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ESTONIA

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Q&A

Please provide a brief overview on how an ESOP in a start-up is usually structured in your jurisdiction (of particular interest: virtual or real participation programs, market practice with regard to vesting, participation (exits, proceeds and dividends) and voting rights).

Estonian law does not address employee stock ownership plans, with the exception of Estonian Income Tax Act which provides some tax incentives for employee share options. As being the only tax beneficial form of providing real participation in the employer's or employer group company's equity, the share option plan is the most common method used by Estonian start-ups for providing employees with interest in the company.

Estonian tax authorities have defined employee share option for tax purposes as a derivative agreement, under which the employee has a right (i.e. not an obligation) to buy from the issuer of the share option or sell to the issuer of the share option an underlying asset with the exercise price and within the term as specified in the agreement, where the underlying asset is a shareholding in the employer company or in the group company of the employer and the purpose of which is to involve employees in the circle of shareholders and thereby increase the productivity and efficiency of such employees and reduce the labour turnover. Following from the definition, share option is aimed at providing provides real participation in the employer of employer's group company. If the share option is aimed at providing virtual participation (i.e. phantom option which functions as a formula under which bonus salary is calculated), it does not

qualify as share option and it cannot enjoy share option tax benefits.

As **vesting** does not have generally relevance in tax treatment, the vesting schedules vary a lot. The general market practice is to have 3 year vesting with 1 year cliff and vesting of remaining 1/24 on a monthly basis. Vesting over 4 years is also common, but usually not longer. Vesting in less than 3 years is uncommon as exercise before 3 years from grant results in fringe benefit taxes totalling 66,25% of the value of benefit employee receives.

Exercise period for share options is usually minimum of 3 years. This is determined by the tax law, under which exercise taking place before 3 years has passed from the grant is subject to fringe benefit taxes, while exercise after 3 years has passed from the grant is not treated as fringe benefit and is therefore exempt from fringe taxes (subject to capital gains tax upon sale by employee).

Upon **exits**, variety of alternatives can take place depending on the future business considerations and structure of exits.

- The most common method is to have a roll-over (to change the underlying asset of share option from the current employer to the acquirer's company), which is supported by the in-come tax law stating that if the material terms of share option agreement are not changed, the 3 year waiting period for tax exemption does not restart. Issues can be faced if different types of programs are used (e.g. share options are rolled over to RSUs).

- Upon exits, employees usually have a possibility to exercise the vested shares. If it is a full exit situation (i.e. 100% of the shares in the issuing company are sold), the income tax law supports that by enabling to apply fringe benefit taxes on a time-based pro rata basis if the full exit takes place before 3 years has passed from grant. Such tax exemption was introduced by recognizing that fact that in full exit scenarios employees usually do not have a right to refuse from exercising and it would be unjust to apply fringe taxes in such situation.

In case employees exercise share options, they would be treated as ordinary shareholders with voting and dividend rights.

As for **generating proceeds** from share option, employee can either receive dividends or earn capital gains from the sale of shares. In full exits the share options are commonly exercised and shares are sold. Due to the flexible guidelines from tax authorities, the formal exercise and sale can be substituted by cancellation of share options in consideration of cash payment (cash-out, from tax law point of view if functions as the economic content and legal form differs and economic content is followed), sharing the same tax treatment, provided that the intent of arrangement parties confirm that. Mere cancellation of share option for consideration of cash would be subject to fringe taxes.

Restricted stock units as real participation forms are used in rare cases. Restricted stock units are restricted shares which are delivered to employee upon grant, but which turn into

ordinary shares upon vesting. Depending on exact mechanics, RSUs may or may not fall under the definition of share option and respective tax exemption. As long as RSUs do not provide any rights to employees upon grant and are not possible to sell, also provided employee has a choice to acquire the full share or not (i.e. through stop vesting or just waiving from the right to turning RSU into full share), it should be possible to apply share option tax treatment also to RSUs.

