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EMPLOYEE SHARES: TAXATION ISSUES IN LATVIA

This paper argues that: 1) acquisition of stock on a free-of-charge or privileged basis should not be treated as income gained by a private individual, and that such acquisition should not be subject to taxation; 2) the recipient of shares gains taxable income (including labour income) only upon alienation of a stock or gaining other income from capital, such as dividend or liquidation quota.
Keywords: *employee stock option; employee share (stock); tax benefits; labor income; income from capital.*

Ольга В. Лукашина

АКЦІЇ СПІВРОБІТНИКІВ: ПРОБЛЕМИ ОПОДАТКУВАННЯ В ЛАТВІЇ

У статті обґрунтовано, що: 1) акції, які отримані безкоштовно або зі знижкою, не повинні визнаватися доходом фізичної особи і ставати об'єктом оподаткування; 2) оподатковуваний дохід в одержувача акції (в т.ч. трудовий дохід) може виникнути лише за умови відчуження акції або при отриманні інших доходів від капіталу, наприклад, дивідендів чи ліквідаційної квоти.
Ключові слова: *опціон акцій співробітників; акції персоналу; податкові пільги; трудовий дохід; дохід від капіталу.*
Літ. 15.

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АКЦИИ ПЕРСОНАЛА: ПРОБЛЕМЫ НАЛОГООБЛОЖЕНИЯ В ЛАТВИИ

В статье доказано, что: 1) акции, полученные бесплатно или со скидкой, не должны признаваться доходом физического лица и становиться объектом налогообложения; 2) налогооблагаемый доход у получателя акции (в т.ч. трудовой доход) может возникнуть только при отчуждении акции или при получении прочих доходов от капитала – дивидендов или ликвидационной квоты.
Ключевые слова: *опцион акций сотрудников; акции персонала; налоговые льготы; трудовой доход; доход от капитала.*

Problem setting. A very unexpected rule was included into the law "On Personal Income Tax" in Latvian legislation in 2013. According to this rule, "income obtained from implementation of the stock purchase option, which has been granted to an employee... on the basis of employment relations, shall be considered as income for which payroll tax must be paid. Income obtained from the implementation of the right to stock purchase option shall not be subject to tax in the cases referred to in Section 9, Paragraph one, Clause 43 of this Law" (Par ... nodokli, Section 8, Paragraph 2.5). This means that personal income tax and social tax may be imposed on the employees acquiring shares from their employer on a free-of-charge or privileged basis. The enacted rule, however, has been the first step in taxation not only of income actually gained by an individual but also of their potential right to gaining such income.

Application of the new taxation rule to acquired stock (shares) as taxable labour income would make business in Latvia far less attractive. Moreover, such a rule would

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increase tax burden on the applied work, in contradiction to the recommendation of EU for Latvia made in 2014 (European Commission, 2014).

Recent research and publications analysis. In relation to the scientific project "PEPPER" (Promotion of Employee Participation in Profits and Enterprise Results), suggested by the European Commission at the turn of 80–90s, the terms "employee shares", "employee stock option (ESO)" and "Employee Stock Ownership Plan (ESOP)" are becoming widespread. The first and the second stages of this research (PERRER I in 1991, PEPPER II in 1997) introduced a typology of financial participation schemes. Nevertheless, the issue of tax imposed on the income of employees acquiring shares from their employer, were not raised or discussed until the third stage (PEPPER III in 1998–2006). At that time PEPPER investigated this issue in the new members and candidate countries of the European Union, and a group of prominent scientists studied the problems of taxes on employee shares in the European Union (European commission, 2003). They worked out "The Taxation of Stock Options in the EU" ordered by the European Commission. That paper set out some criteria for "common taxation principles, where the following principles were the most controversial ones: "Employee share options should constitute employment income for the purposes of taxation and social security charges", "Options should only be taxed at grant if they are tradable (e.g., they are traded at a stock market)", "Where employee share options are not freely tradable, they should, as a general rule, be taxed on exercise" (European commission, 2003).

