Taxation

Taxation and key aspects of equity and cash-based compensation plans in Estonia

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Comprehensive guide to taxation and key aspects of equity and cash-based compensation plans in Estonia

The purpose of this guide is to give an overview of the taxation and key aspects of different equity-based compensation plans and cash-based awards in Estonia.

The first part provides a more detailed overview of the taxation and key considerations applicable to the various types of equity compensation plans. The second part summarises these plans in a table, setting out the key features of Employee Share Option Plans (ESOPs), Restricted Share Units (RSUs), Performance Stock Units (PSUs), Employee Share Purchase Plans (ESPPs), Stock Appreciation Rights (SARs), phantom stock and other cash-based plans.

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Part I
General taxation

Basis of taxation

In Estonia, most types of equity awards are treated as fringe benefits for tax purposes. An exception applies to cash-based awards, such as SARs, phantom stock and other similar cash plans. These cash-based awards are taxed as salary and are subject to full payroll taxes.

Fringe benefits in Estonia are taxed only at the level of the employer. This also applies where the benefit is granted by another group company, such as a foreign parent company. If an equity award is treated as a fringe benefit, no employee level taxes apply at the time the benefit is received. Fringe benefits are not personalised in Estonia. The employee may become subject to tax only if the shares acquired are later sold.

Unlike in most other jurisdictions, where fringe benefits are generally taxed in a similar way to salary, Estonia applies employer level taxes only. The employer pays corporate income tax at a rate of 22/78, which corresponds to approximately 28.21% of the net benefit, and social tax at a rate of 33%. In addition, the corporate income tax amount itself is subject to social tax. As a result, the combined effective tax burden is approximately 70.51% [(1)] of the net benefit received by the employee.

By way of example, if the value of the benefit provided to an employee, for example the value of shares underlying RSUs at settlement, is EUR 1,000, the total tax payable by the employer is EUR 705.13. The corporate income tax is calculated as

$$EUR\,\frac{(1,000)}{0,78} \times 22\% = EUR\ 282.05$$

The social tax is calculated as

$$EUR\ (1,000 + 282.05) \times 33\% = EUR\ 423.08$$

[(1)] The exact percentage is 70.5128205128205.

Taxable event

As a general rule, the taxable event occurs when the employee receives the shares underlying the equity award. For example, in the case of RSUs, this is the vesting or settlement date. For share options, the taxable event is the exercise date. Under an employee share purchase plan, taxation arises on the purchase date, when the discount is granted and the shares are acquired.

For the avoidance of doubt, the grant of share options, RSUs or similar awards does not trigger taxation.

Taxable value

The taxable value is the benefit received by the employee and depends on the type of equity award.

In the case of RSUs, the taxable value is the market value of the shares at the time of settlement. For share options, the taxable value is the market value of the shares at the time of exercise less the exercise price, meaning the spread. For an employee share purchase plan, the taxable value is the discount granted to the employee.

By way of example, if the market value of the shares underlying a stock option is EUR 1,500 and the exercise price payable by the employee is EUR 600, the resulting benefit, and therefore the taxable value, is EUR 900. Unless a tax exemption applies, as described below, this amount is subject to fringe benefit taxation.

Compensation of taxes by the employee

If an agreement or plan requires the employee to compensate the employer or the issuing company for the tax cost, either in cash or through a reduction in shares, the compensated amount reduces the taxable value of the fringe benefit for the employer. This is because the compensation reduces the actual benefit provided to the employee.

The following example illustrates this.

Assume that the gross benefit granted to the employee is EUR 1,000 and the combined effective tax rate applicable to fringe benefits is 70.5%.

If the employee is required to compensate the employer for the full tax cost of EUR 705.13, the taxable value for the employer is reduced by the same amount. As a result, the remaining taxable value is EUR 294.87 (1,000 − 705.13). The employer's actual tax cost is then approximately EUR 207.92 (294.87×70.51%), which is significantly lower than the amount paid by the employee. This outcome is not economically neutral.

A more appropriate approach is to treat the EUR 1,000 as an amount inclusive of taxes. In that case, the taxable value should be calculated by dividing the total amount by 1 plus the combined tax rate:

$$EUR\,\frac{1,000}{(1\ +\ 70.51\%)} = EUR\ 586.47$$

This means that the actual tax cost is EUR 413.53 (1,000 − 586.47). If the employee compensates the employer for this amount, the taxable value for the employer is EUR 586.47, and the taxes payable by the employer equal EUR 413.53. In this scenario, the tax cost borne by the employee matches the tax paid by the employer.

