From 2021 Latvia has one of most attractive tax regimes for employee stock options 2/13/21

Director, Tax, and Head of Pan-Baltic People and Organisation Practice, PwC Latvia

Irena Arbidane

Employee stock option[1] plans are gaining traction as a tool for motivating employees in Latvia. Employees elsewhere in the world have for years been able to become company shareholders, which has boosted their contribution to their company and its growth. The grant of employee shares[2] or stock options is essentially a type of employee compensation linked to the company's development (profitability).

How does an employee stock option plan work?

Employee incentive programmes include an immediate grant of employee shares and the grant of stock options, which allow the employee to buy shares at a specified future date. Compared to an immediate grant of shares, the stock option is a more popular instrument because it allows the company to motivate its employees in the long term by offering employee stock option programmes of various lengths (mainly three years). A stock option in fact means an agreement between the employer and an employee that allows them to receive or buy (usually at a discount) a specified number of shares in the future if they achieve targets set by the employer, such as completing a project or achieving a budget goal or an agreed profit level.

As with most types of compensation paid for performing job duties, the grant of employee shares or options is employment income to be measured according to the market value of shares. If the employee buys shares at a discount, only the discount represents employment income. If shares are given away for free, without the employee contributing anything, then employment income equals the market value of shares. This income can be either taxable or exempt depending on local legislation.

Latvia's tax-favoured treatment

Many countries have introduced tax relief for employee stock options to make employers interested in choosing this long-term staff motivation tool. Income arising on the grant of employee stock options has been exempt from Latvian salary tax since January 2013 if the following conditions are met:

1. Stock options are granted according to an employee stock option plan;
2. The minimum holding period (from granting to vesting) is 36 months;
3. The individual is employed by the company (or a related party) throughout the holding period; and
4. The employer has provided the tax authority with the information prescribed by section 11.11(4) of the Personal Income Tax ("PIT") Act within two months after the grant date.

The old interpretation restricted employee stock options to publicly traded shares, so employee stock options could be granted only by a Latvian or foreign public limited company.

The new rules

From January 2021 the PIT treatment of employee stock options has become yet more generous.

First of all, amendments to the PIT Act state that an employee stock option plan can provide staff not only with shares in a public limited company but with any shares that entitle them to dividends. So a Latvian or foreign private limited company can now launch an employee stock option plan.

Another very important change is that the minimum period for holding stock options has been shortened from 36 to 12 months. This suggests that the rationale behind these amendments was to enable start-ups to attract and motivate employees because the value of start-ups can grow rapidly within a year.

The amendments also relax restrictions on former employees by extending the tax-favoured treatment to employee stock options that are exercised within six months after the end of employment.

The special treatment is not available to an employee with a loan from the employer (or a related party) that is not repaid before the vesting date. This rule is designed to stop employees using funds borrowed from the employer to buy the shares.

But it is possible that the legislature will soon amend the PIT Act again to prevent this restriction from being applied to credit institutions, the Development Finance Institution, savings and loan associations, and licensed consumer credit service providers. This amendment would be crucial for banks, who have been using stock options to motivate their employees in various countries while also being able to provide their employees with credit services, such as mortgages.

Also, the requirement that the employer must file information with the tax authority within two months after the grant date remains unchanged. If this requirement is not satisfied, the employee stock options will be ineligible for the tax-favoured treatment even if the other requirements are met.

Employee stock options, immediate grant of shares, cash bonus

Of course, there are also some other tools to motivate employees, for instance, an immediate grant of shares or a cash bonus, yet employee stock options are a sustainable solution with a tax benefit. The table below shows differences between various staff motivation tools:

	Immediate grant of shares	Grant of employee stock options	Cash bonus
Timing of benefit	Shares are granted straight away without the employee taking part in an incentive plan.	Shares are granted under an employee stock option plan that expires at a specified date or gradually (e.g. in 12 or 36 months' time).	Cash is paid immediately. In certain cases the employer will have set up an incentive programme that defers the bonus payment (like employee stock options).
Dividends	An entitlement to dividends arises immediately.	An entitlement to dividends does not arise until shares are purchased (e.g. 12 or 36 months later).	The employee does not become a shareholder and is not entitled to distributed profits.

Revocation	No revocation unless an extra instrument is created.	May be revoked if the employee fails to achieve their goals.	May not be paid depending on the agreement with the employer but once paid, cannot be revoked.
Tax treatment	The market value of shares is part of employment income. Full taxes are charged at the grant of shares as with employment income.	If the PIT Act criteria are met, the shares are considered an exempt income.	Bonus is a fully taxable employment income.
Capital gains	A taxable profit can arise on the sale of shares. Profit is the difference between the value of shares at the time of sale and the value at the time of grant, on which salary tax has been paid. Profit attracts a 20% PIT through the capital gains tax return. The employee carries the administrative burden and is responsible for paying taxes.	A taxable profit can arise on the sale of shares. Profit is the value of shares at the time of sale with no deductions. The value at the time of grant is not deductible because salary tax is not paid on it. The employee carries the administrative burden and is responsible for paying taxes.	

Conclusion

The new rules make the tax-favoured treatment of employee stock options better accessible and allow employees under their current plans with a 36-month holding period to obtain an exemption from salary tax sooner by exercising their stock options in 12 months' time.

And the new rules encourage companies that have never launched an employee stock option plan to consider this option because the tax-favoured treatment offers compensation for employees quite soon.

To ensure transparency you need to draw up an employee stock option plan, value your company shares, and file documents with the tax authority. Remember, only plans reported to the tax authority qualify for an exemption from salary tax. Also, there are new PIT rules for stock valuation that allow the list of valuers to include foreign as well as Latvian certified valuers.

Tax treatment of employee stock options in Latvia

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[1] Section 248.1 of the Commerce Act

[2] Section 255 of the Commerce Act