Chapter 11 - Employee Share Ownership Trusts (ESOT)

This document should be read in conjunction with section 519 and Schedule 12 of the Taxes Consolidation Act 1997

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11.1 Introduction

The legislation on approved Employee Share Ownership Trusts (ESOT) can be found in section 519 and Schedule 12 TCA 1997.

An ESOT is, in many ways, similar to an approved profit-sharing scheme (APSS) - it is essentially a trust established by a company for the purpose of placing company shares into the hands of employees. However, the ESOT has, in some ways, fewer constraints than an APSS in that:

- the APSS has only one principal source of funds - direct contributions from the employer company – whilst the ESOT, on the other hand, can obtain finance from a number of sources (for example, it can borrow money, earn dividends as well as take contributions from the employer company);

- the APSS must appropriate the shares to employees within 18 months of their acquisition whereas the ESOT can hold the shares for up to 20 years.

Except in the case of deceased beneficiaries, any shares transferred to, or cash payments made directly to, the beneficiaries of an ESOT by the trustees of the ESOT will be liable to income tax in the hands of the beneficiary.

Generally, an ESOT is established in tandem with an APSS. Beneficiaries of the ESOT may be appropriated shares through the profit-sharing scheme in a tax-free manner under the normal rules for an APSS.

11.2 Main Features of an ESOT

A Revenue approved ESOT must meet certain legislative requirements including that:

- it must be established by a trust deed.
- the company establishing the ESOT must not be under the control of another company (i.e. it must be the parent company that establishes the ESOT).

Legislation contained within Part 17 TCA 1997 provides that:

Employees -

- relief from income tax for eligible employees/directors who have ordinary shares appropriated to them under an APSS linked to an approved ESOT.

Companies -

- a deduction from corporation tax in respect of the costs of establishing an approved ESOT and for any payments made to the trustees which are expended in the expenditure period for qualifying purposes.

ESOT -

- an exemption from income tax for the trustees of an ESOT in respect of income accruing to the trust in so far as that income consists of dividends, and only to the extent that such income is expended within the expenditure period for qualifying purposes. No tax credit will arise in respect of such dividends.
- an exemption from CGT for the trustees of an ESOT on any shares transferred by them to the trustees of an APSS.
- an exemption from CGT for the trustees of an ESOT on any shares sold by them on the open market but only to the extent that the proceeds of sale are used to:
    - repay borrowings by those trustees,
    - to pay interest on the borrowings, or
    - to pay a sum to the personal representatives of a deceased beneficiary.

As in the case of an APSS, where the company establishing the ESOT has control of another company or companies, a group scheme can be established to include some or all of the group companies. However, a scheme will not be approved by Revenue that will result in shares being appropriated wholly or mainly to the higher paid employees/directors in the group of companies.

Certain conditions must be satisfied before Revenue will approve an ESOT. These can be classified under the following headings:

- General conditions (see section 11.4);
- Trust, Trustees, and Trustees' functions (see section 11.5);
- Beneficiaries (see section 11.6); and
- Securities (see section 11.7).

11.3 Approval Process

11.3.1 The Revenue Technical Service (RTS)

Revenue recognises that taxpayers and or their agents may need, on occasion where a matter is not fully dealt with in Revenue's published guidance, to make contact to clarify the technical treatment of transactions prior to completing a tax return. All such technical queries should be directed to Revenue through the Revenue Technical Service. Comprehensive guidance regarding submitting technical queries through the RTS can be found in Tax and Duty Manual (TDM) Part 37-00-00a

11.3.2 Direct contact for approved Share Schemes

The only exception to submitting technical queries through the RTS will be where companies are proposing to establish and operate specific share schemes requiring approval (i.e. APSS, ESOT or SAYE). In such circumstances, case specific queries prior to application can be sent to Revenue. All such queries and scheme applications should be sent to the Employee Share Scheme Section of Revenue at the below address.

Employee Share Scheme Section,
Personal Taxes Policy & Legislation Division,
New Stamping Building,
Dublin Castle,
Dublin 2.

Alternatively, an email address is available shareschemesection@revenue.ie. Revenue does not recommend sending personal or confidential information to this email address as it is not secure. My Enquiries - TDM Part 37-00-36 should be used as an alternative.

11.3.3 Approval

Revenue will accept queries on particular technical issues where clear guidance is not available on the Revenue website. Such case specific queries can be submitted to the unit for consideration in advance of making the submission for approval.

