

EMPLOYEE INCENTIVE SCHEMES

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INTRODUCTION

The purpose of this presentation is to give you a basic understanding of the types of employee incentive schemes that are available and how they operate. As the focus of the my presentation is employee incentive schemes for early stage companies I intend to devote the greater part of my time to share option schemes and deferred share schemes. I believe that in practice these are more likely to be of relevance to you though I will give some time to some other incentive schemes you may have heard about.

The purpose of employee incentive schemes is primarily to give a company a means of retaining employees as these schemes commonly restrict the participating employees from receiving a benefit thereunder until a pre-determined time in the future. A secondary purpose is to provide an additional means of remuneration which can allow smaller businesses to attract highly skilled staff where they might not otherwise be able to compete on purely cash terms with better resourced competitors. Thirdly, share plans align the interests of shareholders with employees and this can be a driver when growing the business. Obviously, with the downturn in the technology sector the attractiveness of share based incentive schemes has diminished somewhat particularly for employees who may have had the experience of participating in share option schemes with larger concerns and finding those options to be now “under water”¹. However, share incentive schemes will still, in the future, play an important part in the package of incentive measures used to attract and retain key employees. Naturally the prospects of

¹ (i.e. the option price per share is greater than the current market value of the company shares)

employees making a “windfall” on the flotation of a company on a stock market have now been dramatically reduced. The most likely market for shares acquired by employees under an incentive scheme will be through the more traditional route of a sale of the company or maybe a sale to other shareholders.

Before deciding on setting up a share incentive plan you need to decide what is the likely way participants will be able to access value for their shares otherwise your plan may back fire due to the fact employees will own a small illiquid shareholding. You also need to consider the reasons why you are setting up the plan. Is it a must have or a nice to have? For example, employees may be less enthusiastic these days about obtaining share rights which may never become valuable. Instead, they may prefer more salary. Also reflect on its longevity and the number of new shares which will be issued under it. It is usually sensible to plan the lifetime of the scheme in the context of your business plan, likelihood of future key hires, and terms in any shareholders’ agreements on the size of the share plan pool. You should plan to issue shares on a phased basis under the plan.

If you are raising money the vc’s will usually expect to see a share plan issue limit of something between 5-10%. Bear in mind that once employees are shareholders they have a right to attend AGMs, see your accounts and so forth. Depending on your plan it can be possible to ring fence these rights. I am now going to briefly run through some of the more common share plans we see in practice.

UNAPPROVED SHARE OPTION SCHEMS

What is a share option?

A share option is a right given to an employee to buy a share in the company at some time in the future at a price fixed on the date the option is granted (“Option Price”). If the market value of the shares increases, an employee can exercise the option at the Option Price which is then less than the market value of the shares at the time of exercise.

Principal Tax Consequences [See note at end]

- Where the option is granted on terms that it must be exercised within seven years of its date of grant, no income tax charge will arise on the grant of the option. However, if the option can be exercised more than seven years from the date of grant, income tax will be chargeable at the time of grant on the difference between the Option Price and the market value of the shares at the date of grant. For this reason most unapproved share option schemes require that options must be exercised within seven years of their date of grant and if not so exercised the options simply lapse.
- On exercise of an option under an unapproved share option scheme, income tax is chargeable on the difference between the Option Price and the market price of the shares when the option is exercised. An employee can now elect, on submission of a tax return, to defer the income tax charge arising on exercise until the shares are disposed of or for seven years (whichever is the earlier).
- On disposal of the shares, any gain in value in the shares between the date of their exercise and their disposal is subject to capital gains tax which is currently 20%.

In summary, employees who acquire options under an unapproved share option scheme face two principal tax events being, firstly, an income tax charge on the date of exercise of the option (which charge can be deferred as set out above) and a separate capital gains tax charge on the disposal of the shares. A separate income tax charge may arise on the date of grant if the option is capable of being exercised more than seven years after the date of grant, but, in a properly

drafted unapproved share option scheme options will be exercisable within seven years and this particular income tax charge will not arise.

