TSG 07/22

Employee Financial Participation Schemes

I. INTRODUCTION

1. Over the years, the Government has provided a number of tax reliefs for approved employee financial participation schemes with a view to fostering partnership at the level of the enterprise. The area is complex and the schemes have been amended on many occasions. The National Centre for Partnership and Performance (NCPP) produced a report in January of this year entitled '*Improving Performance, Sharing the Gains*', which set out an agreed set of guidance rules on "best practice" in relation to employee financial participation schemes.

2. This paper is primarily meant to be a discussion paper. It deals with (i) the various changes being sought to the current approved schemes, (ii) requests for the introduction of favourable tax treatment for restricted share schemes and (iii) gainsharing schemes.

II. EXISTING TAX RELIEVED SHARE SCHEMES

3. There are currently four employee share schemes for which various tax reliefs are available. These are:

   a) ***Approved Profit Sharing Schemes (APSSs)***
   b) ***Employee Share Ownership Plans (ESOTs)***
   c) ***Save As You Earn Share Option Schemes (SAYEs)***
   d) ***Approved Share Option Schemes (APSOs).***

4. A brief synopsis of these schemes is given in appendix 1.

5. All of the above schemes contain the following important elements:
   - All employees are able to participate on similar terms[1],
   - They provide an opportunity for employees to acquire an equity stake in their employing company,

[1] This does not mean that all employees have to receive the same number of shares/options. Employees may, for example, be treated proportionately in relation to the shares/options to which they have access having regard to their level of remuneration or length of service.

- With the exception of APSOs, there are financial limits on the value of shares that can be appropriated under the various schemes.

III. REQUESTS FOR AMENDMENTS TO THE CURRENTLY APPROVED SCHEMES

6. Changes have been sought in the tax treatment of the following schemes:

(i) Approved Share Option Schemes

(ii) Employee Share Ownership Plans (ESOTs)

(iii)Approved Profit Sharing Schemes

7. **APPROVED SHARE OPTION SCHEMES:** The legislation for Approved Share Option schemes was introduced in Finance Act 2001. The purpose of the legislation is to promote wider share ownership by employees in their employing companies and to act as a measure to help companies to recruit and retain employees in a competitive labour market. Under the current tax legislation any gain on the exercise of the share options is exempt from income tax and PRSI. Where the shares are disposed of, any increase in the value of such shares becomes liable to capital gains tax, on the date of disposal.

8. It is understood that currently 32 companies have approved share option schemes in place with approximately 11,000 employees participating. The numbers applying to have their schemes approved have been reducing steadily since its introduction in 2001. The scheme has cost in the region of €300,000 in taxes forgone, which relates to the first 2 years. However, this figure is set to increase as it only accounts fully for share options granted in 2001 and 2002. Share options made available in 2003 could at the earliest be exercised in 2006 and full returns for this tax year are not yet available.

9. In a pre-budget submission, **IBEC** have sought that the current scheme be replaced with a simpler system, which would be more flexible and reflect “current practice”. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX The Small Business Forum in its report “*Small Business is Big Business*” sought the

replacement of the 'all employee' rule with a requirement that schemes should be available to a minimum of 50% of the employees in order to be approved.

10. ***As regards the "Similar Terms and All Employee Rules"***, the approved share option scheme already features additional flexibility in relation to the 'similar terms rule' over and above the normal flexibility conditions regarding levels of remuneration and the number of years service that apply to the other Revenue approved schemes.

11. Companies can grant share options <u>without</u> regard to the "similar terms" rule in the following cases:

- To key employees (employees whose specialist skills, qualifications and experience are regarded as essential to the future success of the company). However, the total number of shares over which options can be granted to key employees cannot exceed 30% of the total number of shares over which share options have been granted to all employees (including key employees) under the scheme in any particular year.
- To employees who are nearing retirement. In this way a company has the flexibility of not granting share options to employees who are close to retirement.
- New recruits in the first year of employment. This facilitates companies in attracting employees with, for example, specialist skills.

