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Employee share schemes

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/ **Employee share schemes**

This article is relevant for candidates preparing for P6 (MYS), *Advanced Taxation*, and is based on prevailing laws as at 31 March 2015.

The purpose of this article is to discuss the Malaysian income tax implications arising from the provision of employee share schemes. The focus of this article will be on Employee Share Option Schemes and Employee Share Purchase Plans. Candidates should be able to analyse the tax implications of these schemes from both the perspective of the employer and the employee.

Introduction to fundamental concepts

Employees are an important asset to any organisation. To ensure continuous growth and development, businesses realise the need to gain employee loyalty and to retain them. In this respect, employee share schemes are often used as a tool to retain and

motivate employees. The grant of shares to employees recognises the role of employees in the organisation by inculcating a sense of belonging in that the employees now have ownership rights in the company through the shares.

There are various ways in which employee share schemes can be implemented. The employees can be offered shares in the company in which they are employed or shares in the employer's holding company. Some of the commonly used employee share schemes include the following:

- Employee Share Option Schemes ('ESOS') – the employees are given the option(s) to purchase shares at a certain price, normally referred to as the offer price, over a specified period of time.
- Employee Share Purchase Plan ('ESPP') – the employees are allowed to purchase the shares, normally at a discount, at certain intervals over a specified period of time.
- Share Award Schemes – the employees are given free shares in the company.

Apart from the above schemes, which all offer rights to actual shares in the company, employers may also offer a cash equivalent to the value or appreciation in value of shares without undertaking a transfer of ownership of shares – for example, share appreciation rights ('SAR') schemes, etc.

Each employee share scheme is likely to be different depending on the objectives of the organisation and the specific rules governing the share schemes. These rules are normally set out in the scheme's by-laws and constitutions.

In the past, there were no specific provisions under the Income Tax Act, 1967 ('the Act') that addressed the taxability and deductibility of such schemes. However, as the Government realised that more organisations were launching employees share schemes, they also recognised the need to provide clarity on the tax treatment of such schemes. The Government first introduced provisions governing the taxability of such schemes in the hands of the employees in the year of assessment ('YA') 2006 and, subsequently, rules relating to the tax deductibility of employee share schemes for the employer were introduced in the YA 2013.

The tax implications of employee share schemes are also discussed in detail in *Public Ruling 11/2012 Employee Share Scheme Benefit* as well as *Public Ruling 9/2013 Special Deduction for Expenditure on Treasury Shares*.

In understanding the tax implications of employee share schemes, there are a few common features of the schemes which need to be understood.

Firstly, being a retention tool, most schemes would incorporate a vesting period before the shares can be acquired / the options can be exercised. A share scheme offers the right, but not the obligation, to an employee to purchase a specific number of shares at a specified price and at specific time. Before an employee can purchase the shares (or exercise their options under a share scheme) they need the option to purchase. In order to earn the right to purchase these shares, the employee needs to have a vested right to acquire these shares. Normally shares are considered vested upon fulfilment of the conditions imposed under the scheme which must be fulfilled by the employee in order to have the right to purchase or exercise the option to acquire the shares.

Examples of such conditions would include the continuation of employment for a period of time or the achievement of certain performance measures.

Example 1

Cerise Bhd ('Cerise') launched an ESOS on 1 April 2014 whereby all eligible employees were given the option to purchase 10,000 shares in the company at an offer price of RM1.50. The employees can only exercise their options to purchase the shares after 1 April 2015 (the vesting date) if the company achieves an annual turnover of RM100m and the employee continues to be employed by Cerise during the vesting period.

The employees are given until 31 March 2017 to exercise their options. For the financial year ended 31 March 2015, the company achieved a turnover of RM120m.

Based on the above example, whilst the scheme was launched on 1 April 2014, the option to acquire the shares was only vested on 1 April 2015 upon the fulfilment of the conditions imposed under the scheme – that is, achievement of the required turnover level and the employee remaining in employment with the company.

