MALAYSIAN INSTITUTE OF ACCOUNTANTS
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The Malaysian Institute of
Certified Public Accountants

DISCUSSION PAPER

TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 2: SHARE-BASED PAYMENT

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Tax Implications Related to the Implementation of FRS 2: Share-based Payment

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1. INTRODUCTION

1.1 BACKGROUND OF FRS 2

1.1.1 Rationale

Prior to the issuance of FRS 2, there was no standard covering the recognition and measurement of share-based payment transactions. As share-based payments were, in most cases, not reflected in the financial statements, concerns were raised given the increasing prevalence of share-based payments.

FRS 2 requires an entity to recognise share-based payment transactions in its financial statements including transactions with employees or other parties to be settled in cash, other assets or equity instruments.

1.1.2 Scope of FRS 2

The scope of FRS 2 encompasses all transactions in which shares/equity instruments as well as cash payments that are based on the market price of an entity's shares are given in return for goods or services.

There are 3 types of share-based payment transactions:-

1.	Equity-settled	where goods or services are acquired by an entity for consideration in the form of equity instruments (shares or share options) of the entity; e.g. employee share options scheme.
2.	Cash-settled	where goods or services are acquired by an entity for an amount of consideration that is based on the price/value of an entity's share/equity instruments; e.g. share appreciation rights that entitle employees to payments calculated by reference to the market price of an entity's shares or the shares of another entity in the same group.
3.	Choice of equity or cash-settled	where goods or services are acquired by an entity and the terms of the arrangement provide either the entity or the suppliers with a choice of settlement in cash/other assets or by issuing equity instruments.

1.1.3 Definition of essential terms

Fair value – the fair value of an instrument can be measured using various valuation models, e.g. Black-Scholes, Binomial, Monte Carlo, etc. Where the market price is available, fair value will be the market price, adjusted for the terms & conditions imposed.

Intrinsic value – this is calculated as the difference between the fair value/market price and the amount the counterparty is required to pay or the exercise price.

Grant date – the date when share based arrangement is agreed and parties have a shared understanding of the terms & conditions. If agreement is subject to an approval process, the grant date is the date when approval is obtained.

Vesting period – the period during which all the specified vesting conditions of share-based payment arrangement are to be satisfied.

Vesting conditions - the conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions include service conditions, which require the other party to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).

1.1.4 Effective date

FRS 2 is effective for annual periods beginning on or after 1 January 2006.

2. REQUIREMENTS INTRODUCED BY THE FRS REGIME

2.1 MEASUREMENT OF TRANSACTION

FRS 2 requires share-based payments to be measured at fair value (FV). Where the FV cannot be estimated reliably, the following alternatives are available:-

Equity or cash settlement	Measured at	Only if not possible, then at	Only if not possible, then at
Equity settled (Goods or non-employee services)	FV of goods/services at the date goods/services are obtained	FV of instruments granted at the date goods/services are obtained	Intrinsic value of instruments at the date goods/services are obtained *

Equity settled (Employee services)	FV of instruments granted at grant date	Intrinsic value of instruments at date services are obtained *	
Cash settled	FV of liability at balance sheet date		

* Intrinsic value is re-measured at each reporting date until date of settlement. Any change in the intrinsic value is recognised in the profit and loss account for the period.

2.2 TIMING OF RECOGNITION

Purchase of goods - transaction is recognised when entity obtains goods
Purchase of services - transaction is recognised over the vesting period

3. ACCOUNTING AND TAX TREATMENT

3.1 EQUITY-SETTLED TRANSACTION

3.1.1 Scenario 1: ESOS in a single company (new share issue)

	Before FRS 2	With FRS 2
Accounting entries	-	Dr Employees expense Cr Equity (separate component) *Recognise FV of options as employee expense over the vesting period*
	Dr Cash Cr Equity (share capital) Cr Equity (share premium) *Receipt of exercise price when options are exercised.*	Dr Equity (separate component) Dr Cash Cr Equity (share capital) Cr Equity (share premium) *Receipt of exercise price when options are exercised.*

