

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

Discussion Paper  
August 2013

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## CONSULTATION PROCESS

### Request for feedback and comments

Interested parties are invited to provide comment on the details outlined in the consultation paper. While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

### Closing date for submissions: 30 August 2013

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### Confidentiality

All information (including name and address details) contained in submissions will be made available to the public on the Treasury and Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education websites unless you indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain confidential should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate.

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## FOREWORD



Innovation is vital to Australia if we are to continue to improve our living standards, create new business opportunities and be globally competitive. The development of a strong and innovative economy is essential to creating jobs and improving productivity and competitiveness. A flourishing start-up sector is an important element of ensuring Australia is a thriving hub for innovative industry.

The Australian Government understands the challenges that face start-ups such as access to capital, attracting and retaining skilled employees, managing fast growth and being competitive in overseas markets. We want to support Australian start-ups to grow into successful businesses.

Attracting and retaining skilled and experienced employees is important for start-ups seeking to grow and be globally competitive. Employee Share Schemes (ESS) can be an important tool for resource strapped start-ups, as they provide an option to help attract and retain talented people (locally and from overseas) while ensuring sufficient capital is available for the start-up to grow. Importantly, they also provide an effective incentive for early employees to put their passion and commitment into the new opportunity with a promise of benefit if the business grows.

On 12 June 2013, the Australian Government released *Advancing Australia as a Digital Economy: An Update to the National Digital Economy Strategy*. The Update included the announcement of a regulatory review into Employee Share Schemes to address the difficulties being faced by start-up companies. This Review will complement measures designed to encourage high-growth start-up firms outlined in *A Plan for Australian Jobs: The Australian Government's Industry and Innovation Statement* announced on 18 February 2013.

We have announced this Review in acknowledgement of the importance of start-ups to Australia's diverse economy and future productivity. The Review will assess whether current arrangements strike the right balance between having a flexible and simple system that can be used to incentivise employees and protecting the integrity of our tax system for all users.

This Discussion Paper is the first step in the Review. It outlines current arrangements and possible options for changes to the current ESS system. The Discussion Paper will help the Government by enabling you to bring your ideas into consideration in deciding what measures could be taken to enhance our start-up companies through employee share schemes.

We encourage all stakeholders who have an interest in the current arrangements of employee share schemes to provide comments on the issues raised in this Discussion Paper, and we really do appreciate you taking the time to do so.

The Hon David Bradbury MP  
Assistant Treasurer

Senator the Hon Kim Carr  
Minister for Innovation, Industry, Science and Research

Senator the Hon Kate Lundy  
Minister Assisting for the Digital Economy

# 1. INTRODUCTION

1. This Review of the administrative and taxation arrangements of employee share schemes (ESS) for start-up companies is part of the further work the Government committed to as part of *A Plan for Australian Jobs: The Australian Government's Industry and Innovation Statement*<sup>1</sup> and the Update of the National Digital Economy Strategy.
2. As part of *A Plan for Australian Jobs*, the Government announced that it was exploring options around the impact of ESSs on Australian start-ups.<sup>2</sup>
  - 2.1. The *2012 Review of Venture Capital and Entrepreneurial Skills*, released as part of the Industry and Innovation Policy Statement recommended that the Department of the Treasury and the former Department of Industry, Innovation, Science, Research and Tertiary Education undertake further work, in consultation with industry, to:
    - 'gain a better understanding of the difficulties start-up companies face in providing appropriate remuneration (including shares or options) to attract and retain experienced and skilled employees;
    - how these challenges have been addressed internationally; and
    - what, if any, actions should be taken to remove constraints on start-ups growing within Australia'.<sup>3</sup>
3. On 12 June 2013, the Australian Government released *Advancing Australia as a Digital Economy: An Update to the National Digital Economy Strategy*.<sup>4</sup> Recognising that more can be done to support start-ups by reducing the cost and complexity of administering ESSs, the Government announced that it would consult with stakeholders to determine the most effective measures to address the barriers faced by start-up companies (Action 7 of the Update Initiatives). In particular, the Review will look at:
  - developing guidance to reduce the administrative burden (meaning the cost of valuing shares and options) of establishing an ESS;
  - adjusting the valuation methodology of options; and
  - examining the point at which share options are taxed for start-up companies.
4. The review is being undertaken by The Treasury and the Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education (DIICCSRTE) and will report back to Government by December 2013.

