OFFERING EMPLOYEE EQUITY HAS BECOME MUCH EASIER FOR AUSTRALIAN START-UPS

From 1 July 2015 the way in which options granted by any company to its employees in Australia will be taxed has changed, but the main winners under the new tax rules are those Australian companies that qualify for the start-up concessions. For Australian start-ups looking to implement a new employee share scheme, this article is a must read…

A RE-CAP ON THE NEW TAX RULES FOR AUSTRALIAN START-UPS

The specific start-up tax rules are both a reaction to the industry's disappointment at the tax changes made in 2009, and the fact that the Australian tax rules can make offers here uncompetitive compared to equity offers in other countries.

There are strict requirements used to determine whether companies and company groups will qualify as "eligible" start-up companies. As a starting point, to be eligible a company (or any company in a multinational group) must:

- have an employer which is an Australian resident taxpayer (i.e. the scheme does not apply to branch or permanent establishment employees);
- not have a company which is more than 10 years old;
- not be listed; and
- not have aggregated turnover (of the group) exceeding $50 million.

For a full list of those requirements see **25 March 2015 article.**

Even if the company or company group satisfies these rules, there are additional rules which must apply to the actual offers they wish to make to their employees, including:

- for an ordinary share, the discount cannot exceed 15% of the market value of that share at the date of grant;
- for an option, the exercise price for the option must not be lower than the market value of ordinary shares at the date the option is granted;
- the scheme must require that the share/option is held for at least 3 years (noting that this rule is waived if the entity is sold, undertakes an IPO or the employee leaves); and
- the employee cannot own more than 10% of equity (including any unexercised options) in the company.

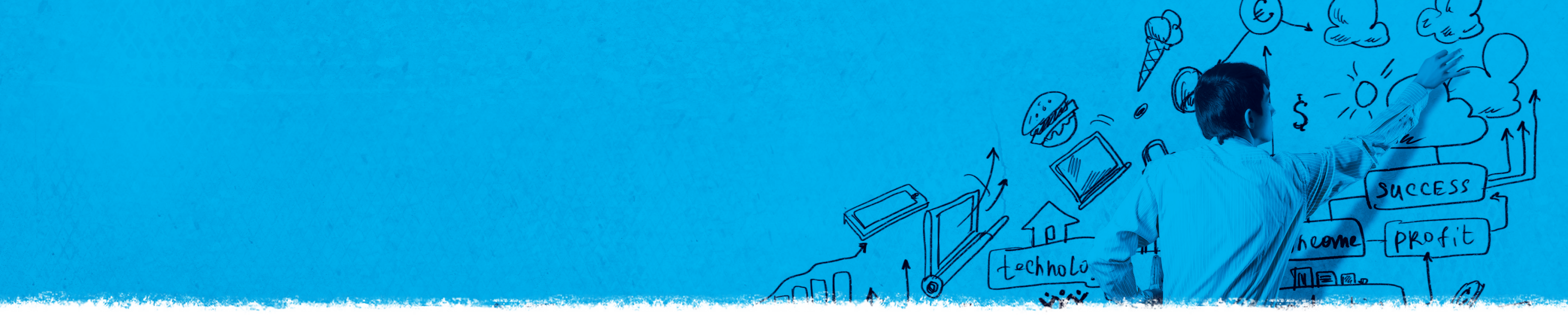
But even for an "eligible" start-up company, implementing a new employee share scheme can be seen as a daunting task and comes with its own particular issues.

Two of those issues, documenting and communicating the terms of the scheme and the valuation of awards, have been addressed by recent releases from the Australian Taxation Office (**ATO**) but there are some potential traps to be aware of.

ATO STANDARD DOCUMENTATION AND SOME IMPORTANT TIPS FOR AUSTRALIAN START-UPS

The ATO has now released a set of standard documentation designed to assist eligible start-up companies with the initial planning and information gathering stages of rolling-out an employee option plan.

Those documents are template employee option plan rules, a template offer letter to be provided to employees, and an instruction guide on how to use those documents, and



can be accessed **here**. Importantly however, as the ATO notes, these templates are not a replacement for obtaining professional advice.

