Employee Ownership
Australia & New Zealand
Making it your business

Employee Share Schemes and Start-up Companies: Administrative and Taxation Arrangements

Employee Ownership Australia and New Zealand's (EOA)
Expert Panel's Reply to Treasury's Consultation

February 2014

Introduction

This reply has been was created to provide a reply to the Treasury's Invitation to comment dated 21 January 2014. EOA has not provided answers to every question in relation to the invitation to comment but has provided focussed strategic areas of concern that sit within the discussion topics and questions raised.

The Importance of Start-Up Companies in Australia

As recognised in the consultation groups, start-ups have a significant role in the Australian economy. They are critical to lift productivity, competition, economic growth, and employment through the creation of, and access to, new markets and the invigoration of established markets.

Innovation-active companies are also significantly more engaged in the digital economy, earning over $144 billion in internet commerce in 2010-11 collectively, more than three times that of non-innovators. Innovation also encourages a more connected and skilled economy with greater market diversity and consumer choice. [1]

Google recently commissioned a PwC report, " The start-up economy, How to support tech start-ups and accelerate Australian innovation, in April 2013 that highlighted some key facts:

- Starts ups are likely to contribute $109 billion and 540,000 jobs to the Australian economy by 2033.
- There are 1,500 start-ups in Australia with the key hubs in Sydney and Melbourne.
- There are many sectors for growth that are untapped and there are good support systems already in place. In some ways there is no better time for an entrepreneur.
- The growth of the Australian technology sector is essential to the future success of the economy. It enhances productivity, creates global reach and improves customer experience.
- The changes to the taxation of options, however, has significantly impacted this sector's ability to attract and retain quality employees.

Yet, the recent report, *Silicon Beach: A Study of the Australian Start-up Ecosystem*, found that 4.8 per cent of Australian companies successfully scale up to sustainable businesses compared with 8 per cent in the Silicon Valley and 6.7 per cent in New York.[2]

When start-ups succeed, they invariable go on to reinvest in a new start-up venture. So helping the sector succeed helps grow the economy further. The current usage of plans has declined so significantly or has been adapted to ensure that the plans are taxed at gain that the potential revenue gain is likely to be greater rather than smaller by any change. This is added to additional company taxes which will occur when companies are successful. These factors should offset any revenue concerns that Treasury may have.

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1 Australian Innovation Systems Report 2012, http://www.innovation.gov.au/Innovation/Policy/Pages/AustralianInnovationSystemReport.aspx. Please note that the text is taken directly from the discussion paper.

2 Silicon Beach Building Momentum: A Study of the Australian Start-up Ecosystem http://www.deloitte.com/au/siliconbeach.

Start-ups are critical to lift productivity, competition, economic growth, and employment*. *Starts ups are likely to contribute $109 billion and 540,000 jobs to the Australian economy by 2033.

The Key Focus for Australia is Being Globally Competitive

The current taxation regime does not allow Australian start-up companies to compete for talent globally. The current regime has inhibited companies from being able to attract staff because the equity plans offered can be complex, cost prohibitive and difficult for companies to implement.

In comparison to other countries like the UK and US this tax regime has impacted option plans which are most predominantly used in the US and UK.

Any reform should have as its key principles the desire to create a more even playing field for Australian start-ups. Unless we can match the conditions available in e.g. the Silicon Valley Australia will lose the battle for start-up companies and start-up talent. We must be on at least a level playing field with the US and the UK. This means tax should be paid only at realisation.

THE CURRENCY OF SILICON VALLEY

Almost without exception US technology start-ups use option plans. Options are granted to employees because they provide a share of future growth in value without diluting existing ownership. They are also less complex than shares (no trust is required, they crystallise only at exit or IPO, there is no minority shareholder concerns, no need to claw back existing issued shares with no requirements to create a market for employees to dispose of the shares and most companies do not have a dividend stream so there is no advantage in using shares). Most importantly in the US there is no tax to pay until the options are exercised and the shares are realised by the employee and any gain is on the capital account. The most obvious recent examples of the use of this model are Facebook and Google.

In the US and UK they recognise that in the life cycle of a start-up company everything is geared towards an exit event. Employees' tax is aligned to that event. There is no tax to pay until employee can realise the equity value.

THE UK MODEL – DRIVING THE START-UP ECONOMY

As set out in the Discussion Paper, in 2000 the UK Government introduced a plan called the EMI (Enterprise Management Incentive Plan) which was specifically created for start-up companies. EMIs are tax advantaged share options. They are designed to help small, higher risk companies recruit and retain employees who have the skills to help them grow and succeed. They are also a way of rewarding employees for taking a risk by investing their time and skills to help small companies achieve their potential[3].

