IPSA GUIDE TO STOCK OPTION SCHEMES

What is a stock (or share) option?

A stock, or share option is a right, but not an obligation, to acquire a specified number of shares in a company at a pre-determined price at a future date. Such a purchase, using a stock option, is referred to as exercising the option.

Why operate a stock option scheme?

The primary objective of a stock option scheme is to motivate its participants (employees) to improve company performance and thereby effect an increase in the share price. By exercising their options, the participants can then purchase stock at a price below the current market price. If the share price is below the option price, a participant should not exercise their options. A stock option scheme also helps to increase stock ownership levels in an organisation creating a stronger link between employees and the performance of the business.

Purposes of an option scheme

As part of a stock benefit within a company's overall compensation plan, share options can help support a company's compensation philosophy:

- to attract, retain, and motivate employees necessary to enhance the company's longer- term growth and profitability;
- to reward employees for their personal performance;
- to encourage employees to help to drive the company's long-term growth and share in resultant company success;
- to align employee's goals and interests with those of the company and its shareholders.

How do stock option schemes work?

Stock Option schemes usually have performance conditions attached, which must be met prior to the stock option "vesting" (i.e. being capable of exercise). In most listed companies, the vesting of the option is generally conditional on the achievement of predetermined financial performance criteria, or fixed targets being met. Some of the more common performance conditions are Earnings Per Share (EPS), Total Shareholder Return (TSR) or growth of X% over and above inflation over a specified period. The determination of the performance conditions would usually be arrived at following consultation with institutional investors and approval by shareholders. There would normally be a range of acceptable performance and the option would vest proportionately to the performance.

In addition, stock options usually have a vesting period, (normally three years), before which, the stock option cannot be exercised.

As a stock option scheme (other than an SAYE scheme) is not Revenue approved, there are no requirements to be satisfied regarding employee participation and the number of options to be granted. This gives a company a lot of flexibility over the employees to whom options are granted and number of options granted.

When the vesting period has elapsed, and the performance conditions have been met, stock options may then be exercised. It is normal practice for options to be capable of exercise for a period of up to 7 years from the date they become granted. If the performance conditions have not been met during the three-year performance period, the stock options lapse, which means they are no longer capable of exercise.

Constitution

An option scheme is governed by written rules. In the case of quoted companies, the rules will normally be approved by shareholders at a general meeting and will also need to comply with relevant institutional investor guidelines. The timing of the implementation of an option scheme will therefore need careful consideration.

Tax Implications

Assuming the option is granted at market value or has an option life of less than seven years then, in general, there are no personal tax implications when a stock option is granted, or when it vests.

However, when stock options are exercised, the individual becomes liable to income tax, the universal social charge and employee PRSI on the difference between the exercise price and the actual stock price on the date of exercise.

The taxes due, on the exercise of an option, must be paid within 30 days of exercise and a Form RTSO1 must be filed along with the payment due. The exercise of a stock option brings the participant within the self-assessment tax system which imposes automatic tax payment and filing obligations. Participants in a stock option scheme should obtain professional tax advice in this regard.

Where the shares are shares in the employer company, or a controlling company, there is no employer PRSI charge on the gain made on exercise.

If an option is disposed of immediately, on exercise, there are generally no further taxation issues to consider. However, if the participant decides to retain the shares acquired on exercise of the option, and disposes of them at some later date, the capital gain / loss will be subject to the normal capital gains tax rules.

Annual Return

There is an obligation on companies to electronically file a return with Revenue for any year in which it grants an option to an employee, or any year in which an option is exercised, transferred or released. Self-assessment principles apply to the making of a return. The relevant information must be filed online using the return Form RSS1, Return of Share Options and Other Rights.

Regulatory & Listing Requirements

As a stock option scheme involves company stock, if this is traded on a stock exchange, there are a number of regulatory and listing requirements, which must be met prior to the introduction of a stock option scheme.

Example

An employee is granted 10,000 stock options at €10 in February 2016. After three years, 80% of the performance conditions have been met, and therefore, under the rules of the scheme, 80% of the options may be exercised. The balance of the 10,000 stock options (i.e. 2,000) will lapse.

On 1st March when the company stock price is €15, the employee exercises their options. This means that the employee pays €80,000 to purchase 8,000 units of stock, which has a value of €120,000. The gain on exercise is €40,000 on which income tax, the USC and employee PRSI of €20,800 is due. The income tax, the USC and employee PRSI due must be returned to the Collector General together with Form RTSO1 within one month from the date on which the option was exercised i.e.by 31st March 2019.

The foregoing reflects current tax rules and Revenue practice which is subject to change. This document is of a general narrative only and should not be regarded as a substitute for professional advice. Such advice should always be taken before acting on any of the matters discussed.

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