The company must apply to Revenue for formal approval by submitting the following documentation and information:

- a copy of the executed Trust Deed;
- a copy of the Board Resolution establishing the ESOT;
- a copy of the Memorandum and Articles of Association/Constitution of the company establishing the ESOT;
- a copy of any documents that will be issued to the beneficiaries of the ESOT;
- a declaration signed by the Company Secretary that the securities to be used satisfy the conditions set out in paragraph 14 of Schedule 12 TCA 1997. The declaration should be on company headed paper;

- where the founding company is a member of a group of companies, a declaration signed by the Company Secretary that the scheme does not and would not have the effect of conferring benefits wholly or mainly on directors of companies in the group or on those employees of companies in the group who are in receipt of higher or the highest levels of remuneration. The declaration should be on company headed notepaper; and
- a final similar terms document.

11.3.4 Approval of Alterations to Schemes

It may be necessary from time to time for a company to make amendments to an ESOT. Approval of an ESOT will cease automatically if an alteration is made to the Trust Deed, unless the alteration has been approved by Revenue.

Once a Deed of Amendment has been executed, a copy should be provided to Revenue for approval. Any such amendments do not take effect until they have been approved by Revenue.

11.3.5 Withdrawal of Approval

Revenue has the authority to withdraw approval of an ESOT in the following circumstances:

- Where any of the conditions that are required to be met in relation to the securities, beneficiaries, trust, trustees' functions, or other general conditions set out in Paragraphs 6 to 18 of Schedule 12 TCA 1997 are contravened.

- Where shares acquired by the trustees receive different treatment from other shares of the same class (in particular, the shares must not receive different treatment in respect of dividend rights, repayment rights, restrictions attaching to the shares and bonus or rights issues – however, this does not mean that there are grounds for withdrawal of approval if newly issued shares do not rank for the next dividend on the same basis as shares of the same class already in issue).

- Where the trustees fail to provide information requested by Revenue under Paragraph 3(4) Schedule 12 TCA 1997 or information which is required to be delivered under Paragraph 3(5) Schedule 12 TCA 1997.

The withdrawal of approval is effective from the date of the first occurrence of such circumstance unless Revenue specifies a later date.

11.3.6 Right of Appeal

A company has a right to appeal to the Appeal Commissioners where it is aggrieved by refusal to approve an ESOT or an alteration to an ESOT or the withdrawal of approval of an ESOT. Information on appeals can be found in the Tax & Duty Appeals Manual on the Revenue website.

11.4 General Conditions

There are a number of general conditions that must be satisfied before Revenue will approve an ESOT. These are set out below.

- **Establishment of trust**
  The founding company must establish a trust and the trust deed must provide for the establishment of a body of trustees which must be one of three possible structures which comply with Paragraph 8, 9 or 10 of Schedule 12 TCA 1997 (see section 11.5).

- **Non-essential features**
  The ESOT must not contain any features which are neither essential nor reasonably incidental to the purpose of acquiring or transferring sums and securities to employees and directors and transferring securities to the trustees of an approved profit-sharing scheme.

- **Requirement regarding a group scheme**
  Where the company establishing the ESOT is a member of a group of companies, the ESOT will not be approved unless Revenue is satisfied that the trust does not and would not have the effect of conferring benefits wholly or mainly on directors of companies in the group or on those employees of companies in the group who are in receipt of higher or the highest levels of remuneration.

11.5 Trust, Trustees and Trustees Functions

11.5.1 Structure of Trust

The trust must be established by the founding company which at the time the trust is being established is not under the control of another company.

11.5.2 Trustees

The trust deed must provide for the establishment of a body of trustees which must be one of three possible trust structures which comply with Paragraph 8, 9 or 10 of Schedule 12 TCA 1997. These are explained below.

11.5.3 Trust Structure 1

The first trust structure is one that provides for the majority of trustees to be employee representatives. In these circumstances, the trust deed must appoint the initial trustees and contain rules for the retirement, removal and appointment of replacement and additional trustees. There must be at least 3 trustees who are resident in the State and the below conditions are also met.

- One trustee must be a professional trustee (a trust corporation, a solicitor or member of another professional body approved by Revenue).
- A majority of the trustees must not be, or ever have been, directors of the founding company or of a group company,
- A majority of the trustees must be representatives of the employees of the founding company or a group company and who have not nor ever had a material interest in any such company. Such trustees must be selected by a majority of employees of the founding company's group at the time of selection.

