05 Nov 2022

CHEBET & Co

Issue XXXIV

Legal Updates and Articles

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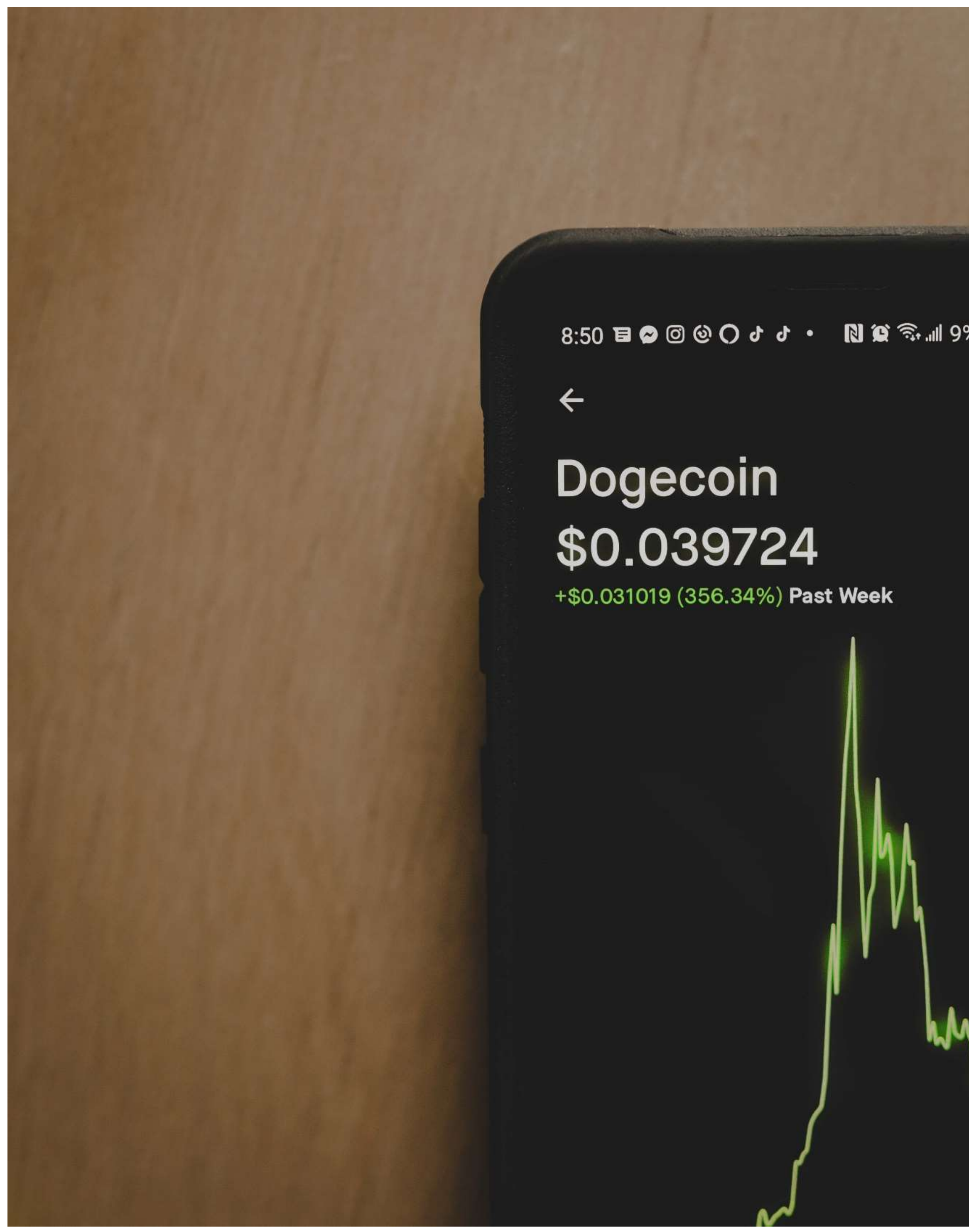
Recent legislation

2022 has so far seen few legislative bills passed into law by the national assembly, most being revenue raising legislation. The depressed legislative activity is likely attributable to heavy political activity across the country for the better part of this year, culminating in the Presidential and General elections in August, followed in September by the reference to and determination by the Supreme Court of Petitions against the pronouncement of the now president of Kenya, H.E Dr. William Ruto.

