The Consultative Committee of Accountancy Bodies-Ireland

Chartered Accountants Ireland
The Association of Chartered Certified Accountants
The Chartered Institute of Management Accountants
The Institute of Certified Public Accountants in Ireland

47/49, Pearse Street,
Dublin 2

Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2, D02 R583
taxpolicy@finance.gov.ie

24 June 2016

Consultation on the Taxation of Share Based Remuneration

Dear Sir/Madam

Please find enclosed our submission on the Taxation of Share Based Remuneration.

We look forward to participating in any follow up discussion on this submission.

Yours faithfully

Paul Dillon

Paul Dillon, Chairman, CCAB-I Tax Committee

Consultative Committee of Accountancy Bodies – Ireland

Taxation of Share Based Remuneration

CCAB-I Response to the Public Consultation conducted by the Department of Finance

June 2016

Introduction

Growing Ireland's economy has been paramount in the minds of the Government in recent months. Businesses in Ireland, particularly the Small Medium Enterprise (SME) sector, are keys to this success. We are all aware of the importance of foreign direct investment (FDI) in Ireland and it is widely recognised that the IDA has been very successful in attracting multi-national companies to this country. However, the FDI environment is getting more competitive and focus is switching to the SME sector where rebuilding and expanding the economy should be focused. The Taoiseach has even expressed a desire to make Ireland the best small country in the world in which to do business.

The SME sector is very diverse. It is estimated that there are approximately 200,000 SMEs in Ireland which accounts for 68% of Irish private sector employment and 52% of total employment[1]. In terms of pay and benefits, large and multi-national firms pay employees substantially more than SMEs and in the manufacturing sector, for example, it can be up to 25-30% more.

In order to grow the SME sector, key employees need to be attracted and retained. In 2015, 38% of SMEs cited talent constraints as significantly impacting company performance with 55% confirming that the availability of key skills is a significant threat to business growth[2]. SMEs are often unable to compete against larger corporations in terms of salaries and benefits and employees view large organisations as a more secure employment option with a better benefits offering. It is widely regarded that offering employees a range of incentives and benefits will enable SMEs to reward their employees appropriately and help retain the best staff.

A review[3] of employee engagement, commissioned by the UK Government in 2008 during the economic downturn, determined that organisations in the top quartile for employee engagement showed 18% better productivity, a 12% improvement in customer ratings, a 37% reduction in absenteeism, as well as being 16% more profitable than others.

Employees like to feel engaged and part of an organisation. Giving them a greater stake in the company they work for is a powerful way of aligning the interests of employees with that of the business. An employee who has a financial and personal stake in a company will be more vested in the company and take more responsibility for its success. Studies[4] have shown that employee ownership contributes to improved economic performance and growth for the

[1] Irish Small and Medium Enterprises Association Facts http://isme.ie/advice/sme-facts-faq
[2] Irish SMEs going for growth SME Pulse Survey, PWC 2015
[3] Engaging for success: enhancing performance through employee engagement, David MacLeod and Nita Clarke.
[4] Sharing Success. The Nuttall Review of Employee Ownership, July 2012.

company and increased economic resilience in tough times. Share plans promote greater employee engagement and commitment, drive innovation, lower absenteeism, creates a happier workforce and therefore there is less staff turnover and higher profitability.

It is important however that participation in companies does not lead to significant adverse tax liabilities for employees of SMEs or employers. There is some evidence that employees of SMEs are often paid less than their counterparts in multi-national companies. Adverse tax liabilities could be viewed as a disincentive to such employees and could harm the growth of the sector. This would not be in keeping with the policies outlined by the Government in its *Enterprise 2025* policy statement.

Overall we would concur with the view expressed in *Enterprise 2025* that:

> Share ownership has the potential to support the attraction and retention of talent, and to reduce fixed labour costs and capital requirements for high potential start-ups and scaling companies which are cash flow poor but have significant potential for capital appreciation. There is some scope to enhance the attractiveness of share-based remuneration in the Irish context.[5]

This consultation document provides a critique of the current system with a focus on SMEs and offers an alternative proposal. It also highlights the important role that SMEs play in contributing to the sustained growth of the Irish economy.

Possible improvements to the current system of taxation of share based remuneration

The current Irish tax regime for share incentive plans imposes restrictions on SMEs in particular. There are in essence two tiers of share incentive schemes; Revenue Approved Share Schemes which offer income tax reliefs to participants on receipt of shares and share schemes that are not approved by Revenue and participants suffer income tax and related charges on receipt of shares.

Therefore a company has two options when establishing a share scheme; either they seek approval from the Revenue Commissioners (Revenue) and operate schemes such as Approved Profit Sharing Scheme (APSS), Employee Share Ownership Trusts (ESOTs) or Savings Related Share Option schemes (SAYE) or they give shares to their employees within a scheme that is not approved by Revenue.