11.5.4 Trust Structure 2

The second structure is a trust which provides for equal employee and company representation in addition to an independent trustee. As for structure 1 the trust deed must appoint the initial trustees and contain rules for the retirement, removal and appointment of replacement and additional trustees. There must be at least 3 trustees who are resident in the State and the below conditions are also met.

- At least one trustee must be a professional trustee (that is, a trust corporation, solicitor, or member of another professional body approved by Revenue) who must not be an employee or director of the founding company or of a group company, and who -
    - o when appointed as an initial trustee was selected by persons who were later appointed as the initial non-professional trustees, or

    - when appointed as a replacement or additional trustee was selected by persons who at the time of selection were the non-professional trustees.

- At least 2 trustees must be non-professional trustees at least half of whom must be employees of the founding company or of a group company who have never had a material interest in any such company, and who must be selected either by a process under which all the employees of that company or those companies are (in so far as is reasonably practical) given the opportunity to stand for selection and to vote for those standing or by persons elected to represent those persons.

11.5.5 Trust Structure 3

The third structure is a trust with a single trustee. The single trustee must be a company resident in the State which is controlled by the founding company. As for structures 1 and 2, the trust deed must appoint the initial trustees and contain rules for the retirement, removal and appointment of replacement and additional trustees.

The trust company must have a board of directors composed in the same manner as trust structure 2 – equal employee and company representation.

11.5.6 Appointment and Removal of Trustees

Where a trustee is removed and a new trustee is appointed, Revenue must be notified, and the relevant Deeds of Removal and Appointment must be submitted to Revenue for approval.

11.5.7 Functions of the Trustees

The functions of the trustees and in particular the following general functions must be clearly set out in the trust deed.

- To receive sums from the founding company and other sums, by way of loan or otherwise.
- To acquire securities.
- To grant rights to acquire shares to beneficiaries under the ESOT.
- To transfer securities or sums (or both) to beneficiaries under the ESOT.
- To pay sums or transfer securities to the personal representatives of deceased beneficiaries.
- To transfer securities to the trustees of approved profit-sharing schemes.
- Pending transfer, to retain and manage the securities by exercising voting rights or otherwise.

11.5.8 Sums received by trustees

The trustees of an ESOT may receive funds from the founding company or it may borrow funds. All sums obtained by the trustees must be used within the expenditure period and must be used for qualifying purposes.

The expenditure period is the 9-month period starting, where the sum is received from the founding company or a group company, from the end of the accounting period in which the sum was expended by the company, and in any other case, the day the sum is received.

The following are qualifying purposes:

- acquisition of shares in the founding company or specified securities,
- repayment of borrowings,
- payment of interest on borrowings,
- payment of any sum to a beneficiary of the ESOT,
- payment of any sum to the personal representatives of a deceased beneficiary, and
- the meeting of the expenses of running the ESOT.

11.5.9 Monies held by trustees

Monies held by the trustees must be held in cash or in an account with a relevant deposit taker within the meaning of section 256 TCA 1997 (e.g. bank or building society in the State).

11.5.10 Payments to Beneficiaries - General

The trust deed must provide that where the trustees pay sums to different beneficiaries at the same time, all the sums must be paid on similar terms. Similar terms may include terms which in relation to beneficiaries vary according to their levels of remuneration, their length of service or similar factors.

Sums paid to the beneficiaries of an ESOT are regarded as emoluments of the director or employee concerned and consequently are chargeable to tax under Schedule E. PAYE/PRSI/USC must also be deducted by the trustees from any sums paid.

11.5.11 Payments to Beneficiaries – Treated as Distributions

Normally the trustees of an ESOT will be able to use dividend income received by them on securities held in the trust for qualifying purposes. However, it can happen, albeit very infrequently, that surplus dividend income has to be distributed to the beneficiaries of the ESOT as a cash payment.

In these circumstances and where the ESOT is linked to an approved profit-sharing scheme, any surplus dividend income that is distributed to the beneficiaries of the ESOT on or after 3 February 2005 is treated as a distribution to which Dividend Withholding Tax (DWT) applies. The trustees of the ESOT will apply the DWT where relevant payments are being made and the beneficiary will be provided with documentary evidence showing the distribution and the amount of DWT deducted.

The distribution is subject to the normal tax treatment in the beneficiaries’ hands. The individual is liable to income tax at his or her marginal rate subject to a credit for the DWT. The beneficiary must make a return of the distribution in the normal manner.