Many European scientists (Lowitzsch et al., 2009; Globocnik, 2007; Spitsa and Lowitzsch, 2007; Globocnik and Ackermann, 2006; Dempsey, 2007) devoted their research to practical aspects of tax benefits application to employee shares and ESPO (or employee stock options). All of them pointed out significant differences and contradictions in the taxation of employee shares that exist in a number of EU states. Some of them didn't agree with "common taxation principles". Thus, T. de Liedekerke (2006: 30) argued that "for stock option major problems for employees arise from the difference in timing of taxation and from the risk of double taxation". In 2007, at the conference TOBEQU in Riga, N. Spitsa and J. Lowitzsch (2007: 18) noted that "tax benefits should apply to Employee and Employer in relation to high burden income, especially to social insurance payments". At the same conference N. Globocnik (2007: 10) claimed that "Employee's share in profit is not part of the salary, therefore a different tax regime should be applied. Employee's share is taxed twice: as a net profit of the company and as "other income" from employment relationship".

Nevertheless, a number of taxation issues related to employee shares, ESO and ESOP have remained unresolved until now.

The object of this study refers to stock securities obtained by employees of an enterprise; and **the subject** covers the rights attached to such securities as well as obligations (including tax obligations) derived from them.

The objective of this research is to prove that: 1) acquisition of stock on free-of-charge or privileged basis may not be treated as income gained by a private individual, and that such acquisition should not be subject to taxation; 2) a recipient gains taxable income (including labour income of employee) upon alienation of a stock or gaining of other income from capital, such as dividend or liquidation quota. **The methods of research** are represented by logical and historical methods and comparative analysis.

Key research findings. Let us begin with the historical analysis of this problem. As soon as the laws "On Personal Income Tax" (hereinafter – PIT) and "On Corporate Income Tax" (hereinafter – CIT) were enacted in Latvia in 1993, the so-called "cash basic accounting" method and "accrual accounting" were declared applicable to accounting and disclosure of income of a private individual and income gained by a legal entity, respectively. For the purposes of taxation it means that individual income is only taxable when actually received, while corporate income is taxable when gained and when obligation of a debtor arises to pay the bill issued by a creditor.

Employee shares (referred to as employee stock in Latvian law) granted free of charge were treated as the right which was not taxable. If, however, an individual would later turn such shares into real funds, the received income was treated as income from sale of personal property and exempted from taxation for 10 years. The PIT Law in 2000 clearly marked the moment of gaining income by holders of employee shares: it was the moment of redemption when a resigning holder of employee shares exchanged them for ordinary voting shares or sold shares to the issuer against certain consideration. The given norm stipulating that employee shares are taxable upon their transfer remained in effect till 2010. Materials of the PEPPER IV project refer to Latvia as a country where PIT is imposed on employee shares granted for free at the time of their alienation, with no social tax imposed on them (European Comission, 2008: 24–42).

Unresolved issues. In 2010 Latvian PIT Law was supplemented with the rule on taxation of capital income, while the reference to employee shares was omitted. Therefore, the time when employee shares should be considered as income liable to tax became unclear.

It would be logical, on the one hand, to assume that income gained from employee shares remains taxable in accordance with the earlier existing procedure, namely, upon gaining real monetary consideration in a year of their alienation.

On the other hand, starting from 2010, these would be considered taxable twice: as a gift upon their receipt, and taxable as actual income upon their alienation. Arguments of those who held such a position were quite logical. Acquisition of shares free of charge should be considered as a gift. Any gifts made by an employer to an employee of a company, similar to salary, have always been taxable by two types of tax. This rule has been inapplicable to employee shares because of the special exemption provided for in Section 9 of the Law. Once this special rule was deleted from it, the day on which the gift is received should be treated as the day of gaining income from the acquired employee shares. Therefore, the shares acquired free of charge or on the privileged basis constitute a part of taxable income of an individual as "income received... in specie".

In January 2010, Latvian tax advisors had a meeting of their association (hereinafter – LNKA) with a representative of the Ministry of Finance of Latvia. They discussed a number of ambiguous issues of tax legislation resulting from the enactment of new rules regulating capital income taxation. It was established that such rules required more indepth scientific review. In 2011 the LNKA proposed to restore the rule of the said law stipulating that the "benefit" acquired by employees of a company in the form of shares has to be included by the employer into non-taxable income of

private individual. Such "benefit" would become taxable at a later stage, as income gained from increase of capital assets (capital gains) upon transfer of the acquired share.

