

IRAS CIRCULAR

USE OF TREASURY SHARES TO FULFIL OBLIGATIONS UNDER AN EMPLOYEE EQUITY-BASED REMUNERATION SCHEME



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USE OF TREASURY SHARES TO FULFIL OBLIGATIONS UNDER AN EMPLOYEE EQUITY-BASED REMUNERATION SCHEME

INTRODUCTION

Currently, a company is not allowed any tax deduction when it fulfils its employee stock option (ESO) and share award obligations via the issue of new shares. This is because at the time when the company issues new shares, it has not incurred any cost that is wholly and exclusively in the production of its income since the share issue merely involves a movement in the company's share capital account¹.

2 As a consequence of the Companies (Amendment) Act 2005 allowing companies to hold its own shares in treasury instead of cancelling them (such shares are termed as "treasury shares"), companies will be able to use treasury shares to fulfil their obligations under ESO schemes or share award schemes (collectively referred to hereinafter as "employee equity-based remuneration schemes").

3 To facilitate employee equity-based remuneration schemes, PM and Minister for Finance announced on 17 February 2006 in his Budget Statement 2006 that companies that grant ESOs or share awards through treasury shares will be accorded a tax deduction. This is in recognition that companies are increasingly linking employee remuneration to the performance of the companies by granting ESOs or share awards under a move towards a more flexible wage system. Given that equity-based remuneration that are effected through treasury shares involves the companies incurring an actual outlay in buying back their own shares to fulfil their ESO or share award obligations, such outlay will be granted a tax deduction.

4 This Circular explains this tax change to allow a tax deduction for treasury shares transferred under an employee equity-based remuneration scheme. It also provides clarification on the following related issues:

- (i) Tax treatment of "gains" or "losses" upon transfer/disposal of treasury shares; and
- (ii) Recharges from parent company for shares transferred to subsidiary company's employees.

EFFECTIVE DATE OF TAX CHANGE

5 The above tax change will take effect from 30 January 2006, in line with the Companies (Amendment) Act 2005. This means that a tax deduction will be allowed for treasury shares transferred under the following employee equity-based remuneration schemes:

¹ This view is supported by the case of *Lowry v Consolidated African Selection Trust* (1940) 23 TC 259.

- (i) in the case of an ESO scheme, options that are exercised on or after 30 January 2006; and
- (ii) in the case of a share award scheme, shares that are granted (where there is no vesting imposed) and shares that are vested (where there is vesting imposed) on or after 30 January 2006.

6 Therefore, Year of Assessment (YA) 2007 will be the first effective YA for which the tax change will apply. For example, if a company with an accounting year end of 31 December had granted shares under a share award scheme with vesting imposed or ESOs to its employees during the year 2004, and the shares are vested to or ESOs are exercised by the employees during the year 2006, a deduction will be given to the company for YA 2007 if it uses treasury shares to satisfy its obligations under these schemes.

TIMING OF DEDUCTION TO BE GIVEN

7 Currently, employees are taxed as follows²:

(i) For ESO schemes

- Where there is no selling restriction imposed, ESO gains (i.e. difference between the market value of the shares at time of exercise less the exercise price) are taxed at point of exercise.
- Where there is selling restriction imposed, ESO gains (i.e. difference between the market value of the shares at end of the restriction period and the exercise price) are taxed at end of the restriction period.

(ii) For share award schemes

- Where there is no selling restriction imposed, the gains (i.e. difference between the market value of the shares at time of grant or vesting less the amount paid for the shares) are taxed at the point of grant or vesting of shares.
- Where there is selling restriction imposed, the gains (i.e. difference between the market value of the shares at end of the restriction period and the amount paid for the shares) are taxed at end of the restriction period.

8 The point of deduction will not be the same as the point of taxability in the hands of the employees. Instead, a tax deduction will be allowed at the point when the treasury shares are applied for the benefit of employees, i.e. at the time of exercise of ESOs by the employees, and in the case of share awards, at the time

² For more details, please refer to IRAS Circular on "Changes to Tax Treatment of Employee Stock Options and Other Forms of Employee Share Ownership Plans" issued on 31 August 2002 (revised on 27 December 2002).

when the shares are vested³ to the employee. It is at this point that the company is considered to have incurred the expenditure in awarding the shares to the employees as there is no expenditure incurred in the production of income before this point.

