Republic of Estonia
Tax and Customs Board

Fringe benefits

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Share options

The Estonian Tax and Customs Board defines a **share option** in the meaning of **subsection 5[3] of § 48 of the Income Tax Act** as a **derivative contract** concluded with the employer, which gives the employee the right (not the obligation) to buy options from the issuer or to sell options to the issuer at the exercise price specified in the contract of the underlying asset and within the term fixed in the contract.

The underlying asset of the share option is a holding in the employer or in a company belonging to the same group as the employer. The purpose of share options is to include employees in the circle of partners/shareholders and thereby increase their productivity and efficiency and reduce staff turnover.

It is not considered a share option if, when granting the option, **it is known in advance that the employee will not receive a share in the employer or in a company belonging to the same group as the employer**, but the employer will pay the employee the price of the underlying securities. In this case, the payment is treated as wages, salaries, or additional remuneration, from which all labour taxes are payable.

The granting of a share option is not considered a fringe benefit. No tax liability arises when a share option is granted.

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Conditions of share options

Important conditions of share options are:

- ✓ **the time of granting** the option, i.e. the date of signing the share option contract or the date of agreeing on the terms of the employer's participation program (e.g. employee stock purchase plan, ESPP or restricted stock unit, RSU);
- ✓ **the underlying asset** of the option, i.e. holding (share) in the employer or in a company belonging to the same group as the employer;
- ✓ **the number of underlying assets**, i.e. the specified number of shares / nominal value of the share;
- ✓ **the exercise (realisation) price** of the option, i.e. specified share price / share value;

- **the term of option exercise (realisation)**, i.e. the period from the granting of the option to its exercise, in taxation, the duration of the period of at least 3 years is important;

- **the moment of exercise (realisation)** of the option, i.e. the date when the employee uses the right to acquire a holding arising from the option and receives underlying assets in exchange for the option;

- **the option premium**, i.e. the amount paid by the employee for the option. Option premiums are not mandatory.

If the option contract has not been digitally signed or notarised, the employer is obliged to submit the contract or information regarding joining the employer's participation program to the Estonian Tax and Customs Board at the e-mail address **ariklient@emta.ee** within 5 working days of its conclusion.

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Taxation of share options

Share options are taxed (according to **subsection 5^3 of § 48 of the Income Tax Act**):

- **at the transfer of an option** before it is exercised or

- **at exercising an option** (i.e. buying or selling the underlying asset).

The transfer of a share option before its exercise is considered a fringe benefit, regardless of the three-year term of the option exercise or the moment of the transfer of the share option. The employee is required to notify the employer of the transfer of the share option. The employer incurs a tax liability from the fringe benefit provided.

Exercising a share option, i.e. acquiring a holding that is the underlying asset, **before 3 years have passed** since the option was granted, **is considered a fringe benefit.** The employer has a tax liability on the fringe benefit.
During the term of the option contract with a term of at least three years, **as an exception**, if

- ✓ the entire holding in the employer or in a company belonging to the same group as the employer is transferred (so-called full exit situation) or

- ✓ the employee is diagnosed with total incapacity for work, or the employee dies,

acquiring a holding underlying the option to the extent that corresponds proportionally to the time of holding the option before the event **is not considered a fringe benefit.**

Only the situation where the **entire holding** (100%) in the employer or in a company belonging to the same group as the employer is transferred is not considered a fringe benefit. The exception does not apply to partial transfer of a holding!

Exercising a share option, i.e., acquiring a holding that is the underlying asset, **after 3 years have passed** since the option was granted, **is not considered a fringe benefit.** The employee will benefit from the transfer of securities in the future!

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Three-year term of share options

In the event of a **change in the underlying asset** of the option, a three-year term is calculated from the date of the initial option grant, if the underlying asset changes, for example,

- ✓ due to the reorganisation of the group or the merger/division/transformation of the company;

- ✓ due to a change of job of an employee in the group (e.g., the employer replaces the underlying asset with a holding in a company belonging to the same group);

- ✓ due to the transfer of the entire holding (e.g., the new owner of the employer replaces the underlying asset);

- as a result of a bonus issue. Since a bonus issue is carried out at the expense of the equity without making additional contributions, it is essentially considered equity restructuring and an accounting operation. When the share capital is increased, the line of equity of the balance sheet, on the account of which the bonus issue is carried out (profit, premium), will simultaneously decrease, and the company's assets and the balance sheet total will remain the same.

