain employee share acquisitions.

### **Parent – treatment of receipt**

As explained in INTM464140, the parent company is considered to be making a business facility available to the subsidiary and any transfer pricing adjustment that is needed should be set on this basis (eg using one of the methods explained in INTM464140).

#### Receipts

The nature and treatment of the imputed receipt arising from the transfer pricing adjustment is discussed in INTM464140. As explained there, in general the receipt should be treated as a revenue receipt in its entirety, taxable as income. An exception is if an identifiable amount received by the parent company is consideration for issuing new shares and should therefore be treated as a capital receipt.

INTM464140 accepts that a receipt is capital where the parent company does no more than issue new shares directly to the employees or via a trust. At the other extreme a receipt relating to a scheme that uses only market purchase shares will be a revenue receipt.

#### Deductions

The deductibility of costs that the parent company incurs in providing the business facility will be determined by the normal rules and general legislation permitting deductions.

Paragraph 25 of Schedule 23 places certain limitations on deductions. However, these limitations do not prevent the parent company deducting its costs to provide the business facility to the subsidiary, where these would be deductible otherwise. This is because those costs relate to the provision of a business facility rather than the “cost of providing shares”, as defined in the Paragraph 25 of Schedule 23.

### **Subsidiary – treatment of payment**

Where a transfer pricing adjustment is made by the parent company, the subsidiary is able to make a compensating adjustment and calculate its taxable income on the basis that it has made a payment equal to the receipt that the parent is assumed to have received.

### Deductions

For tax purposes, the subsidiary should treat any such imputed payment in exactly the same way as it would an actual payment of this amount. The imputed payment is made in respect of the provision of the share scheme as a whole.

### Interface with Schedule 23 FA 2003

In general, a payment (or imputed payment) for a service would be treated as an indivisible amount in calculating the payer’s tax liability. I.e., depending on the nature of the service and its purpose and role in relation to the subsidiary’s business, either the whole of the amount would be an allowable expense that can be deducted from the subsidiary’s income, or the whole amount would be disallowed. However, in the particular case of the provision of employee share schemes satisfying the criteria for a statutory deduction under Schedule 23 of the Finance Act 2003, this legislation requires a different approach.

In such circumstances only, the subsidiary must, for the purposes of calculating its corporation tax profits in accordance with the rules in Schedule 23 FA 2003, identify the “cost of providing shares” (as defined in paragraph 25 Schedule 23) and add it back in its tax computation. Any Schedule 23 deduction due for that particular year would appear alongside it in that tax computation.

The treatment of the remainder of the payment which is not regarded as part of the cost of providing the shares should be considered under normal tax rules, which in most cases will allow it to be deducted as part of the subsidiary’s expenditure on employee remuneration.

### Identifying the cost of providing the shares

Clearly, the subsidiary will need to be able to demonstrate the basis on which they have decided the amount to disallow to comply with the requirements of

paragraph 25 Schedule 23 of the Finance Act 2003. Tax Bulletin 63 explains how a cost plus method can be used as one approach for establishing an arm's length result for the provision of employee share schemes. Where such a method has been used it should be possible to identify the "costs of providing shares" incurred by the parent (as distinct from other costs incurred by the parent, such as those referred to in Paragraph 25(3) of Schedule 23 of FA 2003), and for the subsidiary to treat this as the disallowed amount. (In any case where the "cost of providing shares" cannot be distinguished from a larger amount, then the whole amount should be disallowed).

## Frequently Asked Questions

*Q Do I have to use complex derivative valuation formula to determine the value of share options in pricing the business facility that the parent company provides to the subsidiary?*

A No. The guidance in INTM464140 explains that businesses can price this element of the business facility using a straight forward arithmetic method based on the cost of hedging the options by buying shares in the market – whether or not the share options are hedged this way in practice. Details of this alternative method are set out in INTM464140.

*Q Do I need to apply the new legislation on transfer pricing to employee share options granted before 1 April 2004?*

A Yes. The parent company will continue to provide a business facility to the subsidiary during the period between the grant of share options to the subsidiary's employees and the exercise (or lapse) of those options. The price of this facility will typically be spread across the period of the options. Unless actual payments are made in respect of outstanding options that are in line with the guidance in INTM464140, then transfer pricing adjustments will be required, reflecting the continuing value of the business facility from 1 April 2004 onwards.

*Q Would transfer pricing affect a subsidiary if it ran its own share scheme, and bought its parent's shares in the market to provide share options for its employees?*

A No, as there would be no provision between the parent company and the subsidiary.

*Q Will it affect the tax liability of a group whether actual payments (consistent with INTM464140) are made between a subsidiary and the parent, or whether transfer pricing adjustments are made instead?*

A The tax liability of the group should be essentially the same, whether actual payments are made between a subsidiary and the parent or transfer pricing adjustments are made instead.