Taxation of share based remuneration

Grant Thornton response to the Public Consultation conducted by the Department of Finance

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Introduction

Grant Thornton advise Start-ups, Small and Medium Enterprises (SMEs) and multinationals. We worked closely with our clients and the Dublin Commissioner for start-ups in drafting our submission.

The Programme for Government[1] outlines the government's commitment to explore mechanisms through which SMEs can reward key employees with share options in a tax-efficient manner.

The initiative is set out in the Programme for Government under the heading "tax reforms to keep Ireland competitive". Remaining competitive is particularly important for Ireland given the opportunities and threats to our economy arising as a result of the United Kingdom's vote to leave the European Union.

International and Irish research has indicated that Start-ups (rather than SMEs) account for a greater share of job creation[2].

When we talk about share options, we're really talking about how to attract talent. To become an innovation nation that can compete globally we need to be able to attract

1. *key talent to our startups*
2. *key founders to start companies in Ireland.*

And we're not just talking technical talent, we're talking about leadership roles like CEO, CRO, CMO, COO. Senior talent expects to be incentivized by both income and options from the outset and increasingly over time as the company scales.

There is currently no simple, tax efficient share ownership mechanism in Ireland that a startup can use to attract key employees from abroad, incentivise high performing employees to remain with the company, or attract local talent to leave better paying jobs e.g. at multinationals to join a startup.

The government needs to compensate startup employees for taking risk through share options. A simple, tax efficient, performance adjusted share option scheme will allow us to scale our most promising startups by bringing key Irish and internationally based global talent on board.

Niamh Bushnell, Dublin Commissioner for Start-ups

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1 A Programme for a Partnership Government, May 2016

2 1Lawless, Martina (2013), 'Age or Size? Determinants of Job Creation', Central Bank of Ireland Research Technical Paper, 2/RT/13; Chiara Criscuolo, Peter N. Gal & Carlo Menon (2014), "The Dynamics of Employment Growth: New Evidence from 18 Countries", OECD Science, Technology and Industry Policy Papers, No. 14, OECD Publishing.

There is a limited number of highly skilled technical workers available globally, Irish start-ups are competing for talent with established international companies with greater resources.

In an age where talented entrepreneurs are globally mobile, the tax system is a key mechanism for attracting and retaining entrepreneurs and enhancing output, employment, and tax revenue.

What aspects of the current system of taxation of share based remuneration are working effectively and why?

Revenue approved share schemes

Revenue approved share schemes facilitate broad employee ownership and provide a tax efficient means for multinationals and larger companies of remunerating employees as follows:

- no income tax charge on appropriation of shares[3];
- no employer PRSI; and
- a simple means of collecting and administering taxes via the PAYE system.

Unapproved share schemes

Unapproved share schemes provide a more flexible means of remunerating employees than Revenue approved schemes. The following measures make these schemes attractive to both employees and employers:

- the taxable value of restricted shares[4] awarded can be reduced by up to 60% with growth in the value of the shares after award being subject to capital gains tax (currently 33%) instead of marginal tax rates (currently 52%);
- restricted shares are particularly attractive to start-ups and SMEs where the value of the company is low on award of the shares with future growth anticipated and is a means of encouraging employees to share in the future growth of the company;
- forfeiture provisions[5] provide further flexibility to employers and provide a means of linking the award of restricted shares to a number of key reward metrics ;
- no restrictions on the number of shares/share options awarded to any one participant;
- none of the onerous and complex conditions attaching to Revenue approved schemes;
- revenue approval not required; and
- no employer PRSI.

[3] No income tax charge subject to certain limits. USC and employee PRSI still apply.
[4] S128D Taxes Consolidation Act 1997
[5] S128E Taxes Consolidation Act 1997

What aspects of the current taxation of share based remuneration are not working effectively and why?

Revenue approved share schemes

The current conditions attaching to Revenue approved schemes make these schemes largely unworkable for start-ups and SMEs. For example:

- the onerous and complex conditions attaching to these schemes;
- issues in valuing shares in start-ups and SMEs;
- providing a future exit mechanism for employees where there is no readily available market for the shares;
- the administrative burden of obtaining Revenue approval; and
- the cost of establishing these scheme.

Unapproved share schemes

Stock options

There are a number of issues with the current taxation of stock options:

- marginal tax rates (currently up to 52%) apply on the exercise of share options. Therefore, employees have to use their salary and/or other income or where possible sell sufficient shares in order to fund the taxes arising on exercise;
- selling stock options to fund the 52% income tax arising on exercise, depletes the employee's interest in the company, so that future capital appreciation can only be enjoyed on the remainder (i.e. 48%) of their original award;
- selling shares is not always possible where there is no readily available market for the shares in the case of private or start-up companies;
- Capital Gains Tax (CGT) (currently at 33%) applies on the disposal of shares; and
- employees are required to pay taxes due to Revenue within 30 days of exercise and to file personal tax returns which creates an additional administrative burden for employees. This is in contrast to other Irish share based remuneration whereby taxes due are collected via the PAYE system with no personal tax return obligation.

