TAXATION OF SHARE-BASED REMUNERATION

Tax Strategy Group – TSG 16/08

19 July 2016

An Roinn Airgeadais
Department of Finance

Tax Strategy Group Paper 16/09

Taxation of Share-Based Remuneration

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Introduction – Programme for Government Context

1. In the recently published Programme for a Partnership Government there is a commitment to explore the mechanisms through which Small to Medium sized enterprises (SMEs) can reward key employees with share options in a tax efficient manner.

2. In addition, share-based remuneration was highlighted as a specific area of interest in many responses to the consultative process undertaken by the Department of Finance last year to consider options for changes to the tax system to more effectively incentivise entrepreneurship.

3. In light of the Programme for Government commitment and the responses to last year's consultation, the Department decided to conduct a more detailed review of this specific aspect of taxation. The Department undertook a public consultation to invite submissions from interested parties on this issue. This public consultation process ran from Friday 20 May to Friday 1 July.

4. Over 30 submissions were received to this consultation and these are in the process of being reviewed in detail. This paper summarises the main issues raised, and outlines a number of options for future developments in this area of taxation.

Background

Current system

5. The tax system currently has a number of specific incentives which apply to certain types of share-based remuneration. These are:

    a. Approved Profit Sharing Schemes (APSS), with or without an Employee Share Ownership Trust (ESOT);
    b. Save As You Earn share option schemes (SAYE);
    c. Restricted Share Schemes.

    Further details on these schemes are outlined in Appendix 1. It should be noted that the details provided in this paper are intended to provide general information on these schemes only, and do not purport to be a definitive guide.

6. Under an APSS individuals can each receive shares up to a value of €12,700 per annum from their employer tax free, subject to retaining the shares for a minimum of three years. On a subsequent disposal of the shares, Capital Gains Tax (CGT) is charged on the profit over the market value on the date of appropriation. Shares under an APSS are often offered to individuals as an alternative to a cash bonus which would be subject to tax at the individual's marginal tax rate. ESOTs are Revenue approved trusts set up to acquire and distribute shares to employees and have been primarily used by semi-state bodies. An ESOT is usually used in conjunction with an APSS in order to appropriate shares to the employees.

7. In a SAYE share option scheme, employees save fixed sums out of net pay for a period of 3 to 5 years, with an option at the end of the savings period to buy shares in the company at a price not less than 75% of the market value of the shares at the date the option is granted. No liability to income tax arises on the discount from market value on the exercise of the share option. On disposal of the shares, CGT is charged on the profit over the price paid on exercise.

8. In general terms, Revenue approved share option schemes allow the value of the benefit received by an employee to be taxed as a capital gain when the shares are disposed of, rather than as taxable income at the time that the option is granted or shares acquired.

9. In a Restricted Share Scheme, where shares subject to a restriction on sale or "clog" are awarded or acquired by employees, the taxable value of the shares received is reduced by reference to the length of the restriction on sale.

   Where there is a genuine restriction or clog, the following percentage abatements on the amount chargeable to income tax apply:

No. of years on restriction of sale	Abatement
1 year	10%
2 years	20%
3 years	30%
4 years	40%
5 years	50%
More than 5 years	60%

   On disposal of the shares, CGT is charged on the profit over the price paid on acquisition, if any, with account also taken of any abatement on which income tax was paid at date of award or acquisition, where relevant.

10. Example:

   On 1 March 2013, an employee is granted an option to acquire 1,500 shares in his employing company at €1 per share. The option cannot be exercised before the expiry of 12 months from the date of grant. Under the terms of the share option agreement, the shares cannot be disposed of for a period of 3 years after the employee acquires the shares on the exercise of his option. The conditions for qualifying for a reduction in the amount chargeable to income tax are satisfied.

   The employee exercises the option on 2 March 2014 and acquires the shares, which are newly issued shares. The market value of the shares on that date is €2 per share.

   The shares are sold after the 3-year period expires and the sales proceeds are €6,000.

Capital Gains Tax

Sales proceeds		€6,000
Price paid by employee	€1,500	
Amount charged to income tax	€1,050*	
Cost of Option	NIL	
Total		€2,550
Capital Gain		€3,450
Personal exemption (if not already utilised)		€1,270
Chargeable gain		€2,180
Tax due at 33%		€719.40

*The shares cannot be disposed for a period of 3 years after they are acquired. This leads to a 30% abatement of amount chargeable to income tax. With no abatement, amount chargeable to income tax would be €1,500. With 30% abatement, this reduces to €1,050, i.e. 70% of €1,500.

