

## Aspects of share and share option schemes

Share option and share schemes, are an important means of recruiting and retaining employees. They can be particularly useful in enabling the small company, who cannot offer large salary levels, to compete with the big company.

While over 99% of all companies in the EU fall under the definition of small and medium sized enterprises, it is estimated that only between 2% and 4% of SMEs use employee share options.<sup>1</sup> Many small companies do not want to incur the cost of setting up and administering a share option scheme and yet for such companies, such schemes are an ideal vehicle to enable them to compete with the larger companies.

Generally, the key characteristics of a **share option scheme**, is that it grants a right to an employee to acquire shares from his employer or an entity within the employer's group at a price set at date of grant, which reflects the market value of the underlying shares at or around that time. **The option is normally exercisable three years after grant**, but only if the employee remains employed during the performance period and predetermined performance conditions have been satisfied.

Other schemes, such as **long term inventive plans**, grant the employee a conditional right to receive free shares following the expiry of a predetermined period of time ( generally 3 years ) and provided predetermined performance conditions have been satisfied.

A variation on this type of scheme are **equity partnership plans**. An employee buys shares ( usually using his annual bonus ) that he retains for typically three years. At the end of this period, the company will match (often on a ratio of one to one) the number of shares that the employee has retained, provided that certain predetermined conditions have been satisfied.

One other scheme I would also mention, is the cash settled award scheme, where an employee is promised a cash payment based on the future movement of the entity's share price.

A key consideration for the company is whether to seek **Revenue approval** for the scheme ( which necessitates structuring the scheme to accord with one of the Revenue schemes ) or to implement a scheme without Revenue approval.

In the case of **unapproved share option schemes**, the **grant** of the option can attract a tax charge, although the general position for unapproved schemes, is that the **exercise of the option**, will attract a charge to income tax, irrespective of whether the shares are retained or sold immediately. On the sale of shares acquired on the exercise of the option, a charge to capital gains tax ("**CGT**") will also normally arise.

Revenue approved share option or share schemes can be very attractive, because the grant and exercise of the option is usually exempt from income tax, provided the scheme accords with Revenue rules for the scheme concerned. If the shares are subsequently sold, a capital gains tax ("**CGT**") charge will arise on the gain made, but at the lower CGT rate of 20%.

However, Revenue approved schemes impose conditions, which taken together can be onerous, including in general terms that i) the option shares must not be redeemable; ii) the options shares must be in the employing company or a group company and relate to shares quoted on a recognised stock exchange, or be in a company, under the control of a company, whose shares are quoted on a recognised stock exchange or in the case of a private limited company, the company must not be under the control of another company; iii) the scheme must be offered to all employees, although one Revenue scheme allows the employer to include a "key employee" element, permitting such persons, to obtain rights under the scheme which do not satisfy the general rules; iv) the employees or directors granted the options must

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<sup>1</sup> European Commission Report 12.05.2003 "Final report of the Expert Group on Taxation of Employee Stock Options"

not have a material interest in a close company, being either the company itself or a company having control of that company, or a member of a consortium that owns that company. Where the shares to be used in the scheme are not quoted on a recognised stock exchange, the market value of the shares must be approved by Revenue.

While the Revenue approved, Savings Related Share Option Schemes and Approved Profit Sharing Schemes have been particularly popular, the fall in interest rates and the introduction of the Government SSIsAs has effected take up of the former and Revenue administrative changes, have since impacted take up of the latter.

As a comparison, the UK Revenue approved Enterprise Management Scheme ("EMI"), established in 2000, specifically designed to help small higher risk companies to recruit and retain employees, has been very successful.

Only independent trading companies with gross assets of less than £30 million can benefit from the scheme and provided their business is not in an excluded activity ( eg financial services, legal or accounting services, property development, farming, hotels ).

Under the EMI scheme, an employee can be awarded options for shares up to a total value of £100,000, with a maximum share value of £3 million under EMI options to all employees. The employee must not have a material interest in the company. Options granted under an EMI plan are ( apart from some special cases ) only taxed at the time of the sale of shares.

#### **General issues with share option schemes.**

In putting together a share option scheme, significant issues arise relating to structuring the scheme alongside any employee share ownership trust, the extent to which the scheme should dilute existing shareholders, structuring rights to terminate the scheme, dealing with change such as a takeover, merger or capital re-organisation and company law financial assistance rules.

Another significant issue particularly with quoted companies is restrictions on the granting and exercise of share options during certain periods and compliance with listing rules generally.

#### **Accounting standards**

A change in accounting standards introduced since 1<sup>st</sup> of January 2005 has made share option schemes less attractive. All EU companies listed on a stock exchange are for any period of account on or after 1<sup>st</sup> of January 2005, required to prepare their consolidated financial statements for the group in accordance with International Financial Reporting Standards (IFRS), instead of Irish generally accepted accounting principles (Irish GAAP).

Arising from Irish implementation of IFRS, all other Irish companies have the option to use IFRS when preparing their group and individual accounts. However Irish GAAP is gradually converging with IFRS and accordingly, companies will need to carefully consider the full impact of section 48 ( in particular s48 (1)( c ) ) of the Finance Act 2005 (which inserts section 76A into TCA 1997), when contemplating any share scheme.

IFRS 2 in particular, prescribes the measurement and recognition methods for all share based payment transactions.

Essentially IFRS 2 requires the "fair value" of a share plan to be recorded as an expense in a company's accounts.

The effect on the company's accounts arising from IFRS 2 depends on the type of performance condition used in the share or share option scheme.

If a share option scheme has a market vesting condition, an expense charge may be required even if the market condition is not attained and the shares do not vest. Examples of market conditions are those based on total shareholder return ( such as an increase in a sum

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invested in an entity over a period of time based on certain assumptions, or a condition based upon a general but relevant share market index ).

Where the performance condition is non market based (service and performance), the award is valued at date of grant and subsequently at every reporting date. The cumulative charge should only then reflect the options that actually vest.

Accordingly, whilst the starting point in putting together a share option or share based scheme has traditionally been whether the company should adopt a Revenue approved scheme or go the unapproved route, now the impact of IFRS (including IFRS 2) has also to be considered.

It is possible that IFRS 2 will result in a move towards performance based share schemes with less use of share option schemes. However for high growth companies, the attractiveness of share options is likely to remain.

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