



Share Option Schemes

DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

SHARE OPTION SCHEMES

This is a high level overview of the issues that should be considered and addressed when establishing and running a scheme pursuant to which shares in a certain company will end up in the hands of either the employees or directors of a company or both. The issues have been divided into the following three broad categories:

1. Practical Considerations
2. Relevant points under the Companies Acts 1963-2006
3. Taxation matters

1. Practical Considerations:

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. The number of shares covered by the option, the date(s) on which the option can be exercised (known as the “vesting date”), the option price and any targets that must be achieved are commonly set out in a share option scheme or an option agreement with the employee. Before embarking on drafting of any such scheme, the matters set out below should be fully considered. It is even possible that after such discussions have taken place, it transpires that a share option scheme is not the best choice for the employer after all; their objectives may be served equally well or better by a simple bonus scheme.

1.1 Review of key company documents:

Prior to establishment of a shareholders’ scheme the following documents should be reviewed:

-  The Articles of Association
-  Any Shareholders’ Agreement in place

In reviewing the above documents, the following matters should be considered:

- ▣ Will shareholder or board approval be required for the implementation of the plan – if shareholder approval is required, is it easily obtainable? Are there any large or institutional shareholders who may object?
- ▣ What are the pre-emption rights on either allotment or transfer or both?
- ▣ What type of shares are currently in issue – will a special class of shares be required?
- ▣ Is it intended that employees will attend AGMs and have voting rights or just share in the economic growth of a company? i.e., create a special class of non-voting shares (but beware of any “deferred shares” since the changes introduced by the Finance Act 2008 – see further below in taxation section).

1.2 The Beneficiaries

The intended beneficiaries must also be fully considered:-

- ▣ Who does the company intend to benefit under the proposed scheme or plan?
- ▣ In a Revenue approved scheme, all eligible employees must be able to participate on equal terms; options can be granted without the “similar terms” conditions for “key employees” over not more than 30% of the total options granted under the scheme
- ▣ In a non-revenue approved scheme, the company is free to use a more selective approach - caution should nonetheless be exercised to ensure compliance with equality laws, including in relation to full and part-time employees
- ▣ Consideration needs to be given to the compulsory transfer of shares on cessation of service (“good and bad leaver”) as well as the “drag along” of employee shareholdings in the event that the company is to be sold; again there is less flexibility in this regard under a Revenue approved scheme than in an unapproved scheme

1.3 Dilution

The possibility that the existing shareholders will be diluted by the creation of the scheme needs to be considered.

If the scheme is being set up in an early stage company, dilution probably won't be necessary. If there are existing investors or institutional shareholders - their willingness or not to dilute will have to be considered.

1.4 Performance Targets

If targets are to be set, the employer company will be best positioned to decide upon appropriate targets for its workforce. Where there are several existing shareholders, including investors, the efficacy and precision of the targets to be met may affect the willingness or not to dilute.

The grant of options may be conditional upon the employee continuing in service for a certain period of time and/or the achievement of certain targets. (As stated above, in a Revenue approved scheme – all eligible employees must be able to participate on an equal basis; in addition, the basis of calculation of entitlement needs to be submitted when seeking Revenue approval.)

1.5 Private company concerns

The following are some practical issues that are of particular concern to a private company:

1.5.1 Revenue approved scheme v unapproved

Although income tax exemption is afforded by adopting a revenue approved scheme, it is difficult to accommodate the business concerns of a private company within the framework of a Revenue approved scheme, e.g., concerns about the transferability of shares and ensuring that (employee) shares do not pass to persons unconnected with the company. In a Revenue approved scheme the ability of a company to limit the transferability of shares held by employees when they leave employment of the company is constrained.

Thus if income tax exemption is not the primary motivation, an unapproved scheme will offer greater flexibility for a private company. There are, however, certain other concerns to be addressed which are set out below.

1.5.2 Valuation of shares

As there is no quoted price for the shares in a private company, it is more difficult in practice to establish the market value of the shares which are the subject of the option grant. The market value will be relevant in a number of scenarios, including the calculation of any taxation liability; good and bad leaver provisions etc.