The other key concept is the date of exercise and the exercisable period. Being offered an option to a share scheme does not require the employee to exercise the option (purchase the shares) immediately. Share schemes normally have a specified exercisable period during which an employee can exercise the right to a share scheme. The exercisable period is the period from the first date the employee can exercise the right to the share scheme (the vesting date) to the final date the share scheme can be exercised. An employee is considered to have exercised an option to a share scheme when they have taken steps to purchase the relevant shares.

Based on Example 1, the exercisable period of the scheme would be from 1 April 2015 to 31 March 2017. The employee can exercise the option at any time during this period.

Employee's perspective: Taxability of employee share scheme

With effect from the YA 2006, Section 25(1A) of the Act provides that –

'The gross income from an employment in respect of any right to acquire shares in a company of the kind to which paragraph 13(1)(a) applies, shall where the right is exercised, assigned, released or acquired in the relevant period be treated as gross income of the relevant person for that relevant period'.

In other words, a benefit derived from a share scheme is considered to be part of gross employment income in the relevant period in which the rights are exercised.

The basis of computing the taxable benefit of a share scheme is provided under Section 32(1A) of the Act. It provides that:

'Where in the relevant period a relevant person acquired any right to acquire shares in a company of the kind to which paragraph 13(1)(a) applies, under his name or in the name of his nominee or agent, the amount in respect thereof to be included in his gross income from the employment shall be -

(i) the market value of the shares where the right shall be exercised, assigned, released or acquired on a specified date or where the right shall be exercised, assigned, released or acquired within a specified period, the first day of that period; or

(ii) the market value of the shares on the date of the exercise, assignment, release or acquisition of the right, whichever is the lower less the amount paid for the shares'.

The calculation of the taxable benefit can be summarised in the table below:

RM

Compare:

| | |
|---|----|
| Market value of share on the date the scheme is exercisable (vesting date) | xx |
|---|----|

| | |
|--|-----------|
| Market value of shares on the date the scheme is exercised | <u>xx</u> |
|--|-----------|

| | |
|--------------------|----|
| Whichever is lower | xx |
|--------------------|----|

| | |
|--|---------------|
| Less: Price paid for the shares (if any) | (<u>xx</u>) |
|--|---------------|

| | |
|--|-----------|
| Perquisite regarded as gross employment income | <u>xx</u> |
|--|-----------|

How do we establish the market value of the shares? This would depend on whether the company is listed on any Stock Exchange. In the case of a listed company, the market value of the shares is ascertained by averaging the highest and the lowest market price of the shares for the day. For non-listed shares, the market value is determined based on the net asset value of the company.

Example 2

Based on the scenario in Example 1, Siva is an employee of Cerise and is a member of the ESOS. He decided to exercise part of his option to acquire 5,000 shares on 1 September 2015. The market value of the ordinary shares of Cerise on 1 April 2014, 1 April 2015 and 1 September 2015 were RM1.50, RM1.80 and RM2.00, respectively.

The exercise date in this case is 1 September 2015. The date when the scheme is exercisable would be the date when the option is vested on Siva. In this instance, that date is 1 April 2015, being the date when Siva can exercise his option (upon fulfilment of the relevant conditions).

The taxable benefit of the ESOS in the hands of Siva is determined as follows:

RM

Compare:

| | |
|---|---------------|
| Market value of share on the date the scheme is exercisable – ie 1 April 2015 (5,000 shares x RM1.80) | 9,000 |
| Market value of shares on the date the scheme is exercised – ie 1 September 2015 (5,000 shares x RM2.00) | <u>10,000</u> |

| | |
|---|----------------|
| Whichever is lower | 9,000 |
| Less: Price paid for the shares (if any) (5,000 x RM1.50) | <u>(7,500)</u> |

| | |
|--|--------------|
| Perquisite regarded as gross employment income | <u>1,500</u> |
|--|--------------|

Example 3

Baik Bhd ('Baik') introduced an ESPP for its senior management team on 1 June 2014. The market value of the ordinary shares of Baik on 1 June 2014 was RM1.10. Rama, an employee of Baik, was offered the right to purchase 2,000 shares every 6 months through salary deductions at a 20% discount from the market value of the shares at the expiry of each six-month period. The market value of the shares as at 30 November 2014 was RM1.50 per share.