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1 <http://www.aussiejobs.innovation.gov.au/industry-and-innovation-statement/Pages/default.aspx>.

2 [http://www.aussiejobs.innovation.gov.au/programs/Documents/12285%20fact%20sheet\\_venture%20aust\\_D3.pdf](http://www.aussiejobs.innovation.gov.au/programs/Documents/12285%20fact%20sheet_venture%20aust_D3.pdf).

3 Review of Venture Capital and Entrepreneurial Skills, p 31.

4 <http://www.nbn.gov.au/nbn-benefits/national-digital-economy-strategy/>.

## 2. BACKGROUND

### 2.1 INNOVATION AND START-UPS

5. Innovation is considered a major contributor to a nation's economic growth. It is critical to lift productivity, competition, economic growth, and employment through the creation of, and access to, new markets and the invigoration of established markets. In terms of economics and social prosperity, Australia ranks as one of the highest countries in the world. Our long-term productivity growth is impacted by innovation with innovative companies nearly twice as likely to report an increase in productivity compared with non-innovative companies. 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.<sup>5</sup>
6. Vibrant small businesses and an active start-up sector are key elements of the innovation system. It is difficult to determine how many start-ups there are in Australia at any time. The survival rate of start-ups indicates their sporadic nature and their transient existence.
7. Australian start-ups have an important role to play in the development of a strong and innovative economy and job creation. The *National Endowment for Science, Technology and the Arts* (NESTA) in the United Kingdom (UK) has found that high growth innovative companies account for only six per cent of the economy but have the highest business growth and generate the majority of jobs.<sup>6</sup> According to the Kauffman Foundation research, in the United States (US) from 1980-2004, firms less than five years old accounted for all net job growth in the US during this time.<sup>7</sup>
8. Start-ups positively impact economic growth and development and have the potential to generate new markets and significant employment growth, facilitate trade and exports and generate strong future productivity growth. Start-ups also create prosperity and jobs in a much shorter timeframe when compared to other small businesses. Australia's transition to a digital economy is helping remove the constraints of geographical distance and time and driving innovation more rapidly than we have witnessed before.
9. Technology start-ups also serve an important role in the Australian economy as enablers of technology-based productivity growth. Australian technology firms have made significant contributions to the ability of Australian firms in other industries to take advantage of the digital economy by providing the tools to do business online affordably and easily. Encouraging the growth of these 'enabling' firms by ensuring a supportive regulatory environment can lead to benefits for the economy more broadly.
10. Start-ups have significant potential to achieve success and deliver high growth. However, they face a number of challenges which include the attraction and retention of skilled and experienced employees. According to research conducted by Deloitte, Australian technology

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5 Australian Innovation Systems Report 2012,

<http://www.innovation.gov.au/Innovation/Policy/Pages/AustralianInnovationSystemReport.aspx>.

6 The vital 6 per cent: How high-growth innovative businesses generate prosperity and jobs, NESTA, Research Summary, October 2009.

7 <http://www.entrepreneurship.org/en/Blogs/Policy-Forum-Blog/2011/February/FastTrac-Leading-to-Startups-and-Job-Creation-Across-the-Nation.aspx>.

start-ups are less likely to reach maturity than their international counterparts. 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.<sup>8</sup>

11. Attracting and retaining skilled and experienced people is important and challenging for any business, but particularly for innovative start-up companies. Start-ups may source some staff internationally and Australian companies seek to provide internationally competitive salary and incentive packages. Additionally, highly skilled Australian employees are also lured away by innovative start-ups offshore due to their ability to pay more.

## 2.2 EMPLOYEE SHARE SCHEMES

12. ESSs are one way in which employees can share some ownership of the company for which they work, through acquiring shares or options in the company. Other forms of employee ownership include employee share trusts, co-operatives, phantom stock and stock appreciation rights.
13. An ESS and other forms of employee ownership provide significant benefits for employers and employees. They improve the alignment of employee and employer interests, encourage positive working relationships, boost productivity through greater employee commitment to a company, reduce staff turnover and encourage good corporate governance. For this reason, the Government provides a level of preferential tax and regulatory system benefits for ESS arrangements.
14. They are also valuable tools for cash constrained start-ups, as they offer an option for attracting and retaining talented people, while ensuring sufficient capital is available to allow growth of the start-up. An ESS gives start-ups potentially beneficial options for remuneration, including the capacity to top up a base salary with shares or options for shares in the company.
15. Internationally, ESSs are commonly used in start-ups to attract, retain and reward highly skilled employees. A number of countries, such as Singapore, the UK and the US, have a range of schemes that provide incentives for employee share ownership. Further details on these schemes are at **Attachment A**.
16. However, not all start-ups choose to use ESSs and it is acknowledged that they may not be suitable for all start-ups.

