

Irish Tax Institute's Recommendations on the Key Employee Engagement Programme (KEEP)

The KEEP contains seven significant limitations which significantly impact the feasibility of the scheme and ultimately, its success in achieving the policy aim of helping SMEs to attract and retain talent.

These are:

- a) the impact of the remuneration test on high growth companies in start-up mode
- b) the definition of a 'qualifying individual'
- c) the definition of a 'holding company'
- d) the requirement for new issued shares
- e) share buy backs need to be facilitated to assist with liquidity
- f) reorganisations are not specifically catered for within the provisions of KEEP, and
- g) agreed approaches to share valuations and the development of 'safe harbours' are required.

To address these limitations, we recommend the following amendments to the existing legislation:

- > The third part of the remuneration test requires KEEP share options to be below 50% of the employees' annual emoluments, which is restricting high-growth companies in start-up mode availing of scheme. To preserve cash in the start-up phase of such companies, the cash element of a key employee's remuneration package is often modest, with share options forming the majority of the package being paid. Share options may very well exceed 50% of annual emoluments in these circumstances; therefore, the third element of the remuneration test cannot be met and KEEP cannot be used.

While we acknowledge the role of remuneration limits in a share option regime, they should be based on absolute values to ensure that high growth companies in start-up mode are not prevented from availing of the scheme.

- > The current KEEP provisions envisage that an individual will be an employee of and carry out duties for a single company. However, employees may carry out work for the holding company and one or more subsidiaries or transfer between group companies, as well as devoting their time to the qualifying KEEP company within the group. This will be dictated by business needs. We believe the definition of a 'qualifying individual' should be amended:
 - to allow an employee who transfers to a group company to retain their KEEP options (that qualify for CGT treatment), provided all the other conditions of section 128F TCA 1997 are satisfied, and
 - to allow more practical flexibility (particularly in SMEs), so that employees who spend substantial time in the KEEP company will qualify for the relief even where they carry out some duties for other group companies.
- > Holding companies generally do not only own shares (i.e. a holding company can hold money in a bank account to discharge its running expenses or advance a loan to a subsidiary) and are not always the 100% parent company, which is what is required under the existing provisions to qualify for KEEP. We recommend that the definition of a holding company under the scheme should be amended to adopt a similar definition to that contained within Revised Entrepreneur Relief where a holding company *"means a company whose business consists wholly or mainly of*

the holding of shares of all companies which are its 51 per cent subsidiaries” and which provides for a qualifying group.

- > For commercial reasons, it is common for company share schemes to manage the delivery of shares to eligible employees under a trust arrangement. Furthermore, they will often make available shares for key recruits from a pool of existing shares set aside for that purpose. The flexibility to operate these common and accepted practices is not available under KEEP and that is significantly limiting the use of the regime. To address this gap, the regime should enable existing, as well as new shares, to qualify for use. This could be achieved by deleting the reference to ‘new’ in part (a) of the definition of a qualifying share option under section 128F TCA1997.
- > The provisions of the KEEP scheme do not accommodate the buy-back of shares and this can have significant implications for the liquidity of the business. A substantial challenge for SMEs wishing to operate a KEEP scheme will be to provide assured liquidity for their shares, as not all these companies are likely to be sold or listed on a stock exchange. Section 176 TCA 1997 should be amended to reflect that a buyback of shares acquired under KEEP can be expected to meet the conditions for the benefit of the trade test in that section and consequently, subject to CGT treatment.
- > The current legislation does not provide for the continuing availability of CGT treatment if the SME undergoes a corporate reorganisation during the period in which the KEEP share option rights are outstanding. Therefore, we recommend the adoption of similar provisions in KEEP to those contained within the Revised Entrepreneur Relief legislation, which secure the entitlement of a qualifying individual and a qualifying company to meeting the scheme requirements when a reorganisation takes place.
- > We believe that agreed ‘safe harbour’ approaches to share valuation for KEEP purposes should be developed, similar to the approach to valuations adopted under accounting standards. This will ensure the scheme is more accessible, easily understood and capable of implementation without undue duplication of effort and cost to SMEs.

Background to the Institute's Recommendations on KEEP

We welcome the introduction of the new KEEP share scheme, which provides an opportunity for SMEs to compete with listed companies, to attract and retain key employees. However, KEEP contains seven limitations which could significantly impact the feasibility of the scheme and ultimately, its success in achieving the policy aim of helping SMEs to attract and retain talent.