Ideally, valuation exercises are required at regular intervals in order to ascertain the “market value”. As this is probably not practical from a cost perspective valuations could be carried out once a year and trading in the shares by the relevant employees could be then limited to a fixed period following the carrying out of such valuation. (The Scheme should obviously refer to any such period and the employees should be made aware of them.)

1.5.3 Liquidity/Realisation

How will the employee shareholders access value for their shares? As there is no readily available market for private company shares, the question arises as to how the relevant employees will actually be able to dispose of the shares held and realise his/her investment. Another method or “market” thus needs to be created. The following are some possible solutions to consider:

- ▣ A specific future event – it may be that the option holders cannot exercise options until immediately before an event that crystallises value in the shares and makes the shares marketable, e.g. a trade sale. Obviously, however, this may defeat the desired incentive effect of a share option scheme since the timing of such future event is uncertain and employees who are no longer in service at the time of such an event would probably not benefit.
- ▣ Purchase by the company of its own shares – this is a possibility although the company's Articles need to be reviewed to ensure the company is able to do this; and further, the provisions of Section 211 et seq. of C.A. 1990 must be complied with;

- ▣ Repurchase of shares by the parent company – if the scheme uses shares in a subsidiary company, the parent company can purchase the shares in its own subsidiary and this would fall outside the provisions of Section 211 et seq. of the C.A. 1990;
- ▣ A Put Option – a put option may be granted to employees allowing the shares to be sold at an agreed date in the future to either of the following:
 - One or more of the existing shareholders
 - An employees' trust, or
 - The company itself (provided that the provisions of section 214 C.A. 1990 in connection with "contingent purchase contracts are complied with"; in particular the display obligations and shareholder approval as well as the requirement that the purchase price must be funded by funds available for distribution);
 - An Employees' Trust – where a share option scheme is being operated for a large number of employees, a closed market can be created by the use of an employees' trust. The trust can repurchase shares from existing or former shareholders and redistribute them among new or existing shareholders via a share option scheme or profit sharing scheme. Look out for possible S. 60 issues where the trust is being funded by the target company, i.e. the company in which the options over shares are being granted.

1.6 Public Company

The following matters are relevant to public companies:

- ▣ The market value of shares will obviously be more easily obtained;
- ▣ The relevant stock exchange rules on disclosures as well as when shareholder approval is required for the issue of new shares should be considered.
- ▣ Section 30 of the CA 1990 – it is an offence for a director of a public company to purchase a right to call for delivery or to make delivery at a specified price within a specified time of a specified number of shares or debentures in a public company of which he is a director or in an associated

company. There is exemption in respect of Revenue approved schemes and the right to simply subscribe for shares.

- ▣ Since 1st January 2005, all companies listed on a stock exchange are required to prepare their consolidated group financial statements in accordance with IFRS as opposed to GAAP. IFRS2 prescribes the treatment of share based payment transactions and requires the “fair value” of a scheme to be recorded as an expense. The effect will depend on the type of performance condition; if it is a market related condition (e.g. a condition based on total shareholder return, or a condition based on a relevant share market index) an expense charge may be required even if the shares did not vest. If the target is non market based (e.g., performance and length of service) the charge should only reflect the options that actually vest.

(Since GAAP is gradually converging with IFRS, this may become a relevant issue for private companies as well.)

- ▣ As for a private company, where there is any possibility that the company will be financing the acquisition of the shares, Section 60 needs to be considered. There are certain exemptions set out in Section 60 in respect of employees, former employees and salaried directors only (Section 60.12 (e) and (f)) and if a company wants to avail of such exemptions, the provisions therein must be followed carefully. In addition, in a public company, even such “exempted” financial assistance in connection with a share scheme must come out of profits available for distribution.

