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Government Review of Employee Share Schemes for Start-Ups

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Employee share schemes – Start-ups

Highlights

- As part of its latest update to the National Digital Economy Strategy ("NDES"), the Australian Government released a discussion paper " Employee Share Schemes and Start-up Companies: Administrative and Taxation Arrangements" on Friday 2, August 13.
- The paper outlines potential alternatives for addressing issues for Start-Up companies with the current employee share scheme ("ESS") tax rules as follows:
  - Proposed definition of a start-up
  - Concessional tax treatment alternatives for start-ups, which includes 2 alternatives that will change the taxing point and 2 alternatives that increase the discount available to securities provided by start-ups
  - Valuation of Options for start-ups which includes the Net Asset Back Valuation method, Australian Accounting Standards Board No.2 (for share based payments) and other alternative formula-based valuation methodologies (ie Monte Carlo option pricing model, Binomial option pricing model)
- The Government appears to have opted for reform through modification to the existing ESS arrangements under Division 83A of the ITAA 1997, rather than designing a new regime for start-ups.
- While the Corporations Act requirements are alluded to in the Paper, there is no meaningful consideration of their interaction with the tax laws.
- As part of the review of the current ESS regime, the Government has called for submissions (that closes on 30 August) to issues raised in the discussion paper. PwC will be involved in the consultation process and provide feedback.

When cash is tight employee share plans and the promise of possible future returns can make a difference in terms of attracting and retaining the talent necessary to turn a business idea into a future profitable business.

In order for this Government review to deliver meaningful change, we believe that the following three key principles must be met.

1. Only tax a gain when the value has been realised

The likelihood of a return on the shares is in most cases is low, and therefore it is critical that a new taxing regime recognises this fact and focuses on taxing only real world gains when they are realised. For us, this is the key principle which must underpin any new ESS taxing regime for start-ups.

2. The costs and administration to comply with the new rules must be low

Start-ups do not have the time or resources (in terms of cash and people) to wade through complicated rules to determine whether they qualify for any concessions under ESS rules. The rules should focus on what is a "Start-Up" and when this definition is met provide a new tax concession where tax is due only on sale. This removes all the complexities around valuation at the time of award, application of tests around real risk of forfeiture and genuine disposal restrictions.

3. The new regulatory framework must be considered holistically

While a new tax regime would go a long way to helping to encourage the use of ESS in start-ups, there are many other regulatory issues that get in the way. It is noted that ASIC are separately reviewing the Corporations Act requirements as part of their current consideration of ASIC Class Order 03/184 and Regulatory Guide 49. For the review to make a real difference, it needs to be approached from a holistic basis, tax, compliance, valuation and legal – ie securities laws. For example, in many cases it can be the Corporations Act requirements regarding disclosure, licensing, hawking etc which have the most significant impact on the commercial objectives of the start-up when structuring ESS.

If we approach this review from the right perspective we have a real chance of making meaningful change that will remove a key impediment to creating an environment where Australian start-ups can truly thrive.

Potential alternatives for taxation reform of ESS rules

In our view the only alternative that meets our key principles is Alternative 2. The other alternatives in our view would not drive any improvement in the take up of ESS by start-ups.

Alternative	Upfront Tax	Taxing Point for discount	Taxable Discount	T ax Rate on Discount	Tax on Capital Gains Realised		PwC View
1	No	Vest	Difference between market value at vesting and consideration paid.	Marginal tax rates, no $1,000 concession	CGT payable on the difference between disposal price and the vesting price. CGT discount may be available.	✘	This alternative doesn't defer tax to a point to when the value is recognised by the individual and will leave employees with a tax bill on liquidation. No upfront taxation, however tax is payable at a deferred taxing point which is the earliest of: when the employee exercises the options, the employment ceases, or 7 years after the shares or rights are acquired. Most of the gain will also be taxed at normal rates not CGT rates.
2	No	When shares or options are sold or realised	Difference between market value at acquisition and consideration paid.	Marginal tax rates, no $1,000 concession	CGT is paid on the difference between disposal price and acquisition value. CGT discount may be available.	✔✔	This alternative appears to be the most ideal option amongst those presented given that tax can be deferred to a point where the value can be recognised by the individual, ie at exercise or disposal and any growth from acquisition is taxed at CGT rates.
3	Yes	On grant	Difference between market value at grant and consideration paid.	15% with a $1,000 concession available	CGT is paid on the difference between disposal price and acquisition value. CGT discount may be available.	✘	Even if the discount is taxed at a concessionary tax rate upfront, individuals are subject to tax prior to being able to recognise any value from their securities.
4	Yes	On grant	Difference between market value at grant and consideration paid.	Marginal tax rates with a $5,000 concession available	CGT is paid on the difference between disposal price and acquisition value. CGT discount may be available.	✘	Individuals can benefit from $5,000 concession from tax however, they are subject to tax prior to being able to recognise any value from their securities. The concession is too low to be meaningful.

