

Employee share scheme update

Further to the Government's release of Advancing Australia as a Digital Economy: Update to the National Economy Strategy on 12 June 2013 (refer to Employee share scheme announcement - 21 June 2013 for an overview), Treasury and the Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education issued the discussion paper Employee Share Schemes and Start-up Companies: Administrative and Taxation Arrangements.

The discussion paper focuses on the regulatory requirements surrounding employee share schemes (ESS) and how the current tax treatment of ESS may hinder a start-up company's ability to attract and retain talented staff. The Government has recognised that while the current taxation of ESS attempts to pursue equality and fairness in the tax system, it must also give consideration to the innovative nature of start-up companies, to ensure that they retain a work environment that fosters new ideas.

Current taxation treatment of ESS

Broadly, Division 83A of the *Income Tax Assessment Act 1997* may apply to a scheme under which shares in a company or a right to acquire a beneficial interest in shares in a company, including options (ESS interests), are provided to employees (or their associates) in relation to their employment.

Generally, Division 83A provides that any discount an employee receives on the market value of an ESS interest will be taxed as part of that employee's taxable income in the year it is acquired. Concerns raised regarding the current tax treatment of an ESS interest include:

- it is inconsistent and out of date when compared with global practices;
- tax is required to be paid on shares in companies that may never mature;
- it is an additional barrier to investment;
- employees may not be able to afford the market value tax bill on the discounted shares; and
- determining market value can often be a costly and time consuming process.

Defining a start-up company

While the characteristics of a start-up company are readily understood, no legal definition exists. In the context of considering amendments to the taxation provisions applying to ESS, Treasury has proposed that a start-up be defined as a company which:

- has 15 employees or less;
- generates less than \$15 million in aggregated turnover;
- is not a subsidiary of, owned, or controlled by another corporation;
- has been in existence for no more than 5 or 7 years;
- is unlisted;
- is providing new products, processes or services based on the development and commercialisation of intellectual property;
- is not undertaking an excluded activity (a list of excluded activities will be generated); and
- has the majority of its assets and employees located in Australia.

Key areas being reviewed

There are two key areas of Division 83A that are considered by the discussion paper in the context of reducing the complexities and costs for start-ups where Division 83A has application.

The first of these key areas is a review of the tax treatment for employees if Division 83A applies. The second is the issue of valuation for the purposes of determining the amount of the discount that the employee has received and therefore the amount of the taxation liability.

The review of each of these key areas by the discussion paper is outlined below.

Tax treatment options for securities provided by start-up companies

The discussion paper outlines four options for a new tax treatment of ESS and how each one applies to start-up companies. These options include:

1. Defer taxing point for securities offered by start-up companies

An employee with an ESS interest will be taxed at the 'ESS deferred taxing point' rather than when the ESS interest is acquired. However, the usual \$1,000 discount will not be available. The ESS deferred taxing point will be the earliest of:

- when the employee exercises the options;
- when the employment ceases; or
- seven years after the shares or rights were acquired.

2. Defer payment of tax on securities offered by start-ups

The tax payable on the discount received on ESS interest would be deferred until the share or option is sold or exercised. However, the usual \$1,000 discount will not be available.

3. Tax securities offered by start-ups at a lower tax rate

This option is the same as the current tax treatment of an ESS interest except that the tax rate would be discounted. Under this option the availability of a \$1,000 discount would be retained.

4. Increase the concession for start-up securities

The current tax treatment of securities would be maintained, while the tax concession of \$1,000 would be increased to \$5,000.

The discussion paper outlines the benefits and drawbacks associated with each of the four options, noting that the first two options do not reduce the tax liability of the employee, but allow those with an ESS interest to defer the tax liability until the shares or options can be traded.

Options 3 and 4 may reduce the potential tax liability of an ESS interest, but they fail to address the biggest issue with the current taxation of ESS interests in start-ups – that the interests are still taxed before they can be traded.

Proposed reforms to the valuation method

The discussion paper acknowledges that ESS is often used as a method of remunerating employees when the cash flow of a start-up company is low. The need for a start-up to obtain a valuation of the company at a significant cost often negates the value of implementing an ESS. In reviewing alternatives to obtaining a market valuation, the discussion paper considers two options.

One option is to provide alternative valuation methods that use information held by the start-up company. The discussion paper suggests two approaches for this:

- The first is referred to as Net Asset Backing Valuation whereby the net assets, as shown in the company's balance sheet, are divided by the number of total issued shares that give access to capital on the winding up of the company.

The advantage of using this method is that all the information is readily available from the company's accounts. However, it is arguable that the value determined will be less than the market value.

- The second approach is the application of Australian Accounting Standards Board Standard No.2, which requires the implementation of generally accepted option pricing models that take into account:
 - exercise price;
 - option life;
 - current price of underlying shares;
 - expected share price volatility;
 - expected dividends, if any; and
 - risk free interest rate of the option life.

The second option outlined in the discussion paper is to retain the current methods of obtaining market valuation, but update the statutory tables.

Reducing the complexities associated with an ESS

Establishing an ESS is not easy and will often require the assistance of an accountant and/or a lawyer. The discussion paper raises the possibility of introducing standardised documents to decrease the costs and complexities associated with the establishment of an ESS.

Consultation questions to stakeholders

As part of the discussion paper, Treasury is seeking input from various stakeholders regarding ESS issues with the due date for submissions being 30 August 2013.

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