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TEMPLARS ThoughtLab

Taxing Sweat Equity in Nigerian Startups: A Founder's Roadmap to Compliance

Introduction

The concept of '***Sweat equity***' is one that is increasingly familiar to the Nigerian corporate landscape, especially to startups. It refers to the unpaid labour that an employee, entrepreneur, co-founder or investor (collectively, a **"contributor"**) contributes to build a business, typically rewarded with equity[1]. Unlike cash payment, this form of compensation grants an ownership stake to those who invest their time, energy, and skills into the company's success, with the expectation that the value of their stake will grow as the business prospers[2]. In the dynamic landscape of startups in Nigeria and abroad, sweat equity has emerged as a vital tool for founders and distributed teams looking to align interests, foster growth, attract and retain top talent[3]. According to the Companies and Allied Matters Act, 2020 (CAMA), if an employee's contract of service entitles him to share in the company's profits as an incentive, he is entitled to this share regardless of whether dividends have been declared.[4] Accordingly, when sweat equity shares are issued, they are classified as a form of compensation for services rendered by employees or directors.

[1] Leah Brownlee 'Sweat equity: how it works and why it matters to startups' (2023) < Sweat Equity: How it Works and Why It Matters to Startups (cakeequity.com)>
[2] Ibid
[3] Jon Victor, "Google's defense against OpenAI's talent grab: Special Stock" (The Information, 2024) < Google's Defense Against OpenAI Talent Grab: Special Stock — The Information>
[4] Section 431 CAMA

PITA categorizes all employment income as taxable thus, any salary, wage, fee, allowance, or other gain from employment including compensations, bonuses, and benefits are subject to taxation.

As companies increasingly rely on non-monetary contributions and compensations to drive their ventures forward, understanding the tax implications, challenges, requirements and strategies of these arrangements becomes crucial. This article delves into the complexities of tax considerations surrounding sweat equity in Nigeria (at grant, vesting, or sale) in comparison to other jurisdictions, providing insights for founders and teams on structuring arrangements that not only incentivize contributions but also comply with local regulations.

How is Sweat Equity Structured?

Companies would usually structure sweat equity in a way that is attractive to contributors. The typical structures are stock options, employee stock purchase plans, restricted stock units (RSU), and stock appreciation rights (SAR). Stock options grant employees the right to purchase shares at a predetermined price, typically lower than the market value, with the expectation that the shares will appreciate over time. Also, employee stock purchase plans allow employees to acquire company stock at a discounted rate through payroll deductions, making it an accessible option for those seeking ownership without the upfront risks associated with stock options. In contrast, RSU are shares awarded to employees that vest either over time or upon achieving specific performance goals, providing a clear pathway to ownership while imposing vesting conditions to encourage retention. Finally, SAR offer employees compensation based on the increase in stock price, usually paid in cash, allowing them to benefit from share value growth without the need to own or sell actual shares. Together, these equity compensation strategies create a robust framework for employee engagement and investment in the company's success.

How is Sweat Equity Taxed?

The taxation of sweat equity varies significantly across jurisdictions. In certain jurisdictions, such as India, the United Kingdom and the United States of America, the term 'sweat equity shares', is recognised and explicitly incorporated within their principal tax legislations.

In Nigeria, the Finance Act, Capital Gains Tax Act (CGTA), Personal Income Tax Act (PITA), Company Income Tax Act (CITA), and the CAMA collectively speak to the taxation of sweat equity in Nigeria.

PITA categorizes all employment income as taxable thus, any salary, wage, fee, allowance, or other gain from employment including compensations, bonuses, and benefits are subject to taxation.[5] The implication is that, if shares are issued at a discount to their fair market value (FMV), the difference is considered part of the employee's income and taxed.[6] The value of these shares is treated as a perquisite or a benefit.[7] In a public notice issued in 2017[8], the Lagos State Internal Revenue Service, relying on section 3(b) of PITA, clarified that share/stock options agreements give rise to taxable income for the employees for whose benefit they are executed. For publicly traded companies, the share price is based on market value, while for non-listed companies, it is determined by net assets divided by the number of shares. Additionally, dividend payments are subject to a 10% withholding tax, and employers are obligated to deduct income tax at source on the perquisite value of sweat equity shares.

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[5] Section 3(b) Personal Income Act, 2011
[6] Tricia Equity (2020), "How does sweat equity" <[How Does Sweat Equity Work? - trica equity blog](#)>
[7] Perquisites encompass benefits like housing, cars, and other non-monetary advantages received by employees.
[8] https://pwcnigeria.typepad.com/files/lirs-notice_taxation-of-employees-share-schemes_sep2017.pdf

₦100,000,000.00 threshold

The Finance Act of 2021 substituted section 30 of the CGTA to introduce exemptions from CGT under specific conditions such as when proceeds from share sales are reinvested into Nigerian companies or when they fall below a threshold of ₦100,000,000.00 (One Hundred Million Naira) within any 12 (twelve) month period.

