The Personal Tax Planning Review

TAXATION OF SHARE OPTIONS: A HETERODOX NOTE

Robert Venables QC

Even ignoring the recently proposed change, the rewarding of employees by the conferring of share options is a relatively tax-inefficient method of remuneration. If the proposed change is implemented, it will become grossly inefficient.

At the heart of the problem is a wafer-thin majority of the House of Lords in 1939 where technical considerations of company - not tax - law were allowed to prevail over common sense and fiscal justice. Although the director/employee is taxed on his profit as and when he realises it, the company obtains no corresponding tax deduction. Thus, if a cash bonus is paid, the company saves tax at, say, 33% and the employee is taxed at 25% or 40%. If the employee makes a profit on the exercise of a share option, he is generally taxed at the same rate as on a cash bonus but the company obtains no tax deduction.

It is quite extraordinary how the raging debate has missed the basic point. Yet it is in no way arcane. I put it fairly and squarely in my *National Insurance Contributions Planning*[1] Chapter 11, 'Employee Trusts', at 11.3.4, 'Corporation Tax Considerations':

> "If a company merely issues shares in itself, albeit at a discount on market value, it obtains no deduction whatsoever for the shares cost it nothing. That was decided by a bare majority of the House of Lords in *Lowry v Consolidated African Selection Trust, Ltd* (1940) 23 TC 259. It is clearly wrong. Lords Wright and Romer dissented in the House and Sir Wilfred Greene MR and the Court of Appeal found for the taxpayer. It is possible that one day the House of Lords may be persuaded to reverse the decision. In the meantime, it stands; a monument to narrowness of judicial mind.
>
> Despite this enormous fiscal disadvantage, it is amazing how commonly one comes across schemes of this type. Their only advantage is that the accounts will show a deceptively rosy picture in that the true cost of obtaining the services of the employees is not disclosed either in the

---

1 Published by Key Haven Publications PLC in 1990.

> accounts or in the levels of remuneration shown in the Directors' Report. While the shares may theoretically cost the company nothing, the equity of the other shareholders is diluted just as much as if cash payments had been made to the employees and they had then used them to subscribe for fresh share capital. In fact, the cost to the other shareholders is even greater as their shares have been reduced even more in value by the artificial charge to corporation tax."

Share options also give rise to accounting distortions. The profit the employee makes is obtained at a corresponding cost to the owners of the company. Yet this cost is not reflected in the company's accounts. Its profits are thus overstated.

The solution to both problems would be to treat the company, both for accounting and tax purposes, as receiving from the employee the market value of the shares acquired by him and immediately paying him a cash bonus of the difference between that value and the actual price paid.

The employee would still be taxed on his gain when realised. Whether realisation should be deemed to be on exercise of the option rather than on realisation of the shares and whether the charge should be to capital gains tax rather than income tax are, with respect, relatively minor policy considerations compared with the basic injustice of the treatment of the company.

I myself always recommend alternative employee incentives, particularly properly structured employee trusts, which avoid the tax traps and are honestly reflected in the company's accounts. If the Revenue prove unrelenting, they will no doubt come into more general use.