Employees will frequently elect to defer the income tax charge arising on the exercise of an option, as they may not have available cash to discharge the income tax charge at that stage. However the amount of the income tax charge is fixed, being the difference between the market value of the shares at the date of exercise and the Option Price, and is taxed at the employee's marginal rate. If the value of the employee's shares drops between the date of exercise and their disposal or if there is no disposal within seven years the employee may be faced with a situation where he has insufficient or no funds from the shares to discharge the income tax charge.

Establishment/Operation Of Unapproved Share Option Scheme

Normally the board of directors of the company passes a resolution establishing a share option scheme and setting out the rules of the scheme. You will need to check if any shareholders' agreement require shareholder approval for establishment/implementation of a share option scheme. No formal documentation needs to be submitted to the Revenue Commissioners. The Company is free to frame its rules howsoever it wishes. Below is a typical scenario:

After the adoption of the scheme, the board of directors may, from time to time, grant options to eligible employees. The options may be conditional upon the employee continuing in service for specified periods and/or the achievement of certain targets. The number of shares covered by the option, the date(s) on which the option can be exercised (known as "vesting date"), the option price and any targets which must be achieved are commonly set out in an option agreement executed by the employee.

The rules usually provide that in the event that an employee leaves the employment of the company (or a group company) before the option has vested (i.e. becomes capable of exercise) then the option lapses. Where an employee holds “vested options” (i.e. options that have become capable of exercise) the rules normally provide that the employee is given a specified period in which to exercise his options, failing which the option will lapse and cease to be exercisable. Sometimes longer periods are allowed in circumstances where the employment ceases by reason of illness or death. Once options have been exercised, the employee becomes a shareholder in the company. If the company does not want former employees to hold shares in the company it may include provisions in its articles of association requiring such employees to compulsorily transfer their shares. I have dealt with this in more detail in my previous presentation on shareholders’ agreements.

The rules of an unapproved share option scheme commonly also provide what is to happen in a situation where the company is acquired by another party. In these cases it is common that those employees holding vested options must exercise their options and they would then sell their shares to the acquiring party. For those employees holding unvested options the share option scheme may give the board of directors a discretion in these circumstances to accelerate the vesting of unvested options thereby allowing, by concession, the holders of unvested options to exercise some or all of their options and they would then sell the resulting shares to the acquiring party. In other cases the rules of the share option scheme may require unvested options to be “rolled over” into equivalent options issued by the acquiring party. Because it is not possible to predict with certainty when putting a scheme in place whether an acquiring party will be agreeable to the accelerated vesting of unvested options, it is normally better to give the board of directors of the company a broad discretion whether to allow accelerated vesting (in whole or in part) or to require the options to be rolled over and, in either case, to give the board of directors a discretion to determine the terms on which such options will be accelerated or rolled over. It is

common to find that an acquiring party will not be disposed towards allowing accelerated vesting of options because this may in its view reduce the incentivisation of the employees who may obtain a windfall.

The responsibility for the operation of the share option scheme is normally vested in the board of directors who may delegate certain elements of day to day administration to a sub committee of the board (e.g. the granting of options within pre-defined limits, execution of option agreements etc.). Furthermore the board of directors may have the power to agree certain variations to the terms of the option scheme though certain matters which may adversely effect the option holders may require consent of the option holders.

Advantages of an Unapproved Share Option Scheme

Summary

- The company has broad discretion in setting the terms of the option scheme and, unlike revenue approved share option schemes, an unapproved share option scheme does not have to comply with specific revenue commissioner requirements. In particular, the company may set different eligibility criteria for different employees.
- No income tax charge on grant if option require to be exercised exercise within 7 years of the grant date.
- Income tax charge on exercise which can be deferred.
- Capital gains tax charge on disposal.
- Option can be offered to employees on a selective basis and on different eligibility criteria.

Revenue Approved Share Option Scheme

Since the passing of the Finance Act, 2001 it is been possible to have a revenue approved share option scheme. Under such a scheme employees will not be chargeable to income tax on the

exercise of an option. Capital gains tax will still be payable on the gain between the Option Price and the disposal price.

