



# The Irish Accounting & Tax Summit 2020

## Session 4

### Employee Share Ownership Pools ("ESOPs") – Tax & Commercial Considerations



### Presenter:

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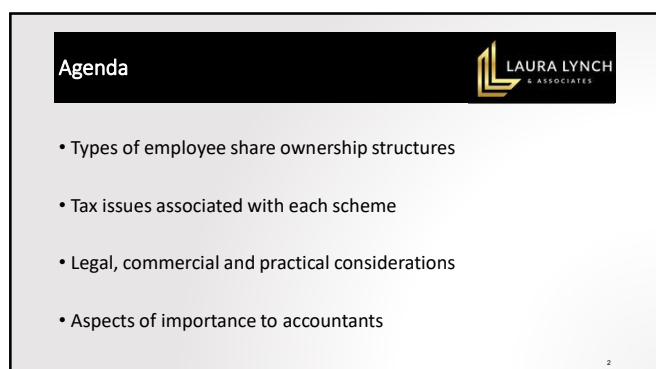
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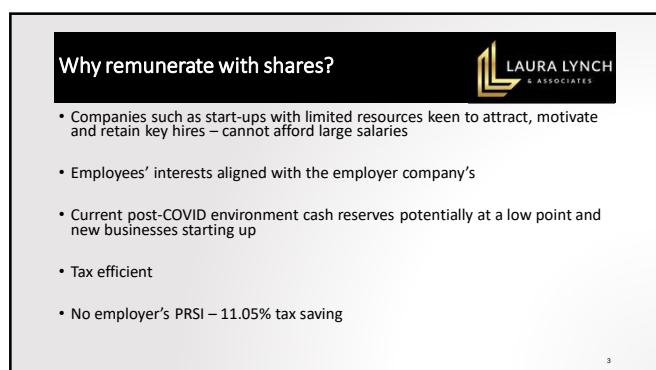
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LAURA LYNCH  
& ASSOCIATES

## Employee share schemes – basic principles

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**Types of employee share schemes**LAURA LYNCH  
& ASSOCIATES

- Restricted shares
- Share options – unapproved
- Share options – KEEP Scheme
- Growth (flowering) shares
- Quasi-shares - RSUs and phantom shares

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**Employee share schemes – tax issues**LAURA LYNCH  
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- Tax on market value at date of share issue
- Employer reporting and tax payments – everything except share options
- Employee reporting and tax payments – unapproved share options

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## Restricted shares

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**Restricted shares – how they work**

- Shares are issued to employees upfront
- Potentially lower market value than shares issued at a future date
- Shares retained in a trust structure
- “Clog on disposal” – restricted from disposing of shares within certain timeframe
- Reverse vesting and good/bad leaver provisions

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**Restricted shares – tax aspects**

- Tax on market value at date of share issue
- Clog on disposal discounts
  - 1 year 10%
  - 2 years 20%
  - 3 years 30%
  - 4 years 40%
  - 5 years 50%
  - 6+ years 60%

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### Restricted shares – example



• Employee 1 is issued 100 shares in Widgets Limited when they are worth €300 per share in 2020. She is required to pay €0.01 per share. She cannot sell the shares for at least 3 years.

Restricted shares	Year of issue	No. shares	MV on issue	Issue price €	Period of clog (Yrs)	Clog % discount	BIK €	Tax @ 52%
Employee 1	1	100	30,000		1	3	30%	20,999

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### Restricted shares – example



• There is an exit opportunity in **Year 4** for €1,500 per share

• CGT calculation:

MV on exit	€150,000
Base cost	(€21,000) = taxed BIK in Year 1
Gain	€129,000
CGT @ 33%	€42,570

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### Restricted shares – example



• There is an exit opportunity in **Year 2** for €1,500 per share.

- Recalculation of BIK €30,000 \* (30%-20%) = €3,000 extra
- CGT calculation

Sales proceeds	€150,000
Base cost	(€24,000) = recalculated BIK
Gain	€126,000
CGT @ 33%	€41,580

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### Restricted shares – reporting



- Taxable through PAYE system – employer to remit to Revenue
- Collect from employee through payroll
- Further BIK if not fully repaid by 31 March of following year- deemed loan to acquire shares

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### Share options

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### Unapproved share options – how they work



- Option to acquire shares in employer company in future at pre agreed option price
- Discount on market value
- If option price > market value: “underwater”

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### Unapproved share options – tax aspects



- No tax on date of grant if cannot exercise after 7 years
- Income tax payable on exercise - market value minus price paid
- Employee pays 52% RTSO within 30 days of exercise – ROS procedures
- CGT on future sale of shares (limited if sold shortly after exercise date)

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### Unapproved share options – example



- Employee 1 is given an option to acquire 100 shares in Widgets Limited at their nominal value of €0.01 per share. They can exercise their option between 3 and 7 years after the date of grant. There is an exit opportunity in Year 4, at which stage they decide to exercise their option. The shares are worth €1,500 per share on that date.