## 2.3 ESS ARRANGEMENTS IN AUSTRALIA

17. In Australia, if no concession applies, any discount on the market value of an interest in a share or right provided to an employee under an ESS is taxed as part of the employee's taxable income in the year it is acquired. Receiving a share or right under an ESS is just another form of employee remuneration, and its taxation treatment is therefore consistent with the taxation of an employee's salary and wage income.

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

18. The Australian tax system offers two types of concessions for shares and rights provided to employees under an ESS. Both provide employees (and not employers) with a personal benefit. The first is a \$1,000 concession for eligible ESS interests subject to tax upfront, and the second is a deferral of tax for other eligible ESS interests.
19. Concerns have been raised during consultations with stakeholders that the current arrangements for ESS in Australia are complex, costly and create a barrier or disincentive for many start-ups to set up an ESS. If this is true, it puts Australian start-ups at a distinct competitive disadvantage in international markets and impacts the ability of start-ups to attract and retain the skilled employees needed to grow the company.
20. Stakeholders have expressed concern with the difficulties and high costs involved in establishing an ESS in Australia, as start-up companies often need to seek legal, financial and accounting advice to establish an ESS. There are further costs involved in the ongoing operation and administration of an ESS, with a valuation required when additional shares or options are issued under an ESS. Stakeholders have advised that this can cost as much as \$50,000 per valuation. Stakeholders have also advised that multiple valuations can be required each year depending on when shares and options become taxable. This often makes an ESS unaffordable to many capital intensive start-ups as they seek to focus their capital on the growth of the company.
21. Several industry sectors have raised concerns that the current tax arrangements, which require tax to be paid when shares or options are acquired rather than on disposal, are inconsistent and out of step with global practice.<sup>9</sup> Specific concerns are listed below.
  - 21.1. Given that few start-ups will actually achieve full size as a sustainable company and realise their full potential, tax is required to be paid on shares that may never have a convertible or realised value to the employee. It has been suggested that the changes that were made to the tax arrangements in 2009 have significantly exacerbated this problem (see Section 3.2 below).
  - 21.2. Stakeholders have noted that the Australian tax treatment may create additional barriers to accessing investment in Australian enterprises through sources like venture capital, as many venture capital funds will only invest in companies with an ESS. Establishing an ESS allows the start-up to have more capital available to focus on the growth of the business.
  - 21.3. Employees are often provided shares or options for little or no upfront cost but do not have funds available to pay the resulting tax bill.
22. These concerns were raised by stakeholders in a number of forums, including most recently at the Prime Minister's Digital Economy Forum and through the *2012 Review of Venture Capital and Entrepreneurial Skills*. A number of consultations were also undertaken in the preparation of the Update of the Digital Economy Strategy, where the Departments of the Treasury; Industry, Innovation, Climate Change, Science, Research and Tertiary Education; Broadband, Communications and the Digital Economy; and the Prime Minister and Cabinet discussed concerns about ESS arrangements with a number of start-ups, venture capitalists, incubators and advisers.

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9 Baker and McKenzie, Submission into the operation of employee share schemes in Australia, 2009.

## Discussion Topic 1 — ESS in Australia

1. What barriers do Australian start-ups face in attracting and retaining staff?
2. What type of employees do start-ups typically seek from overseas rather than source domestically?
3. As a start-up, do you offer shares or options through an ESS to your employees? What other benefits do you offer your employees? Are these sufficient to retain or attract the necessary employees? If you do not offer an ESS, what are the major reasons why not?
4. What are the barriers start-ups face in offering an ESS, including tax and other regulatory requirements?
5. What is the relative importance of ESS arrangements to start-ups in Australia compared to other factors such as economic conditions or policy settings?