Bills that have become law in 2022, and some noteworthy subsidiary legislation are as follows:

- The Military Veterans Bill, 2022
- The Finance Bill, 2022
- The Supplementary Appropriation (No. 2) Bill, 2022
- The Pharmacy and Poisons (Registration of Health Products and Technologies) Rules, 2022
- The Crops (Miraa) Regulations, 2022
- The Kenya School of Technical and Vocational Education and Training Order, 2022
- The Regulation of Wages (General) (Amendment) Order, 2022
- The Companies (Beneficial Ownership Information) (Amendment) Regulations, 2022
- The Central Bank of Kenya (Digital Credit Providers) Regulations,2022
- The Bribery Regulations, 2022
- The Pharmacy and Poisons (Conduct of Clinical Trials) Rules, 2022



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TAXATION OF ESOPS IN KENYA

Clarity offered in taxation law amendments by the Finance Act 2022

Employee Share Ownership Plans (ESOPs), also often referred to as employee share schemes, are a type of equity compensation granted by companies to their employees giving employees a right to purchase the company's shares at a specified price for a specified period.

ESOPs are becoming a more common form of remuneration, particularly for start-up companies wishing to attract high caliber of human capital without high revenue leakages that these companies cannot afford in their early years. As a long-term incentive framework, ESOPs works to retain talent and skills as employees are likely to be motivated to dedicate quality time to their work when they are part owners of the employing company.

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'Phantom' ESOPs have the advantage of remunerating and incentivizing a large number of staff without 'clogging' the shareholder register with many minority shareholders.

ESOPs are becoming a more common form of remuneration, particularly for start-up companies wishing to attract high caliber of human capital without high revenue leakages that these companies often cannot afford in their early years.

Of course, if an employee is given an option to purchase shares at market price, though presumably incentivizing, there is no 'gain' or benefit that is taxable.

ESOPs may be structured in a number of ways, depending on what a company sees to be most efficient for its purposes. The structure is usually contained in scheme rules and option agreements prepared by the company.

The most common format of an ESOP is where an employee is given a right to buy shares at no cost or at a cost lower than presumed market price. Typically, a company will provide that a certain pool of its shares will be offered to eligible staff, who then become shareholders at the time they exercise the option and purchase the shares offered.

An ESOP may also be structured as a 'phantom' ESOP where an employee does not have a right to buy actual shares of the company, but rather a right to the economic benefit of shares, usually also offered at no cost or at a cost lower than market price. 'Phantom' ESOPs have the advantage of remunerating and incentivizing a large number of staff without 'clogging' the shareholder register with many minority shareholders.

In Kenya, remuneration and other benefits from employment are taxable under the Income Tax Act, and therefore provided an ESOP offers an employee a benefit (such as purchase at a lower than market price), they are similarly taxable.

Taxation frame-work pre-July 2022

Prior to the enactment of the Finance Act 2022, the Income Tax Act's provisions concerning taxation of ESOPs was limited and somewhat impractical, particularly for private companies.

ESOPs were required to be registered with the Commissioner General of the Kenya Revenue Authority as a 'collective investment scheme' within the meaning of Capital Markets Authority Act for the recognition of the benefit for taxation purposes. This implied that no tax was due on account of unregistered ESOPs, an obvious flaw in law bearing in mind that the intention of the taxation legislation was to bring under taxation all and any benefits from employment.

Additionally, for private companies which are not regulated by the Capital Markets Authority, registration as a collective investment scheme was generally untenable and largely a framework for scrutiny and supervision of public companies.

In terms of the legal provisions on taxation of the ESOPs, the Income Tax Act provided that the taxable value of the benefit derived by the employee from an ESOP was the difference in market value and offer price of shares on the date an option to buy shares (pursuant to an ESOP) is granted, with the tax thereon deemed to accrue and due on the date the option vests.

Changes to taxation from 01 July 2022

The Finance Act 2022 introduced important amendments to the Income Tax Act as far taxation of ESOPs are concerned. Currently, the value of the benefit that is taxable is the difference between offer price of shares when the option is granted and the market price of the shares when the employee exercises the option. Of course, if an employee is given an option to purchase shares at market price, though presumably incentivizing, there is no 'gain' or benefit that is taxable.

In addition, the tax point, which is the date when the benefit is deemed to have accrued to the employee, is the date the employee exercises the option.

This is a much more practical approach to the value or benefit that the employee has in fact received from the employer, and is the more common model for valuing the taxable benefit in other jurisdictions.

Where the market value of shares that are subject of an ESOP is not known, as is often the case with start-up companies, particularly where arms-length capital or investment has not been sought or received by the start-up, the correct manner of arriving at a market value for purposes of ESOP taxation remains a challenge. The Income Tax Act provides that where the company's shares are not 'fully listed' (as would be the case with private companies, the market price *is the price which the shares might reasonably be expected to fetch on sale in the open market, which shall be agreed upon with the Commissioner before the grant of the options.*

The requirement to have a market value for ESOP shares agreed with the taxman, the KRA, remains a hurdle, though one that can be overcome for companies wishing to employ ESOPs as an incentive scheme for its employees.