Based on the above, in relation to the first tranche of share purchased by Rama, the taxable benefit would be calculated as follows:

RM

RM

| | |
|---|------------|
| Market value of share on the date the scheme is exercisable / exercised – ie 30 November 2014 (2,000 shares x RM1.50) | 3,000 |
| Less: Price paid for the shares (if any) (2,000 x RM1.50 x 80%) | (2,400) |
| Perquisite regarded as gross employment income | <u>600</u> |

It should be noted that the date of exercise and the date of exercisable for the scheme is the same date – ie 30 November 2014. The taxable benefit would need to be reported as gross employment income of Rama for the YA 2014.

Gains from the subsequent sale of the shares acquired

The employee may then sell the shares and realise a gain. The gains derived from a subsequent sale of the shares would be regarded as a capital gain and therefore, would not constitute a taxable income to the employee.

Employer's perspective: Tax deductibility of employee share scheme

An employee share scheme could involve shares in the employer company itself or shares in the holding company. Where the shares to be given to the employee are the shares of the holding company, the holding company may make a charge to the subsidiary company for granting the shares under a share scheme to the employees of the subsidiary company.

The source of shares to be granted under an employee share scheme could also differ. Companies may decide to give shares to employees through the issuance of new shares in the company. Alternatively, in the case of listed company, the company may decide to repurchase its own shares from the Stock Exchange to be given to its employees. In such a case, the shares bought back from the Stock Exchange by the company are referred to as treasury shares.

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A company will incur costs in acquiring such treasury shares and may also incur related costs, for example legal or broker's fees. The question to be considered is whether such expenses are deductible for tax purposes. Until YA 2013, there were no specific provisions governing the tax deductibility of employee share scheme expenditure under the Act. Therefore, prior to YA 2013, the deductibility of such expenditure was determined based on the general deductibility rules as set out in Section 33(1) of the Act.

With effect from the YA 2013, a new Section 34D of the Act was introduced to accord a special tax deduction on the costs incurred in acquiring treasury shares by a company to fulfil its obligations under an employee share scheme. The timing of the deduction and method of computing the amounts that can be allowed as a deduction are also provided under Section 34D of the Act. The legislation also provides specific rules to determine the tax deduction in a situation where a holding company repurchases its own shares and transfers them to employees of a subsidiary company under the terms of the holding company's employee share scheme.

Employee share scheme involving treasury shares for its own employees

Where treasury shares are given to the company's own employees under an employee share scheme, the special tax deduction is determined as follows:

RM

Cost of acquiring treasury shares which are transferred to the employee

xx

Less: Amount payable by the employee for such treasury shares (if any)

(xx)

Amount allowable for tax deduction

xx

The tax deduction would be given in the basis period for a year of assessment when the shares under the share scheme are being exercised by / vested on / offered to the employees, as the case may be.

In determining the cost of acquiring the treasury shares, in addition to the actual cost of repurchasing the shares, the following costs directly related to the acquisition of treasury shares can also deducted:

- Brokerage charges, commission to broker and Central Depository System (CDS) charges,
- Stamp duty, and
- Interest costs incurred to finance the acquisition of treasury shares intended for use by a company to fulfil obligations under an employee share scheme.

It is further provided that a company may acquire treasury shares at different prices and at different times. The cost of acquiring treasury shares which are subsequently transferred to the company's employees under an employee share scheme will then be determined on the basis that the treasury shares acquired by the company at an earlier point in time are deemed to be transferred first (based on the First-in First-out (FIFO)) method.

Example 4

Bagus Bhd ('Bagus') makes up its accounts to 31 December each year. It has launched an ESOS to its employees using treasury shares. On 1 August 2014, a group of employees exercised their rights under the ESOS to acquire a total of 200,000 shares. The offer price is RM2.50 per share.