9 Where there is selling restriction imposed, deduction will still be allowed at the point of exercise/vesting, and not at the end of the restriction period. This is on the basis that at the point of exercise/vesting, the company is considered to have parted with the shares and the employee is legally and beneficially entitled to the shares even though the employee is prohibited from selling the shares. However, there may be cases where the legal and beneficial ownership of the shares is not transferred to the employee or his trustee/custodian irrevocably at the date of exercise (for ESOs) or date of grant (for share awards) and the employee does not enjoy any dividend or voting rights until after the expiry of the restriction period. For such cases, a deduction will only be given at the end of the restriction period when the legal and beneficial ownership of the shares is actually transferred to the employees.

10 In a case where the “deemed exercise” rule (see footnote 2) is applicable to the employee, it should also not make any difference to the deduction point. In other words, even though the employee is taxed on the deemed gain at an earlier point in time, deduction would only be allowed at the time of exercise of the ESO by the employee under a stock option scheme, or at the grant/vesting of the shares to the employee under a share award scheme.

AMOUNT OF DEDUCTION TO BE ALLOWED

11 With the adoption of Financial Reporting Standard (FRS) 102 *Share-based Payment*, the fair value of ESOs and shares granted to employees must be recognised as an expense (with corresponding increase in equity) in the financial accounts in the year of grant. If the equity instruments vest immediately, the full amount is recognised immediately on grant date⁴. If there is a vesting period, the amount is recognised over the expected vesting period. Once the fair value of the shares has been estimated and the staff cost recognised over the vesting period, if the fair value of the shares at the time of exercise by the employee is different from the market price, no adjustment will be made on the difference (i.e. the value measured on grant date will not be adjusted for subsequent changes in market conditions). There should not be any subsequent reversal of the amount recognised

³ In the case of a share award where there is no vesting imposed, the date of vesting would be the same as date of grant of the shares.

⁴ FRS 102 defines grant date as the date at which the entity and the employee (or other party providing similar services) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

for services received from employees if the vested equity instruments are later forfeited or the ESOs are not exercised.

12 For the purpose of allowing a deduction for treasury shares transferred under an employee equity-based remuneration scheme to any employee, the tax treatment will not be aligned with the accounting treatment under FRS 102. Instead, the amount of deduction is based on what the company has actually incurred, i.e. the difference between the cost to the company of acquiring the treasury shares transferred to any employee and the amount payable by that employee for the treasury shares. Any difference in the value (between the fair value and the cost) relates to an appreciation/depreciation in the value of the company's shares which is merely an accounting "gain" or "loss". Since we recognise the costs incurred by companies to buy back their own shares to fulfil their ESO obligations as a staff expense, the deduction allowed will be based on the actual costs at which these treasury shares are acquired.

13 A company may acquire treasury shares at different times and at different prices. For the purpose of valuing the cost of the treasury shares that are transferred to its employees under an employee equity-based remuneration scheme, it can adopt either the "first-in-first-out" method or weighted average method⁵, so long as the method used is consistently applied.

14 Annex 1 provides an example showing the timing and amount of deduction to be given using the two methods.

TAX TREATMENT OF "GAINS" OR "LOSSES" UPON TRANSFER/DISPOSAL OF TREASURY SHARES

15 Section 76K of the Companies Act provides that where shares are held as treasury shares, a company may at any time –

- (i) sell the shares (or any of them) for cash;
- (ii) transfer the shares (or any of them) for the purposes of or pursuant to an employees' share scheme;
- (iii) transfer the shares (or any of them) as consideration for acquisition of shares in or assets of another company or assets of a person;
- (iv) cancel the shares (or any of them); or

⁵ Under the weighted average method, the cost to a company in acquiring treasury shares transferred to any employee is to be determined by the following formula

$$\frac{A}{B} \times C$$

where A is the number of treasury shares transferred to the employee;
B is the total number of treasury shares held by the company immediately before the transfer to the employee; and
C is the total cost of acquiring all the treasury shares held by the company immediately before the transfer to the employee.

- (v) sell, transfer or otherwise use the treasury shares for such other purposes as the Minister may by order prescribe.

16 Based on section 761 of the Companies Act, there is a limit on the number of treasury shares a company can hold, and the company is required to dispose of or cancel any excess shares in accordance with S76K (as stated in paragraph 15 above) within a stipulated period.

17 According to FRS 32 *Financial Instruments: Disclosure and Presentation*, no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of treasury shares of a company, and the consideration paid or received shall be recognised directly in equity. This leads to the question on the tax treatment of such “gains” or “losses”, i.e. the difference between the cost of purchase and the fair value of the treasury shares upon the transfer/disposal of these shares.