11.5.12 Payments to Deceased Beneficiaries

Most ESOTs work in tandem with an approved profit-sharing scheme. In many cases, the beneficiaries of the ESOT are notionally allocated securities that are held in the ESOT, and these securities are appropriated to the beneficiaries through an approved profit-sharing scheme sometime later.

Where a beneficiary dies and he or she would otherwise have received an appropriation of shares (based on his or her notional allocation in the ESOT) through an associated APSS, the trustees of the ESOT may transfer securities or their cash equivalent direct to that deceased beneficiary's personal representatives. In these circumstances, and notwithstanding the general rule on payments to beneficiaries, the transfer does not give rise to an income tax charge.

11.5.13 Transfer of Securities to Beneficiaries

The trust deed must provide that securities are transferred to beneficiaries on qualifying terms. The qualifying terms are that securities must be offered to all persons who are beneficiaries under the ESOT at the time of transfer and that the transfer must be made on similar terms to all persons who have accepted the offer. Similar terms may include terms which vary in relation to beneficiaries according to their levels of remuneration, length of service or similar factors.

Where securities are transferred to the beneficiaries of an ESOT directly and not through an associated approved profit-sharing scheme, the securities are regarded as emoluments of the director or employee concerned, and consequently chargeable to tax under Schedule E. In practice, this is unlikely to happen.

11.5.14 Reporting Requirements

The trustees of an ESOT are required, in relation to any year of assessment, to make an annual return of information on Form ESOT1 to Revenue on or before 31 March in the year following that year. This form is available on the Revenue website. Revenue has the authority to withdraw approval of an ESOT where a return is not made for any year.

The trustees of an ESOT are under the same obligations as any other trustees of any other trust. This means that the trustees are also required (under section 890 TCA 1997 as applied by section 894(3) TCA 1997) to make an annual return of any income or gains arising to the trust on Form 1 on or before 31 October.

11.5.15 Trustees - Exemption from Income Tax

The trustees of an ESOT are exempt from income tax on any dividend income received by them in respect of securities held to the extent that such income is expended within the expenditure period for qualifying purposes.

11.5.16 Trustees - Exemption from Capital Gains Tax

The trustees of an ESOT are exempt from capital gains tax on the following:

- the transfer of securities by them to the trustees of an approved profit-sharing scheme,
- the transfer of any securities to the personal representatives of a deceased beneficiary,
- any gains arising on the sale of securities by them on the open market or the redemption of securities if and to the extent that the proceeds of sale are used to:
  - repay monies borrowed by the trustees,
  - pay interest on such borrowings, or
  - pay a sum to the personal representatives of a deceased beneficiary.

11.6 Beneficiaries

11.6.1 Introduction

The trust deed must contain provisions as to the beneficiaries under the trust. There are rules as regards which directors and employees must be included as a beneficiary of an ESOT and those that may be included.

11.6.2 Who Must be Eligible to be a Beneficiary?

All employees and full-time directors of the founding company or a group company, who have been such at all times during a qualifying period (which must be specified in the trust deed, and which cannot exceed 3 years) and who are chargeable to income tax under Schedule E, must be eligible to be a beneficiary of the ESOT.

A “full-time director” is a director who has worked for the company concerned for at least 20 hours a week ignoring holidays and sick leave.

11.6.3 Who May be Eligible to be a Beneficiary?

An ESOT may allow for the following categories of persons to be beneficiaries:

- Former employees or directors of the founding company or of a group company may be beneficiaries (for up to 15 years from the time they have ceased employment, or the company has ceased to be a group company) where the following conditions are satisfied -

    - The person was an employee or director of the founding company which established the ESOT or of a company within the founding company’s group at all times during a qualifying period (which must be specified in the trust deed, and which cannot exceed 3 years).

    - The person was such an employee or director on the date the ESOT was established or at sometime within 9 months prior to that date or at any time in the 5 years beginning with that date.

    - At all times in the 5 years (or such lesser period as allowed by the Minister for Finance) since the ESOT was established, 50% (or such lesser percentage as allowed by the Minister for Finance) of the securities held by the trustees were pledged as security for borrowings.

    - The ESOT has been established for more than 20 years.

- Former employees and directors of the founding company or a group company, where -

    - the person was an employee or director of the founding company which established the ESOT or of a company within the founding company’s group at all times during a qualifying period (which must be specified in the trust deed, and which cannot exceed 3 years), and

- the person has ceased employment with the company within the previous 18 months (or the company has ceased to be a group company).

- A charity, where -
  - the ESOT is being wound up, and
  - there are no other eligible beneficiaries at that time.