2. Company Law

Once the employer's main priorities for the proposed scheme are clear, such priorities need to be examined within the framework of the Companies Acts 1963-2006. Key legislative matters to bear in mind are as follows:

- ▣ What type of company is seeking a plan – public or private (consider the matters outlined above)
- ▣ The statutory pre-emption rights on allotment contained in Section 23 C.A.A 1983 - these will not apply to an employee share scheme within the meaning of that section; i.e.;

“any scheme for the time being in force, in accordance with which a company encourages or facilitates the holding of shares or debentures in the company or its holding company by or for the benefit of employees or former employees of the company or of any subsidiary of the company including any person who is or was a director holding a salaried employment or office in the company or any subsidiary of the company”

Thus the inclusion of consultants or non-executive directors will bring a scheme outside the definition above and the statutory pre-emption right will apply (unless already disapplied by the Articles of a company). Any veto rights contained in shareholders’ agreements as well as pre-emption rights on transfer as opposed to allotment contained in either Articles or shareholders’ agreement should also be addressed where relevant.

- ▣ Section 60 issues – ensure that the precise requirements of the exemptions in Section 60.12(e) or (f) are met – for example if the cash is being provided by the company for the acquisition of shares and the potential beneficiaries of proposed plan includes consultants or non-executive directors, the relevant S.60 exemption is not available. It should also be noted that the whitewash procedure is not available to a public company.
- ▣ If the scheme includes directors, ensure that various company law provisions relating to directors’ disclosure requirements are complied with (e.g. Part IV of the Companies Act 1990, Sections 53 and 58 in particular).
- ▣ Section 33 C.A. 1963 - the maximum number of shareholders in a private company is 99; this will probably be easily complied with in smaller companies and in larger companies where another vehicle is used to hold shares on trust; however care should be taken if for example former employees can hold on to their shares in an individual capacity after cessation of service.
- ▣ If the scheme envisages any repurchase or contingent purchase contract in relation to the employee shares, ensure the provisions of Part XI of the C.A. 1990 are complied with, in particular Sections 211 et seq. as mentioned above, which will apply, in differing ways, to both private and public companies.

- ▣ Accompanying company secretarial matters:
 - Section 53 Notices for the disclosure of interests in shares;
 - Returns to the CRO on the allotment of shares - in the event of non-cash consideration being given for the shares, the appropriate return to the CRO and the Revenue needs to be made;
 - Section 60 documentation and filing of special resolutions;
 - G1s in respect of any other required special resolutions (for example, any new Articles adopted, authorisation to buy back shares etc.).

3. Taxation

It is of paramount importance to ensure that the taxation aspects of any scheme or plan are being addressed, either by this firm or by the company's own tax advisers.

3.1 Unapproved Schemes

The following summarises the tax matters for options under an unapproved scheme:

▣ Tax on Grant

An option is a "short option" if its duration is less than 7 years. If its duration is more than 7 years, it is treated as a "long option". Where a long option is granted, the Revenue reserves the right to levy income tax on receipt of the option and may assess to income tax the difference between the option price and the market value (if higher) of the shares at the date of the grant.

As a result of the above, most private companies will wish to grant a short option so that there is no question of income tax arising at the date of grant. Furthermore, it is more difficult to ascertain with certainty the market value of a share in a private company.

▣ Tax on Exercise

Income tax will arise on the date of exercise *if* the shares' market value is greater than the option price paid for the shares.

Tax is due to be paid without an assessment and is payable within 30 days at the rate of 40% of the gain or at 20% if the employee/tax payer has obtained revenue approval to pay at the lower rate within the 30 day window.

Tax on Sale

CGT is payable at the current rate of 22% on the profit made on selling the shares. For CGT purposes, the cost of the shares is the amount paid for them plus any amount of income tax paid at time of exercise.

“Convertible Shares”

In the past, options were granted over a form of valueless deferred convertible shares carrying no right to vote or dividend or other right except the right to convert into ordinary shares at some predetermined time in the future, usually, on the sale or listing of the company. There was some scope to treat the gain between the time of grant of an option over such a deferred convertible share and time of conversion into an ordinary share as falling within the CGT regime as opposed to the income tax regime.

However, the Finance Act 2008 has changed this and now, a charge to income tax will arise on the date of grant based on the value of the shares as if converted, unless it can be shown that the deferred convertible shares were not granted for tax avoidance purposes. In addition, the new provisions provide for an income tax charge on the conversion, release or disposal of such shares.

