

## STAFF PAPER

17-21 February 2014

## IASB Meeting

Project	Narrow-scope amendments to IFRS 2 <i>Share-based Payment</i>		
Paper topic	Share-based payments settled net of tax withholdings		
CONTACT(S)	Kenichi Yoshimura	<a href="mailto:kyoshimura@ifrs.org">kyoshimura@ifrs.org</a>	+44 (0)20 7246 6905

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

## Introduction

1. The IFRS Interpretations Committee (the ‘Interpretations Committee’) received a request to clarify the classification of a share-based payment transaction in which the entity withholds a specified portion of the shares that would otherwise be issued to the counterparty upon exercise (or vesting) of the share-based payment. Instead of delivering all of the shares due under the terms of the share-based payment, the entity withholds a portion and makes a payment to the tax authorities in respect of the counterparty’s tax due in relation to the share-based payment. Specifically, does the withholding of a portion of shares and the payment of tax to the tax authorities affect the classification of the share-based payment as equity-settled?
2. In March 2013, the Interpretations Committee decided to recommend to the IASB that, to mitigate diversity in practice on this issue, it should amend IFRS 2 *Share-based Payment* in a narrow-scope amendment by adding specific guidance. The guidance would be to clarify that a share-based payment in which the entity settles the share-based payment net by withholding a specified portion of the equity instruments to meet its minimum statutory tax withholding requirements would be classified as equity-settled in its entirety, if the entire share-based payment would otherwise be classified as equity-settled without the net settlement feature. This amendment would result in more converged guidance with US GAAP.

3. The objective of this Agenda Paper is to provide the IASB with a summary of the issue as well as the discussions of and the recommendations made by the Interpretations Committee.
4. This Agenda Paper is structured as follows:
  - (a) summary of the issue;
  - (b) summary of the discussions of and recommendations made by the Interpretations Committee;
  - (c) additional analysis on the accounting for the cash payment;
  - (d) amendment proposed by the staff;
  - (e) staff recommendation;
  - (f) questions for the IASB;
  - (g) Appendix A—Illustrative Examples;
  - (h) Appendix B—Excerpt from relevant US GAAP literatures; and
  - (i) Appendix C—Annual Improvement criteria assessment.

### **Summary of the issue**

5. The submission describes a situation in which the entity is obliged by the tax laws to withhold a certain amount of the counterparty's taxes associated with the share-based payment, and transfer the amount in cash to the taxation authorities. The share-based payment arrangement permits the entity to deduct from the total number of equity instruments the number of equity instruments needed to equal the monetary value of the counterparty's tax liability for the purpose of meeting the tax withholding requirements.
6. We identified two alternative views on this issue. We have prepared in **Appendix A** an illustrative example of share-based payment transaction settled net of tax withholdings to present the difference in accounting results between Views A and B.

*View A—Separate accounting for each component of the transaction*

7. Taking View A, each component of the share-based payment is accounted for in a manner that is consistent with the manner of its settlement. Thus, because the share-based payment provides for both the payment of equity instruments and the payment of cash (or other assets):
- (a) the portion for which the entity has incurred a liability to pay cash is accounted for as a cash-settled share-based payment; and
  - (b) the portion with which the entity settles the compensation obligation by the issue of equity instruments is accounted for as an equity-settled share-based payment.

*View B—Consistent accounting for the entire transaction as equity-settled*

8. View B views the transaction as the net impact of two different transactions:
- (a) the equity-settled share-based payment transaction that is satisfied in its entirety through the issue of equity instruments; and
  - (b) the immediate repurchase by the entity of a portion of the equity instruments that was issued (see paragraph 29 of IFRS 2).

**Summary of the discussions by the Interpretations Committee**

9. The following paragraphs present a summary of the discussions of the Interpretations Committee. The further details of the staff technical analysis were set out in Agenda Paper 5B<sup>1</sup> for the March 2013 Interpretations Committee meeting.

