Project	**Agenda Decisions**
Topic	**Share-based payment awards settled net of tax withholdings–variation to the original fact pattern in Agenda paper 7**

Objective of the paper

1. Agenda paper 7, *Share-based payment awards settled net of tax withholdings* of March 2011 contains a fact pattern that illustrates the classification of a share-based payment transaction in which an 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 award for purposes of meeting the statutory income tax withholding requirements. This fact pattern is based on the original submission received by the Committee.

2. Agenda paper 7A contains a variation to that fact pattern included in Agenda paper 7 and is provided for the convenience of Committee members so that they can contrast the staff's different approaches on the classification of a share-based payment transaction when an entity withholds a specified portion of the shares to satisfy the employee's tax obligation.

3. The aim of this paper is not to take an alternative view on how the issue submitted to the Committee might be solved under IFRS 2 *Share-based Payment* or answer other questions that were not asked to the Committee in the original submission. The aim is just to introduce a variation to the original fact pattern developed by the staff so that the Committee members can see how this variation might lead to a different classification.

4. Consequently, because the variation included in this paper does not reflect circumstances of the original submission received by the Committee, the staff is not asking Committee members to give their views on how to proceed on them.

5. The following section includes the staff's variation of the original fact pattern.

Variation to the original fact pattern

6. The staff have developed the following fact pattern (shown in the following page). Differences from the original fact pattern (included in Agenda paper 7) are shown in **bold letters.**

On 1 January 20X0 Entity D grants 100 share options to one of its employees subject to a three-year service condition. Entity D estimates that the employee will complete his service period.

At grant date, the fair value of each share is CU 3 and the fair value of one option is CU 2. Subsequent to vesting, the share options will be exercisable at any date until 31 December 20X3 at an exercise price of CU 3. At the end of the vesting period, the options vested and the employee exercised the options. The fair value of one share at exercise date is CU 20, thus the intrinsic value (ie the difference between the share price and the exercise price) per option at that date is CU 17 (CU 20 – CU 3).

The employee has the legal obligation to pay 40% income tax on employee awards when exercised. The calculation of the tax obligation is based on the intrinsic value of the option at the exercise date, so the tax obligation for the 100 options exercised is CU 680 (CU17 x 40% x 100).

Entity D is obliged by tax law to withhold from the employee's taxable compensation for the period the tax obligation imposed on the employee and immediately remit to the tax authority, in cash, the amount of the tax obligation. Therefore, **Entity D has elected, through the provisions of the share-based payment award, to issue a gross number of shares to the employee (100 shares) and instantly direct a broker to sell in the market the number of shares required to settle the tax obligation** (34 shares=CU 680/CU 20). **Entity D will pay the amount of the employee's tax obligation by using the cash proceeds remitted by the broker (CU 680). There is no shortfall in the proceeds received from the sale to cover the tax payment.**

Under the terms of the share-based payment arrangement between Entity D and the employee, **Entity D will settle the transaction gross** by receiving CU 300 from the employee for the exercise price, **issuing 100 shares. 66 of the shares are delivered to the employee and the other 34 shares are delivered to the broker. The proceeds from the sale of the shares by the broker of CU 680 are remitted** to the tax authority on behalf of the employee.

How should Entity D classify this transaction in accordance with IFRS 2 *Share-based Payment*?

Staff analysis of the fact pattern

Transactions identified

7. The fact pattern included in this paper is **similar** to the fact pattern included in Agenda paper 7 in the following aspects:

   (a) Entity D, receives identifiable services from an the employee and grants an employee a share-based payment award (in the form of share options)

   (b) after the share options have vested, the employee exercises all options (CU 300); and

   (c) Entity D pays on the employee's behalf to the tax authority cash to satisfy the employee's tax obligation (CU 680).

8. The fact pattern included in this paper is **different** from the fact pattern included in Agenda paper 7 because:

   (a) Entity D satisfies its obligations under the share-based award **by issuing and transferring a gross number of the shares granted** (100 shares), instead of issuing a net number of shares to the employee and withholding a number of shares needed to equal the monetary value of the employee's tax liability. 66 of the shares are delivered to the employee and the other 34 shares are delivered to the broker.

   (b) Entity D **directs a broker** to sell a portion of the shares (34 shares) in the market to fund the employee's tax obligation

   (c) **Entity D is not using its own cash resources** to satisfy the employee's tax obligation, but instead, is using the cash proceeds remitted by the broker to satisfy the employee's tax obligation.

Principal and agent analysis

9. In the staff's view, Entity D acts as:

   (a) a *principal* in fulfilling its obligation to pay for services received from the employee. Entity D issues and delivers 100 shares (instead of in two parts, shares and cash, as in the original fact pattern presented by the staff –refer to paragraph 15 in Agenda Paper 7).

(b) an *agent* in:

(i) delivering 34 of the shares to the broker, on behalf of the employee to sell the shares needed to satisfy the employee's tax obligation and

(ii) remitting the cash received from the broker on the sale of those shares to the tax authority to settle the employee's tax obligation.

Price-risk analysis

10. Some could argue that Entity D is not bearing any risk in respect of the sale of shares (eg share price fluctuations, credit risks, etc) as the shares needed to settle the employee's tax obligation are sold in the market via an independent, third-party brokerage firm and Entity D remits from the payments received by the broker, the payment to the tax authority.

Staff application of IFRS 2 to the fact pattern

Classification under IFRS 2

The focus in IFRS 2 is the manner of settlement

11. As stated in paragraphs 20 and 21 of Agenda Paper 7, the classification of share-based payments by IFRS 2 is driven by the manner of settlement. In the fact pattern analysed in this paper, the share-based payment transaction is settled entirely in shares. In addition, Entity D facilitates the sale of some shares on the market to meet the employee's tax obligation. No shares are withheld by the entity; instead, all the shares are issued. The manner of settlement is wholly through issue of equity instruments and therefore, in accordance with IFRS 2 the transaction should be classified as equity-settled in its entirety.

Price risk analysis

12. Similar to the staff's conclusion for the original fact pattern, the staff conclude that the fact pattern should not be analysed in accordance with a price-risk approach (analysed in paragraph 10 above) as the focus of IFRS 2 is the manner

in which the transaction is settled. Consequently, in the staff's opinion, IFRS 2 does not apply a risk-based approach to classification.

Staff recommendation

13. In conclusion the staff think that:

    (a) consistent with the definitions of equity-settled share-based payment transaction included in Appendix A of IFRS 2, the manner of settlement determines the classification of an award on a share-based payment transaction in accordance with IFRS 2. The staff thinks that IFRS 2 requires that a share-based payment settled in equity instruments (shares) to be classified as equity-settled share-based payment transactions.

    (b) two actions of the entity are being fulfilled:

        (i) the entity is fulfilling its obligation to pay for the services received from the counterparty. The entity is paying for the employee's services by the issue of equity instruments only. The entity is acting as a *principal* in this respect.

        (ii) the entity is acting as *agent* on behalf of the employee in:

        - facilitating the sale of shares through a broker-assisted cashless exercise settlement arrangement and
        - transferring cash received from the broker to the tax authority to satisfy the employee's tax obligation.

14. The staff believes that the existing guidance in IFRS 2 is sufficient to reach these conclusions.