3.2 Revenue Approved Schemes

In relation to all revenue approved schemes, the employer company which sets up the plan or scheme will get a tax deduction in respect of the costs of set up and running the scheme provided certain Revenue requirements are met.

Revenue Approved Option Scheme:

Where all the various requirements of an approved scheme have been met and an approved scheme thus established, no tax on exercise arises. However, due to the complications involved in setting these up, few have actually been established .

- ▣ *Revenue Approved Save as You Earn option Scheme:*
The difference between the option price and value of shares on date of exercise is tax free, provided that the option is not exercised for at least 3 years.

The interest earned on the saving deposits is also tax free.

- ▣ *Revenue Approved Profit Sharing Schemes*
The shares are received free of tax provided that they are held in trust for 3 years and their value does not exceed the relevant annual limit.

The base cost of the shares for CGT purposes is the value at the time they were allocated under the scheme.

If the shares are sold within the three year period, tax arises. There are other detailed rules on the various scenarios in which tax arises – detailed tax advice should be sought.

3.3 Revenue Filings

Once the scheme is actually established, certain Revenue filings are required in respect of both approved and unapproved share schemes. New notification obligations have also been introduced in relation to any convertible securities acquired after 31 January 2008.

Share Option Schemes – Checklist

- ▣ Review the Articles of Association – any amendments required?
- ▣ Is there any existing shareholder agreement? Any amendments necessary / any relevant pre-emption rights or veto rights?
- ▣ Corporate approval for the establishment of the scheme – board/shareholder approval – check shareholders agreement for any specific requirements
- ▣ Who will be participating? All employees, some employees only, directors, non-executive directors, consultants?
- ▣ Revenue approved scheme or not – address taxation priorities upfront – is income tax exemption a priority or not? Ensure that client takes tax advice
- ▣ Valuation of shares – if a private company, has the client considered how the shares will be valued and how often will it be necessary to carry out valuations?
- ▣ How are the shares to be acquired – issue of new shares/transfer of existing shares? Any pre-emption rights? Any dilution necessary?
- ▣ Setting targets – will the grant of options be subject to performance targets?
- ▣ Liquidity of shares once option is exercised – is there a readily available market for the shares? If not, some kind of realisation mechanism will be required
- ▣ Potential Section 60 issues need to be addressed
- ▣ Disclosure of interest requirements for directors (Part IV CA 1990 & stock exchange rules if relevant)
- ▣ CRO filings & Revenue filings
- ▣ Accounting treatment – IFRS V GAAP

Date: January 2009
Author: Sarah Gallagher

CONTACT US

Our Offices

Dublin

33 Sir John Rogerson's Quay,
Dublin 2,
Ireland.
Tel: +353 1 667 0022
Fax.: +353 1 667 0042

Cork

8 Webworks Cork,
Eglinton Street,
Cork, Ireland.
Tel: +353 21 425 0630
Fax: +353 21 425 0632

Boston

26th Floor,
225 Franklin Street,
Boston, MA 02110,
United States of America.
Tel: +1 617 217 2866
Fax: +1 617 217 2566

New York

245 Park Avenue
39th Floor
New York, NY 10167
United States
Tel: +1 212 792 4166
Fax: +1 212 792 4167

Tokyo

12th Floor,
Yurakucho Itocia Building
2-7-1 Yurakucho, Chiyoda-ku
Tokyo 100-0006, Japan
Tel: +813 6860 4885
Fax: +813 6860 4501

e-mail: enquiries@dilloneustace.ie
website: www.dilloneustace.ie

Contact Points

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.

Keith Smyth

e-mail: keith.smyth@dilloneustace.ie

Tel : +353 1 667 0022

Fax: + 353 1 667 0042

DISCLAIMER:

This document is for information purposes only and does not purport to represent legal advice. If you have any queries or would like further information relating to any of the above matters, please refer to the contacts above or your usual contact in Dillon Eustace.

Copyright Notice:

© 2009 Dillon Eustace. All rights reserved

DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

33 Sir John Rogerson's Quay, Dublin 2, Ireland.
www.dilloneustace.ie

In alliance with Arendt & Medernach