SQUIRE PATTON BOGGS

Management Incentive Plans for Private Equity Acquisitions in Ireland

Structures and Tax Considerations

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Introduction

When a private equity (PE) firm acquires an Irish target company, implementing effective management incentive plans (MIPs) is crucial for aligning the interests of key management with those of the PE investor.

These plans not only incentivise management to drive growth but also provide tax-efficient remuneration structures that benefit both the company and its key employees. This article outlines the various MIP structures available in Ireland and their tax implications for PE acquisitions.

Equity-based Incentive Structures

- **Sweet Equity**

  Sweet equity represents one of the most common MIP structures in PE transactions, where management acquires ordinary shares at a relatively low value due to the capital structure of the acquisition vehicle.

  PE investors typically invest through a combination of loan notes and/or preference shares with fixed interest rates (8%-12%) alongside ordinary shares, with management purchasing a portion of these ordinary shares.

  Employees typically need to pay fair market value upfront to avoid an income tax charge on acquisition of the shares. If shares are acquired at a discount to market value, the discount is subject to income tax, Universal Social Charge (USC) and Pay Related Social Insurance (PRSI) at a rate of up to 52%.

  However, when properly structured, gains on sweet equity can be subject to Capital Gains Tax (CGT) at 33%, rather than income tax rates. The debt-heavy structure of a PE transaction often keeps the initial value of equity low, making it affordable for management, while providing potential for significant upside.

  Employers benefit from an exemption from employer PRSI on equity-based remuneration compared to cash bonuses. The company may also be eligible for corporation tax relief on the costs associated with establishing and maintaining the scheme.

- **Growth/Hurdle Shares**

  Growth shares (also known as hurdle or flowering shares) are a special class of ordinary shares with minimal initial value until certain performance targets are achieved. These shares only participate in value creation above a predetermined threshold or hurdle. If issued at market value, no upfront tax charge arises for the employee. If issued at a discount, income tax, USC and PRSI apply to the discount. The initial market value is typically very low due to the hurdle requirements, minimising upfront tax costs.

  Subsequent gains on a disposal of the shares by the employee are subject to CGT at 33%.

  Employers save on employer PRSI contributions compared to cash remuneration, and the company may claim corporation tax deductions for costs associated with establishing the scheme.

  This type of MIP allows management to participate in the future growth of the company without diluting existing equity value.

- **Restricted Shares**

  Restricted share schemes involve awarding shares subject to transfer restrictions for a specified period. The shares are usually held in trust for a period ranging from 1 to 5+ years, during which they cannot be transferred or sold.

  The upfront income tax charge can be reduced by up to 60% depending on the restriction period. The abatement percentages are: 10% for 1 year, 20% for 2 years, 30% for 3 years, 40% for 4 years, 50% for 5 years, and 60% for 5+ years.

  Income tax, USC and PRSI are due on the discounted value at the time of award and must be withheld by the employer via Pay As You Earn (PAYE).

  Upon disposal of the shares after the restriction period, CGT applies on any gain accrued since the acquisition of the shares.

  No employer PRSI is payable on restricted share awards, providing significant savings compared to cash remuneration.

  The employer must operate PAYE withholding on the taxable value at the time of award.

  Corporation tax relief may also be available for costs associated with establishing and operating a restricted share scheme. The benefit of a restricted share scheme is that it provides immediate equity ownership with significant tax benefits while promoting retention.

- **Forfeitable Shares**

  Forfeitable shares are subject to clawback provisions if certain targets are not met.

  Employees receive shares that are forfeited if specific performance conditions aren't satisfied. If the shares are forfeited, the employee is entitled to a rebate of any tax paid on the acquisition of the shares. Income tax, USC and PRSI are payable on any discount at which the shares are acquired.

  No employer PRSI is payable on forfeitable share awards, and the employer must operate PAYE withholding on the taxable value at the time of award.

  Corporation tax relief may be available for the employer in relation to costs associated with establishing the scheme.

Option-based Incentive Structures

- **Unapproved Share Options**

  These are options to acquire shares at a later date without Revenue approval.

  Employees receive the right to purchase shares at a predetermined price in the future. No tax arises on the grant of the option, but income tax, USC and PRSI apply on the exercise of the option (on the difference between market value of the shares at exercise and the option price).

  CGT applies on the subsequent disposal of the shares by the employee.

  From January 2024, employers are responsible for withholding and remitting the tax on option exercises through the PAYE system. Employers can implement "cashless exercise" arrangements to fund these tax liabilities.

  No employer PRSI is payable on share option gains. Employers must report annually to Revenue on all share options granted to or exercised by employees.

- **Key Employee Engagement Programme (KEEP)**

  KEEP is a tax advantageous share option scheme specifically designed for qualifying Small and Midsize Enterprises (SMEs).

  No income tax, USC or PRSI arise on the grant or exercise of the option, and CGT only applies on a future disposal of the shares by the employee.

  The CGT rate of 33% applies instead of income tax rates of up to 52%.

  Options must be granted at market value of the shares at the date of grant to qualify for the favourable tax treatment.

  There are limits on the value of options that can be granted (€100,000 in any year, €300,000 in all years or 100% of annual salary).

  No employer PRSI liability arises on KEEP options and employers can claim corporation tax deductions for the cost of establishing the scheme.

  The scheme does not require Revenue approval, reducing administrative burden.

Employer Benefits Across All Schemes

Regardless of the specific MIP structure chosen, employers can benefit from:

- **PRSI savings** – All equity-based remuneration schemes exempt employers from the 11.05% employer PRSI contribution that would apply to cash bonuses.
- **Corporation tax relief** – Employers can generally claim corporation tax deductions for costs associated with establishing and operating share schemes.
- **Talent attraction and retention** – Tax-efficient remuneration helps attract and retain key management without significant cash outlay.
- **Alignment of interests** – Share-based incentives align management interests with company performance and PE investor objectives.

Conclusion

When structuring management incentive plans for Irish target acquisitions, PE firms should carefully consider both the commercial objectives and tax implications of each approach for both employees and employers. The optimal structure will depend on the target's size, growth prospects and the specific management team being incentivised. Professional advice is essential to navigate the complex tax rules and ensure compliance with Irish tax legislation, while maximising tax efficiency for both the company and its key employees.

At Squire Patton Boggs Ireland, we pride ourselves on our deep expertise, comprehensive knowledge and unwavering passion for helping our clients to thrive. Our team is dedicated to providing the strategic guidance and practical solutions needed to drive growth and maximise value. With a proven track record and a commitment to excellence, we are here to support our clients in every step of their journey, ensuring that your tax strategy aligns seamlessly with your business objectives and growth aspirations.

Please contact our Head of Tax for Ireland, Andre Vermeulen, to discuss any queries you may have in relation to the application of Irish taxes.

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