[3] This wording is taken directly from HMRC site, http://www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm

Tax advantaged share options with a market value of up to £250,000 from 16 June 2012 (£120,000 prior to 16 June 2012) may be granted to a qualifying employee[4] of a qualifying company, subject to a total share value of £3 million under EMI options to all employees.

For companies to qualify they must have maximum gross assets of no more than £30 million; for groups, this applies to the assets of the group as a whole. The company whose shares are the subject of the option must be independent, and the company or group must be trading. From 21 July 2008, there is a requirement that a company has to have fewer than 250 employees in order to grant EMI options. There is also a requirement that the company trades wholly or mainly in the UK.

The grant of the option is tax-free and there will normally be no tax or National Insurance contributions (employer withholding tax) for the employee to pay when the option is exercised (unless the option is granted with an exercise price that is less than the market value of the underlying share at the date of the grant). Capital Gains Tax is only payable on sale of the share.

The Barriers for Start-up Companies and the Impacts of the 2009 Taxation Changes -

The six key barriers for start-up companies are:

1. The ability to attract and retain staff in Australia and from overseas

Start-up companies commonly do not necessarily have the cash flow to attract key staff needed to start and grow the business. The salaries offered to attract staff are generally not as generous as the salaries offered by larger entities within Australia and overseas. Employees are also likely to face greater risk and uncertainty in a start-up organization. To counter this many companies would offer significant equity stakes in the business to staff. These equity stakes can be high risk but have large potential upside that allows start-up companies to attract and retain staff. Most commonly start-up companies would use options. Option plans have been significantly impacted by the 2009 changes (see below).

2. The changes to the taxation of options plans that happened in 2009, in conjunction with the refund rules

The use of employee share option plans has significantly declined. This is largely because of the introduction in Division 83A of taxation at vesting rather than the taxable event being on realisation of shares, in the case of options with a market value exercise price, or in any event not before exercise of options (as applied to options prior to the introduction of Division 83A). In addition, the elimination of tax refunds for vested but “out of the money” options has also exacerbated the situation.

Employee share option plans were formerly widely used in small to medium, privately owned enterprises including start-up companies, in particular because of the potential for upside that such plans deliver. From a practical perspective, more options are typically awarded than shares or performance rights (because the option plan has an exercise price and hence a lower intrinsic value). This could lead to larger gains for employees in start-ups who rely on this type of plan to offset the lower initial salary and higher risks inherent in a start-up company. The change in taxation of option plans has severely impacted the ability of many such companies to effectively remunerate their

[4] An employee must spend at least 25 hours a week working for the company or the group. If his hours are shorter, he must spend at least 75 per cent of his working time working as an employee for the company or group.

employees through employee share options and retain key talent in their businesses during the early period of growth.

Further, the change to the time of taxation of employee share options from exercise to vesting is one of a number of reasons that has forced listed Australian companies to expend considerable time and financial costs in restructuring employee equity plans.

Finally, the new tax refund rules unfairly impact option awards. For options awarded since 1 July 2009 the income tax liability typically arises at vesting, and this is the case even if the options are "out of the money" (i.e. the option exercise price exceeds the market value of the underlying shares at the vesting date). Further, this income tax liability cannot be refunded under the new rules even if the options lapse unexercised. The reasoning behind it is that the employee "chooses" not to exercise their options and therefore should not be allowed to access the tax refund provisions.

3. The cap on an individual owning legally or beneficially more than 5% of the company

The current and previous taxation rules do not allow tax deferral for an individual where they own legally or beneficially more than 5% of the company. This often prevents initial employees/founders from using equity to top up salary because the 5% is prohibitive in a company that has limited issued capital and provides a majority of the share capital to its employees to top up salary.

4. The current exemptions from prospectus filing that prevent more than 20 non senior employees being granted equity in any 12 month period

For an unlisted company the largest consideration at the outset is the disclosure filing requirements. If rights/options or shares are issued, any offer will be subject to the disclosure filing requirements (prospectus, short form prospectus and offer information statement) under Chapter 6D of the Corporations Act 2001, specifically section 706. There are limited exemptions that can be relied upon to exempt a company from these disclosure filing requirements. There is some cost and complexity in producing a disclosure document so this can inhibit a company's ability to offer the ESS plan broadly.