12.XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX - RTSO is paid on share options provided through unapproved share option schemes. Just over half of the total amount of RTSO paid in the years 2003-2005 (€222m) was paid by less than 2% of those employees who paid RTSO in those years. Generally speaking, those employees with the higher share option gains are paid higher levels of remuneration. Based on a randomly selected sample of 400 cases, the average salary of those employees who paid in excess of €100,000 RTSO in 2004 was €430,000, compared to an average salary of €68,000 for the remainder of employees who paid RTSO in that year.

13. An approved share option scheme, which allowed the company discretion in selecting employees to benefit from it, was in place between 1986 and 1992. There was no limit on the value of shares over which options could be granted. The scheme was abolished in 1992 as part of a reform of a range of tax exemptions and tax incentives. The way in which the scheme had been used by companies was also very influential in its abolition. In practice, the scheme had become, in the main, a tax incentive scheme for directors (with less than 10% shareholding) and highly paid executives.

14. The current approved share option scheme can be seen as an effort to draw a balance between competing objectives – all employee participation on similar terms and employer discretion.

15. It is also worth noting that the general EU policy would appear to be that employee share schemes and, in particular, schemes that attract tax advantages, should, in general, be open to all employees and be aimed at treating employees on similar terms.[2]

16. The question of deadweight would also need to be considered, as many companies currently operate unapproved share option schemes without any tax incentives. The total amount of Relevant Tax on Share Options (RTSO) paid in 2006 was €109 million.

17. **EMPLOYEE SHARE OWNERSHIP PLANS (ESOTs)**: The legislation on Employee Share Ownership Trusts (ESOTs) was introduced in Finance Act 1997 and was designed to allow employees acquire significant interests in or take over their employer company in a more tax efficient manner than was available under existing incentives. To avail fully of the tax incentives that go with an ESOT, it must operate in tandem with an Approved Profit Sharing Scheme (APSS) and the two combined are known as an Employee Share Ownership Plan (ESOP).

18. It is understood that 11 companies currently have an ESOT in place and the estimated total cost to the Exchequer of the favourable tax treatment afforded to these is €66 million up

[2] Communiqué on a Framework for the Promotion of Employee Financial Participation - European Commission, Brussels, COM (2002) 364 final, p12.

to the end of 2005. It should be noted that the costs to the Exchequer associated with ESOTs are generally encountered within the first few years of the formation of the ESOT. Thereafter, favourable tax treatment is received through the associated APSS scheme.

19. The Irish Congress of Trade Unions (**ICTU**) has sought a number of changes to the legislation governing ESOTs, as well as the introduction of Union based ESOTs. The Department of Finance and the Revenue Commissioners have met with ICTU to discuss their proposals in these areas.

20. ***15 Year Rule:*** Current provisions in the ESOT legislation provide that former employees can only receive shares from an ESOT up to 15 years after its establishment. ICTU say that this time limit means that employees may not be able to receive all of the shares allocated to them in a tax efficient manner. There is currently a limit of €12,700 per annum on the value of shares that can be allocated while still qualifying for the associated tax relief. ICTU are seeking that the 15 year time limit be extended to 20 years.

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22. ***20 Year Limit:*** The current legislation requires the trustees of an ESOT to transfer shares out to employees within 20 years of the date of receipt. ICTU are seeking a longer period for this transfer or an increase in the annual tax relief limit in order to allow employees to receive all of their shares within a preferential tax regime.

