

## LATVIA



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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).**

Latvian law does not address employee stock ownership plans, with the exception of Latvian law On personal income tax 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 Latvian start-ups for providing employees with interest in the company.

Latvian 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 real participation in the employer or the 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, however, following the latest amendments in the tax law as of 2021 it could decrease to 1 year. In some cases it is set out that the shares vest in instalments each month over the vesting period.

**Exercise** period for share options is usually a minimum of 3 years. According to the latest amendments in the tax law the minimum vesting period should be 1 year. If the exercise of an option is taking place before 1 year has passed from the grant of the option, it is subject to payroll taxes, while exercise of an option after 1 year has passed from the grant is not treated as a taxable benefit and is therefore exempt from payroll taxes (subject to capital gains tax upon sale by employee).

There are no special regulations regarding the voting rights in case the employee has exercised his/her option. If a company has only one category shares, under the law such shares would have the same rights, including voting rights. Under the law Latvian companies may have several different categories of shares, if so provided in the Articles of Association of a company. Therefore, it is possible to establish share categories and provide for share options, e.g., shares with rights to dividend but without voting rights. In practice sometimes voting arrangements are included also in option agreements with employees, e.g., by employee undertaking to vote in the same way as majority shareholders or by employee undertaking to issue a PoA to majority shareholders for voting on their behalf, however, such contractual arrangements are binding only between the parties of the respective agreement.

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

As for **generating proceeds** from a share option, employee can either receive dividends or earn capital gains from the sale of shares.

In general, as share options are still not used very widely in Latvia, there is no common uniform practice and the provisions concerning vesting, exercise, exits etc. vary on a case by case basis, however, generally the companies tend to follow European or often also USA's trends in these matters.

**Restricted stock units** as real participation forms are used in rare cases. Restricted stock units are not used in Latvian companies, however, in rare cases may be used by Latvian employers when granting shares to employees in another group company in another jurisdiction, e.g., USA. Restricted stock units are restricted shares which are delivered to employees upon grant, but which turn into ordinary shares upon vesting. Depending on the exact mechanics, RSUs may or may not fall under the definition of a share option and the respective tax exemption. As long as RSUs do not provide any rights to employees upon grant and cannot be sold as well as provided the employee has a choice to acquire the full share or not (i.e. stopping vesting or just waiving the right to request turning RSU into full shares), it should be possible

to apply the 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 shares, functioning as bonus salary calculation formulas which include a variable as regards the company's value. Such plans are not regulated under the law, and these are not benefitting from the share option tax treatment since they do not provide for real share capital participation. The same applies to **stock appreciation rights**, which enable payment of cash bonus equal to the appreciation in the company stock. Such methods are 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 employees is exempt from any taxes;
- Exercise of a share option in the company other than the employer and the employer group company is always subject to payroll taxes;
- Exercise of share options in the employer or employer's group company is subject to payroll taxes except if the following criteria are met:
  - 1) the minimum vesting period (i.e. the period from the date of granting the stock options to the day when the employee exercises the right to purchase shares) is at least 12 months;
  - 2) during the whole minimum vesting period (12 months), the employee is employed by the company which has granted the stock options or with its related company within the meaning of Latvian Taxes and Duties act;
  - 3) within two months after the expiry of the period during which the employees can apply for purchasing shares or two months after the shares have been granted (if the share purchase rights implementation plan does not provide the application procedure), the employer should submit information on the stock option plan to the Latvian State Revenue Service;
  - 4) the right to purchase shares must be exercised within 6 months from the date of termination of the employment relationship between the employee and the employer (the company which has granted the stock options or its related company);
  - 5) the company which has granted the stock options or a related company has not issued a loan to the employee that has not been repaid until the date when the

employee exercises the right to purchase shares.<sup>1</sup>

The list of information to be provided to the Latvian State Revenue Service as mentioned in the point 3 above is as follows:

- 1) companies involved in the implementation of stock options plan;
- 2) the criteria set for employees to qualify for participation in the stock options plan;
- 3) the conditions under which an employee may purchase shares at the time of exercise of stock options;
- 4) the minimum holding period provided in the stock options plan;
- 5) the possibilities to exercise the stock options if the employment relationship is terminated;
- 6) the possibilities of the employee to alienate the granted stock options or the possibilities to inherit the stock options in the event of the death of the employee;
- 7) the conditions for the exercise of stock options;
- 8) list of employees who have confirmed their participation in the stock options plan.<sup>2</sup>

In case any of the criteria applicable to share option schemes is not fulfilled, the fringe benefit derived by an employee in the form of shares will be taxed as employment income at the following progressive personal income tax rates:

(1) a rate of 20% applies to monthly income up to EUR 1,667;

(a) a rate of 23% applies to the part of the monthly income exceeding EUR 1,667.

In addition, employment income is subject to 34.09% social security contributions - 23.59% are born by the employer while the remaining 10.5% are born by the employee. If the annual employment income exceeds 62 800 EUR (in 2021), the excess is not subject to social security contributions, but the solidarity tax is payable from this income at the total rate of 25%.

The Latvian employer is responsible for calculating, withholding and remitting payroll taxes, as well as for reporting such income in the payroll tax return to the tax authorities on a monthly basis.

Sale of shares acquired from the exercise of the option is subject to capital gains tax at the employee level only. Capital gains tax for individuals is 20%.

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<sup>1</sup> Article 9 (1) (43) of the Personal income tax law

<sup>2</sup> Article 11<sup>11</sup> (4) of the Personal income tax law

**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 1 year from grant. Reinvesting proceeds fall under the general tax treatment.

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

Yes. In case the employer has decided to provide shares to employees at a discounted price, it is tax beneficial to grant share options and provide actual shares through exercising of these share options after 1 year has passed from grant. In such case payroll taxes (including employer part of social security contributions (23.59% from gross benefit)) are not payable.

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 payroll tax exemption available for ESOP if exercise is after just 1 year from grant, while capital gains tax depend on the tax residency of the employee.

Con: As the information about the share option plan must be sent to the Latvian State Revenue Service, entering into the agreements and using the share option administration programs require some tailored approach to be compliant and to enable the above described tax benefits.