The cost of acquiring the treasury shares can be summarised below:

| Number of treasury shares | Date of acquisition | Cost per share (RM) |
|---------------------------|---------------------|---------------------|
| 150,000 | 1 March 2014 | 3.00 |
| 60,000 | 30 April 2014 | 4.00 |
| 50,000 | 1 February 2015 | 2.00 |
| 50,000 | 1 April 2015 | 3.50 |

The amount of allowable deduction is calculated as follows:

Exercise on 1 Aug 2014

RM

Exercise on 1 Aug 2014

RM

Cost of acquiring the treasury shares which are transferred to the employee (FIFO basis)

First 150,000 shares (150,000 shares x RM3.00)

450,000

Balance of 50,000 shares (50,000 shares x RM4.00)

200,000

650,000

Less: Amount payable by the employees for such treasury shares (200,000 shares x RM2.50)

(500,000)

Amount allowable for tax deduction

150,000

The tax deduction of RM150,000 will be given in the basis period in which the ESOS is exercised – ie YA 2014.

There may be a situation where the amount payable by the employee is more than the cost to the company of acquiring the treasury shares. In such circumstance, no tax deduction would be given. In addition, the excess would be credited into an account kept by the company and this excess would then be applied to reduce the cost of subsequent treasury shares to be transferred to employees. This is illustrated in the example below.

Example 5

Following from Example 4, the following shares were acquired by employees under the ESOS:

Date of exercise

Number of shares

1 March 2015

50,000

1 July 2015

50,000

The amount of allowable deduction to Bagus is then calculated as follows:

| Exercise on 1 March 2015 | RM |
|--|------------------|
| Cost of acquiring the treasury shares which are transferred to the employee (FIFO basis) | |
| First 10,000 shares (10,000 shares x RM4.00) | 40,000 |
| Balance 40,000 shares (40,000 shares x RM2.00) | <u>80,000</u> |
| | 120,000 |
| Less: Amount payable by the employees for such treasury shares (50,000 shares x RM2.50) | <u>(125,000)</u> |
| Excess | <u>(5,000)</u> |
| Amount allowable for tax deduction | <u>Nil</u> |

The excess of RM5,000 should be credited into a special account kept by the company for the purpose of Section 34D of the Act.

| Exercise on 1 July 2015 | RM |
|--|----------------|
| Cost of acquiring the treasury shares which are transferred to the employee (FIFO basis) | |
| First 10,000 shares (10,000 shares x RM2.00) | 20,000 |
| Balance 40,000 shares (40,000 shares x RM3.50) | <u>140,000</u> |
| | 160,000 |

Exercise on 1 July 2015

RM

| | |
|---|--------------------|
| Less: Amount payable by the employees for such treasury shares (50,000 shares x RM2.50) | (<u>125,000</u>) |
|---|--------------------|

35,000

| | |
|---|------------------|
| Less: Excess from special Section 34D account | (<u>5,000</u>) |
|---|------------------|

| | |
|------------------------------------|---------------|
| Amount allowable for tax deduction | <u>30,000</u> |
|------------------------------------|---------------|

Therefore, for the YA 2015, the amount allowable for tax deduction in respect of the exercise dates of 1 March and 1 July 2015 would be RM30,000 (Nil + RM30,000).

Employee share scheme involving treasury shares for employees of its subsidiary companies

Specific rules apply in the situation where treasury shares of a holding company are given to the employees of a subsidiary under an employee share scheme of the holding company. The quantum of the allowable amount to the subsidiary company in such circumstances is ascertained as follows:

RM

Compare:

| | |
|---|-----------|
| Cost recharged to the subsidiary by the holding company | xx |
| Cost of acquisition of the treasury shares by the holding company | <u>xx</u> |

Whichever is lower

| | |
|--|---------------------|
| Less: Amount payable by the employees for the treasury shares (if any) | xx (<u>xx</u>) |
|--|---------------------|

RM

Amount allowable for tax deduction

XX

Based on the formula, where the amount payable by the subsidiary's employees is higher than the holding company's actual cost of purchasing the treasury shares or the amount of recharge (whichever is the lower) no tax deduction is allowed to the subsidiary.

The deduction is allowable on the date the shares are transferred to the employees under the employee share scheme or on the date the payment in respect of the recharge is made to the holding company by the subsidiary company, whichever is later. Where no recharge is made to the subsidiary, the subsidiary would not be entitled to any tax deduction as the subsidiary does not incur any cost in respect of the shares.