Since the employee acquires a real holding in the employer or in a company belonging to the same group as the employer at the time of execution of the option contract, the important conditions of the share option are not changed, and the counting of the three-year term is not interrupted. If essentially a new share option contract is concluded with the employee and under new conditions, then a new three-year term will begin.

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Determining the price and the taxation of fringe benefits

The **"Procedure for determining the price of fringe benefits"** is established by Regulation No. 2 of the Minister of Finance of 13 January 2011 (hereinafter *the Regulation*).

If the fringe benefit is the income obtained from the **transfer of a share option**, then **the difference between the market price of the share option and the option premium paid to the employer is considered the price of the fringe benefit** (**subsection 1 of § 7 of the Regulation**).

If an employee did not pay option premium to the employer, the market price of the share option is considered the price of the fringe benefit.

If the fringe benefit is the income received from the **acquisition of the holding underlying the share option**, then the **difference between the market price and the realisation price of the holding, minus the option premium paid to the employer, is considered the price of the fringe benefit** (**subsection 2 of § 7 of the Regulation**).

Therefore, if 3 years have not passed since the option was granted and the option is exercised (realised), the employer is obliged to tax as a fringe benefit

- ✓ the market price or
- ✓ the market price minus the exercise price (realisation price) of the option paid by the employee and/or the option premium

of the underlying holding acquired by the employee.

In practice, there have been situations where the entire holding (100%) in the employer is transferred (the so-called full exit situation) and the options are terminated and exercised (realised) before 3 years have passed, on the condition that **the employee no longer receives a holding** upon termination and realisation of the option, **but financial compensation pay-out corresponding to the value of the holding**. This is because the new owner (investor) acquires the entire holding (100%) and does not continue with the option program. Since the new owner does not include employees in the circle of owners, it is not justified to formalise the holding in the name of the employee(s) only to immediately transfer it to the new owner (investor). In such a situation, the tax authority is guided by the content of the transaction and takes the position that, as a fringe benefit, **the monetary pay-out is not taxed as a fringe benefit in the extent that corresponds to the time the option is held**. Monetary pay-out exceeding the time the option is held is taxed as a fringe benefit.

EXAMPLE

There have also been situations where a **partial holding** (less than 100%) in the employer is transferred and/or by agreement of the parties, the right to use the option and the obligation to exercise the option are waived and a monetary pay-out is made to the employee (compensation is paid). In this case, the **monetary pay-out is taxed in full as a fringe benefit.**

Fringe benefit is declared in Annex 4 of the form TSD at codes 4080–4083.

If an employee performs their duties in Estonia and their wages are taxed with both income tax and social tax and social payments in Estonia, then the fringe benefit given to the employee is also subject to taxation with income and social tax in Estonia.

If a non-resident employee performs their duties in a foreign country and their wages are taxed with both income tax and social tax and social payments in the foreign country, then the fringe benefit given to the employee is also not subject to taxation in Estonia. The employer may have a tax liability in a foreign country.

In the future, if the employee benefits from the transfer of securities (acquired holding), they have the right to take into account the amount taxed as a fringe benefit with income tax according to **§ 48 of the Income Tax Act** by the employer as the cost of acquiring securities (**subsection 8 of § 38 of the Income Tax Act**). The employer's certificate is the basis for determining the acquisition cost.

EXAMPLES OF CALCULATING THE PRICE OF FRINGE BENEFIT

There have been situations where, with an option contract, an employee has the right to exercise an option and acquire a holding before 3 years have passed since the conclusion of the option contract, and this on the condition that the employee pays (reimburses) the tax liability related to the acquisition of the holding to the employer when the option is exercised. In such situation, the price of the fringe benefit is calculated according to the agreement between the employer and the employee, and the acquisition cost of the holding paid by the employee to the employer. Two examples can be given from practice to calculate the tax liability and the acquisition cost of a holding.