11.6.4 Who Cannot be a Beneficiary?

Employees and directors cannot be beneficiaries if they have, or at any time in the previous 12 months had, a “material interest” in the company.

An individual has a “material interest” in a company if he or she, either on his or her own or with any one or more of his or her associates, or if any associate of his or hers with or without any such other associate, is the beneficial owner of, or is able, directly or through the medium of other companies or by any other indirect means, to control more than 15% of the ordinary share capital of the company.

11.7 Securities

11.7.1 Introduction

Only certain securities (i.e. shares (including stock) and debentures) may be acquired by the trustees of an ESOT. These are generally shares in the founding company, but there are circumstances where the trustees may acquire securities other than shares in the founding company.

11.7.2 Shares in the founding company

The shares must -

- form part of the ordinary share capital of the founding company,
- be fully paid up,
- be non-redeemable,
- not be subject to restrictions other than restrictions that apply to all shares of the same class or be a permitted restriction,
- not be acquired by the trustees of the ESOT-
  - for less than market value, or
  - at a time when the founding company is controlled by another company (other than where the founding company is a company into which a trustee savings bank has been reorganised under section 57 of the Trustee Savings Bank Act 1989).

11.7.3 Permitted Restrictions

The shares may be subject to a restriction which is imposed by the company's articles requiring-

- Directors and employees of the company or any other company controlled by that company to dispose of their shares on the cessation of their office or employment.

- All shares acquired by former directors and employees (for example, on the exercise of share options or other rights after cessation of an office or employment), or shares acquired by other persons who acquired the shares in pursuance of a right or interest obtained by a director or employee, to be disposed of when they are acquired. The disposal must be by way of sale for money and on terms specified in the articles of association. The same terms for disposal must apply to all shares of the same class.

11.7.4 Other Securities

The trustees may acquire securities other than shares in the founding company in the following circumstances -

- Where the securities are acquired by the trustees of the ESOT as a result of a reorganisation or reduction in share capital (e.g. bonus issue or rights issue) in accordance with section 584 TCA 1997.

- Where the securities are acquired by the trustees of the ESOT on an exchange basis in the case of a company amalgamation to which section 586 TCA 1997 applies.

To determine whether or not the securities have been acquired in either of the circumstances outlined above, the company must forward all documentation governing the transaction together with a brief outline of the steps involved and a synopsised diagrammatic representation of the company group organisational structure pre and post restructure, detailing shareholdings etc.

11.7.5 Transfer of Securities

The trustees must transfer any securities acquired by them within 20 years of having acquired them.

In the case of securities acquired by the trustees of an ESOT in any of the circumstances outlined in section 11.7.4, the trustees are treated as acquiring the securities at the same time as they acquired the exchanged securities or the original securities, as the case may be.

In practice, the trustees of the ESOT transfer the securities to the trustees of an APSS, for onward appropriation to the beneficiaries of the ESOT.

11.8 Corporation Tax Deduction

11.8.1 Introduction

A company that establishes an approved ESOT is entitled to claim a corporation tax deduction in respect of certain expenditure incurred in relation to the ESOT provided that the expenditure is used for qualifying purposes and is expended within a specified period.

11.8.2 Expenditure Qualifying for a Deduction

A company may claim a corporation tax deduction in an accounting period for the cost of –

- Setting up an approved ESOT.
- Contributions to the trustees of the ESOT where the company or a company it controls has employees or directors who are beneficiaries under the ESOT, and those contributions are expended by the trustees of the ESOT during the expenditure period for qualifying purposes.

If an approved ESOT is established later than 9 months after the end of the accounting period in which the establishment costs are incurred, then the costs should be treated as having been incurred in the accounting period in which the ESOT is established and not in the accounting period in which the establishment costs were actually incurred.

11.8.3 Expenditure Period

The expenditure period is the 9 months period starting from the end of the accounting period in which the contributions by the company to the trustees of the ESOT are made or such longer period as agreed by Revenue. A longer period will only be considered in exceptional circumstances.

11.8.4 Qualifying Expenditure

The contributions made by the company to the trustees of the ESOT must be used by the trustees for qualifying purposes.

All of the following are regarded as qualifying purposes -

- Acquisition of shares in the company that established the ESOT.
- Repayment of borrowings used for qualifying purposes.
- Payment of interest on such borrowings.
- Payment of any sum to a beneficiary of the ESOT.
- Payment of any sum or the transfer of any securities to the personal representatives of a deceased beneficiary.
- The meeting of the expenses of running the ESOT.