Analysis

NCL Investments Ltd: accounting not optional

Speed read

The Upper Tribunal has found for the taxpayers in a case mainly concerned with the interaction between the accounting and tax rules, which aimed to resolve the question as to whether charges made to a company's P&L account under the accounting rules are deductible in that company's corporation tax calculations. Although the legislation has since been amended to prevent deductions in these specific circumstances, the case is of interest because accounting standards are increasingly seeking to establish the fair value of the costs that companies incur in doing business and reflecting those costs in companies' financial statements. This can result in a discrepancy between the costs of doing business in cash terms and those reflected in the financial statements of a company.

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In a judgment handed down on 8 April 2019, the Upper Tribunal (UT) rejected HMRC's appeal in *HMRC v NCL Investments Ltd Smith & Williamson Corporate Services Ltd* [2019] UKUT 111 (TCC).

Because FA 1998 mandated that a company's accounts form the basis for its corporation tax calculations, the question then arises as to whether accounting charges that do not have an actual monetary basis should be deductible.

The accounting rules

In this case, the accounting standards governing the grant of employee share options and other types of share awards are set out in IFRS 2 (this accounting standard was adopted with a few minor amendments as FRS 20 and was incorporated into FRS 102 at section 26).

Under these rules, when an option is granted to an employee, the employer is obliged to calculate the value of that option, typically using an option pricing mechanism like the Black-Scholes formula. The employer must then amortise that value over the expected life of an option, meaning that there will be charges to the company's income statement in each year during an option's vesting period.

When an option lapses the amortised cost of that option is not written back through the income statement; instead there will be a movement on reserves to 'true up' the position.

In this case, options to acquire shares in Smith & Williamson's holding company, Smith & Williamson Holdings Ltd, had been granted to employees of two of its subsidiaries by the trustees of a group employee benefit trust. When the options were granted, each of the subsidiary companies evaluated the value of the options and then recognised annual debits in their income statements to reflecting the amortised value of the options ('the IFRS 2 debits').

The group applied a system of recharges in connection with its employee share schemes, which meant that the employer subsidiaries made payment to the employee benefit trust for the value of the share options. The result was that there were a number of balance sheet entries that effectively offset the option debits, so that there was no observable credit balance in the balance sheet related to the options.

The tax rules

The current law on the calculation of profits, which can be found in CTA 2009 s 46, provides that:

'(1) The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes.'

This is reinforced by provisions in s 48, which clarify that amounts debited or credited under the accounting rules must be taken into account, irrespective of whether an amount has been actually received or paid, unless there is a clear statutory provision to the contrary (for example, the rules on capital allowances, which disallow depreciation and substitute separate statutory deductions).

Under rules originally introduced in FA 2003, an employer company may claim a corporation tax deduction when an employee exercises a share option that meets a number of criteria set out in Part 12 of CTA 2009. Broadly speaking:

- the shares must be fully paid, non-redeemable ordinary shares;
- the shares must be shares in the capital of a company that is not under the control of another company, shares in a listed company or shares in a company that is under the control of a listed company; and
- the shares must be shares in the employer company or the parent company of the employer company.

Where these conditions are met, the employer company will be able to claim a deduction in its corporation tax calculations in the year that the options are exercised. The deduction is equal to the difference between the market value of the shares on the date that they are acquired and the exercise price paid by the employees.

The relief is entirely unrelated to the accounting entries made by the employer company in respect of the options and is not dependent on the employees' tax position.

Under CTA 2009s 1038, no other relief can be claimed in respect of share options if an option qualifies for relief under CTA 2009 Part 12. However, if an option is not exercised and ultimately lapses, no relief will be given under Part 12, which suggested that other reliefs were capable of being claimed.

The law was changed after the periods under discussion in this case by FA 2013, which substantially revised s 1038 and added a new s 1038A. The effect of these changes was to deny relief where Part 12 might be in point and to deny relief in respect of lapsed options.

Where an EBT is involved, it is also necessary to consider the rules on deductions for 'employee benefit contributions' in CTA 2009 Part 20. These rules, set out in s 1290, provide that where a company makes an 'employee benefit contribution' that company can only claim a deduction as and when employees are subject to PAYE and NICs on that deduction, irrespective of the accounting entries.

'Employee benefit contribution' is defined in s 1291:

(1) 'For the purposes of section 1290 an "employee benefit contribution" is made if, as a result of any act or omission—

(a) property is held, or may be used, under an employee

benefit scheme, or
(b) there is an increase in the total value of property that is so held or may be so used (or a reduction in any liabilities under an employee benefit scheme).
(2) For this purpose "employee benefit scheme" means a trust, scheme or other arrangement for the benefit of persons who are, or include, present or former employees of the employer [or persons linked with present or former employees of the employer].'

The relief in Part 12 takes priority over other deductions or reliefs, so, in the context of employee share awards that are settled by EBTs, the rules in Part 20 are rarely in point. However, in this case Part 12 relief was not available for the lapsed options.