By the end of 2012 this proposal was elaborated in more detail and supplemented with certain relevant clauses. The draft law in the form proposed by the Ministry of Finance, along with the set of other budget laws for the year 2013, was approved on the urgent basis by the Parliament of Latvia, without virtually any discussion in commissions (Likumproekta...anotacija, 28.09.2012). It is reasonable to note that clauses proposed by the Ministry of Finance had the effect of enacting a rule opposite to that proposed by the LNKA.

Thus, new rules were included in the Law in 2013. They stipulated that allocation of shares to employees on free or privileged basis should be treated as labour income and only exempted from taxation if certain conditions are met. Section 9 clarified these conditions: terms of the agreement with employees have to be presented to the tax administration; 3 years have to pass from subscription for shares and their acquisition; throughout this period the prospective shareholder must be employed by his employer or by an affiliated company.

The Law was supplemented with a new Section 11.11. It contained the answer to the question: what does "implementation of stock purchase option" mean? The Law stipulates that "the stock purchase for the price determined in a stock purchase option contract, or, if it is determined in the contract, receipt of stocks free of charge, shall be considered as the implementation of stock purchase option" (Par iedzivotaju ienakuma nodokli, Section 11.11, Paragraph 3). Thus, realizing the right to employee shares in Latvia is not a monetary income from such shares, but getting the other right, namely – the right to join the club of shareholders.

The current version of the Law provides a clear and unequivocal answer that shares received on the privileged basis constitute labour income of an employee and are therefore taxable the same way as salary.

Tax controversy and risks for shareholders. The range of shares, privileged acquisition of which has been referred to in tax legislation since 2013, consists not only of "free of charge employee stock" mentioned in Latvian Commercial Law (Komerclikums, 2000: Section 255). This range is much wider; it allows and even suggests acquisition of voting shares by employees. These shares may not only be granted as a gift but also sold at below market price. Commercial Law only speaks about "employee stock" of an employer company, whereas tax legislation provides for employee right to shares of a parent, subsidiary or another related company.

There has never been a term "stock options for employees" in commercial and tax legislation of Latvia. Nevertheless, the abovementioned rules lead to the conclusion: Latvia is introducing the practice of using stock options for employee in order to encourage them to invest their money in financing their company's development. "Employee stock option" is an agreement between an employee and their employer which results in the issuance of securities for which an employee receives the right to buy a certain number of shares of the issuer on the preferential basis at a low price, on a certain date, provided that certain prerequisites are fulfilled.

The new rules are unlikely to encourage employees to acquire such shares. Attracting employees to participation in capital including on the privileged basis has

never been prohibited in Latvia, but such participation was not popular even when it was not taxable. According to the new rule in Latvian law, distribution of shares is promised to employee, either free of charge or at a discount price (executed option agreement), yet the employee first has to wait for the promised share for 3 years and then the share is made available at the price fixed on the date of agreement. At that point, tax of more than 30% of the amount of granted discount is deducted from the actual salary. In fact, what is the real benefit here? It is quite possible that the real market price of the share is notably lower upon distribution of shares than the price of option fixed at the time of agreement. The expected dividend could probably mitigate this negative point. In Latvia, however, income tax obligation "from the implementation of the stock ... option" arises even if a new holder has acquired an employee share with no right to influence the decision of voting shareholders regarding the distribution of profit and dividends. Such shareholder has no right even to get liquidation quota of the company if voting shareholders decide to wind up the company.

The newly enacted rule stipulating that acquisition of a share constitutes real, taxable income of a private individual would eventually extend to other transactions involving acquisition of shares and stock. For example, Latvian tax legislation provides no answer to the question whether or not the value of contribution of capital assets into the equity of a company is taxable, when an expert of the Register of Enterprises has assessed the value of such contribution notably higher than the acquisition value of such contribution. In practice similar transactions are not taxable at present. Yet there is a real risk that State Revenue Service of Latvia would start imposing tax on such income which in fact only constitutes the right to income, rather than real income.