Definition of a start-up/Valuation methodology

Definition of a Start-Up

The Government has proposed a limited definition for a start-up company being ; *a start-up business with 15 employees or less, which has been in existence for 5 or 7 years or less and would exclude the following industries:*

- property development or land ownership
- finance, to the extent that it is banking, providing capital to others, factoring, securitisation or leasing
- insurance
- construction activities (including extension, improvement or up-grading)
- making investments, whether made directly or indirectly, that are directed to deriving income in the nature of interests, rents, dividends, royalties, or lease payments
- other activities could include mining and mineral exploration; and farming and agriculture

- No current legislation that defines a start-up.
- The Governments proposed definition is narrow and restrictive, it needs to be broad and less prescriptive.
- Mining/exploration companies have been listed as an excluded business activity. Typically mining/exploration companies are one of the heavier users of equity based compensation given their similarity to technology start-ups: cash poor, culturally high risk/high reward operations.
- No guidance on why certain industries have been excluded, the exclusions simply follow those under the Early Stage Venture Capital Limited Partnership regime in the tax law.
- Review and consider aligning the Australian definition of a start-up as developed by countries such as Singapore and the UK that have successful models for start-ups in place.
- The UK has a concessional tax regime known as the Enterprise Management Incentive (EMI) scheme that defines start-ups as trading companies as those with gross assets of no more than £30 million and full time employees of no more than 250. Allows for Options of up to £120,000 per employee with a total cap of £3 million in total for all employees.

Valuation Methodology

Valuation methods that have been outlined in the paper include:

- Net Asset Back Valuation method which the Government considers a 'safe harbour' method where it is not possible to obtain market valuation. This method allows for start-ups to acquire a valuation at no additional cost as this information should already be readily available to them, however the valuation generally produces an outcome that is materially less than fair market/market value.
- Australian Accounting Standards Board 'AASB' No.2 (for share based payments) such as the Black Scholes-Merton formula for valuing options.
- Other alternative formula-based valuation methodologies (ie Monte Carlo option pricing model, Binomial option pricing model) which attempt to attribute value to the right with the outcome being generally reflective of the market value of the underlying share, however needing to use complex formulas to derive outcomes where the accuracy of the outcome may be somewhat restricted in the case of unlisted securities where the requisite information may not necessarily be available.

- Amend ESS rules such that taxation of ESS interests occurs when individuals are able to access the actual benefit of their securities (ie avoid upfront taxation and defer taxation to exercise/sale).
- In turn, valuation of securities will be a much more simplistic, cost effective process – no longer have to rely on formal valuation assistance to ascertain the market value of unlisted securities.
- We note, the discussion paper hasn't fully addressed or expressed any solutions to the actual issues associated with valuation of ESS interests in the unlisted environment.

Securities law regime

While the Corporations Act requirements for ESS are alluded to in the Paper, there is no meaningful consideration of their interaction with the tax laws. It is noted that the Corporations Act requirements are being reviewed separately by ASIC as part of their current consideration of ASIC Class Order 03/184 and Regulatory Guide 49.

In our view, in order to develop a meaningful and impactful solution, an integrated and holistic approach needs to be adopted by government organisations to resolving the various issues involved in regards to the current ESS arrangements such as tax, compliance, valuation and legal.