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24. ***Cost of shares for CGT purposes:*** The original cost of shares for capital gains tax purposes is set at the date that the shares are first available for appropriation (rather than the date that the shares are called for by participants). ICTU are seeking that the date used for fixing the original cost of shares for CGT purposes be changed to the date that the shares are called for by the participants. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
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25. ***10 Year Rule:*** Where an ESOT encumbers 50% of its shares to guarantee a loan, the current legislation allows for a tripling of the annual tax relief in the year that the loan is paid off subject to certain conditions. These include that the loan must be for a period of ten years and that at least 50% of the shares must be encumbered for the first 5 years. The tripling of the tax relief in the year that the loan is paid off is in recognition of the possibility that a substantial proportion of the shares would not have been available for transfer out of the ESOT and thus the employees could not have gained access to the annual tax relief limit whilst they were encumbered. ICTU are seeking a reduction in the 10 year loan period to facilitate ESOTs that may wish to pay off their loans early, whilst still retaining access to the triple level of tax relief (€38,100) in the year that the loan is paid off.

26. The 10 year rule was introduced to cater for genuine cases where ESOTs needed to borrow money over a long term and thus could not disburse shares to employees as they were encumbered for the duration of the loan. It was not intended that the once-off limit of €38,100 would be available simply where shares were encumbered *per se*. In conjunction with the 10 year rule, it was designed to cover situations of serious long-term borrowing. The current regime might encourage the trustees of an ESOT not to pay off a loan prior to the expiry of the 10 year period, regardless of whether they have sufficient funds to do so, which goes against the aim of getting shares into the hands of employees as soon as possible.

27. It is technically possible under the current system for employees to avail of the annual limit of €12,700 over the lifetime of the ESOP and retain access to the once-off limit of €38,100 in the year that the loan is paid off. The once-off limit was never designed for such practice and was only intended for cases where shares could not be distributed to employees for a number of years.

28. ***Founding Company Rule:*** Current legislative provisions require that the "founding company" of an ESOT must be the top company of the group. ICTU say this has caused practical problems where Irish companies with ESOTs have been taken over by foreign companies. They are seeking an amendment in the legislation that would allow the original founding company to continue to manage the ESOT in such cases. ICTU has agreed to submit examples showing how the problems are manifesting with the current regime and these will be examined with a view to finding a solution.

29. ***Introduction of Union-Based ESOTs:*** ICTU has indicated that it favours longer term collective ownership of shares in a union-based ESOT (possibly in addition to an ESOT along traditional lines within the same company). XXXXXXXXXXXXXXXXXXXXXXX
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30. **APPROVED PROFIT SHARING SCHEMES:** The legislation for approved profit sharing schemes was introduced in Finance Act 1982. It is the most popular of all of the current approved EFI schemes with approximately 438 company schemes currently in existence.

31. The theory behind the legislation envisages the sharing of the profits of a company with its employees. The majority of companies operating the scheme give employees the choice of taking their discretionary bonuses, which are generally linked to the profits of the

company, in taxable cash or by way of shares in their employing company (or its parent) through an APSS.

32. Shares up to the value of €12,700 per annum can be appropriated to each employee without any liability to income tax or PRSI provided that they are held in trust for a period of at least 3 years. The total cost of the scheme between 1983 and 2005 amounts to approximately a cumulative €403 million.

33. The current legislation permits an employer (in accordance with the company's articles of association) to require that employees that leave the organisation must sell their shares after the three year retention period. However, if implemented, the employee must sell all shares that they hold in the company and not just those that have been acquired through the approved scheme. This is because the legislation specifies that any such requirement imposed by the articles of association must apply to all persons disposing of shares of the same class. **IBEC** have sought an amendment to the current legislation that would require that only shares acquired under the scheme would have to be sold. The amendment is being sought to facilitate certain shareholders, including founder shareholders, in retaining shares in organisations after they have left these organisations.

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35. By way of Revenue administrative practice, in place since the early 1990s, employees can forego up to 7.5% of their gross basic salary and take shares in the APSS in lieu of the salary foregone. For each share purchased by means of salary forgone a further share must be appropriated 'free of charge' by the company. Additionally, subject to the same conditions that apply to salary forgone, employees can fund the acquisition of shares out of net salary (net after tax and PRSI deductions).

