



GMS Flash Alert

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Finland – Supreme Administrative Court Rulings on Employee Share Issues

On 28 June 2023, the Finnish Supreme Administrative Court delivered two notable rulings (KHO 2023:65 and KHO 2023:66) concerning the special valuation rules applicable to Employee Share Issues (“ESI”) of unlisted companies. The rulings clarify the requirements under which ESIs may be performed with the mathematical value of the shares without generating taxable salary income for the participants.

WHY THIS MATTERS

The special valuation rules applicable to ESIs of unlisted companies provide an attractive tax incentive for unlisted companies to utilize ESIs as one element of the total remuneration of their employees, provided that certain requirements are fulfilled. Notably, the allocation of shares to participating employees or groups of employees must be based on objective and common criteria. Whereas previous tax practice has been somewhat unclear and restrictive on the subject, the recent rulings provide clarity as well as increased flexibility on the permitted criteria for share allocation, further increasing the attractiveness of ESIs as a tool for rewarding and committing employees in unlisted companies.

Background

Pursuant to Income Tax Act (1535/1992, fin. *tuloverolaki*) § 66.1, participants in an ESI generally derive taxable salary income to the extent that the subscription price is lower than the FMV of the shares. If the option of participating in the ESI is available to the majority of the staff, taxable value is only derived to the extent that the difference between the subscription price and the FMV exceeds 10 percent of the FMV.

However, Income Tax Act § 66 a, in force since 1 January 2021, establishes a more beneficial ESI valuation regime for unlisted companies: ESIs of unlisted companies generate taxable salary income for the participants only to the extent that the subscription price is lower than the mathematical value of the shares, meaning that no taxable income is derived if the subscription price is equal to or higher than the mathematical value of the shares. For this beneficial ESI valuation regime of unlisted companies (Income Tax Act § 66 a) to be applicable, the ESI must fulfil the following major requirements¹:

- the issuing company must be unlisted
- the share issue must be based on an employment relationship
- the option of participating in the share issue must be available to a majority of the staff
- different number of shares may be allocated to employees and groups of employees, but the allocation must be based on objective and common criteria applicable to all participating employees
- participating employees must not hold shares representing more than 10 percent of the total voting rights in the company

Of the requirements of the beneficial ESI valuation regime for unlisted companies (Income Tax Act § 66 a), the most uncertain and contentious has arguably been the requirement for share allocation to be based on objective and common criteria applicable to all participating employees: it has previously been largely unclear what criteria are considered “objective and common” in addition to the respective gross cash salaries of the employees. This has limited the flexibility of share allocation in ESIs, as the gross cash salary of employees may not always accurately reflect their value for the company.

Contents of the Rulings

The recent Supreme Administrative Court rulings KHO 2023:65 and KHO 2023:66, both delivered on 28 June 2023, specifically concerned the permitted criteria for share allocation. In case KHO 2023:65, a Finnish startup company with about 30 employees was planning to perform an ESI with share allocation based on the length of service of each employee.² In case KHO 2023:66, a larger Finnish company with around 220 employees was planning to perform an ESI with share allocation based on classification of employees according to their role and the value of their work contribution for the company.³

Both companies claimed that the selected allocation criteria were permitted (objective and common), and that the beneficial ESI valuation regime of Income Tax Act § 66 a was consequently applicable. The tax authorities argued to the contrary.

The Supreme Administrative Court ruled in favor of both companies. The rulings confirmed the following significant principles for share allocation in ESIs:

- allocation differences between employees or groups of employees are allowed
- allocation based on the value of work contribution of the employees is allowed
- the value of work contribution of an employee or a group of employees can be determined with metrics other than their respective cash salaries
- the employer company can determine the factors affecting the value of work contribution of different employees and groups of employees, provided that the determination does not favor or discriminate against any employee or group of employees and that no employee or group of employees receive only a nominal/minimal number of shares

Of particular significance in the rulings was parliamentary preparatory material⁴ of the special ESI valuation provision (Income Tax Act § 66 a), which supported the fact that share allocation may differ between employees and groups of employees and may be based on metrics other than cash salary, provided that the criteria are objective and do not result in the *de facto* favoring or discrimination of certain employees or groups of employees. As the allocation criteria in cases KHO 2023:65 and KHO 2023:66 were considered objective and not favoring or discriminating any employees or groups of employees, the beneficial ESI valuation regime was confirmed by the Supreme Administrative Court to be applicable in both cases.

KPMG INSIGHTS

The rulings provide more legal certainty and flexibility to the requirements for the application of the beneficial ESI valuation regime, making ESIs an increasingly attractive option for rewarding and retaining employees in unlisted companies. ESIs may be a particularly enticing for startup companies, when the difference between the mathematical value of the shares at grant and the potential FMV in the future may be significant and the need to keep key employees may be particularly high.

Notwithstanding the increased legal certainty provided by the rulings, careful design, planning, and implementation of ESIs are still crucial to ensure the applicability of the beneficial ESI valuation regime. In uncertain cases, applying for an advance ruling from the Tax Administration or the Central Board of Taxes may be recommended. It should also be noted that not all legal uncertainty has been eliminated by the rulings: for example, what constitutes “favoring or discrimination” of employees or groups of employees is still largely a matter of interpretation.

KPMG Finland served as counsel to the companies in both cases.

FOOTNOTES:

- 1 See e.g., Finnish Tax Administration’s tax guide issued on 21 February 2022 (dnro VH/6503/00.01.00/2021) (in English, Finnish and Swedish). [Taxation of employee offerings](#), at 3.2.
- 2 For the full ruling (in Finnish with a synopsis in Swedish) and more, see [Supreme Administrative Court ruling KHO 2023:65](#), 28 June 2023.
- 3 For the full ruling (in Finnish with a synopsis in Swedish) and more, see [Supreme Administrative Court ruling KHO 2023:66](#), 28 June 2023.
- 4 In particular, the Supreme Administrative Court referred to the government’s bill to parliament for regulation regarding the taxation of employee share issues of unlisted mited liability companies (in Finnish) [HE 73/2020 vp, fin. hallituksen esitys eduskunnalle listaamattomien osakeyhtiöiden henkilöstöantien verotusta koskevaksi sääntelyksi](#), pp. 24-29.

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