If the tax cost is compensated through a reduction in shares rather than in cash, the same principles apply. Using the example above, the value of the shares to be withheld or reduced should correspond to EUR 413.53.

Tax declaration

The employer must declare fringe benefits on the TSD tax return, Appendix 4. The TSD return, together with the relevant annexes, must be submitted to the Estonian Tax and Customs Board, and the tax must be paid by the 10th day of the month following the month in which the taxable event occurs.

If the conditions for the tax exemption described below are met, the employer is not required to declare the benefit or pay tax.

Tax exemption (tax incentive)

As an exception to the general rule described above, a tax exemption applies if both of the following conditions are met:

- there is a minimum period of 3 years between the grant date and the settlement or exercise of the equity award; and
- the underlying asset of the equity award is a participation in the employer or in a company belonging to the same group.

If these conditions are satisfied, the exercise of share options, the settlement of RSUs and the discount granted under an employee share purchase plan are exempt from employer level taxation.

In addition, where 100% of the shares of the issuing company are sold, or where an employee becomes disabled or dies, taxation applies only on a pro rata basis. In such cases, the taxable portion is calculated based on the actual period between the grant date and the relevant event, relative to the required 3-year period.

Employees eligible for the tax incentive

The tax rules described above apply only if the participant qualifies as an employee under Estonian tax law. For these purposes, the term "employee" includes:

- employees;
- members of the management or supervisory board;
- self-employed persons; and
- natural persons who work or provide services under a contract for services, an authorisation agreement or another type of contract governed by the law of obligations.
- individuals working under employer of record arrangements may be treated as employees for the purposes of fringe benefit taxation, including eligibility for the applicable tax exemptions.

Accordingly, these special rules do not apply where services are provided through a personal company, or where the contractual relationship is with a personal company, but the equity awards are granted directly to the individual.

Reporting

If the option agreement is not digitally signed in accordance with EU electronic signature standards or notarised, the employer must submit the agreement to the Estonian Tax and Customs Board within five working days of signing.

In practice, the Estonian Tax and Customs Board has confirmed that alternative solutions that allow the signing date to be reliably determined retrospectively are also acceptable. These include share award management platforms such as Carta, Fidelity, E*Trade, Ledgy and Shareforce, as well as the DocuSign e-signing platform. In such cases, there is no requirement to submit the agreements to the Estonian Tax and Customs Board.

TAXATION AT EMPLOYEE LEVEL

Sale of shares

An employee is taxed on any gain realised on the sale of shares at a flat personal income tax rate of 22%. The taxable gain is the difference between the sale proceeds and the acquisition cost. The acquisition cost generally equals the price paid for the shares, if any, reduced by expenses directly related to the sale, such as brokerage fees.

The value of the shares that was taxed as a fringe benefit at employer level is included in the acquisition cost. By way of example, if the benefit received and taxed at employer level is EUR 1,000, and the employee later sells the shares for EUR 1,200, only the gain of EUR 200 is subject to personal income tax.

In addition, if the employee was required to compensate the employer for any tax cost in cash, that amount is also treated as part of the acquisition cost.

The employee must declare the gain realised on the sale of the shares in the annual income tax return. The return must be submitted to the Estonian Tax and Customs Board by 30 April of the year following the sale. The tax is payable by 1 October of the same year.

A different tax treatment may apply if the employee uses the investment account regime available to Estonian tax residents for certain financial assets, mainly listed securities. This regime allows the deferral of personal income tax until funds are withdrawn from the investment account.

Receipt of dividends

Dividends received from abroad are not subject to taxation in Estonia if income tax has already been withheld abroad, or if the profit on which the dividends are based has been taxed abroad and the payment of such tax can be verified. Even where foreign dividends are exempt from Estonian taxation, the employee must still declare them in the annual personal income tax return.

If no income tax has been withheld abroad and the underlying profit has not been taxed abroad, the employee must pay personal income tax on the dividends at a rate of 22% . The annual income tax return must be submitted to the Estonian Tax and Customs Board by 30 April of the year following receipt of the dividends. The tax is payable by 1 October of the same year.

Domestic dividends are not subject to additional taxation at the employee level.

OTHER KEY ASPECTS

Cashless exercise of options

Estonian tax practice generally allows the cashless exercise of share options in connection with a full exit event. In such cases, no shares are actually issued to the option holders. Instead, they receive a cash amount equal to the difference between the sale price and the exercise price, adjusted for any taxes compensated.

