



ESOS: Getting it right

A stock option is a non-tradeable call option giving an employee the right to acquire shares in the company at a preferential price. In addition to allowing employees to participate in the success of the company, stock options are also a powerful staff retention and performance incentive tool.

Normally granted to mid- and high-level executives, stock options form part of their remuneration package and the options are considered perquisites subject to tax.

In this regard, employers who are considering implementing a stock option scheme in Malaysia should be mindful of the relevant provisions under the Income

Tax Act 1967 (ITA) that govern the reporting and taxation of stock options.

Employees participating in a stock option scheme should also be aware of the tax implications. This is important as non-compliance with the tax law would result in penalties for both the employer and the employee.

In addition to Sections 25(1A) and 32(1A) of the ITA, the Inland Revenue Board (IRB) has issued *Public Ruling No. 11/2012 (Employee Share Scheme Benefit)* and *Public Ruling No. 12/2012 (Share Scheme Benefit for Cross Border Employees)* to provide guidance on the tax treatment of share schemes, including stock option schemes.

TAX IMPLICATIONS FOR THE EMPLOYEE

At grant date: There are no tax implications for the employee at the date of grant. Accordingly, there are no reporting obligations in this regard.

At exercise date: At the exercise date, the employee exercises his options and acquires the shares at the pre-determined price (offer price). The taxing point occurs on this date and the benefit arising from the stock options is calculated as follows:

The market value of the shares on exercisable date or exercise date, whichever is the lower, less the price paid for the shares (offer price).

The employee is required to declare the benefit as part of his employment income in his annual tax return.

Dividends received post exercise:

If the shares purchased are shares in a foreign parent company, any dividends received in respect of those shares are considered foreign source income, which is exempted from tax. If the options are in respect of shares of a Malaysian company, the dividends are taxable if these are franked dividends while single-tier dividends or dividends paid out of a tax exempt account are exempt from tax.

Subsequent sale of the shares: Any gains obtained from a subsequent sale of the shares are considered capital gains, not subject to tax.

TAX IMPLICATIONS FOR THE EMPLOYER

The employer has various reporting and tax withholding obligations that need to be complied with, as outlined below:

Reporting obligations: Upon the launch of a stock option scheme, the employer is required to notify the Inland Revenue Board (IRB) via the submission of a prescribed form, Form BT/MSSP/2012, within 30 days after the expiry of the period of acceptance of offer by the employees.

The form is to be accompanied by various supporting documents, including the by-law of the share scheme and a list showing the details



of employees who have accepted the offer to participate in the scheme.

Where an employee subsequently exercises his options to acquire the shares, the employer will need to inform the IRB accordingly. Such notification is to be made on an annual basis and in practice, the deadline to submit the notification is 31 January of the following year. For example, options exercised throughout the calendar year 2013 will need to be reported to the IRB by 31 January 2014.

Reporting of the benefits will also need to be made in the Form EA of the respective employee for the calendar year in which the options are exercised.

Tax withholding obligations: When an employee exercises his options, the employer is required to deduct the relevant tax from the employee's salary based on the Monthly Tax Deduction Schedule.

However, the employee may apply for an installment scheme from the IRB to settle the tax liability and in practice, a maximum of 12 monthly installments is generally allowed.

Alternatively, the employee may opt to settle the tax liability by

himself upon filing his tax return for the calendar year concerned. If this option is pursued, the employee is required to make the election in writing and furnish this to his employer and once this is done, the employer is absolved from withholding obligations on this matter.

CHALLENGES FOR EMPLOYER

Managing a share scheme effectively can pose several challenges, particularly if it involves the shares of an unlisted company. Also, share schemes involving cross-border assignments add to the complexity of determining which country has the taxing right as well as the chargeability of the benefit.

Shares of an unlisted company:

Under the ITA, the benefit arising from share options is determined by reference to the "market value" of the shares at two different dates, i.e. the date on which the option becomes exercisable and the date of exercise.

For shares in a listed company, the law provides that the market value is ascertained by averaging the highest and the lowest price of the shares

for the day and such information is readily available.

In the case of shares in an unlisted company, however, the market value shall be the net asset value of the share for the day. As prescribed by the IRB, the net asset value is to be based on the audited accounts of the unlisted company on the relevant dates, and management accounts will not be accepted. This causes great difficulty for companies to comply with and may ultimately hamper the implementation of such share scheme.

Cross border assignments: There are various taxation issues that need to be considered for cross border employees undertaking assignments to or from Malaysia, who hold shares or options under a stock option scheme. In a cross border assignment, stock options may be taxable in more than one country and the taxation rules may differ from country to country.

For example, stock options granted to an employee while working in Malaysia may be exercised by the employee at a time when he is on secondment overseas. In this case, the benefit arising from the exercise of the stock option may be subject to tax in both Malaysia and the overseas country.

The determination of the amount to be taxed in each country could pose a difficult issue since different countries adopt different taxation rules. Where the incidence of double taxation arises, relief can be sought pursuant to the tax treaty concluded by Malaysia and the foreign country.

CONCLUSION

Stock options have proven to be a popular vehicle to incentivise employees to remain loyal to their employer and to contribute to



the long-term growth of their businesses.

Stock options are generally considered to be part of the employee's remuneration package and constitute taxable income. As such, it is important for the employer and employee alike to be well versed with the applicable tax law governing stock options to ensure full compliance with the reporting and payment obligations to avoid the imposition of penalties.

In Malaysia, there are specific provisions in the ITA that deal with the timing of taxation as well as the computation of the stock option benefit. However, unlike Australia as an example, we do not have specific legislation to determine the taxing rights over share schemes of cross-border employees.

In practice, the IRB's approach is to allocate stock option income by using the following formula:

Stock option benefit from date of offer to exercisable date

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Number of working days in Malaysia from date of offer to exercisable date

Total number of working days from date of offer to exercisable date

A double taxation risk arises where different sourcing rules are applied by different countries. Although relief can be obtained under the relevant tax treaty in this regard, such relief may not be given in full, depending on the tax law of the relevant countries.

Besides complying with the reporting and tax withholding obligations, the key challenge for the employer is dealing with the complex issues that can arise during the life cycle of a share scheme such as changes to regulatory requirements.

In cases of cross border assignments, the employer needs to carefully monitor the movement of employees and to track the grants to ensure compliance with the law in various jurisdictions. A good understanding of the tax law is essential as it provides planning opportunities to reduce costs, particularly where stock option income is tax equalised for cross border assignments.

The employee on the other hand, would also need to understand the tax impact to him in order to decide whether or not he should consider accepting the options. 

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