Example 1

An agreement has been concluded between the employer and the employee that the employee pays the employer **the estimated** (so-called hypothetical) **tax amount** based on the price of the fringe benefit. For example:

- ✓ the market price of the acquired holding, i.e., the price of the fringe benefit, is 1,000 euros;
- ✓ the employee pays the employer the calculated tax amount of 662.50 euros from the price of the fringe benefit of 1,000 euros
  (1,000 × 20 ÷ 80 = 250 euros; 1250 × 33% = 412.50 euros; income tax 250 euros + social tax 412.50 euros = 662.50 euros);
- ✓ since the employee paid (reimbursed) 662.50 euros to the employer, the taxable fringe benefit for the employer is 337.50 euros (1,000 – 662.50 = 337.50);
- ✓ the employer declares and pays the actual tax amount of 223.60 euros from the fringe benefit of 337.50 euros
  (337.50 × 20 ÷ 80 = 84.38 euros; 421.88 × 33% = 139.22 euros; income tax 84.38 euros + social tax 139.22 euros = 223.60 euros);
- ✓ the market price of the acquired holding, i.e., the price of the fringe benefit, is 1,000 euros.

The employee has the right to take into account 1,000 euros as the acquisition cost of the holding, i.e., 662.50 euros paid to the employer + 337.50 euros taxed as fringe benefit.

If the employee sells the holding in the future for, e.g., 2,500 euros, their gain will be 2,500 – 1,000 = 1,500 euros.

The acquisition cost of the holding must be documented, and it is important that the employer gives the employee a certificate indicating the amount taxed as a fringe benefit.

Example 2

An agreement has been concluded between the employer and the employee that the employee pays the employer **the actual tax amount** based on the price of the fringe benefit. For example:

- ✓ the market price of the acquired holding, i.e., the price of the fringe benefit, is 1,000 euros;

- ✓ the taxable fringe benefit of 586.47 euros for the employer can be found as follows: 1,000 euros is the total amount of the fringe benefit and tax expense, or 170.513% in percentage terms (fringe benefit price of 1,000 euros, i.e. 100%, + tax amount on the fringe benefit of 705.13 euros, i.e. 70.513%); therefore the fringe benefit (100%) for the employer is 1,000 euros × 100% ÷ 170.513% = 586.47 euros;

- ✓ taxable fringe benefit for the employer is 586.47 euros and the tax amount on it is 413.53 euros (586.47 × 22 ÷ 78 = 165.41; 751.88 × 33% = 248.12; income tax of 165.41 euros + social tax 248.12 euros = 413.53 euros);

- ✓ the employee pays (reimburses) the employer the actual tax amount of 413.53 euros from the price of the fringe benefit of 1,000 euros (tax liability calculated from 586.47 euros out of 1,000 euros: 586.47 × 22 ÷ 78 = 165.41; 751.88 × 33% = 248.12; income tax 165.41 euros + social tax 248.12 euros = 413.53 euros);

- ✓ since the employee paid (reimbursed) 413.53 euros to the employer, the taxable fringe benefit for the employer is 586.47 euros (1,000 – 413.53 = 586.47);

- ✓ the employer declares and pays the actual tax amount of 413.50 euros from the fringe benefit of 586.47 euros.

The employee has the right to take into account 1,000 euros as the acquisition cost of the holding, i.e., 413.53 euros paid to the employer + 586.47 euros taxed as fringe benefit.

Like the first example, if the employee sells the holding in the future for e.g., 2,500 euros, their gain will be 2500 – 1,000 = 1,500 euros.

The acquisition cost of the holding must be documented, and it is important that the employer gives the employee a certificate indicating the amount taxed as a fringe benefit.

Both examples and calculations are possible in practice.

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Employee’s gains from transfer of securities

Employees incur income tax liability from the gains of transfer of securities (**subsection 1 of § 15 of the Income Tax Act**). Employees’ gains (loss) from the transfer of securities (acquired holding) are calculated as the **difference between the selling price and the acquisition cost** (**subsection 1 of § 37 of the Income Tax Act**).

Employees can take into account as the acquisition cost, according to **§ 48 the Income Tax Act**, the amount taxed as a fringe benefit, or with income tax in a foreign country (e.g. in the case of a foreign company belonging to the same group as the employer) and/or the option premium paid by the employee and the realisation price of the holding.

The acquisition cost must be documented.

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