## 2.4 PREVIOUS ESS REVIEWS

23. The Board of Taxation (the Board) was asked by the Government to undertake a review of the taxation arrangements, following concerns that were raised during consultation on the 2009-10 Budget changes, in particular that the proposed changes would disproportionately affect start-ups, Research and Development (R&D) and speculative-type companies. The Board presented its report, *Review into Elements of the Taxation of Employee Share Scheme Arrangements*, in February 2010.
24. Stakeholders raised with the Board many of the concerns set out above. The Board also undertook a comparison of the tax regimes in different countries.
  - 24.1. The Board found that there is some merit to the argument that the existing restrictions that operate to limit access to the existing ESS tax concessions tend to be particularly onerous for start-up, R&D and speculative-type companies.<sup>10</sup> However, the Board noted that it is difficult to define strict eligibility criteria and there is a risk to the integrity of the ESS tax regime in the absence of the ability to adequately ring-fence eligibility.
  - 24.2. The Board did not recommend the introduction of separate tax deferral arrangements for start-up, R&D and speculative-type companies. Rather, the Board recommended that 'any additional support for start-up, R&D and speculative-type companies would be better provided by Government through support mechanisms such as programs administered by Commercialisation Australia and the new R&D tax incentive which can be better targeted than any further tax concession.'<sup>11</sup>
25. The Board of Taxation also recommended that the factors underlying the statutory valuation tables for valuing unlisted rights issued under an ESS be reviewed and updated to more accurately reflect current market conditions. In its response to the Board's review, the Government agreed to consult with the affected community and make any decisions on

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10 Review into Elements of the Taxation of Employee Share Scheme Arrangements, Board of Taxation, February 2010, Page ix.

11 Ibid.

updating the statutory table in the context of the Budget. This process will be undertaken separately from the current consultation on ESS arrangements for start-up companies. Timing for this process will be determined at a later date.

26. The Senate Economics References Committee conducted a review of the operation of employee share schemes in Australia in August 2009. This Review was undertaken as changes to the taxation arrangements for ESS announced in the 2009-10 Budget were being progressed. The Committee recommended that the Government delay the introduction of the legislation implementing the changes in order to take note of other reviews in this area, to ensure legislative integrity and coherence.<sup>12</sup> The Government's legislative changes received Royal Assent on 14 December 2009.

### 3. CURRENT TAXATION TREATMENT OF ESS ARRANGEMENTS

#### 3.1 TAXING POINT

27. The Government has long supported ESS arrangements through tax concessions, recognising the benefits that an ESS provides to employers, employees and the economy more broadly through greater productivity and improved corporate governance.
28. Under Division 83A of the *Income Tax Assessment Act 1997* (ITAA 1997), generally, any discount on the market value of an interest in a share or right provided to an employee under an ESS is taxed in the income year of acquisition (where the discount is generally taken to be the difference between the market value of the share or right and any amount paid by the employee to acquire the share or right).
29. If discounts on ESS interests are taxed up front, employees with adjusted taxable income of \$180,000 or less are eligible for a tax concession on the first \$1,000 of discounts received each year on eligible ESS interests.

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12 [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate/Committees?url=economics\\_ctte/completed\\_inquiries/2008-10/employee\\_share\\_schemes\\_09/report/index.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Committees?url=economics_ctte/completed_inquiries/2008-10/employee_share_schemes_09/report/index.htm), Page ix.

### Example — Current Arrangements

Hugh works for TechCo which is developing new innovative software. Hugh earns \$75,000 and TechCo provided Hugh with 1,500 shares in TechCo when he joined the company in August 2011. Hugh pays \$2 per share from after-tax income, however the shares are valued at \$5. There is no risk of forfeiture of the shares and the 1,500 shares do not account for more than 5 per cent of TechCo. Hugh is therefore eligible for the \$1,000 concession.

As Hugh has received a \$3 discount per share, this is included in his assessable income in the year he acquired the shares. He will include \$3,500 [ $(\$3 \times 1,500) - \$1,000$ ] in his 2011-12 tax return to be taxed at his marginal rate (32.5 per cent) and will pay \$1,137.50 in tax.

Hugh then sells his shares for \$12 each in September 2013. He has made a gain of \$7 per share compared to the value of the share when he acquired it ( $\$12 - \$5$ ). He will pay capital gains tax on this gain but as he has held the share for 12 months, he is eligible for the capital gains tax (CGT) discount. Hugh will therefore include \$5,250 [ $(\$7 \times 1,500) / 2$ ] on his tax 2013-14 tax return.