***Arguments for each view***

10. Those who support View A argue that:
- (a) paragraph 34 of IFRS 2 indicates that a share-based payment transaction, or components of that transaction, should be classified as

---

<sup>1</sup> <http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/March/AP05B%20-%20IFRS%202%20SBP%20settled%20net%20of%20tax%20withholdings.pdf>

cash-settled if, and to the extent that, the entity has incurred a liability to settle in cash or other assets.

- (b) the portion withheld in the share-based payment is more akin to the granting of redeemable shares. Paragraph 31 of IFRS 2 lists a share-based payment that is settled by redeemable shares as an example of cash-settled share-based payments. This example better describes the substance of the transaction than the example in paragraph 29 of IFRS 2.
- (c) the entity is acting as an agent on behalf of the counterparty in transferring cash to the taxation authority to settle the counterparty's tax obligation. However, at the same time, the entity is fulfilling its obligation to settle the share-based payment for the services received from the counterparty as a principal by transferring cash to the taxation authority.
- (d) the entity settles the portion withheld by paying cash from its own cash resource in the share-based payment. The classification of this share-based payment should be different from that of other types of share-based payment arrangements involving tax withholding features such as a 'broker-assisted cashless service',<sup>2</sup> in which the entity settles the entire share-based payment by issuing equity instruments.

11. On the other hand, those who support View B argue that:

- (a) Appendix A of IFRS 2 defines a cash-settled share-based payment as “a share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services” (emphasis added). However, the entity does not pay cash directly to the counterparty in this transaction. Thus, the share-based payment transaction does not meet the definition of a cash-settled share-based payment transaction in IFRS 2.

---

<sup>2</sup> A 'broker-assisted cashless exercise' represents a share-based payment transaction involving tax withholdings in which all of the shares that are to be issued in accordance with the arrangement are in fact issued, and the entity facilitates the sale of some of these shares to the market and pays the cash received to the taxation authority to settle the counterparty's tax obligation.

- (b) the entity is acting as an agent in paying cash to the taxation authorities because the tax obligation is the counterparty's obligation. In this regard, it should be assumed that the share-based payment transaction was settled entirely in equity instruments with a separate, yet simultaneous, repurchase of a portion of those equity instruments to which paragraph 29 of IFRS 2 applies.
- (c) the classification of the share-based payment with a net settlement feature should be consistent with other schemes such as 'a broker-assisted cashless service', which, in their view, would have similar economic substance (see **Scheme 2** in **Appendix A** of this Agenda Paper).
- (d) taking View A would require an entity to estimate changes in tax laws, including changes in tax rates, that affect the amount that is to be withheld by the entity. As the estimate changes, the entity would need to reclassify a portion of the share-based payment. This would add additional complexity, the cost of which would likely outweigh the benefits.
- (e) View B would result in consistent requirements with those in US GAAP.

### ***Diversity in practice***

- 12. The Interpretations Committee noted that this issue is widespread and there is significant diversity in practice. It further noted that the difference in accounting results under Views A and B could be significant.
- 13. Hence, the Interpretations Committee concluded that guidance should be added to IFRS 2 to clarify the accounting for the share-based payment with a net settlement feature.

### ***Approaches to amendment to IFRS 2***

- 14. Considering the arguments for Views A and B, the Interpretations Committee noted that it is difficult to reach a consensus on whether the portion withheld by

the entity in the share-based payment transaction should be classified as cash-settled or equity-settled in the light of the existing guidance in IFRS 2. Divergent views were expressed by the members of the Interpretations Committee and interested parties on the interpretations of the relevant requirements in IFRS 2.

15. Furthermore, the Interpretations Committee was concerned that requiring a different classification of the portion that is withheld by the entity from the classification of the other portion could cause an undue burden to the entity. Accordingly, the Interpretations Committee observed that it would be difficult to develop guidance that is derived solely from the principles in IFRS 2.
16. Consequently, in order to mitigate the diversity in practice, the majority of the members of the Interpretations Committee supported adding guidance that addresses only limited types of share-based payments with net settlement features on the basis of the accounting model in View B.
17. The guidance would specify that a share-based payment transaction in which the entity settles the share-based payment net by withholding a specified portion of the equity instruments to meet its minimum statutory tax requirements would be classified as equity-settled in its entirety, if the entire award would otherwise be classified as equity-settled without the net settlement feature. This approach is similar to that taken in US GAAP.