18 For treasury shares transferred under an equity-based remuneration scheme, the “gain” or “loss” does not give rise to any tax implication since the tax deduction allowable to the company is based on cost of treasury shares. As for “gains” or “losses” upon disposal of treasury shares under the circumstances stated in paragraph 15(i) and (iii), the tax treatment (i.e. whether the gains/losses on disposal are capital or revenue in nature) is to be determined based on the circumstances of each case.

RECHARGES FROM PARENT COMPANY FOR SHARES TRANSFERRED TO SUBSIDIARY COMPANY’S EMPLOYEES

19 As stated in paragraphs 3 and 12 above, a company will be granted a tax deduction if it grants ESOs or share awards to its employees through treasury shares, and the amount of deduction to be allowed is the difference between the cost of acquiring the treasury shares transferred to the employees and the amount payable by the employees for the treasury shares. Similarly, if a parent company buys treasury shares to be transferred to the employees of its subsidiary company under an employee equity-based remuneration scheme and recharges the subsidiary company, the amount of the recharge will be allowed to the subsidiary company as a tax deduction to the extent of the difference between the cost of the treasury shares and the amount payable by the employees for the treasury shares.

20 Where a parent company issues new shares to the employees of its subsidiary company and recharges the subsidiary company, no deduction will be given to the subsidiary company for the recharge. This is consistent with the treatment that no tax deduction will be allowed to any company when it fulfils its employee ESO and share award obligations via the issue of new shares.

ENQUIRIES

21 For enquiries on the contents of this circular, please call 1800-3568622.

Inland Revenue Authority of Singapore

EXAMPLE SHOWING THE TIMING AND AMOUNT OF DEDUCTION TO BE GIVEN

The following table shows the timing and amount of the deduction for a company (with an accounting year end of 31 December) that has used treasury shares to fulfil its obligations under its employee equity-based remuneration schemes.

		ESO scheme	Share award scheme															
	<p><u>Example:</u> Details of acquisition of treasury shares:</p> <table border="1"> <thead> <tr> <th>Date of purchase</th> <th>No. of treasury shares acquired</th> <th>Cost</th> </tr> </thead> <tbody> <tr> <td>31 Jan 2006</td> <td>2,000</td> <td>\$ 4,000</td> </tr> <tr> <td>5 Apr 2006</td> <td>5,000</td> <td>\$ 7,500</td> </tr> <tr> <td>12 Aug 2006</td> <td><u>1,000</u></td> <td><u>\$ 3,000</u></td> </tr> <tr> <td></td> <td><u>8,000</u></td> <td><u>\$14,500</u></td> </tr> </tbody> </table>	Date of purchase	No. of treasury shares acquired	Cost	31 Jan 2006	2,000	\$ 4,000	5 Apr 2006	5,000	\$ 7,500	12 Aug 2006	<u>1,000</u>	<u>\$ 3,000</u>		<u>8,000</u>	<u>\$14,500</u>	<p>Date of grant of option: 5 Dec 2002</p> <p>Date of exercise: 8 May 2006</p> <p>No. of options exercised: 3,000</p> <p>Exercise price payable by employee: \$1 per share</p>	<p>Date of grant of shares (with vesting imposed): 31 Mar 2003</p> <p>Date of vesting: 3 Sep 2006</p> <p>No. of shares vested to employees: 4,500</p>
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A	Whether deduction for treasury shares can be given to company	Since the options are <u>exercised on or after 30 Jan 2006</u> , a tax deduction will be given to the company for shares transferred to employees under the ESO scheme.	Since the shares are <u>vested to the employees on or after 30 Jan 2006</u> , a tax deduction will be given to the company for shares transferred to employees under the share award scheme. <i>[Note: For share awards with no vesting imposed, a tax deduction will be given for shares <u>granted on or after 30 Jan 2006</u>]</i>															
B	Timing of deduction	At the date of exercise – 8 May 2006 (i.e. deduction given for YA 2007)	At the date of vesting – 3 Sep 2006 (i.e. deduction given for YA 2007)															