30. However, there are arrangements which apply to certain complying schemes. Broadly, if there is a real risk of an employee forfeiting their discounted shares under the conditions of the ESS or they are acquired through a salary sacrifice arrangement, then taxation is deferred until the earlier of:
  - removal of the risk of forfeiture and the scheme no longer genuinely restricts the disposal of the interest;
  - cessation of employment; or
  - seven years from acquisition of the interest.
31. An ESS interest acquired by an employee is at real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee may forfeit or lose the ESS interest, other than by intentionally taking no action to realise the benefit. Real risks of forfeiture in a scheme may include conditions where retention of the ESS interests is subject to performance hurdles, or a minimum term of employment.<sup>13</sup>
- 31.1. In situations where the tax is paid and shares or rights are subsequently genuinely forfeited, a tax refund is available. However, as the refund provisions are not intended to protect the employee from downside market risk, a refund is not available where the share interest is forfeited only because the value of the securities has fallen due to market forces. Where the taxpayer is not eligible for a refund, the taxpayer would instead have a capital loss under the capital gains tax provisions.
32. In order to access these tax concessions, the shares or rights issued under the ESS arrangement must satisfy eligibility requirements. These requirements aim to ensure, among other things, that: participation in the scheme is widely available to employees, and that the

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<sup>13</sup> The Australian Taxation Office provides guidance on the real risk of forfeiture test: [http://ato.gov.au/General/Employee-share-schemes/In-detail/Restrictions-and-forfeiture/Real-risk-of-forfeiture/?default=&page=3#Real\\_risk\\_of\\_forfeiture\\_test](http://ato.gov.au/General/Employee-share-schemes/In-detail/Restrictions-and-forfeiture/Real-risk-of-forfeiture/?default=&page=3#Real_risk_of_forfeiture_test).

concessions cannot be accessed by shareholders who are effectively able to exert control over the company's operations.<sup>14</sup>

## 3.2 2009-10 BUDGET CHANGES

33. The Government announced changes to the taxation arrangements for ESSs in the 2009-10 Budget, including removing the ability of employees to elect when tax would be paid on the discount. These changes were designed to better target ESS tax concessions and ensure all forms of remuneration were taxed equally and were part of a package of measures to improve the fairness and integrity of the tax system.
34. Withholding and reporting requirements were also introduced as part of this measure, to help address non-compliance with the ESS rules. This sought to address the fact that there was little information about how many employers offered an ESS and how many employees received shares or options under an ESS.
- 34.1. The following table details the number of employees who declared discounts (both assessable, exempt or deferred) and the values of the discounts in the respective income years. It should be noted that the ESS reforms did not apply to the 2008-09 income year but did apply to the 2009-10 and 2010-11 income years.

	2008-09	2009-10	2010-11 <sup>15</sup>
No. of employees	6,045	138,400	210,800
Total discounts	\$112 million	\$1.7 billion	\$2.3 billion

### Discussion Topic 2 — Changes to taxation treatment of ESS

1. If you were a start-up prior to 2009-10, did you change your ESS arrangements following the 2009-10 Budget changes? If so, how?
2. What were the impacts on your business of the additional tax withholding and reporting requirements introduced in 2009-10?
3. Are there other impacts from the changes in 2009-10?

## 3.3 CURRENT VALUATION METHODS

35. In order to determine whether, and how much, an employee must include in their income for personal income tax purposes in relation to the acquisition of a share or option, the market value of the company must first be determined. Only the difference between the market value of the share or option and the amount, if any, paid by the employee is subject to income tax under the ESS tax provisions. However, determining the market value is not always a straight forward process.

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14 Specific restrictions include: The ESS interests must not result in any one employee owning more than 5 per cent of the shareholding or controlling more than 5 per cent of the maximum voting rights; the scheme must be offered on a non-discriminatory basis to at least 75 per cent of Australian resident permanent employees with three years' service; there is not a real risk of forfeiture and the shares must be held for three years or until the employee ceases employment.