Example

Company A grants 100 options to each of its 10 key executives on 1 January 2006. The grant is conditional upon the employees working for the company for the next 3 years, i.e. the vesting period is 3 years. The company's estimated/revised estimated and the actual number of options that are vested are as follows:-

Estimate @ 2006	1,000
Revised estimate @ 2007	800
Actual @ 2008	800
Fair value of option at grant date	RM5
Exercise price	RM3

Accounting treatment

	2006 (RM)	2007 (RM)	2008 (RM)
Value of share option	1,000 x 5 x 1/3 = 1,667	800 x 5 x 2/3 = 2,667	800 x 5 = 4,000
Accounting charge	1,667	2,667 – 1,667 = 1,000	4,000 – 2,667 = 1,333

The journal entries in Company A's books would be as follows :-

		Dr (RM)	Cr (RM)
1	Dr Employee benefits expense	1,667	
	Cr Equity (separate component)		1,667
	Recognition of employee benefits expense in 2006		
2	Dr Employee benefits expense	1,000	
	Cr Equity (separate component)		1,000
	Recognition of employee benefits expense in 2007		
3	Dr Employee benefits expense	1,333	
	Cr Equity (separate component)		1,333
	Recognition of employee benefits expense in 2008		
4	Dr Equity (separate component)	4,000	
	Cr Equity (share capital)		800
	Cr Equity (share premium)		3,200
	Recognition of shares issued on exercise (100 shares to 8 employees at a nominal value of RM1 per share)		

5	Dr Cash	2,400	
	Cr Equity (share premium)		2,400
	Receipt of exercise price		
	(100 shares to 8 employees at RM3 per share)		

Tax treatment

The expenses charged to the profit and loss account from 2006 to 2008 are not deductible as no expenditure has been incurred by Company A. This is also in line with the House of Lords' decision in Lowry v Consolidated African Selection Trust Ltd (1940) 23 TC 259.

For items 4 & 5, if the share options granted are not exercised/lapsed, the accounting entries would be:

DR	Equity (separate component)	4,000	
CR	Retained Earnings/Other Income		4,000

Tax treatment

The income should not be taxable as this is a reversal entry and no tax deduction claimed previously.

3.1.2 Scenario 2: ESOS in a single company (treasury shares)

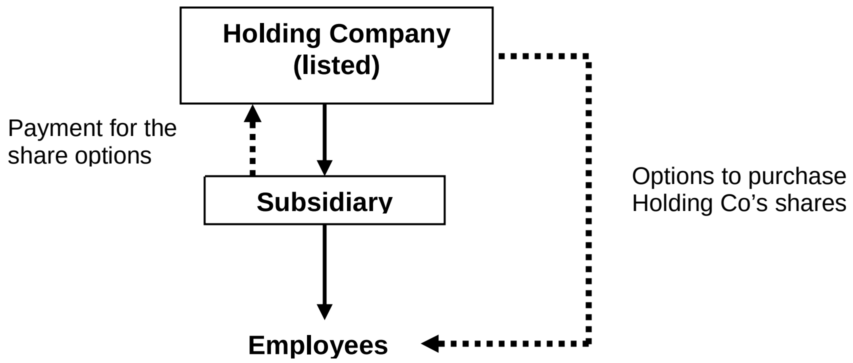
In certain cases, the employer's obligations under ESOS may be satisfied by transferring to the employees treasury shares which have been bought back by the employer.

	Before FRS 2	With FRS 2
Accounting entries	Dr Treasury shares Cr Bank *Upon shares buy-back*	Dr Treasury shares Cr Bank *Upon shares buy-back* Dr Employee expenses Cr Equity (separate component) *Recognition of FV of options over the vesting period*
	Dr Retained earnings Cr Treasury shares *Upon exercise of share options by employees*	Dr Equity (separate component) Cr Treasury shares *Upon exercise of share options by employees*

Tax treatment	No employee expense is charged to the profit and loss account, no tax adjustment.	Add back employee expenses charged to the profit and loss account over the vesting period. The actual cost incurred (calculated as the difference between the cost incurred in buying back the treasury shares and the amount payable by the employees, i.e. exercise price) would be deductible under Section 33(1) when the options are exercised by the employees. In cases where treasury shares are acquired at different times and at different prices, it is recommended that the weighted average price be used to determine the cost of treasury shares for tax deduction purposes.