For tax purposes, two separate events are still recognised: first, the exercise of the option, including the assessment of whether any tax exemption applies, and second, the sale of the shares.

Alternative equity-based compensation plans

In practice, a wide range of equity-based compensation plans are used, depending on the jurisdiction of the issuing company. For example, arrangements similar to an employee share purchase plan often provide employees with additional free shares if the shares are held for a specified period.

The Estonian Tax and Customs Board has confirmed that comparable plans may also benefit from the special tax rules in Estonia, provided that the benefit, meaning the free shares, is not transferred before the third anniversary of the start of the plan.

The Estonian Tax and Customs Board has also confirmed that where shares are held through a custodian bank, fund or association, the relevant tax rules may still apply. However, such structures must be analysed on a case-by-case basis, for example in the case of a French FCPE.

Taxation of cash-based compensation plans

As noted above, cash-based compensation plans, such as SARs and phantom stock, are taxed as salary and are subject to full payroll taxation. According to the practice of the Estonian Tax and Customs Board, even where the cash payment is made by a foreign parent company, the actual employer, for example a local subsidiary, must process the payment through local payroll. This reflects the fact that the remuneration is directly linked to the employment relationship.

The applicable taxes are as follows.

Employee level taxes withheld from the gross amount:

1) Unemployment insurance contribution at a rate of 1.6%, employee portion.
2) Funded pension contribution at a rate of 0%, 2%, 4% or 6%, depending on the employee's election.
3) Personal income tax at a rate of 22%.

Personal income tax is withheld from the taxable amount, meaning the gross payment, after deducting unemployment insurance contributions, funded pension contributions and the basic tax exemption of EUR 700, where applied by the individual.

Employer level taxes paid on top of the gross amount:

1) Unemployment insurance contribution at a rate of 0.8%, employer portion.
2) Social tax at a rate of 33%.

The employer must declare the cash payments on the TSD tax return, Appendix 1. The return, together with the relevant annexes, must be submitted to the Estonian Tax and Customs Board, and the taxes must be paid by the 10th day of the month following the month in which the payment is made.

In light of the above, employers should generally seek to make use of the tax incentives available for share based compensation plans, as the tax treatment is significantly more favourable from the employer's perspective.

Deductibility of equity award costs

Equity award costs are deductible for the employer.

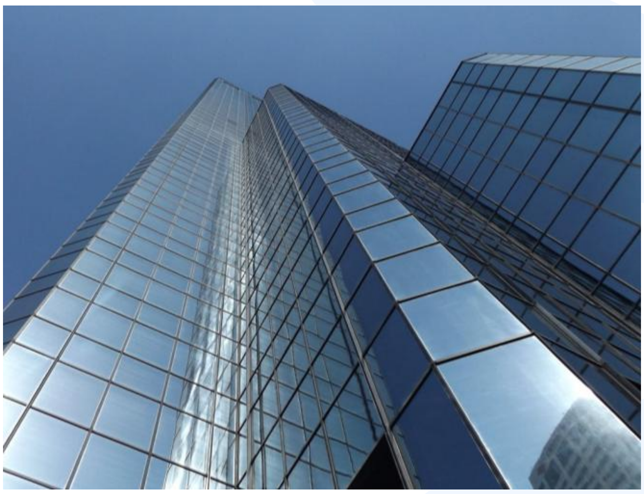
Employment law considerations

Estonian labour law does not specifically regulate equity awards, and there is no established case law on this topic. As a result, it is not entirely clear whether equity awards and similar employee incentive plans should be regarded as part of the employment contract or as a separate legal relationship between the parties.

If such awards are considered to form part of the employment contract, employees may bring related disputes before the Estonian courts or the Labour Dispute Committee, irrespective of any jurisdiction clause included in the relevant agreement or plan.