C	Amount of deduction to be given if “first-in-first-out” method is used	<p>(i) Upon exercise of the options on 8 May 2006:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="padding-left: 20px;">Cost of 2,000 shares acquired on 31 Jan 2006</td> <td style="text-align: right;">\$4,000</td> </tr> <tr> <td style="padding-left: 20px;">Cost of <u>1,000</u> shares acquired on 5 Apr 2006</td> <td style="text-align: right;"><u>\$1,500</u></td> </tr> <tr> <td style="padding-left: 20px;">Cost of <u>3,000</u> shares transferred on 8 May 2006</td> <td style="text-align: right;"><u>\$5,500</u></td> </tr> <tr> <td style="padding-left: 20px;">Less : Exercise price payable by employees</td> <td style="text-align: right;"><u>\$3,000</u></td> </tr> <tr> <td style="padding-left: 20px;">Deduction to be allowed</td> <td style="text-align: right;"><u>\$2,500</u></td> </tr> </table> <p>(ii) Upon vesting of shares to employees on 3 Sep 2006:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="padding-left: 20px;">Cost of 4,000 shares acquired on 5 Apr 2006</td> <td style="text-align: right;">\$6,000</td> </tr> <tr> <td style="padding-left: 20px;">Cost of <u>500</u> shares acquired on 12 Aug 2006</td> <td style="text-align: right;"><u>\$1,500</u></td> </tr> <tr> <td style="padding-left: 20px;">Cost of <u>4,500</u> shares transferred on 3 Sep 2006</td> <td style="text-align: right;"><u>\$7,500</u></td> </tr> <tr> <td style="padding-left: 20px;">Less: Amount payable by employees</td> <td style="text-align: right;"><u>NIL</u></td> </tr> <tr> <td style="padding-left: 20px;">Deduction to be allowed</td> <td style="text-align: right;"><u>\$7,500</u></td> </tr> </table> <p>Total deduction to be allowed for YA 2007 (\$2,500 + \$7,500) <u>\$10,000</u></p>	Cost of 2,000 shares acquired on 31 Jan 2006	\$4,000	Cost of <u>1,000</u> shares acquired on 5 Apr 2006	<u>\$1,500</u>	Cost of <u>3,000</u> shares transferred on 8 May 2006	<u>\$5,500</u>	Less : Exercise price payable by employees	<u>\$3,000</u>	Deduction to be allowed	<u>\$2,500</u>	Cost of 4,000 shares acquired on 5 Apr 2006	\$6,000	Cost of <u>500</u> shares acquired on 12 Aug 2006	<u>\$1,500</u>	Cost of <u>4,500</u> shares transferred on 3 Sep 2006	<u>\$7,500</u>	Less: Amount payable by employees	<u>NIL</u>	Deduction to be allowed	<u>\$7,500</u>
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D	Amount of deduction to be given if weighted average method is used <i>[Note: Cost of treasury shares computed based on formula stated in footnote 5 of this circular]</i>	<p>(i) Upon exercise of the options on 8 May 2006:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="padding-left: 20px;">Cost of 3,000 shares ($\frac{3,000}{7,000} \times \\$11,500$)</td> <td style="text-align: right;">\$4,929</td> </tr> <tr> <td style="padding-left: 20px;">Less : Exercise price payable by employees</td> <td style="text-align: right;"><u>\$3,000</u></td> </tr> <tr> <td style="padding-left: 20px;">Deduction to be allowed</td> <td style="text-align: right;"><u>\$1,929</u></td> </tr> </table> <p>(ii) Upon vesting of shares to employees on 3 Sep 2006:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="padding-left: 20px;">Cost of 4,500 shares [$\frac{4,500}{5,000} \times (\\$14,500 - \\$4,929)$]</td> <td style="text-align: right;">\$8,614</td> </tr> <tr> <td style="padding-left: 20px;">Less: Amount payable by employees</td> <td style="text-align: right;"><u>NIL</u></td> </tr> <tr> <td style="padding-left: 20px;">Deduction to be allowed</td> <td style="text-align: right;"><u>\$8,614</u></td> </tr> </table> <p>Total deduction to be allowed for YA 2007 (\$1,929 + \$8,614) <u>\$10,543</u></p>	Cost of 3,000 shares ($\frac{3,000}{7,000} \times \$11,500$)	\$4,929	Less : Exercise price payable by employees	<u>\$3,000</u>	Deduction to be allowed	<u>\$1,929</u>	Cost of 4,500 shares [$\frac{4,500}{5,000} \times (\$14,500 - \$4,929)$]	\$8,614	Less: Amount payable by employees	<u>NIL</u>	Deduction to be allowed	<u>\$8,614</u>								
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