There is a prospectus filing requirements within the Australian Securities and Investment Commission (ASIC) Class Order for employee share and option plans CO 03/184. However the only exemption for unlisted companies is for options, with the requirement that a prospectus is lodged prior to exercise. This exemption is only effective for companies that are considering an IPO in the next 3 – 5 years.

The other common exemptions are:

Exemption 1 - Section 708(1) allows a company to make offers to 20 individuals in any twelve month period up to a certain dollar cap ($2,000,000).

Exemption 2 – Section 708(12) exempts offers that are made to senior managers. The definition of 'senior manager' for the purpose of this section is a person:

(a) who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or

(b) has the capacity to affect significantly the corporation's financial standing.

An individual falls into the exemption if either (a) or (b) are met.

The current exemptions by their nature allow grants only to limited employees or companies that are close to an IPO.

Recommendation:

Any review of the taxation regime should be made in conjunction with other regulatory reviews to ensure consistency, simplicity and certainty. If the tax legislation changes without the prospectus filing barriers being lifted then the impact of the changes will be marginalised.

5. The valuation process for ESS plans can be prohibitive

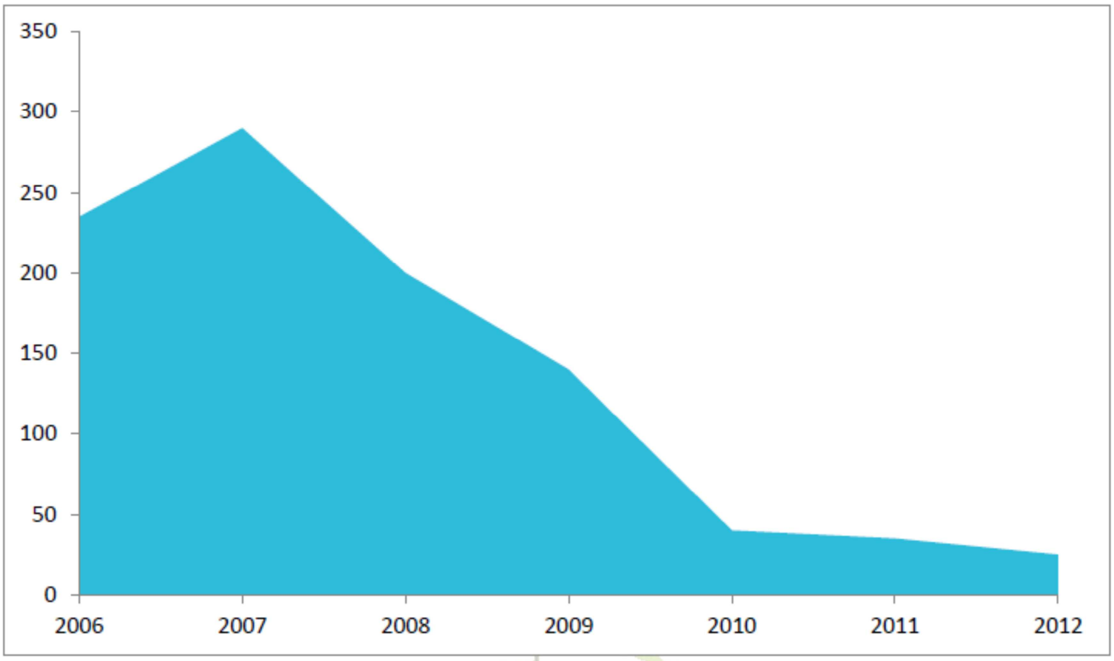
The Market Value of the shares of an unlisted company is needed for the purposes of option valuation, income tax and the operation of the plan. There are no accepted methodologies that can be used by an unlisted company and no means to validate the methodology that a company uses by the ATO. Companies as a result tend to use external parties to value their shares and for some start-ups this can be cost prohibitive. The changes that removed the requirement for the an external party such as an accountant to provide a valuation are welcomed but further steps can be taken to minimize costs. The only complete solution to this problem is taxation only at the point of realization.

Impacts of 2009 Changes

The decline in option plans has been highlighted in Employee Ownership Australia and New Zealand's previous report in April 2013, The Changing ESS Landscape since 1 July 2009.

Division 83A has significantly reduced participation in ESS option plans.

Figure 5: Decline in Option Plan Usage after the 1 July 2009 changes



Note: Employer population based on 500 employers.

The statistics from Link's private client database show that since 2009 most companies now use a non-Division 83A plan:

	Loan Plan	Non 83A Option Plan	Division 83A Plan	Other (cash)
% use	56%	23%	6%	5%

Pre 2009 85% of companies used Division 13A option plans. There has also been a 20% decline in companies seeking plan advice since the changes.

