TAXATION OF EMPLOYEE SHARE OPTION PLANS (ESOPs)

General Features of an ESOP

An ESOP is an incentive and retention plan intended to motivate employees by giving them a stake in the company through equity participation. In most instances, companies seeking to set up ESOPs set up trust funds, into which they contribute new shares of their own or cash to buy existing shares in the company. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. The company then appoints a trustee (or trustees) who holds the shares in trust on behalf of the eligible employees.

Shares or units in the trust are then allocated to individual employee accounts on the vesting day as per the terms of the trust deed of the ESOP. Allocations are made either on the basis of relative pay or some other preferable formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, through a process known as vesting.

Vesting is pegged on condition that the employee is in employment with the company at the vesting date. Vesting of the shares can either be done all at once (cliff vesting) or gradually. The trust deed of the ESOP will stipulate among other terms, when an employee can leave the ESOP and what happens when the employee leaves.

Taxation of ESOPs

An ESOP typically has three key stages, i.e. the Grant/ Pre-Vesting Stage, the Vesting Stage and the Post Vesting Stage.

Pre Vesting Stage (Grant Stage)
At the Grant Stage, the shares ordinarily have no value pegged to them and an option is given to an eligible employee to exercise in the future i.e. upon vesting. As such, during this stage no taxes are triggered on the eligible employees.

Taxes would only be triggered during this stage, if any distributions are made by the company to the trustees.

Vesting Stage

At the vesting Stage, the employee makes a decision as to whether to exercise the option granted or not. As per the provisions of the Income Tax Act if the employee opts to exercise the option, this creates a benefit, similar to any other employment benefit. This is because access to the option is only granted as a result of one's employment and it is thus not possible to classify this as anything other than a benefit of employment.

The tax position of ESOPs at the point of vesting is generally governed by *Section 5(5)* and *(6)* of the Income Tax Act (ITA). *Section 5* basically provides for the benefit whilst Sub-*Section 6* provides for valuation.

As per Section 5(5) of the ITA the value of the benefit will be the difference between the market price per share and the offer price per share at the date an option is granted. Worthy of note is that in instances where the value of the benefit cannot be determined, the Commissioner has powers to prescribe a cost or fair market value for the benefit.

Section 5(6) on the other hand provides that for the benefit to be chargeable to tax, the ESOP has to be registered with the Commissioner General of the Kenya Revenue Authority (KRA) as a Collective Investment Scheme (CIS). For the ESOP to be registered with the Commissioner, it must have been approved by the Capital Markets Authority as a CIS, as provided in the Capital Markets Act.

Where the ESOP is registered with the Commissioner, the benefit will be deemed to accrue to the employee at the end of the vesting period, and will be based on the difference between the market value, and the offer price, per share at the date the option is granted by the employer.

As the Capital Markets Act governs listed companies, the Capital Markets Authority would only be in a position to approve ESOPs that have been created by listed companies. Following approval by the Capital Markets Authority, the ESOP would then be registered with the KRA, and at this point the provisions in section 5(5) as read together with section 5(6) would be applicable.

It is worth noting that the ITA does not provide explicitly for the tax rules of unregistered ESOPs. In practice however, KRA has adopted the OECD Model. Under this model, the taxable benefit is taken to be difference between the market value at the time of vesting, and the offer price per share at the date the option is granted.

The understanding is that such difference in the value of the shares represents a benefit of employment and that such benefit arises at the time of the exercise of the option. Since the share price is likely to have appreciated during the vesting period, the taxable benefit would be higher for members of an unregistered ESOP. In as much as there may be arguments countering such tax treatment, the KRA would always seek to adopt the general rules applicable to employment benefits. It is for this reason that we would always recommend a registered ESOP as the tax rules on this are not only uncontested, but also favorable.

Post Vesting Stage

Post vesting of the shares, the employee would become an investor in the company like any other shareholder. Any distributions made on account of the units in the trust constitute dividends from the shares of the company are taxed at 5% (withholding tax). On future disposal/redemption of the units, any gains made will be subjected to capital gains tax, unless the shares are listed on the Nairobi Stock Exchange in which case the gain realized will be exempt from tax.