Ambiguity of taxation rules and contradicting arguments "in favour" and "against" the application of 24% tax on each occasion makes similar transactions less attractive. A responsible tax-payer has to seek analogous, yet clearly defined and more attractive rules in the law upon discussions with tax administration. If such method of analogy is applied, it is much more probable that the income in question is not qualified as taxable income of a private individual. Given the abundance of controversies in tax legislation of Latvia, it is quite possible to find such a rule and to apply the method of analogy in an attempt to seek exemption from taxation.

There are at least 4 such examples of analogues in the applicable tax legislation of Latvia. All of them stipulate that acquisition of a right to monetary income is non-taxable income. Regulatory acts of Latvia concerning income tax recommend the interpretation of this right as "deferred income", which may be taxable upon actual receipt of income, rather than upon the accrual of right to such monetary income.

The first analogue provides for exchange of shares or stock. The law contains no reference to similar transactions. But the Cabinet of Latvia interprets the given situation (Likuma ... kartiba, 2010: item 97.1). Acquisition of a share here is not treated as gaining taxable income. Therefore, this rule fully corresponds with the principle of imposing tax on gained, rather than potential income. The second analogue is related to the right to income acquired by an individual in the form of "Cession of Right to Claim". For example, somebody (the cedent, assignor) acquires from the previous creditor (cessionary, assignee) the right to collect a debt in a certain amount. According to the above-stated Cabinet Regulations, such a right is exempted from

taxation even if it takes the form of gift. The Regulations stipulate that in the case of cession taxable income is the difference between the amount of money received by a cessionary from a debtor as a result of cession and the amount paid by a cessionary (Likuma ... kartiba, 2010: item 25). What is the difference between the income gained from promissory note received as a gift and the income gained from stock received as gift? The existence of contradicting rules that govern the same tax in the same category of regulatory acts is inconsistent.

The third analogue is related to shares of former non-profit organizations resulting from transfer of the exempted part of profit of such organization into the share capital of the limited liability company established upon reorganization. Some private individuals managed to increase their capital share several hundred times in the course of such reorganization, and they did so, on the account of non-taxable income. The question about how and when they would pay tax for such right acquired free of charge was simply resolved in 2004, when the Law "On PIT" (1993) was altered. In this occasion the right acquired in the form of stock (shares) is taxable no sooner than such stock (shares) is converted into real amounts of money.

The fourth analogue is the rule that regulates how and when income tax has to be paid by the companies that have acquired tangible values, funds or services free of charge. Such rule was enshrined by the Cabinet of Latvia in Regulations No 537 (Kartiba, 2004: items 10 and 14). Let us note the key point here: long-term investments received as gift are treated as deferred income (income in future periods) that is not taxable at the point of receipt. It has to be gradually disclosed as income gained during the accounting year to the extent of written-off depreciation. If the received item is not subject to depreciation (land, long-term securities) the gained income is only attributed to taxable income when the gift is disposed of or written off. It should be reminded that "accrual accounting" is applied by businesses for recording and recognition of income in case of legal entities, and even then no tax has to be paid upon the receipt of stock.

The PIT Law situation is quite different. It remains unclear however, why some sections of the Law concerning private individuals prescribe the method of "cash basic accounting" while others deviate from such a method.

Comparison with tax legislation of other countries. The rule enacted in 2013 was not drafted by the legislators of Latvia alone. They were guided by experience of other countries. Virtually all countries were enacting legislative rules regarding employee stock options with the view to support the process by granting tax privileges for the parties to the option transaction. European countries have ample experience in handling such privileges.

For example, in France during the "share blocking" period (temporary prohibition to transfer shares) tax privileges are normally granted to employees: part of their salary is exempted from salary tax and retained during 3–5 years by the employer to form accumulation for shares acquisition (European Commission, 2008: 28–29). In Denmark, tax legislation stipulates that no tax is applicable at the time of granting an option; instead, it becomes taxable upon realization to the extent of price difference and the imposed tax is similar to that imposed upon salary distribution (European Commission, 2008: 34–35).

