

# WHAT IS EMPLOYEE SHARE OPTION PLANS (ESOP)?

## Why ESOPs are important for startups (in general)



### Main advantages of employee share option plan

- motivational booster and engagement for employees
  - motivates employees to use a long-term approach aimed at the increase of the value of company
  - promotes efficient management and operation of company
  - appreciation of employees' performance, responsibility, loyalty and other characteristics
- unite employees and shareholders for common goals (distribution of profit, sale of shares at exit and/or initial public offering (IPO))
- tax-free employee's remuneration tool (if law requirements are met) and lower tax costs



## Why Latvia is the most friendly startup country in the world based on its stock option policy

Substantial improvements to laws in Latvia regarding ESOP implementation and tax-free regime that become in force in the beginning of 2021



## Laws in Latvia regarding ESOP implementation and tax-free regime

- In general, the benefit that an employee derives from the acquisition of shares under their market value, is applicable with taxes related with salary and the employer is obliged to cover these taxes
- If the requirements set out in laws are met, then this benefit is tax-free for both – employee and employer
  - submission of information set out in laws about ESOP and employees participating in ESOP to State Revenue Service within 2 months after start date
  - cliff vesting period must be at least 12 months
  - employee must be into the employment relationship during whole cliff vesting period (in case of management or supervisory board member – also other type of legal relationship with a company)
  - exercising date is set not later than within 6 months after termination of employment relationship
  - on exercising date, an employer or its related person has not granted a loan to employee (one exception provided in the law On Personal Income Tax)
- Shares can be paid up by employer itself from undistributed profit
- Shares can entitle different rights to holder of shares, including voting right, right to dividend and right to liquidation quota or other specific rights and preferences (priorities)
- If law requirements regarding tax-free regime are met, then valuations in respect of shares value are not required
- In case of limited liability company share transfer occurs only if the transfer document is signed in presence of notary or with EU official electronic signatures



## Most important laws applicable to ESOP in Latvia

**The Commercial law** (issuance of shares, rights arising from shares, governance of company etc)

**The law On Personal Income Tax** (tax free requirements)

**Cabinet Regulation No 899 'Application procedure of law On Personal Income Tax'** (specifications of tax free requirements)

**The Labour Law** (establishment and termination of employment relationships)

**The Law On Taxes and Duties** (definitions of legal terms related to tax free requirements)



## Main legal terms related to ESOP

- one term in English – share, two terms that can be also used as synonyms in certain cases in Latvian – '(kapitāla) daļa' and 'akcija'
  - '(kapitāla) daļa' is share of limited liability companies and 'akcija' is share of (joint-)stock companies
- in law texts term 'option' is used solely in respect of personnel options ('personāla opcijas') – a legal tool available for (joint-)stock companies
- do not mix up personnel options (personāla opcija) with personnel shares (personāla akcija)
  - personnel option is a right to acquire shares of (joint-)stock company granted by (joint-)stock company to employees
  - personnel share is non-transferable share that can be granted by (joint-)stock company to employees
- legal term for 'share options' in the Commercial Law regarding limited liability companies is 'right to acquire share' ('tiesības iegūt sabiedrības daļas')
  - if limited liability company have granted to persons a right to acquire shares of company, the management board ensures record keeping of such rights and their holders (Article 187(13) of the Commercial Law)
- legal term for 'share options' in the law On Personal Income Tax is 'share purchase right' ('akciju pirkuma tiesības') - in this law text refers to both types of shares ('(kapitāla) daļa' and 'akcija')



## How to start employee share options' plan

1.

Define the targets of ESOP

- provide additional remuneration to employees by distributing the profit in dividends (like a bonus or premium)
- engage employees in the adaptation of the important matters that are in the competence of shareholders (election of management board or supervisory board, share capital increase, amendments to articles of association etc)
- motivate employees for successful sale of shares at exit or IPO

2.

Depending on the targets of ESOP decide which rights will arise out of share

- voting rights
- right to liquidation quota (and/or)
- right to dividend (and/or)
- other specific rights or preferences

3.

Choose the 'price' – employee will acquire shares free of charge or for a purchase price

- who will cover the nominal value of shares in case of free of charge?
  - for limited liability companies – shareholders or company from its profit
  - for (joint-)stock companies – shareholders or company from specially formed reserves or from its profit

4.

Understand which employees can participate in ESOP

- management of company, key employees, all employees
- obligation to be worked for a certain period in a company or other precondition to be entitled to participate in ESOP

5.

Set a time schedule of ESOP

- start date – moment of granting ('piešķirt') a share option to employee (start of vesting period)
- acquiring date – moment of acquiring ('iegūt') a share option by employee (end of vesting period)
  - cliff vesting is the process by which employee acquires all or part of share options after a specific period (tax free requirement – at least 12 months from start date)
  - graduated vesting is the process by which employee acquires share options (or part of) gradually (proportionally) over a period (for example 1/48 of share options' total amount per each month)
  - vesting types can be mixed, for example if the total vesting period is 4 years then the first 12 months it can be cliff vesting (employee after 12 months acquires 1/4 of total amount of share options) and afterwards graduated vesting (employee acquires 1/48 of total amount of share options after each month)
- exercising date – moment of exercise ('izlietot') of a share option (can be the same as acquiring date or can be later)
  - helps to organise granting of shares in blocks
  - gives a time for company to buy back shares options from employees before 'exit' (for example, if buyer demands it)



## Share acquiring by employees is the next step of ESOP

- Freedom for implementation of different type and legal ground share options
- What documents are mandatory required to initiate ESOP?
  - the Commercial law mention maintaining the 'register of personnel options in accordance with the procedures laid down Section 247'
  - the law On Personal Income Tax and Cabinet Regulation No 899 mention 'plan of share purchase right implementation'
- What documents can be prepared?
  - agreement between shareholders, company and employees or agreement between shareholders and employees (for example share purchase or share donation agreement) – can be useful tool for a small number of employees
  - rules for issue of options as imitation of personnel options (that are available for (joint-)stock companies))
  - plan of share purchase right implementation (ESOP plan)