### ***Assessment against annual improvement criteria***

18. The Interpretations Committee thought that the potential amendment could be developed and agreed upon by the IASB on a timely basis. However, it noted that the amendment would be perceived as being beyond a clarification and correction of minor unintended consequences, oversights or conflict of existing requirements in IFRS 2. This is because the potential amendment would add specific guidance that addresses only limited types of share-based payment transactions. The amendment would not necessarily be derived from the consensus on an interpretation of the principles of IFRS 2. Accordingly, the Interpretations Committee observed that the potential amendment should be exposed separately and performed in a separate narrow-scope amendment project of the IASB.

19. For the details about the assessment against the annual improvements criteria, please refer to **Appendix F** of Agenda Paper 5B for the March 2013 Interpretations Committee meeting<sup>2</sup>.

### ***Recommendation by the Interpretations Committee***

20. On the basis of the discussions above, the Interpretations Committee decided to recommend amending IFRS 2 in a narrow-scope amendment to specify the classification of limited types of share-based payment transactions with a net settlement feature.
21. The guidance would be to specify that a share-based payment with a net settlement feature should be classified as equity-settled in its entirety if:
- (a) the relevant tax laws require an entity to withhold from the counterparty's compensation an amount to satisfy the counterparty's tax liability incurred as a result of the share-based payment;
  - (b) the amount withheld does not exceed the minimum statutory tax withholding requirements; and
  - (c) the entire share-based payment would otherwise be classified as equity-settled without the net settlement provision.

### **Additional analysis on the accounting for the cash payment**

22. After the discussions by the Interpretations Committee, we learnt of concerns from an IASB member that:
- (a) the tax rates applicable to share-based payments could be so high that a major part of the share-based payment could be settled in cash. Hence, it would be more appropriate to classify the share-based payment as cash-settled in its entirety.
  - (b) applying the approach recommended by the Interpretations Committee, the cash payment to settle the employee's tax obligation would be

---

<sup>2</sup> <http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/March/AP05B%20-%20IFRS%202%20SBP%20settled%20net%20of%20tax%20withholdings.pdf>

accounted for as a deduction from equity, except to the extent that payment exceeds the fair value of the equity instruments at the payment date (see paragraph 29 of IFRS 2). However, the amount of cash paid to the taxation authorities could significantly exceed the total amount of compensation expense (ie the measurement by reference to the grant date fair value). Using the example in **Scheme 1 in Appendix A**, the amount of cash paid at the date of settlement (CU 400) significantly exceeds the total compensation expense recognised over the last four years (CU200). This could arise because of a high tax rate as stated above and/or an increase of the fair value of the equity instruments from the grant date. Thus, even if the share-based payment is classified as equity-settled, some argue that the difference between the balance of equity at the repurchase date and the repurchase amount should be debited to compensation expense rather than equity.

23. We understand the concern in paragraph 23(a) because, in many jurisdictions, marginal personal tax rate is about 40 per cent (although it could be higher or lower in other jurisdictions). However, we think that the fact that almost a majority of a share-based payment could potentially be settled in cash does not justify classifying the entire share-based payment as cash-settled. Thus, we think that the argument in paragraph 23(a) is not consistent with the requirements in IFRS 2.
24. Furthermore, we acknowledge that, for the issue in paragraph 23(b) above, a significant amount of the excess of the repurchase amount over the total compensation expense could arise in all equity-settled share-based payments if vested equity instruments are repurchased. We think that the overpayment occurs because of following the principles for the measurement of an equity-settled share-based payment transaction (ie the measurement by reference to grant date fair value). We are of the view that transactions related to tax withholdings should have no effect on the amount of expense determined in accordance with the principles.
25. In addition, we note that one of the purposes of taking the Interpretations Committee's recommended approach is to achieve further convergence with US



GAAP. We understand that the cash payment to settle the employee's tax obligation is accounted for as repurchase of equity instruments under US GAAP.