In the UK[6] and United States[7] there is no tax on the exercise of share options, and capital gains tax rates as low as 10%[8] (UK) and 20% (United States) apply on the disposal of these shares. These schemes are simple as there is no thinking involved for the employer.

The comments below by Niamh Bushnell, Dublin Commissioner for start-ups, reiterate the impact of the issues outlined above for start-ups:

"In a small company, I'll be taxed on share options at the same rate as regular pay even though I don't know if I'll ever receive them."

"I am better off joining a bigger company where I can pretty much guarantee my options are valuable and will result in a gain for me at some stage in the future."

"The tax burden of share options which is both income tax and CGT is too complex to manage and too onerous to make share options attractive day one. Startups are not using this tool from the toolbox - a critically important tool for talent attraction, that MNCs use all the time."

"Share options need to be awarded in a flexible way based on role, stage of development at joining, performance of employee/s over time."

Restricted shares

In relation to restricted shares awarded under Section 128D TCA 1997, employees are required to pay taxes at marginal tax rates (at up to 52%) upfront on a discounted taxable value (i.e. post 'abatement' or 'clog' discount) of the share award because of the restriction period imposed on the shares. Therefore participants have to use salary and/or other income to fund the upfront tax arising on award of shares, even if computed on the abated value as they do not have recourse to the shares during the restricted period. The upfront tax outlay can be a key stumbling block in encouraging employees to participate in such schemes as there no access to the share during the restriction period. Furthermore, an immediate tax charge arises on award irrespective of any future appreciation in share value. Implementation of trust arrangements for the restriction periods can also place a significant administration burden on the employer company when operating the scheme.

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[6] Enterprise Management Incentives (EMI) is a UK tax-advantaged share option scheme aimed at small entrepreneurial companies.
[7] Incentive Share Options (ISO) is a US tax-advantaged share option scheme
[8] Assuming the qualifying conditions for Entrepreneurs' Relief are met.

Shares awarded by multinationals

US multinationals operating in Ireland generally operate a number of US based share schemes such as employee share purchase plans (ESPP), Restricted Stock, Restricted Share Units (RSUs) etc. Under the current system the following key issues arise:

- they do not enjoy favourable tax treatment in Ireland;
- depending on the characteristics of the schemes, the taxation point can be different in Ireland to that envisaged under the US schemes which can make the foreign schemes unworkable in Ireland; and
- double taxation can arise for globally mobile employees on the award of various share based remuneration. The sourcing approach adopted by Revenue in relation to stock options[9] generally means that there is no double taxation on share options but this is not provided for in other share awards[10] which leads to double taxation, administration and cash flow difficulties until foreign tax credits are claimed via personal tax return filings.

Summary of current position

The programme for government sets out three criteria for share based remunerations should:

1 be workable for SMEs;

2 reward key employees with share options in a tax efficient manner; and

3 keep Ireland competitive with other jurisdictions.

The table below summarises the current system based on our commentary above under these three criteria.

	Workable for SMEs (administrative burden)	Key employees	Competitive with other jurisdictions
Revenue Approved Share Schemes	No - too difficult to administer.	No cannot offer additional shares to key employees	Offers tax relief but foreign based share schemes do not meet the criteria
Unapproved stock options	Yes	Yes	No 52% on exercise + 33% on disposal
Restricted shares	Yes	Yes	No 52% Up-front tax charge + 33% on disposal
United Kingdom	Yes	Yes	Yes
United States	Yes	Yes	Yes

[9] Irish tax applies on the gain arising on exercise but limited to Irish workdays over the vesting period and the other country generally applies tax by reference to workdays spent in that jurisdiction during the vesting period

[10] A “real time” foreign tax credit via payroll is provided for RSUs which provides some measure of relief

Evidence has shown that companies with employee financial performance perform better. If this is the case, is there a policy rationale for the tax system to support share based remuneration?

There is a policy rationale for the tax system to support share based remuneration. Taxation acts as an incentive to the take up of Employee Share Ownership (ESO) schemes and the financial participation of employees in ESO schemes [11] benefits the wider economy:

- firms in which employees have an ownership stake are more profitable, create more jobs and are better taxpayers than firms without ESO schemes;
- companies with ESO schemes do not relocate as easily and are strongly embedded in their local communities and region;
- ESO strengthens employees commitment to and identification with the firm, making the company more productive and more competitive;
- these schemes are likely to decrease absenteeism and labour turnover; and
- the Nuttall Review 2012 showed that these companies are more resilient in tough economic times.