From a legal perspective, while ASIC provides an exemption from Disclosure (preparation of a prospectus) by way of a Class Order relief, this exemption is only available in very limited circumstances to unlisted companies. Instead, start-ups are generally required to rely on specific exemptions in the Corporations Act, from the requirement to make Disclosure such as:

- the 'small scale offerings' exemption (s708(1) Corporations Act)
- the 'sophisticated investor' exemption (s708(8) Corporations Act)
- the 'senior manager' exemption (s708(12) Corporations Act).

In many cases, the above exemptions will suffice in enabling a start-up to offer equity incentives to their employees without the need for Disclosure. However, there are cases where start-ups with larger workforces struggle to fit within the above exemptions. In such instances, the inability to fall within an exemption to the requirement to prepare a disclosure document (eg prospectus or offer information statement) is enough to halt the introduction of an employee equity plan altogether.

Therefore, in line with changes to the tax reform, we believe that Treasury needs to ensure that their work is complimented by the concurrent work being undertaken by ASIC on ASIC CO 03/184 and Regulatory Guide 49 to ensure all aspects of the regulation of ESS for start-ups are aligned. In our view, the following specific responses to commonly occurring Corporations Act issues deserve close consideration:

- Provide a specific exemption from the disclosure/prospectus rules for employee share plan offers to employees of start-ups.
- Define start-ups as per the tax law definition as noted in the discussion in slides above.
- Clarification that consideration for the purposes of s.708(15) of the Corporations Act (Issues or sales for no consideration) – which is an exemption to the requirement to prepare a disclosure document – shall exclude any 'consideration' provided by way of ongoing service or tenure of the employee (ie consideration for these purposes should be limited to consideration by way of cash, property or its equivalent). This would enable start-ups to fall under the s.708(15) exemption to disclosure when they offer equity instruments for free, even if those instruments have a vesting condition linked to the employee meeting a certain period of service or tenure (eg where there is a vesting condition that the employee must remain with the company for 3 years from the grant date).

Revenue impact/Reporting

Revenue impact

We note that any change to current tax arrangements will have an impact on the Government's taxation revenue. The issue is whether this is positive or negative.

The Government believes that deferring the taxing point or payment of tax would mean that the revenue that would be collected in the long term will be deferred resulting in loss of revenue where share or options are not sold or exercised.

However, the Government does not seem to recognise the long term benefits of encouraging start-up companies that have been significant contributors to economies such as the U.S. and Israel from the perspective of an employment and technology-based productivity growth, and ultimately revenue generation.

Included below are some key observations that were highlighted in a recent report prepared by Employee Ownership Australia and New Zealand (EOA)– 'The Changing ESS Landscape since 1 July 2009"[1] :

- The introduction of Division 83A in 2009 was specifically targeted at generating additional revenue for the Government, principally from the new ESS reporting regime.
- However since the introduction of the Division 83A rules, over 90% of plans were suspended in the first year and 30% of plans were suspended for up to 2 years. Of the 30% of plans suspended for 2 years, many have not been reinstated.
- The complexity and cost of amending ESS plans bought by the changes to the ESS rules, resulted in an increase in the number of plans being operated by companies. However the increased number of plans has not translated into greater employee participation, but rather participation levels have dropped significantly.

Commentary from the report prepared by the EOA suggests that the complexity surrounding the new tax rules (including the addition of real risk of forfeiture and genuine disposal restriction concepts) has made ESS plans less attractive to employees, which has in turn impacted the overall participation levels in ESS plans. Given that the Division 83A rules were primarily introduced to increase the Government's taxation revenue, there is some uncertainty as to the likelihood of the Government actually achieving this objective.

Reporting

Deferral of taxation does however mean that where individuals only recognise the value of their securities when they actually sell them, then consideration will need to be given to revised reporting arrangements.

The new start-up regime could require that administrative details of the securities and individual details (such as a tax file number) be provided to the Australian Taxation Office ("ATO") upon issue of such securities to individuals. In addition, the regime could dictate that the ATO must also be notified upon disposal of the securities, in order to track individuals under self assessment/disclosure requirements at the end of the year in which securities are disposed.

[1] Employee Ownership Australia & New Zealand, April 2013, 'The Changing ESS Landscape since 1 July 2009' Employee Ownership Australia & New Zealand Report

How PwC can help?

To have a deeper discussion about these issues, please contact:

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