36. The Small Business Forum in its report ‘*Small Business is Big Business*’ has sought an increase in the maximum value of shares that can be purchased out of an employee’s own resources from 7.5% to an aggregate amount of €100,000 over 5 years, as well as the removal of the requirement for a company to appropriate matching ‘free of charge’ shares. It is not clear whether the Small Business Forum are referring to the practice relating to salary forgone or to the practice relating to the funding by employees of the acquisition of shares out of net salary.

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38. The Small Business Forum has also sought the removal of the requirement for a trust for this scheme. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXX

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IV. REQUESTS FOR THE INTRODUCTION OF ADDITIONAL SCHEMES

40. Requests have been received to have the following schemes approved for favourable tax treatment:

(a) Restricted Share Schemes

(b) Gainsharing Schemes

41. **RESTRICTED SHARE SCHEMES:** IBEC has requested that restricted share awards now be approved for favourable tax treatment in a similar manner to the approved share options scheme.

42. Under restricted share award schemes, employers award shares (as distinct from share options) to employees and place restrictions on the shares. The restrictions can take many forms, but the main restrictions relate to a prohibition on the sale of shares for a fixed period or the forfeiture of shares where employees cease employment with the company within a predetermined period, or where specified performance targets (which can be set at individual or company level) fail to be achieved. Similar restrictions can also be placed on shares acquired by employees on the exercise of share options (in unapproved schemes).

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44. Where an employer awards shares to an employee, the employee is liable to income tax on the full market value of the shares. However, where the shares awarded are subject to restrictions, then by way of a Revenue administrative practice, the income tax charge is generally abated. The level of abatement is dependent on the length of the period of restriction, but it can be as high as 55% where the restriction lasts for a period in excess of 5 years.

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46. **GAINSHARING SCHEMES:** Gainsharing is a concept which attempts to increase the profits of a company by removing any potential for "slack" existing in the company and

thereby improving the performance of the company. The idea is that clearly identified savings from increases in productivity or reductions in costs would be shared with staff on a predetermined basis. It is, in essence, a means of encouraging team working. Any profit over and above the normal profit of the company would be distributed according to a predetermined formula between the owners and employees of the company.

47. An example of gainsharing would be where the predetermined formula was based on the difference between the selling price and employee costs. Therefore, the predetermined formula could state that employee costs should be, say, 42% of added value (i.e. sales less manufacturing costs). If employee costs are lower than this 42% then any savings could be, for example, shared equally by the owners and employees. If employee costs were say €30,000 lower than 42%, then €15,000 would go to the employees.

48. The Department of Finance and the Revenue Commissioners have had recent discussions with **ICTU** who have sought the introduction of favourable tax treatment for gainsharing schemes. This issue was examined in depth by the Working Group on Employee Financial Involvement which was set up under the Programme for Prosperity and Fairness. In 'Towards 2016', the Government and the social partners agreed that the National Centre for Partnership and Performance (NCPP) in conjunction with IBEC/CIF and ICTU would bring to conclusion the development of revised guidelines on employee financial participation including gainsharing. It also charged the NCPP with the development and promotion of an active programme of education and communication for employees, management and unions on the role of employee financial participation.

49. The NCPP produced a report in early 2007 entitled '*Improving Performance, Sharing the Gains*', in which it has put forward guidelines on the operation of the four currently approved employee financial involvement schemes, as well as on implementing a gainsharing scheme. The NCPP report did not propose the introduction of tax relief for gainsharing but noted that the lack of such a relief did not act as a disadvantage of gainsharing *per se* but does make it relatively less attractive when compared to other approved EFP schemes.

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V. CONCLUSION

53. The area of Employee Financial Participation (EFP) is complex, as are the requests for changes. There are no specific commitments in the Agreed Programme for Government to provide further tax concessions in this area. The provisions of ‘Towards 2016’ have already been referred to in paragraph 48 of this paper. Nevertheless, given the perceived benefits of EFP, such proposals merit examination and consideration, as do the existing tax relieved schemes. Further work is required in this area to determine the costs and benefits and if these schemes are achieving the purposes for which they were originally provided. It is to be noted of course, that the upcoming Commission on Taxation will be charged with examining all tax reliefs, including those in the area of EFP.