In our recent article, **Top 10 Tips and Traps for Employee Share Schemes in Australia**, we set out some of our tips on maximising the effectiveness of new and existing employee share schemes. Some of those tips are particularly relevant and worth repeating for any start-up company looking to rely upon the concession and to use the ATO's standard documents:

- **Tip No. 1 Plan** – to be effective, an employee share scheme must be consistent with a company's overall business strategy and people strategy. Participation in a scheme is only one element in an employee's overall remuneration mix and must work well with all other elements, including fixed remuneration and any short term incentives or bonus potential.

  The standard documents are a good start, but as the ATO itself notes, they have not been designed to meet the specific requirements of each company and will need to be amended to suit each company's particular circumstances, strategy and goals.

- **Tip No. 2 Not all employee share schemes are created equal** – there is no one size fits all solution when it comes to implementing an employee share scheme. Companies should always start by asking themselves what are they trying to achieve and work backwards.

  The standard documents only cover where a company is looking to issue options, but the start-up concessions themselves can also apply where a company wishes to issue shares immediately. There are also a number of other very effective structures and award types which start-up companies can use to incentivise their employees, from loan funded share plans through to more bespoke converting or "flowering" share arrangements, which may provide better outcomes.

  As we also suggested in our **Tip No. 2**, to have an effective scheme and to ensure that there are no unintended consequences, companies need to be aware of all of their **legal and compliance obligations.**

  As an example, whenever a company issues shares or options to employees, it needs to ensure that it meets Corporations Act disclosure requirements or comes within one of the available exemptions. While there are exemptions for offers made to "senior managers" and where small scale offerings are made, many unlisted companies will need to look to the broader relief

granted by the Australian Securities and Investments Commission (**ASIC**) under Class Order 14/1001. While the relief provided under that Class Order is broader in some ways to that previously available, for unlisted companies there are some important limitations built into that relief to be aware of – the offers must relate to fully paid ordinary shares only, must be made for no more than nominal consideration and not exceed $5,000 in value for each participant per year, audited financial accounts must be available to participants, and the company must ensure that any offers when aggregated with offers made using ASIC relief in the previous 3 years do not exceed 20% of the company's issued share capital.

As a more general point, companies should carefully consider that if the offers are to immediately provide shares to employees or are for options which are exercisable by employees while the company is still private and unlisted, how are those minority shareholders to be properly managed (such as via a shareholders' agreement), how are the founders' interests to be properly protected (such as by disposal restrictions and drag along rights), and how can the company easily take back those shares if, for example, an employee leaves?

- **Tip No. 6 Effective communication with employees is critical** – once an employee share scheme is implemented, it is critical that there is a clear communication with participating employees as to what the "rules of the game" are – what they are being awarded, what they or the company needs to do or achieve in order for those employees to receive value from their awards, and what happens if those objectives are not met or only partially met.

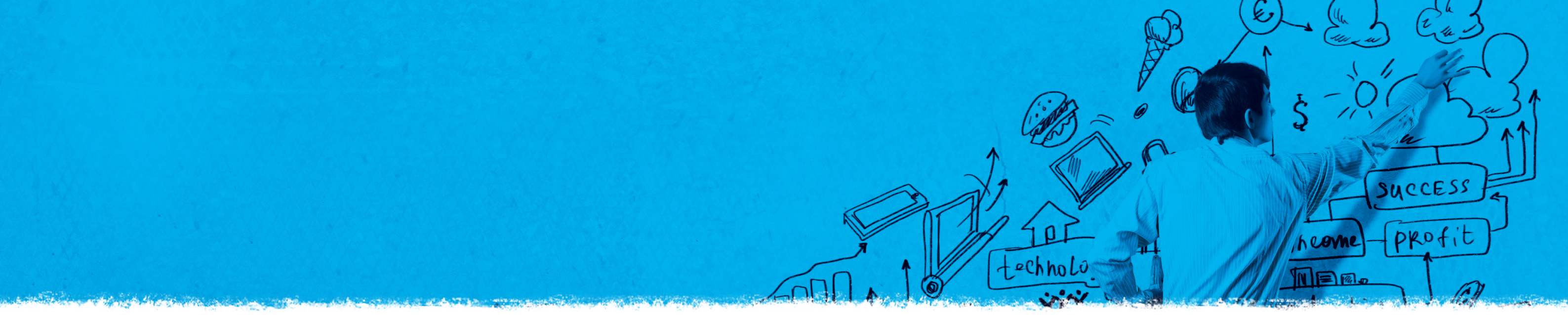
Careful thought needs to be directed as to how a company communicates the roll-out of a new scheme, both in terms of what employees are told and what they are provided in writing, to ensure that employees properly understand the scheme and what it may mean for them.