11. Other types of share-based remuneration are generally subject to taxation as employment income in the normal manner. This includes share option schemes which do not come within the definition of the specific Revenue approved schemes listed above, and which are therefore sometimes referred to as "unapproved" share option schemes. In these schemes, where shares are acquired for a price below market value, the employee is liable to income tax, USC and Employee PRSI on the difference between the price paid and the market value of the shares at the date of exercise. On disposal of the shares, CGT is charged on the any increase in the value of the shares in the period between their acquisition and disposal. Further detail on the more common forms of share-based remuneration is contained in Appendix 2.

12. There is no charge to Employer PRSI on share-based remuneration. This can be a significant benefit to employers as Employer PRSI is charged at a rate of 8.5% for income under €376 per week and a rate of 10.75% for weekly income above €376, with the 10.75% rate being charged on the total income not just the amount in excess of €376.

Recent developments in Taxation of Share-Based Remuneration

13. There have been a number of changes to the tax treatment of share-based remuneration in recent years, including the following:

    - Relief for Approved Share Option Schemes (other than SAYE schemes as outlined above) was abolished where the gain from the exercise of the right is realised on or after 24 November 2010.
    - Employee PRSI and USC apply since 1 January 2011 to all share-based remuneration. However share-based remuneration continues to be exempt from Employer PRSI.
    - Relief to individuals in respect of interest on loans applied in acquiring an interest in a company, provided for in Section 248 of the Taxes Consolidation Act 1997 (TCA), was abolished for loans made on or after 8 December 2010 and phased out in respect of pre-existing loans.
    - Relief for new shares purchased on issue by employers was abolished with effect from 8 December 2010.

Policy Rationale

14. The Government is committed to encouraging employee financial participation (EFP). International research has shown that EFP can be effective in fostering partnership and increasing competitiveness and helping companies to attract and retain staff in a competitive international labour market. Improved competiveness of companies supports the creation and maintenance of employment. This in turn supports economic growth which benefits the economy as a whole.

15. However, taking the potential positive effects for the business in terms of productivity and growth of employee ownership set out above into account, it is also necessary to consider whether supports for share-based remuneration through the tax system are an appropriate use of available fiscal resources. It could be argued that there are sufficient trading benefits to support share-based remuneration without the need to supplement these with a tax support.

16. In evaluating tax expenditures, the question of what market failure a tax expenditure is addressing needs to be answered. This should be borne in mind when evaluating the tax treatment of share-based remuneration, both in considering the existing incentives and any potential new tax incentives. In addition, the rationale for the use of share-based remuneration may vary depending on the age or size of the company and it may not be the case that a single solution would be optimal for every company type.

Gender and Equality Considerations

17. The taxation of share based remuneration is not affected by gender insofar as individuals' gender does not influence how they are taxed. Further details on gender aspects of the personal tax system can be found in the Income Tax and USC TSG Paper, 16/07.

18. The existing APSS and SAYE share schemes contain equality of access provisions, requiring that the schemes must be made available to all company employees and directors on similar terms. Such provisions can however limit the use of share schemes by employers, who may wish to target the use of share schemes at key employees who make a particular contribution to business development or profitability, or who can meet a specific skill requirement experienced by the company.

19. The potential wider economic benefits of allowing a targeted or 'key employee' share-based remuneration relief, including the contribution it may make to the longer-term growth and stability of the business, must therefore be borne in mind when considering any changes to existing taxation provisions.

Other relevant factors

20. A review of share-based remuneration at this time is also timely due to a trend in some sectors towards the use of more share-based remuneration. For example, in the financial services sector there is a move away from annual incentives towards more long-term incentives, influenced by the EU Capital Requirements Directive (CRD) and the EU Alternative Investment Fund Managers Directive (AIFMD), with a view to supporting sustainable and stable business development.