15 Australian Taxation Office, Taxation Statistics various years.

36. Under the existing law, listed securities (including both listed shares and listed rights) are valued in accordance with the ordinary meaning of market value, most often the listed price.
- 36.1. Many provisions of the tax laws require a market value to be determined. The Australian Taxation Office (ATO) has published a guide to assist with determining market value for taxation purposes. This guide provides guidance on business valuation, listed share valuation and unlisted share valuation. It provides five valuation approaches for business valuation: market, income, asset, cost and probabilistic.<sup>16</sup>
37. Unlisted shares can also be valued in accordance with the ordinary meaning of market value.
- 37.1. Prior to the 2009-10 changes, market value of a share or right was required to be determined by either a qualified person (such as an auditor) or via another method approved in writing by the Commissioner of Taxation.<sup>17</sup>
- 37.2. To reduce compliance costs for employers, the 2009-10 changes removed the legislative requirement for an independent valuation and adopted the general principle of market value for determining valuation of listed and unlisted securities. This means that taxpayers are not obliged to use an auditor if they can determine (and sufficiently justify) the market value of the unlisted securities appropriately without one.
38. The *Income Tax Assessment Regulations 1997* provide a market valuation methodology for determining the market value of unlisted rights that must be exercised within ten years of acquisition. The taxpayer can choose to use this methodology or determine market value according to its ordinary meaning when valuing unlisted rights.
- 38.1. The valuation of unlisted rights was considered by the Board of Taxation in its 2010 report, *Review into Elements of the Taxation of Employee Share Scheme Arrangements*. The Government accepted the Board's view that valuing a right solely on its intrinsic value would ignore the 'time value' of the right, being the value of the potential profit from continuing to hold the right until its expiry.

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<sup>16</sup> Australian Taxation Office, Market Valuation for Tax Purposes (available online at <http://www.ato.gov.au>).

<sup>17</sup> Subdivision F of Division 13A of Part III of the ITAA 1936.

### Discussion Topic 3 — ESS Valuations

1. What difficulties and costs do start-ups face in valuing shares or options for an ESS?
2. If you are a start-up, do you use an independent valuation? Why?
3. As a start-up, how often do you carry out valuations for ESS purposes?
4. Do you require a valuation of your company for other purposes? What type/s do you use?
5. Do the current tables in the Regulations for unlisted rights assist? Do they reduce compliance costs?

## 4. OTHER REGULATORY REQUIREMENTS

39. Tax is only one requirement that must be considered in the establishment and operation of an ESS. As an ESS involves the offer of a financial product, aside from a number of limited exemptions (for example, small scale offerings under section 708(1) of the *Corporations Act 2001*), the Corporations Act also contains a number of requirements that apply, including disclosure, licensing and disclosure requirements and restrictions on hawking and advertising, which are part of the general investor protection provisions of the Corporations Act.
40. However, recognising that ESSs involve the offer of financial products in the context of an employment relationship rather than for a fundraising purpose, and to reduce compliance costs in those circumstances, the Australian Securities and Investments Commission (ASIC) has developed Regulatory Guide 49. This sets out ASIC's policy on conditional relief from the disclosure, licensing, hawking and advertising provisions of the *Corporations Act 2001* for ESSs. Relief is available on a case by case basis or on a standing basis under Class Order 03/184, if the conditions of that class order are satisfied.
41. ASIC Class Order 03/184 provides limited relief for unlisted entities to offer options in certain circumstances. In summary, this permits the offer of options over fully paid shares for no more than nominal consideration where there are adequate protections for employees including, the provision of an offer document at the time of offer and at the time of exercising the options; the provision of a prospectus or the ordinary shares of the company have to have been listed on the Australian Stock Exchange for 12 months without suspension for more than two days. The relief is more limited for unlisted entities as there are fewer information sources that the employee can check about the performance of the company and the value of its shares, which heightens the risks for employees. This means that many start-up companies may not be able to receive relief under ASIC's class order or be able to meet the policy settings for individual relief under Regulatory Guide 49.
42. ASIC is currently reviewing Class Order 03/184 and Regulatory Guide 49 with the view to consulting on a range of matters including broadening the classes of financial products and entities eligible for ASIC's ESS relief; and to refine the description of ESSs which may qualify for ASIC relief. This includes considering whether to broaden the scope of unlisted entities to offer ESSs in specific circumstances.

#### Discussion Topic 4 — Other regulatory requirements

1. What difficulties do start-up companies face with respect to corporate regulation of ESS?
2. Are there other regulatory requirements that impose costs or difficulties for start-up wanting to offer an ESS?