Unapproved share option scheme	Year of exercise (exit date)	No. shares	MV on exercise	Exercise price €	BV €	Tax @ 52%	MV on exit	Tax @ 33% on gain	Net proceeds	Total tax
Employee 1	4	100	150,000	1	149,999	77,999	150,000	0	72,001	77,999

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### Unapproved share options – practical issues



- Employer company and employee enter into an option agreement
- Tax due within 30 days
  - Exercise usually aligned with exit opportunity
  - Practical issues for SMEs with no ready market for shares
- Higher tax but commercially maybe more attractive for employer – underperforming employees hold options, not shares

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### Unapproved share options – reporting



- Employee is a chargeable person for that tax year – file Form 11
- Employer files Form RSS1 by 31 March of following year

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### KEEP Scheme



- Key Employee Engagement Programme ("KEEP")
- Introduced in FA 2017 – tax efficient share option scheme for employees/directors of SMEs
- Qualifying options granted from 1 January 2018 to 31 December 2023
- Income tax, USC and PRSI exemption on share option gain on exercise
- Growth subject to CGT (currently 33%) on disposal
- Aligns cash receipt with tax charge

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### KEEP conditions - employer



- Ireland / EEA incorporated and Irish resident or carrying on a business in Ireland through a branch or agency
- Must be carrying on trading activities other than excluded activities such as:
  - Professional services
  - Financial activities
  - Dealing in and developing land, building and construction
  - Forestry
  - Coal, steel and shipbuilding
  - Adventures or concerns in the nature of a trade

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### KEEP conditions - employer



Date of grant conditions:

- The company must be an SME:
  - Less than 250 employees,
  - less than €50m turnover, and / or
  - less than €43m balance sheet
- Total market value of issued but unexercised qualifying **options** must be less than €3m
- Issue – how to value the options?

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### KEEP conditions - employer



Conditions throughout “relevant period” (date of grant to date of exercise):

- The company must be unquoted, other than Irish Enterprise Securities Market (ESM) or its equivalent in EEA / DTA country
- It cannot be a company in difficulty under EU State aid rules

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### KEEP conditions – holding companies



- Business must consist wholly or mainly of holding shares in a qualifying subsidiary or subsidiaries (more than 50% ownership)
- Holdco cannot carry on a trade
- Cannot be controlled by another company

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### KEEP conditions - employee



Throughout the option period to date of exercise:

- Must work at least 20 hours per week for company/group or not less than 75% of their working time to that company/group
- Office / employment capable of lasting more than 12 months
- Working time conditions satisfied if share options exercised within 90 days of leaving office / employment of the qualifying company
- Cease to be qualifying individual if, together with connected parties, directly or indirectly becomes beneficial owner of more than 15% of the ordinary share capital during option period

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### KEEP conditions – limits on relief per employee



- Market value of all shares in respect of which qualifying share options have been granted by the qualifying company to an employee or director cannot exceed:
  - €100,000 in any one tax year,
  - €300,000 lifetime limit, or
  - 100% of the annual emoluments of the qualifying individual in the year of assessment in which the qualifying share option is granted.
- Limits the scope of the relief where employees earn a relatively low salary in a company with high-growth potential

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### KEEP conditions - options



- Ordinary, fully paid up shares in qualifying company
- No preferential current or future rights to dividends, assets on winding up or redemption
- Option price at date of grant cannot be less than market value of shares on that date
- Written contract setting out number and type of shares, option price, exercise period

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### KEEP conditions - options



- Options cannot be exercised within 12 months of grant other than in limited circumstances
- Options cannot be exercised more than 10 years after date of grant
- Options granted for bona fide commercial purposes

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### KEEP Scheme – FA 2019 changes



- Extension of the relief to companies who operate through certain group structures
- Provision to allow part time employees to qualify for relief and facilitate movement between group companies
- Extension of the relief to existing shares as well as new shares
- Awaiting Commencement Order as they are subject to EU State Aid rules

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### KEEP Scheme challenges



- Relatively low uptake due to onerous and complex conditions
- Main issues associated with valuing the options – call for safe harbour rules

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### KEEP conditions – what if?