[5] *Enterprise 2025 Background Report*, November 2015, at page 215

With specific regard to the SME sector, Revenue Approved Share schemes impose a number of conditions which are not appropriate for most SMEs.

For example in SAYE schemes, public and private companies may establish the scheme but the options in a private company must be over shares in a company not under the control of another private company. This is often a difficult condition to meet as many Irish SMEs hold their businesses in a group of companies.

Practical difficulties arise in APSS for SMEs in relation to valuation of the shares and providing a ready market for the shares. Companies can, subject to restrictions and conditions, buy back their own shares which can provide a market for shares but this is in a limited number of circumstances.

Both SAYE schemes and APSS also require that participation in the scheme should be on similar or common terms across the workforce. For SMEs which are seeking to use share based remuneration as a tool to recruit or retain employees with specialist skills or senior management, this requirement prevents them from targeting delivery of share based remuneration to those groups of employees which will value it most and which can best drive improved performance and growth for the employer. We suggest that this requirement for delivery of APSS and SAYE awards on common terms could be removed which could broaden the potential scope of application of these existing schemes.

The scope of application of these existing reliefs could also be broadened in their potential application to SMEs by extending the scope of the eligible awards to Restricted Stock Units (RSU) or share based awards that can be delivered in cash (e.g. where it is not practicable to create a secondary market for non-listed SME shares).

In fact, few schemes have actually being set up due to the complicated nature of certain conditions and the process of getting Revenue approval makes it more difficult for SMEs to establish such schemes. It is proposed that the Revenue approval requirement is abolished and replaced by a Revenue notification process.

At a minimum, it would be very welcome if Revenue could develop jointly with taxpayers pro forma and simplified models for valuation of company shares. The idea would be that, especially in the case of SMEs, companies using pre-approved templates and methodologies to value share based awards could do so with confidence that the valuations would be accepted by Revenue. This approach could reduce the complexity of share valuations and reduce one of the main administrative costs and barriers to wider delivery of share based awards.

In respect of the share schemes that are not approved by Revenue and are in reality share based remuneration, from the employee perspective, on the grant of shares to an employee (or on the exercise of share options), a charge to income tax (often at marginal rates), USC and Employee PRSI arises in the hands of the employee.

The employee is immediately faced with having to raise the funds to pay the tax liabilities. Where the shares are granted in a PLC, this may not pose as big of an issue as the employee can simply sell a portion of the shares to fund the tax liability. In the SME sector however, unless there is a sale of the business or an internal market for the shares, such an option is not available and the employee is faced with potentially a cash flow issue.

Revenue approved share schemes do not trigger an income tax charge in similar circumstances. However USC and employee PRSI is still due which remains a cost for the employee.

While the abolishment of Employer PRSI on share based remuneration was a welcome change, the cash flow issue for employees in the SME sector is particularly apparent.

Employers may seek to mitigate the upfront cash flow costs for employees which is associated with the take up of share based awards by providing a loan to the employee to acquire the shares and meet associated tax costs. Such a loan at present is subject to the Benefit-In-Kind (BIK) preferential loan provisions which means the employee faces BIK at a rate of 13% of the loan amount – a position which acts as a significant disincentive to the employee to participate in the share scheme. We suggest that part of a tax policy to support the delivery of share based awards should include an exemption from BIK for employer loans provided to employees in connection with their take up of shares in the employer company.

We feel that there are many positives emanating from the Revenue approved schemes. The fact that employees are not liable to income tax on the benefit received on the acquisition of the shares is welcome. We would ask that consideration be given to removing the charge to USC and employee PRSI.

In respect of Revenue Approved Share schemes, the exemption from income tax for employees on the value of the shares received where shares are held for three years is welcome. We feel consideration should be given to increasing the limit of €12,700 per annum for Approved Profit Sharing Schemes (APSS) that can be invested in respect of shares for an individual.

Proposed Model

However, some improvements could be made to the taxation of share schemes in Ireland. We recommend that a model similar to that in existence in the UK is adopted. Currently in the UK, employees may receive shares free of income tax and potentially cap their capital gains tax on a subsequent sale of the shares where shares are held for a certain period of time.

The introduction of similar favourable tax rules would assist SMEs in competing with larger companies and attracting and retaining key employees. It is important that Ireland's tax system is viewed as compatible with other countries particularly with regard to key executives in order to encourage employees in coming to Ireland.