However, unlike unapproved share option schemes, in order to implement a Revenue approved share option scheme a number of conditions have to be met which include:-

- the company issuing the options must not be under the control of another private company;
- if the scheme imposes a service requirement it must not exceed three years and all employees/directors must be eligible to participate on similar terms;
- Options can be granted without the “similar terms” condition for “key employees” over not more than 30% of the total options granted under the scheme in the same year.
- A period of not less than 3 years must elapse between the date of grant of the option and date of disposal of any shares acquired on exercise of the option
- the shares must comply with certain conditions, in particular, they usually need to be widely held and subject to the same restrictions affecting all shares of that class.

DEFERRED SHARE SCHEMES

An alternative to share option schemes is a scheme whereby employees are permitted to subscribe at market value for shares forming part of a separate class of shares, which shares are typically initially non voting and carrying no rights to dividends or rights on a winding up. Because of these restrictions the market value of these shares can be quite low and more likely to come within the means of the employees. By allowing the employee to acquire these shares at their market value it removes the exposure to an income tax charge because there is no difference between the subscription price and the market value of the shares. Clearly if the shares are subscribed for by employees below their market value there is an exposure to income tax on the difference between the subscription price and market value of the shares.

After a period of time (typically three to five years) has elapsed; and subject to the employee continuing to be employed by the company throughout that period, the restrictions on voting, dividend and distribution rights are lifted and the shares become equivalent to the other equity shares in the company. Sometimes the achievement of specific targets or the impending occurrence of an event (e.g. a trade sale) are also necessary in order for the restrictions to be lifted.

When the employee disposes of the shares he will be liable to capital gains tax on the difference between the subscription price and the disposal price.

In addition in order to protect the company in the event of an employee leaving employment, these shares are typically redeemable for a specific period by the company at their subscription price thereby allowing the company to acquire such shares from an employee who leaves the employment of the company. Alternatively these shares can be subject to compulsory acquisition by way of requiring the employee to issue a transfer notice in respect of his share as I have described in my previous presentation on shareholders agreements.

As an incentive tool these plans may also include something of a disincentive as they contain a “winner takes all” approach. Under them if the employee has given long valuable service but leaves before the conversion event he will obtain nothing. Also there is a risk that these plans might be legislated against in a future Finance Act as their purpose is to ensure employees pay capital gains tax only on the profit they make (instead of income tax under an unapproved option plan).

OTHER TYPE OF SCHEMES

Approved profit sharing schemes (APSS)

Under an APSS a trust is established and at the same time the employer plans to set aside cash to be used to acquire shares. This can be by way of a profit sharing bonus scheme (but does not have to be). Where a profit bonus scheme arises an employee can elect to take his bonus in cash subject to deduction of PAYE and PRSI or may elect to have the bonus amounts paid to the trustees of the APSS who used the funds to acquire shares in the company. In addition employees may voluntarily apply a certain percentage (which is subject to limits) of their basic gross salary towards the purchase of shares in a similar manner. These funds are passed on by the employer company to the trustees of the APSS who acquire and hold shares in the employer company (or its parent company) for the benefit of the employees concerned. The trustees of the APSS must be Irish resident and must hold the shares subject to the terms of a trust deed. The shares must be held by the trustees in trust for a minimum of two years. Employees may dispose of the shares but will be subject to tax until the shares have been held for a minimum of three years since they were first allocated to the employee within the trust. An APSS requires Revenue approval and is subject to numerous other conditions (in particular, relating to the shares) and for this reason as well, as a greater establishment costs and their complexity, it may not be the most appropriate vehicle for an early stage company.

Employee Share Ownership Trusts (Esot)

An ESOT is a specific form of trust established under a trust deed in which requires Revenue approval. Under an ESOT shares in the company are acquired by the trustees and allocated to employees of the company over phased periods. Shares are normally distributed out of an ESOT to the trustees of an APSS scheme. The cost of acquisition of shares are normally funded by the employer company or, gifts of shares or borrowings. ESOTS to date have been generally established in semi state companies and due to their complexity and greater cost in their establishment and operation they are unlikely to be of relevance to early stage companies.

SAVE AS YOUR EARN SCHEME (SAYE)

An SAYE scheme is a scheme requiring Revenue approval under which an employee agrees to save a fixed sum over a pre-determined period with a selected savings institution and enters into a savings contract with that institution. At the same time options over shares in the Company are granted to the employee i.e. at a discount of up to 25% of the shares' market value at the date of grant. The general aim of the scheme is to permit the employee acquire shares at a discount and to enable the employee to exercise the option without having to borrow and/or having to sell some of the shares to finance the acquisition cost. At the end of the savings period the employee can take the proceeds as a tax free cash sum or can use the proceeds to pay the exercise price for the shares covered by the option. If the employee elects to acquire the shares there is no income tax liability on the exercise of the option.

