4: Taxation and Accounting for ESOPs
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4.1 INTRODUCTION

From a tax viewpoint, ESOPs fall into two distinct categories – Case Law ESOPs and Statutory ESOPs.

Case Law ESOPs have been in existence for a number of years, and their taxation treatment depends upon the general provisions relating to discretionary employee benefit trusts. Statutory ESOPs, on the other hand, are ESOPs which have been established within the framework introduced in the Finance Act 1989.

It is therefore helpful to deal with the taxation implications of the two types of ESOPs quite separately, although the accounting implications are similar and are dealt with together.

4.2 TAXATION OF CASE LAW ESOPs

Taxation of the ESOP

An ESOP trust is a taxable entity, and its tax position is generally the same as for other types of discretionary employee benefit trusts. The tax payable by the ESOP differs according to whether the ESOP is resident in the UK for tax purposes, or resident outside the UK. To establish the ESOP offshore, the trustees must be resident outside the UK, and the ESOP must be administered outside the UK.

Income Tax – Onshore ESOPs

UK resident trustees are liable to income tax on their income at the basic rate (currently 25 per cent) and the additional rate (currently 10 per cent). In the case of dividends received on shares held in the ESOP, the normal rules apply, so that the trustees are liable to income tax on the dividend grossed.
up at the basic rate, receiving a credit for the basic rate tax. Expenses which are properly chargeable to income may be offset against the additional rate liability, but not against the basic rate liability.

There will often be cases where the ESOP makes payments out of post-tax income to employees, and these payments are then subject to a further income tax charge in the hands of employees. Although there is no statutory relief for this double taxation, in practice, by concession, the trustees may be able to reclaim some or all of the tax paid.

**Income Tax – Offshore ESOPs**

If the ESOP is resident outside the UK, any income from UK sources is chargeable to UK income tax. In the case of dividend income, the trustees will be liable to additional rate tax on the amount of dividends actually received (i.e. net of the basic rate tax deducted by the company). In practice, the ESOP is often located in a low-tax jurisdiction (such as Jersey) where income from funds placed on deposit in that country is free of tax.

**Capital Gains Tax – Onshore ESOPs**

If the ESOP is resident in the UK, it will pay capital gains tax on chargeable gains at the additional and basic rates, subject to the usual indexation allowance and the annual exemption (which is currently £2900 for trustees of a discretionary trust).

In practice, there are usually two main ways in which chargeable gains may arise in the ESOP. First, gains may arise from the distribution of shares to employees under approved or unapproved employee share schemes, particularly if the ESOP has bought several years’ allocation of shares at the outset. A gain will arise, for example, if options are exercised where the option price is higher than the trustees’ base cost for the underlying shares. In addition, a gain may arise if shares are sold in the market at a profit before they have been allocated to employees (for example, in the event of a take-over).

Even if the trustees do not make an actual gain on the shares, a distribution of shares to employees may give rise to a deemed gain for the trustees. This is because the trustees may well be deemed to have disposed of the shares for full value, rather than for the actual sale proceeds. However, if the shares are in an unquoted company, it will normally be possible for the trustees to ‘holdover’ this gain under Taxation of Chargeable Gains Act 1992, Section 165. This means that the trustees would not after all be deemed to have made a gain, but the person who receives the shares will be considered for CGT purposes to have paid for the shares the sum (if any) which he has in fact paid, and not the (higher) market value of the shares. Therefore, if he later sells the shares his own gain would be correspondingly greater. A holdover election is not normally possible if the company is quoted, and in any event a real gain cannot be held over. Also the holdover election depends on the agreement