In some cases **phantom option plans** are used. Phantom option plans provide a possibility to cash out virtual company share, functioning as bonus salary calculation formulas which include a variable of company's value. Such plans are not regulated under the law, and these are not benefitting from share option tax treatment as not providing real participation. Same applies to **stock appreciation rights**, which enable payment of cash bonus equal to the appreciation in the company stock. Such method is not used in practice.

Please provide an overview of the respective tax situation an employee finds him-/herself in when he/she participates in a real/virtual equity investment program (applicable taxes and approximate tax burden (a) at the time of the investment and (b) at the time when revenues therefrom are received).

Share options and RSUs falling under the definition of share option are taxed as follows:

- Grant of share options to employee is exempt from any taxes
- Proceeds from the sale of share options is treated as fringe benefit and therefore subject to FBT;
- Exercise of share option in the company other than employer and employer group company is always subject to fringe benefit taxes (FBT)
- Exercise of share options in the employer or employer's group company is subject to FBT with the following exception:

    o If exercise takes place after 3 years has passed from grant, exercise is not treated as fringe benefit and therefore exempt from FBT;

    o If exercise takes place before 3 years has passed from grant, exercise is subject to FBT in full with the following exceptions, in which case the exercise is subject to FBT on a pro rata basis (how much time has passed from grant / term of the option agreement; but limited to vested share options):

        - the exercise takes place in full exit situation and the term of the option agreement is minimum of 3 years. If the term of the option agreement is less than 3 years regardless of the full exit situation or the exit is not a full exit regardless of the option agreement being with the term of 3 years or more, FBT applies in full;

        - In case an employee is established to have no work ability;

        - in the event of the death of an employee.

- Sale of shares acquired from the exercise is subject to capital gains tax at the employee level only. FBT tax base is treated as acquisition cost and therefore not double taxed upon sale.

FBT is fully employer tax, consisting of deferred corporate income tax at the rate of 25% from the benefit, and of social tax at the rate of 33% from the benefit plus the amount of CIT paid. FBT does not include employee level taxes. Benefit is the market value of shares acquired upon exercise minus exercise price paid by employee at some point before exercise or upon exercise. To present this as formulas:

FBT = CIT + social tax
CIT = FBT tax base / 0,8 * 0,2
Social tax = (FBT tax base + CIT) * 0,33
FBT tax base = benefit to employee = market value of shares – exercise price

Capital gains tax at employee level = Sales price – acquisition cost (incl exercise price) – FBT tax base.

Capital gains earned by an employee from the sale of shares is subject to 20% personal income tax in Estonia, payable on an annual basis through personal income tax return. It is not a withholding tax in Estonia..

Are there any tax advantages for an employee if the revenues based on the equity investment are reinvested in start-ups or other companies?

No. There is tax incentive only for exercising share options after 3 years from grant. Reinvesting proceeds fall under general tax treatment.

Are there any tax advantages for the company if an ESOP is established in the company?

Yes. In case employer has decided to provide shares to employees at discounted price, it is tax beneficial to grant share options and provide actual shares through exercising of these share options after 3 years has passed from grant. As the immediate grant of shares at discounted price would be subject to FBT fully at the employer level (totalling 66,25% from the benefit), such exercise would be exempt from FBT and subject to capital gains tax at the employee level. Combined, social tax cost is avoided.

The purpose of ESOP enjoying the above tax incentive cannot be payment of cash compensation to employee.

Please highlight one pro and one con of the legal set up with regard to ESOPs in your jurisdiction.

Pro: full fringe tax exemption available for ESOP if exercise is after 3 years from grant, while capital gains tax depend on the tax residency of the employee.

Con: As share option agreements must be notarized, signed with Estonian digital signature or sent to the Estonian Tax and Customs Board, entering into the agreements and using the share option administration programs require some tailored approach to be compliant and thereby enjoy the above tax benefit.