These are:

- a) The potential impact of the remuneration test on high growth companies in start-up mode
- b) The definition of a 'qualifying individual'
- c) The definition of a 'holding company'
- d) The requirement for new issued shares
- e) Creating liquidity in KEEP shares
- f) Where a SME undergoes a reorganisation
- g) The need for agreed approaches to share valuations and the development of 'safe harbours'

- a) *The potential impact of the remuneration test on high growth companies in start-up mode*

Undoubtedly, it is challenging to draft measures for a broad population of SMEs in Ireland which includes companies still in start-up mode with high growth potential (but limited cash resources) and more mature companies (possibly of longstanding) which are owned by a family or related persons. These are very different types of company, but both have the commercial need to attract and retain key individuals, whilst competing for that talent with listed companies that can offer equity-based awards.

The design of the third part of the remuneration limits¹, which requires that KEEP share options must not exceed 50% of the employee's annual emoluments, appears to restrict high growth companies in start-up mode availing of the scheme. This is particularly the case for companies in the hi-tech sector. To preserve cash in the start-up phase of such companies, pay practices have developed which often result in modest cash remuneration paid to key employees in tandem with share-based awards.

We suggest that, rather than discriminate in practice against the remuneration strategies of these companies and the mix of cash based and equity-based remuneration that they offer employees, the KEEP measures should simply set absolute value limits, such as those included in subparagraph (i) and (ii) of part (d) of section 128F (1) TCA 1997. It should be left to companies to determine the proportionate mix of cash and share-based remuneration as a commercial matter and to follow market driven pay award practices.

We suggest therefore that the remuneration test² be removed from the KEEP provisions so not to restrict high growth companies in start-up mode availing of the scheme.

¹ See definition of a "qualifying share option", part (d) (iii) under section 128F (1) TCA 1997

² See definition of a "qualifying share option", part (d) (iii) under section 128F (1) TCA 1997

b) *The definition of a ‘qualifying individual’*

Under KEEP, the individual exercising the qualifying share option must be a full-time employee or full-time director of the qualifying company and devote substantially whole of his/her time to the service of that company throughout the entirety of the relevant period.

The current provisions³ envisage that an individual will be an employee of and carry out duties for a single company. In reality, an individual may hold the office of director or have a formal contract of employment with one group member but their services are available to other group companies. For example, employees may carry out work for the holding company and one or more subsidiaries and devote their time to the qualifying KEEP company within the group, as the business needs dictate.

Furthermore, while the existing legislation provides for the exercise of a KEEP option within 90 days of an employee ceasing employment, there is no provision for continued ownership of the options where the employee works for or transfers to another group company.

We believe an employee, who transfers to a group company should be permitted to retain their KEEP options that qualify for CGT treatment, provided all the other conditions of section 128F TCA 1997 are satisfied and that the manner in which employee relationships work within SMEs should be accommodated within the scope of the legislation.

c) *The definition of a ‘holding company’*

The scheme recognises that an employee may acquire KEEP shares directly in a company, which is engaged in a qualifying trade or acquire shares in a holding company. However, the definition of ‘holding company’⁴ under the existing legislation makes it practically impossible to give employees KEEP shares where the business corporate structure has a holding company.

Holding companies generally do not only own shares (i.e. a holding company can hold money in a bank account to discharge its running expenses or advance a loan to a subsidiary) and are not always the 100% parent company, which is what is required under the existing provision to qualify for KEEP.

A holding company often oversees and manages the activities of subsidiaries and in doing so, may charge and recoup management expenses whether in the course of the conduct of a services trade or otherwise. This means that the assets of a typical holding company do not consist wholly of the holding of shares that comprise the entirety of the issued share capital of another company, as is required by the existing provisions.

We recommend that the definition of a holding company under KEEP should be amended to adopt a similar approach to Revised Entrepreneur Relief, where a holding company “*means a company whose business consists wholly or mainly of the holding of shares of all companies which are its 51 per cent subsidiaries*”⁵ and which provides for a qualifying group.⁶

³ See definition of a ‘qualifying individual’ in section 128F (1) TCA 1997’

⁴ Section 128F (4) TCA 1997

⁵ Section 597AA (1) (a) TCA 1997

⁶ See definition of a ‘group’ and ‘qualifying group’ in section 597AA (1) (a) TCA 1997

d) *The requirement for ‘new’ issued shares*

A qualifying share option under the KEEP scheme requires that “*new ordinary fully paid up shares*”⁷ are provided to a qualifying individual when the option is exercised. However, in many cases, an SME may wish to use shares set aside, for example, 5% or 10% of the shares in the company, as a pool of shares that would be available to key employees as they are recruited.

By removing the requirement to have new shares, this would allow a company to appropriate and deliver existing shares to qualifying individuals. Delivery of existing shares to employees upon exercise of an option could also be appropriate in circumstances where an employee leaves the company and is replaced by a new recruit (e.g. where existing scheme shares could be bought back from the departing employee by the SME).