26. On the basis of the analysis above, we think that the tax payment to the taxation authorities should be accounted for as repurchase of equity instruments (ie as a deduction from equity) in accordance with paragraph 29 of IFRS 2.

### **Amendment proposed by the staff**

27. The draft wording of the proposed amendments to IFRS 2 is included in Agenda Paper 12G, together with the draft amendments arising from other IFRS 2 issues.

### **Transition requirements**

28. We think that a transition relief for retrospective application of this amendment is unnecessary. The proposed amendment would not require an entity to change the estimates of fair value of the equity instruments as of a past date including the date of grant. We expect that most entities have maintained or have access to the historical information on the grant date fair value of equity instruments granted.
29. Thus, we think that the amendment should be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Notwithstanding the above, we collectively analyse the transition requirements in Agenda Paper 12G for all the amendments proposed in Agenda Paper 12C-12F.

### **First-time adopters**

30. No specific guidance is proposed for first-time adopters in the application of the proposed amendments, because appropriate relief is already given through the exemptions for share-based payments in Appendix D of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

### **Consequential amendments**

31. We have reviewed other IFRSs for potential consequential amendments triggered by this proposed amendment. As a result of this review, we do not propose any consequential amendments.

### **Staff recommendation**

32. We recommend to the IASB that it should propose to amend IFRS 2 in a narrow-scope amendment project by adding guidance in line with the approach recommended by the Interpretations Committee.
33. If the IASB agrees with the proposals in this Agenda Paper, a ballot draft will be prepared for IASB members to approve. We propose that the IASB publishes an Exposure Draft with a 120-day comment period.

### **Questions for the IASB**

#### **Question 1**

Does the IASB agree with the staff recommendation that the IASB should amend IFRS 2 in a narrow-scope amendment project by adding guidance in line with the approach recommended by the Interpretations Committee?

#### **Question 2**

If the answer to Question 1 is 'yes', does the IASB agree to publish an Exposure Draft with a 120-day comment period based on the wording of the proposed amendment in Agenda Paper 12G?

## Appendix A—Illustrative Examples

On 1 January 20X0 Entity A grants an award of 100 free shares to one of its employees subject to a four-year service condition. Entity A estimates that the employee will complete his service period. The employee's tax associated with the award is calculated based on the fair value of the free share on the vesting date. The entity is obliged by the tax laws to withhold an amount of the tax, and immediately remit to the tax authority, in cash, the amount of the tax withheld. On 31 December 20X0, Entity A expects that the tax rate applicable to the employees will be 30 per cent. At grant date, the fair value of each free share is CU2. The fair values of each free share subsequent to the grant date are:

31 December X0: 4  
31 December X1: 3  
31 December X2: 2  
31 December X3: 10

On 31 December X2, Entity A changes its estimate on the applicable tax rate from 30 per cent to 40 per cent because of a change in a tax law.

### Scheme 1—net settlement

The terms of the share-based payment arrangement permits Entity A to settle the transaction net by issuing a reduced number of shares to the employee to meet the entity's tax withholding obligation. Accordingly, on the exercise date, Entity A issues 60 free shares to the employee and remits CU400 (100 shares × CU10 × 40%) to the taxation authority on behalf of the employee. Entity A pays the amount of the employee's tax obligation from its own cash resources.

### Scheme 2—broker-assisted cashless exercise

The terms of the share-based payment arrangement requires Entity A to settle the transaction gross by issuing all the vested shares to employees and direct a broker to sell in the market a portion of the shares required to meet the entity's tax withholding obligation. Accordingly, Entity A issues 100 shares with 60 of them being delivered to the employees and 40 of them being delivered to the broker. The proceeds from the sale of the shares by the broker of CU400 (100 shares × CU10 × 40%) are remitted to the tax authority on behalf of the employee. There is no shortfall in the proceeds received from the sale to cover the tax payment.