Example 6

Suka Bhd ('Suka') is the holding company of Cinta Sdn Bhd ('Cinta'). Both companies have a financial year end of 31 December. Suka operates an ESPP for the employees of Cinta whereby shares are offered at a 20% discount. Suka repurchased 100,000 of its own shares at RM4.50 per share from the open market in 2013. On 1 November 2014, Suka transferred all of these treasury shares to Cinta's employees under the ESPP scheme. The price paid by the employees for the shares was RM4.00 per share and the market value of the shares on 1 November 2014 is RM5.00 per share.

On 15 January 2015, Suka issued an invoice to Suka for RM500,000 as consideration for the shares transferred to Cinta's employees.

The allowable amount of tax deduction for Cinta is calculated as follows:

RM

Compare:

| | |
|--|----------------|
| Cost recharged to the subsidiary by the holding company | 500,000 |
| Cost of acquisition of treasury shares by the holding company (100,000 shares x RM4.50) | <u>450,000</u> |

RM

| | |
|---|------------------|
| Whichever is lower | 450,000 |
| Less: Amount payable by the employees for the treasury shares (100,000 shares x RM4.00) | <u>(400,000)</u> |
| Amount allowable for tax deduction | <u>50,000</u> |

The tax deduction RM50,000 is to be given based on the date when the shares are transferred to the employees or the date when the amount is recharged to Cinta, whichever is later. Although the shares were transferred on 14 November 2014, as the recharge was only made on 15 January 2015, Cinta can only avail for the tax deduction in YA 2015.

Example 7

All facts remain the same as Example 6 except that the share purchase consideration paid by the employees was RM4.80 per share and the market value of the shares on 1 November 2014 was RM6.00 per share.

The allowable amount of tax deduction for Cinta is calculated as follows:

RM

| | |
|---|------------------|
| Compare: | |
| Cost recharged to the subsidiary by the holding company | 500,000 |
| Cost of acquisition of treasury shares by the holding company (100,000 shares x RM4.50) | <u>450,000</u> |
| Whichever is lower | 450,000 |
| Less: Amount payable by the employees for the treasury shares (100,000 shares x RM4.80) | <u>(480,000)</u> |
| Excess | <u>(30,000)</u> |

RM

Amount allowable for tax deduction

Nil

In this situation, as the amount payable by the employee is more than the lower of the cost recharge or the cost of acquisition of the treasury shares, no tax deduction would be available to Cinta. Unlike in the case of shares given to its own employees whereby the excess would need to be credited into a special Section 34D account, there is no requirement to credit this excess to the special Section 34D account in the case of shares given to the employees of a subsidiary company.

As can be appreciated from the above, the new Section 34D of the Act only addresses the tax deductibility of costs relating to treasury shares in the context of employee share schemes. The Act remains silent when it comes to newly issued shares. Nonetheless, the Inland Revenue Board (IRB) has taken the position that employee share scheme expenditure involving newly issued shares is generally not tax deductible.

This is because, when a company fulfils its obligations under an employee share scheme using newly issued shares of its own company, the share issue merely involves a movement in the company's share capital account. Since there is no actual cost incurred by the company, the amount should not be tax deductible. This tax principle has also been established in an old UK tax case of *Lowry vs. Consolidated African Selection Trust Ltd.*

This tax position can be distinguished from the situation involving a company offering its shares to the employees of its subsidiary companies. If there is no actual charge of the share scheme expenditure to the subsidiary, then the amount again should not be tax deductible. However, if an amount is recharged to and paid by the subsidiary company, it can be argued that this expense should be allowed as tax deduction to the subsidiary as it would have fulfilled the general deductibility test under Section 33(1) of the Act. This is because the amount would have been incurred by the subsidiary company and, therefore, should be tax deductible to the subsidiary.

However, until the alternative view is tested in the Courts, it is likely that the IRB would maintain its stance that any employee share scheme expenditure involving newly issued shares should not be allowed as tax deduction.

Written by a member of the P6 (MYS) examining team



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