In some other countries, the law clearly stipulates that salary tax is payable in respect of the privileges granted by a company if the conditions of transaction are not met or the employee has disposed the share acquired on privileged basis before expiration of the prescribed period. It is noted in particular that tax obligations (labour income tax and/or capital gain tax) arise upon disposal of share, rather than upon accrual of stock option or employee share. Taxes arise before disposal of shares only in respect of distributed dividends.

In the course of the project "PEPPER" a lot of experiences has been consolidated and analyzed. As a result of this work some tips on taxation have been prepared for the countries implementing the programs "Employee Stock Options" (ESO) and ESOP. In the part "Summary and Recommendations" of the report "PEPPER IV" J. Lowitzsch et al. (2009) concluded that "tax incentives should (and in most countries do) target those taxes which constitute the heaviest burden in the national taxation system." He noted that the heaviest taxes are usually the progressive personal income tax and social security contributions. Many countries therefore provide: 1) exemptions from social security contributions (SSC) for certain plans (France, Belgium, Ireland, Finland); 2) levying a capital gain tax (UK, Latvia from 2010, Belgium on dividends); 3) levying a special low tax in lieu of personal tax (France); 4) tax allowances for personal income (Austria, Finland, Ireland). Further in the same report, J. Lowitzsch clarified which tax incentives could be the most preferred and effective for ESO and ESOPs. For ESO programs, experts offered generous valuation rules combined with a favorable moment of benefit taxation (often linked to the period of holding shares) and exemption from SSC for employer and employee. But for ESOPs they suggest exemptions from income tax on share acquisition or on share sale if the profit was realized after a holding period. A company may also qualify for tax relief on the loan to acquisition of shares (Lowitzsch et al., 2009).

Conclusions:

1. New labor taxation rules (as well as rules on tax exemption) enforced in Latvia in 2013 allow employees acquire shares of their enterprise free of charge or at a discount. The wording of these rules is inaccurate. It entails ambiguity and contradictions, so these rules don't reach the intended target.

2. Implementation of international practices on employee stock and employee option issuance in Latvia has been inappropriate. The EU countries impose payroll tax on (or exempt from tax, when appropriate) that part of employee's earnings (or employer's capital) which is allocated to the purchase of stock option, rather than the value of such stock. Stock is taxable at the time of its alienation rather than at acquisition.

3. There are two major problems related to taxes on employee stock granted by employer free of charge or on the privileged basis: 1) the distinction between a shareholder's labor income and their capital income; 2) determination of timing for taxation of benefits obtained by shareholder.

4. A shareholder gains benefits at 3 stages: 1) acquisition of stock; 2) ownership of stock; 3) alienation of stock. There are 3 respective groups of benefits which succeed one another: 1) acquisition of stock free of charge or at a discount, which does not always become income; 2) receiving dividends or liquidation quota; 3) receiving income in the form of capital gains.

5. Problems and contradictions of Latvian taxation only arise at the first stage when the first benefit is gained. It may be regarded as employee's labor income liable to PIT and SSC 1) if employee received money from employer to pay for the purchase of shares; or 2) if employer made other payments for employee to cover the cost of their shares. Labor income is also taxable if employee leaves their salary or part of it with employer to pay for ordered shares. Commission of international experts has recommended making such income tax exempt if restrictions related to purchase and/or sale of shares are met. Meanwhile, acquisition of free of charge shares cannot be regarded as income and cannot be liable to tax, if employer issues employee stock by directing part of company's profit to subscribed share capital. In that case, income is deemed taxable at the time when shares are returned to employer if such a transfer has been documented as purchase of shares and if money has been paid. What tax should be imposed on employee, should it be similar to income tax or capital income tax – this is an issue to be discussed and solved.

Proposals on amendments to the tax legislation. In order to eliminate ambiguous norms of Latvian law "On Personal Income Tax", we consider it advisable to make amendments to a number of its sections. Section 8 should state that it is the cost of a share or its part that has been paid for by employer that is taxable, rather than the cost of acquired share or discounts on its price. Section 16.1 should point out that the date when income on a privileged share has been received should be deemed the date when such share was alienated.

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