## Scheme 1 (net settlement)

## Accounting under View A

Year	Expense	Equity	Liability
20X0	65	(35) (= CU2 × 100 shares × 70% × 1/4)	(30) (= CU4 × 100 shares × 30% × 1/4)
<i>The award is divided into two components: the equity-settled component and the cash-settled component, and they are accounted for separately afterwards.</i>			
20X1	50	(35) (=CU2 × 100 shares × 70% × 2/4 – 35)	(15) (= CU3 × 100 shares × 30% × 2/4 – 30)
20X2	35	(20) (= CU2 × 100 shares × 60% × 3/4 – (35 + 35))	(15) (= CU2 × 100 shares × 40% × 3/4 – (30 + 15))
<i>At the end of 20X2, the expected tax rate changed from 30 per cent to 40 per cent. The increase of the expected tax rate results in the reclassification of part of the share-based award from equity-settled to cash-settled.</i>			
20X3	370	(30) (= CU2 × 100 shares × 60% × 4/4 – (35 + 35 + 20))	(340) (= CU10 × 100 × 40% × 4/4 – (30 + 15 + 15))
<i>At the end of 20X3, all shares were vested and 60 shares were issued to the employees.</i>			
Total	520	(120)	(400)

**Scheme 1 (net settlement)**

**Accounting under View B**

Year	Expense	Equity	Liability
20X0	50	(50) <i>(= CU2 × 100 shares × 1/4)</i>	0
		<i>The entire award is classified as equity-settled.</i>	
20X1	50	(50) <i>(= CU2 × 100 shares × 2/4 - 50)</i>	0
20X2	50	(50) <i>(= CU2 × 100 shares × ¾ - (50 + 50))</i>	0
		<i>Because the award is not divided into two, there is no impact from the change in the expected tax rate.</i>	
20X3	50	350 <i>(= CU2 × 100 shares × 4/4 - (50 + 50 + 50) - 400)</i>	(400) <i>(= CU10 × 100 × 40% × 4/4)</i>
		<i>Using this view, it is assumed that all the vested shares were issued to the employees and at the same time 40 shares were repurchased by the entity.</i>	
total	200	(200)	0

**Scheme 2 (broker-assisted cashless exercise)**

*In this scheme, the accounting would be the same under both View A and View B.*

<b>Year</b>	<b>Expense</b>	<b>Equity</b>	<b>Liability</b>
20X0	50	(50) <i>(= CU2 × 100 shares × 1/4)</i>	0
20X1	50	(50) <i>(= CU2 × 100 shares × 2/4 - 50)</i>	0
20X2	50	(50) <i>(= CU2 × 100 shares × 3/4 - (50 + 50))</i>	0
20X3	50	(50) <i>(= CU2 × 100 shares × 4/4 - (50 + 50 + 50))</i>	0
<b>total</b>	<b>200</b>	<b>(200)</b>	<b>0</b>

## Appendix B—Excerpt from relevant US GAAP literature

B1. The followings are excerpt from the relevant US GAAP guidance (emphasis added)

### FASB Accounting Standards Codification

#### 718-10

25-16 A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

- a. The cashless exercise requires a valid exercise of the share options.
- b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

25-17 A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

25-18 Similarly, **a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.**

25-19 Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

### Basis for Conclusions of FAS 123R

B125. Paragraph 35 of this Statement also indicates that a provision for direct or indirect (by means of a net-settlement feature) repurchase of shares issued upon exercise of options (or vesting of shares) to meet the employer's minimum statutory withholding requirements does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. Interpretation 44 also provided that exception for accounting under Opinion 25. **In concept, the Board considers a provision for repurchase of shares at, or shortly thereafter, the exercise of options, for whatever reason, to result in the employer's incurrence of a liability. However, the Board decided for pragmatic reasons to continue the exception for direct or indirect repurchases to meet the employer's minimum statutory withholding requirements.**

B126. Certain respondents to the Exposure Draft asked that the exception for minimum statutory withholding requirements be extended to encompass amounts in excess of the minimum statutory withholding requirements. As noted in

paragraph B125, **the Board included the exception for minimum statutory requirements for pragmatic rather than conceptual reasons.** The Board therefore declined to extend the exception beyond the minimum statutory requirements to which the related exception in Opinion 25 and Interpretation 44 applied.