54. The views of the TSG on these issues would be welcome.

Appendix 1

Existing Tax Relieved Employee Financial Participation Schemes

(a) Approved Profit Sharing Schemes (APSSs)

Under a profit sharing scheme approved by the Revenue, an employee may, subject to certain conditions, receive from his/her employer, free of income tax, up to €12,700 worth of shares per annum. Schemes must be established under a trust deed and be approved by the Revenue Commissioners. In certain circumstances, (essentially, if the shares are encumbered) a participant may receive a once-off allocation of up to €38,100 in free shares. The participants in an APSS must hold the shares for at least three years to benefit from the tax relief. While the participant of an APSS may then dispose of his/her shares after three years without a liability to income tax, the disposal is treated as a disposal for the purposes of capital gains tax i.e. any gain between the market value of the shares at the date of appropriation of the shares and the price at disposal is subject to CGT at 20%. There are currently approximately 438 approved APSSs in operation.

(b) Employee Share Ownership Plans (ESOTs)

An Employee Share Ownership Trust is normally set up to manage a proportion of a company's shares on behalf of its employees. A Trust will operate in tandem with an APSS when it comes to the appropriation of shares to employees. The Trust in conjunction with the APSS is referred to as an Employee Share Ownership Plan. In order to obtain tax relief on any shares distributed to employees, the shares in question must be made available from the ESOT via an APSS. However, the ESOT is more flexible than an APSS. For example, the APSS has only one source of funds in the form of direct contributions from the employer company. The ESOT, on the other hand, can obtain finance from a number of sources. It can borrow money (from the employer company or from a financial institution), receive dividends and sell shares as well as take contributions from the employer company. The APSS must allocate the shares to employees within 18 months of acquisition, whereas the ESOT can hold the shares for much longer periods (up to 20 years) before they are distributed to the employees via an APSS. Once the ESOT has transferred shares to the APSS, all of the normal rules surrounding APSS come into force in relation to those shares. Ten ESOTs have been approved by the Revenue Commissioners to date.

(c) Save As You Earn (SAYE)

This scheme is essentially a savings related share option scheme, the first element of which permits employers to offer a discount of up to 25% on the price of the shares when the option is being granted. The second element is a certified contractual savings scheme which is the means used by employees to save the money required to purchase the shares. Members of a scheme must save for a 3 or 5 year period. However, individuals who save for a 5 year period may leave their savings on deposit for a further two years. Employees can save between €12

and €320 per month and any bonus or interest on the savings is exempt from income tax and PRSI. The legislation underpinning Save-As-You-Earn schemes does not actually require employees to purchase the shares at the end of the savings period. This provision was to ensure that employees would not be forced to buy shares where the price of the shares has fallen below the offer price. Where the employees actually purchase shares, the difference in the value of the shares, between the time that the option is granted and the time of appropriation, is exempt from income tax and PRSI. Shares purchased under the scheme can be disposed of immediately, though any gain (i.e. the difference between the option price and the proceeds of sale) may be liable to CGT. A total of 121 SAYE schemes have been approved by the Revenue Commissioners, of which 96 are still in existence. It is estimated that the schemes have cost approximately €14.2 million between the years of 2000/01 and 2005.

(d) Approved Share Option Schemes (APSO)

This scheme was introduced in Finance Act 2001. Under the current tax legislation any gain on the exercise of the share options is exempt from income tax and PRSI. To avail of the tax exemption, shares must be held for a minimum of three years after the option is granted. When the shares are sold or otherwise disposed of, any increase in the value of such shares (from the time the option is granted, as opposed to exercised) becomes liable to capital gains tax, on the date of disposal. 32 companies have approved share option schemes in place. Since its inception, the scheme has cost in the region of €300,000 in taxes forgone. However, this figure is set to increase as it only accounts fully for share options granted in 2001 and 2002.

Appendix 2

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