The *NCL Investments* case

The two employer subsidiaries had recognised debits to their income statements in respect of the options granted to their employees in accordance with the accounting standard that they were reporting under. The employer subsidiaries prepared their corporation tax returns to reflect the debits made under IFRS 2. All of the options subsequently lapsed without being exercised.

The taxpayers' case was that s 1038 was not in point because no relief was due under Part 12 and therefore, under the principles set out in s 46, the IFRS 2 debits were deductible in their corporation tax calculations.

HMRC advanced four alternative arguments against the position taken by the taxpayers:

1. the IFRS 2 debits were not an expense within the meaning of s 48 because they did not represent monies that the taxpayers had laid out, they were an accounting recognition of services that the taxpayers had received from the employees, that the IFRS 2 debits were not 'incurred' by the taxpayers and that the IFRS 2 debits were not incurred wholly and exclusively for the purposes of the taxpayers' trades;
2. the IFRS 2 debits were capital and not revenue in nature;
3. s 1038 prevented a deduction for the IFRS 2 debits; and
4. the IFRS 2 debits were not deductible because the grant of the options constituted an employee benefit contribution and the rules in Part 20 prevented a deduction unless the employees suffered PAYE and NICs.

HMRC also argued that the changes to CTA 2009 made by FA 2013 were clarificatory and did not represent a change in the law.

The First-tier Tribunal (FTT) had ruled against HMRC on each of these points.

Were expenses incurred wholly and exclusively for the purposes of the taxpayers' trades?

The UT rejected HMRC's argument that the IFRS2 debits were not 'expenses' on the basis that the wording of the s 48 does not need any further investigation than to ask whether an entry had been made in a company's accounts in compliance with generally accepted accounting practice.

The tribunal ruled that the use of the word 'incurred' in s 54 does not mean that monies have to be spent by a taxpayer; taking that view would make a nonsense of s 48.

HMRC had made the ingenious argument that the IFRS 2 debits arose because of the operation of the accounting standard and, therefore, did not have any purpose; being devoid of purpose, they were not incurred for the purposes of the taxpayers' trades. The UT disagreed, pointing HMRC back to the nature of the transaction that the IFRS debits recorded – the remuneration of the taxpayers' employees. Following *Mallalieu v Drummond* [1983] STC 665, the tribunal held that, because there was no duality of purpose in recording the IFRS 2 debits, they could not be said to have any purpose other than assisting in the taxpayers' trades.

Were the IFRS 2 debits capital?

HMRC argued that for the IFRS 2 debits to be revenue and not capital in nature, there needed to be a corresponding credit to shareholders' funds in the balance sheet (in this case, because of the recharge arrangements with the group EBT, there was no corresponding credit). The tribunal rejected this submission: the fact that the taxpayers had made arrangements to receive what amounted to capital contributions to offset the IFRS 2 debits did not change the revenue nature of the IFRS 2 debits.

Did Part 12 prevent a deduction for the IFRS 2 debits?

The tribunal approached this issue by splitting it into two:

- whether relief under Part 12 was 'available' for lapsed options; and
- if Part 12 relief was 'available', were the IFRS 2 debits 'directly related to the provision of shares'.

The tribunal agreed with the taxpayers that Part 12 relief can only be claimed if an option is exercised and shares are actually acquired by an employee. No claim under Part 12 can be made where an option is not exercised, meaning that the relief is not 'available' for lapsed options. On this basis, s 1038 did not prevent a deduction from being claimed in respect of the IFRS 2 debits.

Did the options constitute 'employee benefit contributions'?

HMRC's argument was that either:

- the grant of options resulted in property becoming subject to an arrangement which is for the benefit of employees and was therefore an employee benefit contribution and within the scope of s 1290; or
- the share incentive schemes under which the options were granted were 'employee benefit schemes' and caught by s 1290.

The FTT had rejected those arguments on the grounds that:

- the options embodied contractual rights that they held in their own names, absolutely, the options themselves were the 'benefit' and, therefore, the grant of options could not be 'employee benefit contributions';
- when the employees were granted their options they had received their benefit and those options were not held 'under' employee benefit schemes;
- the EBT's role, in settling the options, was immaterial to the actual benefit, the options, acquired by the employees.

The UT confirmed its agreement with the FTT's reasoning and went on to add that s 1290 is limited: it does not establish a general principal that a company will be denied a CT deduction if it makes an outright payment to or confers an outright benefit on employees that is not immediately subject to income tax.

Conclusion

Although the law has been changed to tighten the rules on corporation tax deductions for share options, this case is of interest because it reinforces the basic principle that a company's accounts, prepared in compliance with generally accepted accounting practices, will define a company's corporation tax base unless there is a specific statutory provision to the contrary.

The case also sees HMRC deploying the sorts of ingenious and pedantic arguments about the construction of statutory provisions commonly used by promoters of avoidance schemes and, in recent cases, roundly rejected by the courts. ■

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▸ Cases: *NCL Investments* (1.5.19)