Issues raised in the Public Consultation on the Taxation of Share-Based Remuneration

21. The Public Consultation on the Taxation of Share-Based Remuneration closed on 1 July 2016. While the submissions received are still at an early stage of review, the main themes raised are:

    - In the case of share option schemes which are not Revenue approved schemes, tax is due on the discount received by the employee at the time of exercise of the option i.e. when the shares are acquired by the individual. Where the shares are in a quoted company the individual has the option to immediately sell some of the shares at market value to pay this tax. However, where the shares are in an unquoted company there may be a limited market, or no market at all, in which to sell the shares. This can be particularly relevant to small start-up companies. Thus individuals may have to pay the tax liability using other net cash income, which can undermine the value to the employee of the share options received.

    - The rate of Capital Gains Tax (CGT) has increased from 20% to 33% in recent years, and some submissions questioned whether Revenue approved share option schemes or restricted share schemes are still a viable incentive mechanism given the increased CGT rate.

    - Currently, the Revenue approved APSS and SAYE schemes require that the schemes are available to all employees on similar terms. It has been suggested that entrepreneurs require flexibility to target incentives to key employees only and that the schemes should be amended to allow for this.

    - The relative attractiveness of Ireland's treatment of share-based remuneration as compared to that of other jurisdictions competing to attract the same pool of skilled workers was also raised in some submissions.

International Comparisons

22. In relation to the Irish system, in 2014 officials from the Department of Finance took part in a European-wide project on "Promotion of Employee Ownership and Participation". During the course of the project it was identified that Ireland compares very favourably with other European countries in terms of the supports it offers to encourage Employee Financial Involvement.[1]

23. Schemes in competitor jurisdictions highlighted in submissions to the public consultation include the UK Enterprise Management Incentive (EMI) and the US Qualified Employee Stock Purchase plans (ESPP). A brief overview of the key features of these schemes is provided below.

UK EMI

- The EMI is a share option scheme available to companies with fewer than 250 employees and gross assets not exceeding €30 million on the date the option is granted

- The EMI option must be granted for the purpose of recruiting or retaining an employee.

- No income tax or national insurance (i.e. PRSI) is chargeable on the grant or exercise of the options once they are exercised within 10 years of their granting and the exercise price is at least equal to the market value of the shares at the date the option was granted.

- An individual can receive EMI options over shares with a value of up to £250,000 at the date of grant of option. The total market value of shares under EMI options granted by a company cannot exceed £3 million at any time.

- A capital gain arising on disposal of shares acquired via an EMI option may qualify for the UK's CGT Entrepreneur Relief, which provides for a reduced CGT rate of 10% subject to the conditions relevant to that scheme.

[1] The project lead to a published study titled 'The Promotion of Employee Ownership and Participation. Study prepared by the Inter-University Centre for European Commission's DG MARKT (Contract MARKT/2013/0191F2/ST/OP) Final Report 2014', available at http://ec.europa.eu/internal_market/company/docs/modern/141028-study-for-dg-markt_en.pdf

US ESPP

- A Qualified ESPP allows employees to purchase company stock at a discount from market value, without incurring a tax liability on the discount value at the time of purchase.

- Subject to certain exceptions, the ESPP must be made available to all employees of the US company. No employee can purchase more than $25,000 of stock in the plan in a calendar year.

- On disposal of the shares the discount value is subject to income tax and any capital gain is subject to taxation as a long term capital gain.

Options for Change

24. Possible changes to the tax treatment of share-based remuneration could be banded into two categories:

    1. Changes to the taxation of share-based remuneration under the existing Revenue approved schemes.

    2. Changes to the taxation of other forms of share-based remuneration

25. Possible changes might include:

    - Allowing existing Revenue approved schemes to have an element targeted at key employees.

    - For other forms of share-based remuneration, to postpone the tax charge on the acquisition of shares in an unquoted company by employees/directors until the value is realised on the date of disposal of the shares.

    - For both categories, introduce a reduced CGT rate for the disposal of shares acquired by employees/directors of a company. In this context it should be noted that there is a CGT Entrepreneur Relief that provides for a CGT rate of 20%, as opposed to the normal 33% rate, on qualifying disposals. However, it is possible that the requirement to hold not less than 5% of the company's ordinary share capital could render many individuals availing of share-based remuneration ineligible for the reduced rate.