Capital gains tax (CGT) applies to the gains arising from the disposal of shares received as part of compensation in Nigeria. The Finance Act of 2021 substituted section 30 of the CGTA to introduce exemptions from CGT under specific conditions such as when proceeds from share sales are reinvested into Nigerian companies or when they fall below a threshold of ₦100,000,000.00 (One Hundred Million Naira) within any 12 (twelve) month period.

Finally, where the contributors are resident in a country which has an effective Double Tax Treaty with Nigeria, the taxation of those contributors' income will be determined by reference to the relevant Double Tax Treaty.

Common Challenges in the Creation and Taxation of Sweat Equity in Nigeria

Taxation of sweat equity in Nigeria presents several challenges that create uncertainty for startups and entrepreneurs.

First, valuing sweat equity presents significant challenges, particularly in determining the FMV at different stages i.e. grant stage, vesting stage, or sale stage. The complexity arises from the fact that a company's valuation can fluctuate dramatically, especially for early-stage startups. An overvaluation or undervaluation can affect the employee's tax obligations and result in either overpayment or underpayment of taxes. This issue is critical as proper valuation is essential for calculating accurate tax liabilities, ensuring both compliance and financial fairness.

Similarly, the prohibition on the existence of unissued shares in Nigeria creates a unique challenge for sweat equity arrangements that vest over time. Under CAMA, all issued shares must be allotted[9], which connotes that companies cannot hold unissued shares as a pool for future allocation. This requirement complicates the structuring and taxation of sweat equity, particularly where shares are intended to vest over a period of time based on performance or time milestones of contributors.

Another challenge in managing sweat equity is determining the appropriate timing for taxation due to lapses in the local legislation. The inconsistency creates uncertainty for both contributors and companies, as discrepancies between taxable events and actual cash flow can lead to financial strain. For example, if employees are taxed at the grant or vesting stage, they may encounter a tax liability before they have the opportunity to liquidate their equity, resulting in potential liquidity issues.

As startups expand internationally, ensuring cross-border tax compliance also becomes more complex. Cross-border teams need equity plans that are meticulously designed to adhere to the tax regulations of each country involved. Each jurisdiction has its own reporting, withholding, and tax remittance rules, and failing to comply can lead to penalties, increased tax liabilities, or reputational harm for both the contributor and the company. The challenge lies in effectively managing these multi-jurisdictional tax obligations while avoiding excessive administrative burdens.

[9] Section 124 CAMA

Strategies for Structuring Equity Compensation to Minimize Tax Exposure

Prior to implementing an equity compensation plan, it is crucial to thoroughly examine the company's Memorandum of Association and Articles of Association, Shareholders Agreement, Co-founders Agreement, employment contracts and other related documents. This review ensures that sweat equity arrangements comply with legal requirements and take tax implications into account.

As stated above, CAMA requires that all issued shares must be allotted. Companies can avoid this limitation by executing a shareholder agreement which allows the shares to be issued but held in trust or escrow until they vest, utilising phantom shares or SARs as an alternative to actual shares thereby providing financial returns tied to the company's performance without needing to allot shares upfront, creating treasury shares by repurchasing their own shares[10] from existing shareholders willing to dispose of their shares and hold them for future allocations[11] or increasing the company's share capital incrementally (as needed) to accommodate the issuance of shares for contributors.

Equity compensation plans should also be tailored to minimize tax liabilities for both the company and the contributor. This may involve structuring stock options with extended vesting periods or utilizing RSUs that align with local and international tax incentives. Employing tax deferral strategies can be beneficial by structuring equity compensation plans to postpone taxation until a later event, such as the sale of shares. Implementing vesting schedules or leveraging small business stock exemptions can also facilitate tax deferral. For distributed teams operating across multiple jurisdictions, effective cross-border equity structuring is vital for ensuring tax efficiency.

Conclusion

Sweat equity is a dynamic strategy for startups to attract and retain top talent, but it also brings a complex maze of tax and legal challenges. By navigating these complexities with care and crafting thoughtful equity plans, companies can minimize tax exposure while harmonizing the interests of contributors. As businesses expand globally, cross-border tax compliance will only grow in importance. To unlock the full potential of sweat equity, companies should seek professional guidance, ensuring their plans are both tax-efficient and compliant with regulations in every jurisdiction they operate.

[10] Section 184(1) CAMA
[11] Section 189(b) CAMA