3.1.3 Scenario 3: ESOS in a group

In corporate groups, employees of subsidiary companies may be granted options in relation to the listed holding company's shares.



Similar to a single entity scenario, options granted to employees of the subsidiary company have to be fair valued and charged as expense in the books of the subsidiary.

Example

Assuming same facts as in Scenario 1, except that the options are granted by the holding company of Company A to employees of Company A to purchase the holding company's shares. The holding company charges the subsidiary, Company A, RM4,000 for the share options granted to the latter's employees.

Journal entries in the books of employer company (Company A) :-

		Dr (RM)	Cr (RM)
1	Dr Employee benefits expense	1,667	
	Cr Equity (capital contribution from parent)		1,667
	Recognition of employee benefits expense in 2006		
2	Dr Employee benefits expense	1,000	
	Cr Equity (capital contribution from parent)		1,000
	Recognition of employee benefits expense in 2007		
3	Dr Employee benefits expense	1,333	
	Cr Equity (capital contribution from parent)		1,333
	Recognition of employee benefits expense in 2008		
4	Dr Equity (capital contribution from parent)	4,000	
	Cr Cash		4,000
	To recognise amount charged by the holding company for the options granted		

Tax treatment

The expenses charged to the profit and loss account in 2006, 2007 and 2008 are not deductible as no expense has been incurred by Company A. However the amount payable to the holding company of RM4,000 is an actual expense incurred and therefore should qualify for tax deduction under Section 33(1).

Journal entries in the books of the Holding Company :

		Dr (RM)	Cr (RM)
1	Dr Investment in subsidiary (capital contribution)	1,667	
	Cr Equity (separate component)		1,667
	Recognition of capital contribution in 2006		
2	Dr Investment in subsidiary (capital contribution)	1,000	
	Cr Equity (separate component)		1,000
	Recognition of capital contribution in 2007		
3	Dr Investment in subsidiary (capital contribution)	1,333	
	Cr Equity (separate component)		1,333
	Recognition of capital contribution in 2008		

4	Dr Cash / inter-company amount owing	4,000	
	Cr Investment in subsidiary (capital contribution)		4,000
	To recognise amount charged to Company A for the options granted		
5	Dr Cash	2,400	
	Cr Equity (share capital)		800
	Cr Equity (share premium)		1,600
	Receipt of exercise price (100 shares to 8 employees at RM3 per share)		

Tax treatment

The payment of RM4,000 received/receivable from Company A is a capital receipt and hence should not be taxable.

In the case where the amount charged to Company A is, say RM5,000. Journal entry number 4 would be as follows:-

Dr Cash / inter-company amount owing	5,000	
Cr Investment in subsidiary (capital contribution)		4,000
Cr Other income		1,000
To recognise amount charged to Company A for the options granted		

The "other income" of RM1,000 is also not taxable as it is a capital receipt.

3.2 CASH-SETTLED TRANSACTION

For cash-settled share-based payment transactions, the goods or services acquired and the liability incurred are measured at the fair value of the liability. The fair value of the liability is then remeasured at each balance sheet date and at settlement date, and any changes in fair value are recognised in profit or loss for the period.

An example of cash-settled transaction: share appreciation rights granted by a company to its employees as part of the employees' remuneration package. Employees are entitled to a future cash payment (instead of equity instruments) which is based on the increase in the company's share price from a specified level over a specified period of time.

Tax treatment

The company should be entitled to a tax deduction for the total cash payment which the employee is entitled to (i.e. the actual amount of expense incurred by the company).