In light of this, a suggestion for a generally applicable share incentive or share award scheme is as follows:

1. Establish a share incentive plan or a share award scheme by issuing a new class of shares in a company.
2. Employees may purchase shares out of their gross pay with full income tax relief. For example an employee investing €2,000 of pre-tax pay in shares in their company will receive shares in the company valued at €2,000. A limit should be placed on the amount of shares that can be purchased (e.g. 10% of salary). Alternatively, the employees may be allocated free shares as a bonus for example without having to pay income tax. There should also be a cap on the amount of shares that can be received in this manner.
3. No Employer PRSI, Employee PRSI or USC should apply.
4. All employees could be invited to participate and certain restrictions such as requiring an employee has to have worked for the company for 12 months before joining may be applied. It is not anticipated that it is required that the awards should be delivered on common terms across the workforce.
5. The shares should be held in trust for a certain period of time in order to be granted income tax relief (3 years for example). If an employee leaves or sells the shares before that period of time, income tax due along with USC and Employee PRSI is triggered.
6. A limit to the amount of shares that can be issued could be put in place to avail of income tax exemption. Shares granted in excess of this amount could be charged to income tax. This would prevent salary being commuted to shares in order to avail of income tax reliefs.
7. The cost to the company of providing the share scheme is deductible against corporation tax.

8. Capital gains tax will arise on the disposal of shares being the difference between the market value at time of acquisition and the sales price at time of sale.
9. The incentive scheme should be time-bound, say for a three year period with a review at the end of year 2 to establish if it is achieving the desired share ownership patterns.

The above proposal would allow greater employee participation and encourage growth within the SME sector, thereby addressing market failures. The implementation of this scheme could be done in tandem with the development of Revenue approved methodologies and templates for valuing shares used for share based awards.

For SMEs in start-up phase with high growth potential consider an SME share option scheme similar in design to the UK's Enterprise Management Incentive (EMI) but simplified to allow take up by SME's. This design of share based award is likely to be attractive to high growth SMEs which are competing for specialist skills with employers who can offer equity compensation with listed shares. The outline of such as design is to:

1. Grant employees share options at market value on employer shares. The value of share options at the employee and company level might be capped.
2. The scheme is available to SMEs only. The SME group should be a trading group (e.g. excluding business activities which are also excluded from the Entrepreneur Relief regime)
3. Where the share options are granted at market value, the employee is not subject to income tax at date of grant or at date of exercise of the option. An exemption from USC and PRSI also applies. This removes the cash flow disadvantage associated with delivery of illiquid shares
4. The employee is subject to capital gains tax on the disposal of the shares.

For share based awards generally, the BIK on employer loans to employees to participate in share based awards should be removed (whether to fund the acquisition of the shares or to pay income tax on the share award).Improve the workability of existing APSS and SAYE schemes by:

- Removing the requirement for the awards to be delivered on common terms
- Removing the requirement for Revenue pre approval; perhaps allowing a facility for Revenue approval where a taxpayer requires greater certainty on the valuation adopted for the shares, etc.
- Extending the scope of the share based awards under the APSS and SAYE to RSUs or other share based awards that may be delivered in cash to the employees at the end of the performance period.

Existing exemption from Employer PRSI for share based remuneration

The Programme for Partnership Government stated a commitment to explore the mechanisms through which the SMEs can reward key employees with share options in a tax efficient manner.

Share options are already proven to be a way of attracting and retaining key staff in SME. As discussed already, retaining key talent is a pressing issue for SMEs. To re-apply the charge of 10.75% employers PRSI to share based remuneration in an era of severe cash flow restraints for SMEs would act as a disincentive for SMEs to provide share remuneration schemes to their employees. We would recommend continuing the existing exemption from Employer PRSI.

Administration

In order to collect data on share based remuneration, it is suggested that full details are provided on the P35 employer's return. Details of all employees are already included on these returns so additional fields should be included to incorporate the details of share remuneration received by these individuals.

Conclusion

Companies in Ireland realise that giving their employees a stake in the company is an effective way of engaging the employee. When employees understand the impact of their individual performance on the value of the business, ownership of a part of that business can motivate them to be more productive. This in turn increases the output and growth levels of the company and therefore the financial value. This in turn contributes to the economic growth of the economy. The SME sector is an important cog in the Irish economy. We ask that the above tax reliefs are considered carefully in allow greater employee participation in companies and enable continued economic growth.

About CCAB-I

The Consultative Committee of Accountancy Bodies – Ireland is the representative committee for the main accountancy bodies in Ireland. It comprises Chartered Accountants Ireland, the Association of Chartered Certified Accountants, the Institute of Certified Public Accountants in Ireland, and the Chartered Institute of Management Accountants.

Brian Keegan, Director of Taxation at Chartered Accountants Ireland (brian.keegan@charteredaccountants.ie, 01-6377347) may be contacted if any further details in relation to any points made in this submission are required.