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THE LIRS'S NOTICE ON THE TAXATION OF EMPLOYEE SHARE COMPENSATION PLANS: MATTERS ARISING



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INTRODUCTION

One of the many ways in which a company can encourage its employees to contribute to its success is to align the employees' financial interest with that of the company. This alignment can be achieved by compensating the employees with the shares of the company through various share compensation plans. These plans are designed to either give the employees the option to purchase the shares of the company ("Employee Share Option Plans" or "ESOPs") or grant free shares to the employees ("Share Award Plans") provided however, that some conditions are fulfilled.

It is essential that the tax implications of these plans are carefully considered before a company offers these plans to its employees. Although there is no specific guidance on the tax treatment of these plans under the income tax law that applies to individuals – the Personal Income Tax Act 2011 (as amended) (PITA) – nonetheless classifies income derived from these plans as an 'emolument'.

However, the Lagos Inland Revenue Service (LIRS) has attempted to provide some guidance on the tax treatment of these plans by issuing a public notice titled, 'Taxation of Employees Share/Stock Options' (the LIRS' Notice).

This article therefore examines the tax treatment of ESOPs and Share Award Plans in light of the LIRS' Notice.

Employee Share Option Plans (ESOPs)

Under these plans, employees are granted the right, but not the obligation, to purchase the shares of a company. The terms of such purchases are usually contained in a plan document, which would provide the number of shares to be bought, the price to be paid (the exercise price) and the date the option can be exercised. Where the employees exercise the option, the benefit to the employees will be the difference between the full market value (FMV) of the shares and the exercise price.

Section 3 of PITA provides that income tax shall be payable on "*salary, wage, fee, allowances or other gains or profits from employment including compensations, bonuses, premiums, benefits or other perquisites...*" which are earned in the course of employment.

While it is clear from the above provision that the benefit accruing to the employees upon exercising the option would be liable to income tax, there is no guidance in the PITA on the basis of which to compute the income tax.

¹Section 5(5) of the PITA defines gross emoluments as "wages, salaries, allowances (including benefits in kind), gratuities, superannuation and any other incomes derived solely by reason of employment".

In line with section 3 of PITA, the LIRS' Notice confirms that the benefit accruing to the employees upon exercising the option is subject to income tax and provides that the taxable amount is the difference between the "*actual share price and the exercise price*". The LIRS' Notice goes further to provide that the 'actual share price' for listed companies is the price at which the shares of such company trade on the stock market. The LIRS' Notice provides that the price per share for a non-listed company is to be computed by dividing the "net assets" of such company (as reported in its penultimate financial statement) by the number of shares of such company. The LIRS' Notice does not state how to determine the net assets of a non-listed company.

Where the company granting the options to the employees is also the contractual employer of the employees, the benefit accruing to the employee would be liable to income tax. Consequently, the employer would bear the remittance and reporting obligations concerning the income tax. The LIRS' Notice provides that the employer must remit the income by the 10th day following the month that the employees exercised the option.

The LIRS' Notice does not provide guidance where the company granting the options to the employees is not the contractual employer of the employees. This situation could arise where the company issuing the shares to the company is a related company, which in most cases, is usually, the parent company of the contractual employer. Due to the absence of an employment relationship between the company granting the shares and the employees exercising the option, the PAYE regime will not apply to any income tax liability arising from the exercise of the options by the employees. In such a case, the employees would be personally responsible for reporting the income tax liability arising from the exercise of the option. This report is done by filing an annual tax return within 90 days from the end of a fiscal year (ending December 31) in which the option was exercised and paying any tax assessed by the tax authorities tax based on the filing.

Share Award Plans

As stated earlier, employees are granted free shares under these plans. The terms of such grant are usually contained in a plan document, which would provide the conditions that must be fulfilled before the employees would be granted the shares – the vesting conditions and the specific date in future when the employees will be given the shares – the vesting date. The employees are not entitled to the shares at the time of grant but at the date of vesting, provided of course that the vesting conditions have been fulfilled. Some of the common vesting conditions are related to performance and continued employment.

According to the LIRS' Notice, Share Award Plans are to be given the same tax treatment as ESOPs. Therefore, the taxable amount would be the actual value of the shares that are granted to the employees. The price per share for a listed company would be the price at which the shares of such company trade on the stock market, while the amount per share for a non-listed company is to be computed by dividing the net assets of such company (as reported in its penultimate financial statement) by the number of shares of such company.

Just as the case for ESOPs, where the company granting free shares under a Share Award Plan is also the contractual employer of the employees, the actual value of the shares that are issued to the employees would be liable to income tax under the Pay As You Earn regime. Just as the case for ESOPs, the employer would, therefore, bear the remittance and reporting obligations concerning the income tax arising from the grant of free shares and must remit the income tax by the 10th day following the month of the vesting date.

Similar to ESOPs, where the company granting the free shares under a Share Award Plan is not the contractual employer of the employees, the PAYE regime will not apply to any income tax liability arising from the grant of free shares. The employees would, therefore, be personally responsible for reporting the income earned and paying the applicable tax as assessed by the tax authorities, just as the case for ESOPs.

Conclusion

Other than its failure to provide guidance on how to determine the “net assets” of a company in valuing the price per share of a private company, the LIRS' Notice has largely provided some clarity regarding the taxation of ESOPs and Share Award for employees residing in Lagos State.

However, the tax authorities of other states may take views that are different from the LIRS on the tax implications of ESOPs and Share Award for employees residing in their state. This may result in the unequal tax treatment of employees based on their state of residence and lead to different PAYE-related obligations on employers. It is therefore our recommendation that PITA be amended to prevent these occurrences.

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