An important part of this communication piece is also ensuring that employees understand and are comfortable with the tax outcome for them in receiving awards. This is commonly done by providing employees with a general statement on the likely tax treatment of their awards and some worked tax examples to explain that treatment. The standard documents, however, simply refer employees to the ATO's general advice in this regard.

VALUATION METHODOLOGY

For unlisted companies without a ready or liquid market for their shares, the need to obtain a valuation to properly implement an employee share scheme has often created an unwelcome impediment and costly compliance issue.

Any eligible start-up company wishing to rely upon the concession will need a valuation to determine the market value of their shares to ensure that all of the eligibility requirements are met. In particular, this is to ensure that any options are issued with an exercise price at or above the market value of the company's ordinary shares,



or where ordinary shares are to be issued, to ensure that they are issued at no more than a 15% discount to that market value.

The Commissioner of Taxation has now released new guidance on this issue in the form of the *Income Tax Assessment (Methods for Valuing Unlisted Shares) Approval* 2015 (**Approval**). The purpose of the Approval is to set out valuation methods that are acceptable to the Commissioner and can be applied by unlisted companies to work out a market value for awards that are to be offered to employees. Importantly, however, the Approval only applies to companies that are issuing awards that are eligible for the start-up concession and where those companies are not anticipating a change of control occurring within 6 months of the issue of awards. For companies that do not meet those eligibility requirements, valuation will remain an issue.

The Approval recognises the following two valuation methods:

Net tangible assets method

For companies that:

- meet the start-up concession eligibility requirements;
- are small business entities (which means aggregated turnover in the last financial year of less than $2 million or is likely to be less than $2 million in the current financial year) or have been incorporated for less than 7 years;
- have not raised over $10 million in capital (either debt or equity combined) over the preceding 12 month period; and
- will prepare a financial report for the year in which the valuation time occurs, that complies with applicable accounting standards,

the primary method for valuing ordinary shares is the net tangible assets of the company, reduced by potential preference share returns.

This valuation method lends itself to early stage start-up companies who have yet to augment their initial seed capital with any other form of material capital raising.

We have set out a simple example below as to how the valuation method works.

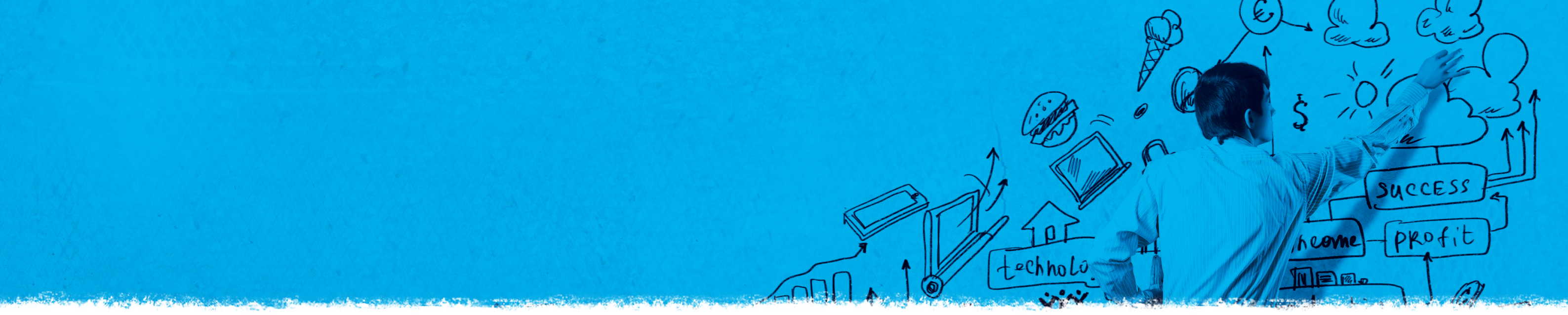
Alternative method

For companies that meet the start-up concession eligibility requirements, but that do not meet the other requirements listed above or who simply wish to choose another alternative, those companies can rely upon the following valuation method.