26. As with all tax expenditures, EU State Aid regulations need to be considered in the context of any changes.

27. The views of the Tax Strategy Group on the current taxation of share-based remuneration and what, if any changes, should be made are sought. In the context of the limited fiscal space available for taxation measures, the group may also wish to consider whether the existing Revenue approved schemes should continue and whether the exemption from Employer PRSI on share-based remuneration should be reconsidered.

Appendix 1: Revenue Approved Schemes

28. There are a number of Revenue approved share schemes, **Approved Profit Sharing Schemes** (APSS) including **Employee Share Ownership Trusts** (ESOT) and **Savings Related Share Option Schemes** (SAYE).

Approved Profit Sharing Schemes (APSS)

29. An APSS generally involves a company allocating shares to its employees. Subject to certain conditions, the employees are exempt from income tax on the value of the shares received.

30. A company's APSS must be available to all employees and directors on similar terms. Shares can be purchased with a corporate bonus based on the company's performance; with an individual bonus based on the individual's performance/appraisal; by way of salary foregone provided the company also makes a contribution; or the company can fund free shares for the individuals. In the majority of schemes the acquisition of shares is funded by the employee's annual bonus. Where the acquisition of shares is funded by the employee's annual bonus, the employer calculates the bonus and pays it over to the scheme trustee who then purchases the shares.

31. A maximum of €12,700 per annum, including salary foregone, can be invested in respect of shares for an individual. The shares acquired are held in Trust for the individual.

Tax Implications

32. There is no income tax charge on the acquisition of the shares by the individual where they are held for at least 3 years. However, Universal Social Charge (USC) and Employee PRSI is chargeable on appropriation of the shares on the market value of the shares appropriated.

33. On disposal of the shares Capital Gains Tax (CGT) is generally calculated on the difference between the Market Value of the shares on acquisition and the sale proceeds.

Savings Related Share Option Scheme

34. A Savings-Related Share Option Scheme operates in conjunction with a Save-As-You-Earn certified contractual savings scheme. It involves employees saving for a period of three or five years under a contractual savings scheme, with a view to purchasing shares in the company allocated under the share option scheme.

35. The contractual savings scheme must be used only in conjunction with the share option scheme. The interest and/or bonus paid on these savings is exempt from income tax and Deposit Interest Retention Tax (DIRT), where relevant, is not deductible from any interest or bonus paid. The maximum monthly savings allowable is €500. Monthly contributions must be sufficient to secure, as closely as possible, repayment of an amount equal to the amount required to pay for as many shares as the individual has the right to acquire under the linked share option scheme.

36. Under the approved savings related share option scheme, employees and full-time directors are given a right to purchase shares at a fixed price at a particular time. The share option price cannot be less than 75% of market value at the date the option is granted. The shares purchased must be financed by the amount saved in the linked contractual savings scheme, including any interest or bonus paid. The schemes are open to all employees and directors on similar terms.

Tax Implications

37. The employee is not liable to income tax on the benefit received on acquisition of the shares – i.e. the difference between the market value on acquisition and the option price. The benefit is however liable to USC and Employee PRSI.

38. On disposal of the shares, CGT is calculated on the difference between the price paid on acquisition of the shares and the sale proceeds. In effect, this results in the discount value being subject to CGT on disposal of the shares, rather than income tax at the time the option is exercised.

Appendix 2: Share-Based Remuneration subject to Income Tax, USC and PRSI

39. In general, with the exception of the specific schemes mentioned in Appendix 1, the value of any shares received by an employee, or the value of a discount from market value on exercise of a share option, is liable to income tax, USC and PRSI in the hands of the employee.

40. In the case of share options, (other than share options granted under a Revenue approved scheme), on exercise of the option the employee is liable to tax on the difference between the option price and the market value of the shares. However, if the option is capable of being exercised more than 7 years after the date of grant, tax may also arise on the date of grant on the difference between the option price and the market value at the date of grant.

41. Other types of share-based remuneration, such as Stock Appreciation Rights (SARs) or phantom shares, may provide a benefit to an employee based on appreciation in the market value of a company's shares without the employee actually acquiring shares.

42. The following is a list of some of the more common types of share-based remuneration which fall to be taxed as employment income in the normal manner:

- Shares
- Restricted Stock Units (RSUs)
- Deferred Shares
- Stock Appreciation Rights (SARs)
- Phantom Shares
- Share options
- Convertible Securities
- Forfeitable Shares