It is common in the case of other share schemes that a company may choose for commercial reasons to manage the delivery of shares to eligible employees under a trust arrangement or they may choose to set aside a pool of shares to be made available as key employees are recruited. Such flexibility could be permitted under the KEEP if existing rather than new shares qualified under the scheme.

We suggest that this flexibility of delivering existing shares could be permitted by deleting the reference to ‘new’ in part (a) of the definition of a qualifying share option under section 128F TCA1997.

e) *Creating liquidity in KEEP shares*

A substantial challenge for SMEs wishing to operate a KEEP scheme will be to provide assured liquidity for their shares, as not all these companies are likely to be sold or listed on a stock exchange. SMEs may need to consider how to create a market in the absence of a third-party exit, such as the owner, other employees or the company itself buying back the shares from an employee.

In general, a company buyback of shares is treated as income rather than capital. However, section 176 TCA 1997 provides that CGT treatment can apply to a buyback or redemption of shares if it is considered to be for the benefit of the trade. The KEEP provisions include a *bona fide* commercial reasons test⁸ to be met as part of the scheme’s requirements. We therefore ask that that section 176 is amended to reflect that a buyback of shares acquired under KEEP can be expected to meet the conditions for the benefit of the trade test in the section.

In addition, KEEP does not impose an ownership or holding period for the shares on the employee once the shares have been acquired under the terms of a KEEP scheme. Section 177(6) TCA 1997 should be amended to align its application with the understood policy intent of the KEEP provisions which is not to impose a post-acquisition holding period on scheme shares. The section should also clarify that CGT treatment can apply to KEEP shares acquired by the employee (the ‘vendor’ for the purposes of section 177). This subsection already includes provisions related to approved employee

⁷ See part (a) of the definition of a ‘qualifying share option’ in section 128F (1) TCA 1997

⁸ Section 128F(11) TCA 1997

share schemes which, unlike KEEP, impose certain holding period requirements on the scheme shares, once acquired by the employee.

An ancillary amendment should also be made to section 178 TCA 1997 to remove the requirement to substantially reduce shareholder ownership where the shares have been acquired under KEEP. As outlined above, it is foreseen that many SMEs will need to put in place redemption or buyback mechanisms to provide liquidity in scheme shares to employees. An amendment to section 178 is necessary to allow the SME to buyback employee KEEP shares in tranches and not be required to repurchase the entire employee's holding at one time.

Furthermore, KEEP shares should be excluded from the requirement under section 178(1) TCA 1997 to have a substantially reduced shareholding immediately following the buyback/ redemption.

We believe that without the amendments outlined above, KEEP will be unworkable for many companies who will not be in a position to offer listed shares e.g. on ESM or a third-party sale event to provide liquidity in their shares.

f) Where a SME undergoes a reorganisation

The current KEEP legislation does not provide for the continuing availability of the relief in the event that the SME (e.g. holding company and its subsidiaries) undergoes a corporate reorganisation during the period in which the KEEP share option rights are outstanding.

We would suggest amending the KEEP legislation to include similar provisions to those contained within the Revised Entrepreneur Relief legislation,⁹ which seeks to address reorganisations¹⁰ that might affect the entitlement of a qualifying individual and a qualifying company to meet the scheme requirements.

g) The need for agreed approaches to share valuations and the development of 'safe harbours'

One of the most significant practical issues that will face SMEs implementing KEEP will be to achieve as much certainty as possible that the valuation conditions have been met (e.g. that the share option price is not less than the market value of the shares at the date of grant).

The valuation of shares can be a complex exercise; especially for non-listed SMEs and valuation costs can place a significant burden on smaller enterprises in delivering share awards employees.

Revenue published guidance¹¹ on the operation of KEEP in April. However, in addition to providing general guidance on the KEEP provisions, we believe comprehensive guidance on share valuations is also required to support companies adopting the scheme. We believe this would make the process more accessible, easily understood and capable of implementation without undue duplication of effort and cost.

⁹ Section 597AA (1) (b) (i) and (ii) TCA 1997

¹⁰ Corporate reorganisations under section 586 and 587 TCA 1997

¹¹ Chapter 9, Share Schemes Tax and Duty Manual

This could be achieved by:

- Developing templates or safe harbour approaches for valuing shares in a SME. This would mean that a taxpayer would have assurance from Revenue that the share valuation is not less than market value for tax purposes, where the taxpayer had adopted the safe harbour approach to valuing the KEEP shares.
- Agreeing that, for the purposes of meeting a market value requirement for an employee share, a market value determined by reference to:
 - > a third-party share valuation event (such as investment by a private equity or angel investor),
 - > a valuation exercise that meets the safe harbour requirements described above, or
 - > standard share valuation exercise

that has occurred within the previous 12 months can meet the tax requirements for establishing the market value of the shares, provided there was no material change in the circumstances of the company.