- Widgets provides architecture services
- Current market value of a share is €2, option price is €1
- Options granted on 1 January 2020 can be exercised before 31 December 2020
- Her salary is €40,000 and she can acquire options over €50,000 worth of shares
- Due to market conditions, the value of the shares on exercise entitles her to 15.1% of the company post-exercise
- Carla falls in love with Patrick and marries him before exercising her options. She exercises them to generate cash to pay for the honeymoon
- Due to a mix-up between the accounts and HR department, the company's reporting submission is delayed until 6 April of the tax year following exercise

**RESULT – INCOME TAX, PRSI AND USC ON EXERCISE**

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### KEEP scheme – example



- Widgets Limited is a start up company that needs to hire a brilliant new engineer. They have limited cash reserves but great potential.
- They offer Carla a modest salary of €40,000 p.a., along with an option to acquire 100 shares in the company.
- Option period between 12 months and 5 years from date of grant.
- Market value at date of grant €100 per share (i.e. €10,000).
- In Year 3, Carla exercises her option when shares worth €1,000 per share.
- Option price paid €10,000 for shares worth €100,000.
- BIK €90,000 exempt from income tax, PRSI and USC.

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### KEEP scheme – example



- Maximum share options:
  - €100,000 in 2019
  - €300,000 lifetime, or
  - €40,000, being 100% of annual emoluments in year of grant

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### KEEP – example (CGT)

- Carla sells shares later that month for €100,000
- CGT @ 33% on sales proceeds minus €10,000 exercise price.
- CGT calculation:

Sales proceeds	€100,000
Base cost	(€10,000)
Gain	€90,000
CGT @ 33%	€29,700
- Tax saving €90,000 @ (52% - 33%) = €17,100



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### KEEP Scheme – practical issues

- Several group structures still do not qualify
- Limits on value of share options which can be granted
- Practical issues associated with valuation methodology and disqualification of the scheme if an employer gets it wrong
- Creating liquidity for scheme shares and impact for family run companies
- Alternative – CGT treatment for share buybacks of KEEP shares



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### KEEP – practical issues

- Trading requirements potentially deny the relief to R&D companies in high tech sectors
- Very limited application to family companies or couples who work for the same employer
- Practical issues for valuing private companies
- Creating liquidity for scheme shares – CGT treatment on share buyback
- Shares acquired under company reorganisations and reconstructions not legislated for
- Interaction with entrepreneur relief and holding periods



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## Other share schemes

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## Growth (flowering) shares

- Non-voting, generally valueless shares that are issued upfront.
- Share issued at market value, albeit very low value, there is no or minimal benefit in kind on issue.
- The shares only acquire value if certain pre-agreed hurdles are achieved, such as a pre-agreed business milestone or exit at a certain value.
- If the hurdle is not achieved, the shares remain worthless.
- If the hurdle is achieved, the shareholder will receive value for their shares on an exit.
- More complex to implement given bespoke nature of scheme.

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## Other employee share schemes

- **Quasi-shares** - non-dilutive equity risk capital. Return based on the performance of the company. Examples include:
  1. **Restricted stock units (RSUs)** – no Irish legislation (MNC concept)
    - Tax treatment set out in TDM <https://www.revenue.ie/en/tax-professionals/tdm/share-schemes/chapter-02.pdf>
    - Employee taxed through the PAYE system when RSUs vest – vesting usually occurs around the time of a realisation event such as exit from the company.
  2. **Phantom shares** - cash payment to an employee when a realisation event occurs such as an exit opportunity for other shareholders.
- **Tax treatment** - all non-option type share schemes taxable through PAYE system

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Why choose.....



- Shares upfront with clog on disposal?
- Unapproved share option scheme?
- KEEP scheme?
- Growth shares?
- RSUs?
- Phantom shares?

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Valuing shares



- Discount for
  - Non-voting rights
  - Lack of liquidity
  - Stage of company life cycle
  - Minority interests
- Clog on disposal discounts
- Forfeiture provisions
  - Not taken into account at date of issue
  - Refund of income tax paid on acquisition of shares under a bona fide written agreement

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Valuing shares – Revenue Guidance



- “The value of a shareholding in an unquoted company depends on many factors.
- For example, the value will depend on
  - the business sector/industry
  - the net assets of the business
  - the profitability of the business
  - its future prospects in the marketplace.
- Revenue expects that in valuing the shares the company should use a valuation method which complies with relevant accounting standards.
- Revenue will not provide an opinion regarding company specific share valuations”.

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Helpful resources and links


- TDM for valuing shares in private companies  
<https://www.revenue.ie/en/tax-professionals/tdm/capital-acquisitions-tax/cat-part21.pdf>
- Revenue share schemes manual(note: KEEP manual not yet updated for FA19 changes)  
<https://www.revenue.ie/en/tax-professionals/tdm/share-schemes/index.aspx>

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Summary


- Share schemes – tax on all except share options collected through PAYE system; cashflow issue for employer company
- Restricted shares – least tax but commercial issues associated with giving shares upfront
- Share options – marginal rate of income tax on future market value
- KEEP scheme – very tax efficient but very difficult to satisfy all conditions

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Questions?


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