The UK employee ownership index shows that companies with an employee share ownership outperform those companies which do not.

[11] The 2014 European Commission study on "The promotion of employee ownership and participation"

Does the rationale for use of share-based remuneration vary based on the size and/or age of the company? If so, what factors are relevant to:

i. Start-up companies
ii. Established small to medium enterprises
iii. Large established enterprises

The resources of Start-ups, SMEs and large companies are different.

SMEs and start-ups account for 68% of Irish private sector employment[12]. They face higher compliance costs due to their smaller size. The tax code recognises this by providing some specific supports to reduce the compliance burden and assisting cash-flow with less frequent filing and payment arrangements for certain taxes, exemption from the requirement to register for VAT where turnover does not exceed certain thresholds, use of the cash basis of accounting for VAT, and deferral of the preliminary tax due date[13].

The tax code does not provide specific supports to SMEs to reduce the compliance cost of share based remuneration.

As set out in 2 above taxing the exercise of a share option can cause cashflow issues as the tax must be funded by the employee. Talented employees that choose to work for a start-up are taking a risk and if there is no simple tax efficient share ownership mechanism for key employees then this limits the potential financial incentive to work for the start-up.

Large multinational companies implement broad employee share remuneration schemes. Multinationals maintain their original share based remuneration policy rather than adapting a new share based remuneration policy for each jurisdiction that they move to.

It would make sense to large multinationals if each jurisdiction had a consistent mechanism for taxing share based remuneration. For example employees in the UK and US are not taxed on the exercise of a share option but if a US company invests in Ireland Irish employees will be taxed on share options on the exercise of the option.

12 Irish Small and Medium Enterprises Association Facts http://isme.ie/advice/sme-facts-faq
13 Tax Strategy Group TAX AND ENTRPRENEURSHIP REVIEW 2015

Enforcing tax on the exercise of an option can lead to the sale of shares to fund the tax liability which is in essence dysfunctional behaviour.

Another issue with employees, particularly key employees with large shareholdings selling shares to fund the tax on the exercise of option is that it reduces market confidence and increases the number of shares for sale which can lower the share price for a listed multinational.

Is the existing exemption from employer PRSI for share-based remuneration an efficient use of the State's resources, or could this expenditure be more profitably employed in other forms of support for employment and/or enterprise?

Under the current regime there are no direct tax costs for the employer if they chose to offer share based remuneration to employees.

Although there are set up and implementation costs in the short term and management costs in the long term, a direct tax cost may be a critical disincentive for employers in deciding whether or not to implement a share-based remuneration.

In the event that employer PRSI were to be introduced, the cashflow costs to meet an employer PRSI liability would have to be considered at the date of grant. An estimation of the employer's PRSI liability together with estimating profitability/cashflow in the year of exercise/award may prove too uncertain to encourage a company to initiate or continue share based remuneration.

Accurate data is essential to the review and justification of tax incentives, but it is recognised that data must be collected efficiently in order to minimise the administrative burden for the employer and/or employee.

With this in mind the Department is seeking views on the most efficient way to collect data on share based remuneration. Options may include a stand-alone share remuneration return by the employer and/or employee, or inclusion in the company's annual tax return, or P35 employers' return.

Employees

Ideally we should have a system similar to the UK and US where there is no tax on the exercise of share options.

The administrative burden on employees to pay taxes and file personal tax returns should be minimal. If tax is payable on the exercise of an option it should be collected by employers via the PAYE system as is the case for other share based remuneration.

Employers

Under the current system employers are required to file various returns e.g. Form RSS1 (unapproved share options), Form SRS01 (SAYE scheme), Form ESSS1 (APSS), Form ESOT1 (ESOT scheme).

While the collection of accurate data in relation to the operation of various share schemes is important both for Revenue and for the industry, this should not be a significant time or cost burden for the employer. Consideration should be given to incorporating the key information into additional fields in the form P35/P30 returns.

Recommendations

The following are the key characteristics which we recommend should be incorporated into any new share scheme system:

- a share option scheme for start-ups and SMEs should be introduced in line with the existing UK EMI scheme to assist with job creation and to restore Ireland's competitiveness with other jurisdictions;
- the taxing point for unapproved share schemes (share options, restricted shares, RSUs etc.) should be on the ultimate disposal of shares when funds are available to fund the tax liability arising;
- the system should be flexible and adaptable to cater for foreign based share schemes and for globally mobile employees;
- share schemes should continue to remain a cost effective means for employers of remunerating employees. Therefore, the employer PRSI exemption should remain; and
- any system should be simple to understand and easy to administer. Therefore, the conditions attaching to such schemes should be concise, no Revenue pre-approval should be required, taxes should be collected via the PAYE system and data should be provided by employers via the annual P35 return.

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