Proposed Definition for Start-ups

It is imperative that any definition of start-up is not so restrictive that it applies to only very limited and exceptional situations. In our opinion employees and years that the company has been incorporated are poor indicators because some business are employee intensive and have large employee numbers quickly because of the nature of their businesses, for example technology companies, whilst others have low employees numbers but take many years to shift from the start-up phase, for example Bio Med companies.

Ideally the definition should be based on a simple and easy identifiable figure that does not require further cost for the company, e.g. figures from financial accounts such as million profit, assets or turnover. What this figure should be considered further and there should be consultation with industry to make sure it is wide enough to be useable for a majority of start-up companies. If there are specific concerns about certain sectors or industries these sectors should be excluded. The requirement that a majority of the company's employees and assets are based in Australia is important if defined correctly and simply.

The important element of any definition is that it can be understood and applied easily and does not require any onerous calculations outside the normal course of business.

The key thing is to ensure that the definition captures the target market. If we are to stop the losses of our start-ups to Silicon Valley and other markets we must ensure that our definition is broad enough to capture most start-ups. Whilst the definition must be simple, it must also be appropriately targeted.

The EMI plan gives a good example of how it could be quantified by using a simple measure that any company would readily disclose in its accounts and which is regulated through accepted accounting principles and providing clear guidance about the other elements of the plan.

Taxation and Plan Design Recommendations

A key discussion of any reform should be about the design of the plans. It should have the same or greater focus as the definition of what is a start-up. To really maximise the aim of the review, which is to super charge the Australia's start-up sector and place Australia in a competitive position globally there are some key design recommendations that EOA has set out below:

Immediate Recommendations

1. Remove vesting as a taxation point for options and replace it with the previous position of exercise as one of the potential taxation points. If this change came into effective the issue with the refund rules would be overcome.

This change should be applied across the board to all companies and should not be restricted to start-up companies. Without exception globally options plans have exercise, not vesting, as the primary taxation point.

2. Create a regime that is specific to start-up companies that:

- **Remove the 5% cap.** In practice this rule is largely only an issue for start-up and SME companies. In the UK the EMI has a 30% cap limit.
- **Remove the need for valuations by taxing the options at the point of realization, i.e. when the employee disposes of the shares.** ***The start-up plan should be crafted so that when the disposal event happens they are taxed on the value at that date, less any costs (exercise or otherwise). The tax applied is a concessional marginal rate of 50% of the individual's marginal rate. There is no need for valuations prior to the disposal event (which would usually be a sale or listing) and at this point a valuation will be known, there is no need for the complexity of considering whether the 12 month concessional CGT period has occurred or whether the amount should be income tax or capital gains tax. This regime should not have a limited or fixed life but is triggered by the realisation event.***

If the plan is taxed at realization at a concessional marginal rate then it makes it simple for everyone to understand, track and pay the correct tax on.

- **Extend the prospectus filing exemptions to include those employees included by the plan.** In most overseas jurisdictions there is a carve from the prospectus filing requirements for employee plans up to a certain dollar limit, this principle should be replicated in Australia. Alternatively, any review of the taxation regime should be made in conjunction with any other regulatory reviews to ensure consistency, simplicity and certainty. If the tax legislation changes without the prospectus filing barriers being lifted then the impact of the changes will be marginalised.

- **Consider using options as the preferred vehicle.** These plans are by far the most common type of vehicle used in start-ups, they reflect the US and UK practise, they create simplicity for start-ups as there is no need for a trust, there is no dividend stream, there no need to buy back shares if a company leaves. Additionally the ASIC Class Order relief as it currently stands has a carve out exemption for options, that if broaden would overcome the prospectus filing issue.

- **Any definition of start-ups should be simple and indicative of the actual market -** A Good example of this may be the R&D definition that is easily understood. However, the review needs to also consider carefully other models, for example the EMI definition in the UK, to ensure that we capture our target market. The current definition is too limited in terms of employee numbers – it misses the target by a big margin.

- **To reduce costs and complexity the creation of standard documents would be welcomed** – part of the difficulties that companies face is the cost of implementation. This is partly due to the taxation and legislative complexity that a company must navigate through to implement an employee equity plan. If this regulation could be simplified and certain standard documents could be approved with a simple guide on how to use them. This would significantly reduce costs for start-up companies. As noted in the Nuttall Review of Employee Ownership - Sharing Success this would need to be complemented by greater awareness of the use of employee ownership.