Security law considerations

The offering of securities in Estonia is subject to the rules laid out in the EU Prospectus Regulation (Regulation (EU) 2017/1129; the "Prospectus Regulation"), which is directly applicable in Estonia. Under the Prospectus Regulation, the offering of transferable securities generally requires the drawing up, registering and publishing a prospectus, unless any exemption under the Prospectus Regulation is applicable. The concept of "transferable securities" is used in the Prospectus Regulation as defined in point (44) of Article 4(1) of the Directive 2014/65/EU with the exception of money market instruments as defined in point (17) of Article 4(1) of Directive 2014/65/EU, having a maturity of less than 12 months. For share option schemes, the European Securities and Markets Authority ("ESMA") has expressed the view that non-transferable options should generally not be considered as "transferable securities" within the meaning of the Prospectus Regulation and, thus, should not fall under the scope of regulation of the Prospectus Regulation. Nevertheless, ESMA has stated that where transactions are structured as options, but in reality constitute an offering of securities, the competent authorities (such as the Estonian Financial Supervision and Resolution Authority (the "Estonian FSA") for Estonia) reserve the right to re-qualify options as offer of securities in order to overcome any circumvention of the Prospectus Regulation. The Estonian FSA has taken the view that in case securities as a class may be transferred by a unilateral declaration of intention, the security would still be considered transferable even if there are limitations on the transfer of the specific security



Part II
Summary of key tax features

<table>
<tr><th></th><th></th><th></th><th colspan="2">Employee-related taxes</th><th colspan="2">Employer-related taxes</th><th></th></tr>
<tr><th>Equity Award</th><th>Taxable Event</th><th>Taxable Amount</th><th>Income Tax Withholding</th><th>Social Insurance Contribution Withholding</th><th>Corporate Income Tax</th><th>Social Tax</th><th>Employer Tax Reporting</th></tr>
<tr><td>Share Awards (e.g., employee share options)</td><td>Exercise</td><td>Difference between fair market value of the shares and the exercise price (the spread).</td><td>N/A</td><td>N/A</td><td>22/78</td><td>33%</td><td rowspan="4">The employer must report fringe benefits at the time of exercise, vesting or purchase, to the extent that the awards do not qualify for the tax exemption. Fringe benefits must be declared on the TSD tax return, Annex 4.

The TSD return, together with the relevant annexes, must be submitted to the Estonian Tax and Customs Board, and the taxes must be paid by the 10th day of the month following the month in which the taxable event occurs.</td></tr>
<tr><td>RSU</td><td rowspan="2">Vesting</td><td rowspan="2">Fair market value at vesting</td><td rowspan="2">N/A</td><td rowspan="2">N/A</td><td rowspan="2">22/78</td><td rowspan="2">33%</td></tr>
<tr><td>PSU</td></tr>
<tr><td>ESPP</td><td>Purchase</td><td>Discount</td><td>N/A</td><td>N/A</td><td>22/78</td><td>33%</td></tr>
<tr><td>Cash Awards (e.g., SARs, phantom stock)</td><td>Payment</td><td>Cash amount</td><td>22%</td><td>Unemployment insurance contribution at the rate of 1.6%; and funded pension at the rate of 0%, 2%, 4% or 6%</td><td>N/A</td><td>33%</td><td>The employer must withhold the applicable taxes from the taxable amount and remit them to the state budget by the 10th day of the month following the month in which the taxable event occurs. The taxable amount and the withheld taxes must be declared on the TSD tax return, Annex 1.</td></tr>
</table>

See above "**basis for taxation**" and "**taxation of cash-based compensation plans**" for exact tax calculations.

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About the author

Tõnu Kolts is a managing associate and co-head of the tax practice at COBALT Law Firm in Estonia. He is a recognised tax law expert with extensive experience in advising both Estonian and international clients.

He also has substantial practical experience in the design and implementation of equity-based compensation plans and regularly advises companies on structuring incentive programmes in a tax-efficient manner, taking into account Estonian tax rules and international group considerations.

Tõnu has advised a wide range of companies across different sectors on the development and implementation of employee incentive programmes. His experience includes advising Bolt on the design of option programme terms and related agreements, as well as assisting publicly listed companies on the Tallinn Stock Exchange, including Ekspress Grupp, with the implementation and revision of employee share option programmes. He has also advised larger Estonian corporate groups with cross-border activities, including companies in the travel sector such as Estravel, on the implementation of employee share option programmes at group level. In addition, Tõnu has advised several international companies on the rollout of share-based incentive programmes, including option plans and share purchase plans, for employees of their Estonian entities.

Tõnu provides tailored advice to companies navigating the legal and tax aspects of employee incentive arrangements, from the establishment of ESOPs to the implementation of global compensation structures.

His work in this area has contributed to the development of Estonian tax practice, and several structures he has advised on have later been reflected in the guidance of the Estonian Tax and Customs Board. These include, among others, cashless exercise of options in exit situations, roll-over options in connection with the sale of an issuer and adjustments to underlying assets in bonus issue situations.

If you have any questions or would like to discuss employee incentive arrangements, Tõnu can be contacted using the details below.

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