As with most revenue approved schemes all employees and full time directors of the company who have been employed for a qualifying service period (which cannot exceed three years) must be eligible to participate in the scheme on similar terms. The options to be granted must be over shares in a private company which is not under the control of another private company. As in all Revenue approved schemes the shares need to comply with various conditions. SAYE schemes are usually found only in quoted companies or subsidiaries of quoted companies.

Phantom Share Scheme (PSS)

You may have heard of this curiously named type of scheme. In reality these are not share schemes but are effectively a cash bonus linked to company performance. An employee is notionally allocated an amount of shares (but is actually not issued shares or granted an option or other rights over shares) and if the value of these "shares" increases the employee will be entitled to a cash bonus equivalent to this increase. A PSS offers no tax advantages as payments made under APSS are liable to income tax and PRSI. However it may hold some interest for an

employer company which for whatever reason does not wish to allocate shares to employees or is not in a position to allocate shares in addition to those shares which are already subject to employee incentive schemes. It also creates a tangible link between the company's performance and the employees' bonuses.

RESTRICTED STOCK SCHEME (RSS)

An RSS scheme is a share scheme which can be used selectively for key personnel or can be established for all employees. A trust is established which is normally funded by the employer company and which acquires either existing or newly issued shares for the purpose of the RSS scheme. Participating employees are given allocations of shares under the scheme. These shares are held by the trustees and participating employees must agree that the shares are held for a fixed period before they are sold. If the employee acquires the shares free or at a discount the value of the shares to the extent so discounted is a benefit in kind of the employee taxable at income tax rates. However where the disposal of the shares are restricted as set out above the Revenue Commissioners grant a concession which operates to abate the benefit in kind charge on a sliding scale running from 10% where the shares are restricted for one year to 55% where the shares are restricted for a period in excess of five years. Other factors which may influence the length of the retention period are whether the scheme is an all employee scheme in which case the retention criteria may be predominant consideration. However where the RSS is primarily or exclusively an executive incentive plan there may be performance criteria included and the retention period may be shorter.

Revenue approval is not strictly required for the operation of an RSS. However where the revenue concession outlined above is sought the Revenue must be informed of the rules of the scheme and Revenue approval must be obtained.

SHARE SUBSCRIPTION SCHEME (SSS)

This describes a “once off” income tax deduction that can be claimed by an individual who subscribes for newly issued shares at market value in a company where that individual is an employer or director of the company concerned or a 75% owned subsidiary of the company. The maximum value of the shares which may be subscribed for is €6,348.69 (IR£5,000) which is a lifetime restriction. There are a number of conditions attached to this relief including:-

- the company must be Irish incorporated and Irish tax resident;
- the company must be a trading company or a holding company whose business consists wholly or mainly of holding shares;
- shares must be newly issued fully paid up and non redeemable;
- the shares must be acquired at their market value;
- if the shares are disposed of within three years all of the income tax relief granted will be withdrawn;
- the shares cannot be subject to any restriction other than those restrictions that attach to all shares of the same class;
- the shares must be issued for bona fide commercial reasons and not part of a tax avoidance scheme.

A person who acquires shares in this manner will be subject to CGT in the normal way on disposal of the shares.

Which even plan you choose to set up for your company will need to be carefully communicated to employees and administered. We find in practice that companies that are interested in these two areas are likely to reap greater rewards than those which don't.

If you wish to discuss any aspect of the foregoing in greater detail please feel free to contact my partner Fiona Thornton (telephone: 353-1-6610866 or email: fthornton@lkshields.ie) who is our specialist on employee share plans or myself.

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[Note: Under the Finance Bill 2003 options under an unapproved share option scheme which are exercised after 30th June, 2003 will be chargeable to income tax at 42% which amount must be paid within 30 days of the date of exercise.]

This memorandum is a summary for general information only. It is not a full analysis of the matters presented and may not be relied upon as legal advice.