The alternative method requires that:

- the valuation of ordinary shares must be performed by either the Chief Financial Officer of the company, or a person having the knowledge, experience and training to perform such valuations;
- the valuation must be fully documented and take into account the following on a reasonable basis:
  - the value of tangible and intangible assets of the company;
  - the present value of anticipated future cash flows;
  - the market value of similar businesses, including the use of earnings multiples; and
  - uplifts and discounts for control premiums, lack of marketability and key person risk; and
- the directors of the company must endorse in a written resolution both the method used and the resultant value.

If a company does not want to use (or cannot) use either of the specified valuation methods referred to above, then the Approval confirms that another valuation method chosen by a company will come within the terms of the Approval, if that other method produces a valuation not less than would have been obtained using one of the specified valuation methods.



Example

The explanatory material to the Approval provides some examples of how those specified valuation methods may work. Based closely on those examples, we have set out below a simple example of the Net Tangible Assets Method.

Two individuals, Ms Allen and Mr Brown, have decided to set up a new technology venture and have incorporated a new company, ABC Startup Pty Ltd, to use as a vehicle to drive that venture. Ms Allen and Mr Brown have each contributed $45,000 for a 50% ownership in the company, giving them 10,000 ordinary shares each. Ms Allen and Mr Brown have spent $10,000 on the initial start-up costs.

ABC Startup Pty Ltd has recently employed two new staff members, Mr Clarke and Ms Davies, to help drive the venture forward. Ms Allen and Mr Brown have decided that as part of their overall remuneration package, ABC Startup Pty Ltd wants to grant options to Mr Clarke and Ms Davies under the terms of a new option plan.

It is proposed that on 1 August 2015 Mr Clarke and Ms Davies will each receive 1,111 options under that new plan. Each of those options when exercised by Mr Clarke and Ms Davies would result in them being issued 1,111 new ordinary shares in ABC Startup Pty Ltd. This (unusual) number of options was chosen, so that if all the options were exercised by Mr Clarke and Ms Davies they would hold 1,111 ordinary shares each, out of a total of now 22,222 ordinary shares then on issue (or just under 5% of the shares in ABC Startup Pty Ltd each).

Those options will only vest and be exercisable by Mr Clarke and Ms Davies if they remain employed by ABC Startup Pty Ltd up to and including 31 December 2019 (approximately 4 1/2 years).

ABC Startup Pty Ltd wants to ensure that Mr Clarke and Ms Davies are eligible for the start-up tax concession. In order to comply with the eligibility conditions for that concession, ABC Startup Pty Ltd needs to ensure that the exercise price of the options offered to Mr Clarke and Ms Davies is not less than the market value of the ordinary shares at the time of grant. ABC Startup Pty Ltd satisfies all other eligibility conditions, including that it is not listed, has been incorporated for less than 10 years, and has turnover of less than $50 million (although Ms Allen and Mr Brown would be happy for this not to be the case). The number of options being offered to Mr Clarke and Ms Davies and the minimum holding period of 4 1/2 years satisfies two of the other important eligibility conditions.

At the time of offering the options, ABC Startup Pty Ltd's only assets are $80,000 cash (after having spent $10,000 of the initial seed capital on start-up costs).

Using the **Net Tangible Assets Method**, the value of an ordinary share in ABC Startup Pty Ltd is $80,000 (net assets) divided by 20,000 (the number of ordinary shares then on issue), or $4 per share.

As a result, provided ABC Startup Pty Ltd sets an exercise price for the options to Mr Clarke and Ms Davies at $4 or more, it will be able to rely on this valuation method to enable Mr Clarke and Ms Davies to be eligible for the start-up tax concession.

MORE INFORMATION

For more information, please read our previous articles on employee share schemes from 28 January 2015 and 25 March 2015, or contact:

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