## 5. OPTIONS FOR REFORM

43. While concerns about ESSs have been raised by a broad range of stakeholders, this Review is looking at the impact of the ESS regulatory requirements and an employee's taxation treatment of their interests in start-ups and the start-up's ability to attract and retain talented staff.
44. Start-ups are new, innovative businesses, which form an important part of the Australian economy. Start-ups often assume the high risks associated with early stage investments and a lack of cash flow can prevent good ideas with high potential being turned into outputs.
45. The Government recognises that the current ESS arrangements may impose costs and complexities that the start-up sector may disproportionately bear and which may undermine other policy objectives. While the taxation treatment of ESSs seek to target tax concessions and ensure equity and integrity within the tax system, these need to be balanced with the Government's other objectives, including encouraging innovation and providing a supportive environment for the growth of Australian start-ups.
46. The Government is therefore examining options for reforms to the current ESS arrangements which seek to reduce costs and complexities for start-up companies. At this time, the Government is not looking to make general changes to the ESS arrangements or extend any of the options to other unlisted companies.

47. The Government is considering a range of options to address the concerns of start-up companies, including:

#### Taxation

- retain the current arrangements;
- defer taxing point or payment of tax;
- tax ESS for start-ups at lower rate; and
- increase the ESS up-front discount.

#### Valuation methodology

- provide alternative valuation methodologies that use information currently held by companies; and
- retain the current methodology but update the statutory tables.

48. However, before these options can be considered, to target the assistance and ensure that any measures do not undermine the integrity of the broader ESS regime, the Government will need to be assured that a robust and useable eligibility criteria for start-ups can be developed and is cost effective to administer and comply with.

## 5.1 DEFINITION OF A START-UP

49. The term 'start-up' covers a wide range of businesses. While there is a general acceptance of the characteristics of a start-up company, there is no current legal definition of a start-up.

50. The *characteristics* of a start-up company include:

- inherently risky;
- small number of employees;
- low level of revenue or turnover;
- recently formed and incorporated; and
- involved in innovative activities.

### 5.1.1 Size — Small number of employees

51. The Australian Bureau of Statistics defines a micro-business as actively trading with 0-4 employees and small business is actively trading with 0-19 employees. In Australia, in 2010-2011, there were 294,210 new businesses. Of these new businesses, 92,247 had fewer than 19 employees.<sup>18</sup> This represents all small businesses that were established during 2010-11, not just start-ups.

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<sup>18</sup> This ABS survey only includes actively trading businesses which have registered for an Australian Business Number (ABN) and have a Goods and Services Tax (GST) role. Early start-ups may not have registered for an ABN or needed to register for the GST and therefore may not be captured by this survey.

52. The *Fair Work Act 2009* defines a small business as a business with fewer than 15 employees.<sup>19</sup>

### 5.1.2 Financial Status

53. The *Income Tax Assessment Act 1997* defines an entity as eligible for the small business entity concessions if it has an aggregated turnover of less than \$2 million in the previous year.

54. A start-up is also a stand-alone company and is not a subsidiary, or substantially owned by, another company.

### 5.1.3 Period of Incorporation

55. A company in the start-up phase of development is generally considered to be a new company that is in its early stage of investment and its life cycle. It is likely to still be establishing and developing and as such, has only been in existence for a short period of time. However, this may vary for the biotechnology, pharmaceutical and medical technology sectors where the path to market or commercialisation is much longer.

### 5.1.4 Area of Activity

56. As noted, not all small businesses would be considered to be a start-up. Start-ups are commonly considered as a small business that carries high technical and market risk and has high growth potential, is involved in the development and commercialisation of a new idea that leads to a new product, process or service and may utilise a high technology component. While the company may be generating some revenue, it is also likely to still have a large investment in R&D.

57. The Board considered a definition of a start-up in its review. The Board noted that a start-up is a company that has: a relatively short history, limited tangible assets, intangible assets usually in intellectual property or exploration, and limited revenue.

58. Undertaking activities that are eligible for the R&D tax offset may be an indicator that a company is a start-up. Eligibility for this offset is determined by whether the company is undertaking a core or supporting R&D activity and not undertaking excluded activities.<sup>20</sup> Core or supporting R&D activities are experimental activities:

- whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:
  - is based on principles of established science;
  - proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and
- that are conducted for the purpose of generating new knowledge (including creating new knowledge or improved materials, products, devices, processes or services).

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<sup>19</sup> Section 23 *Fair Work Act 2009*.

<sup>20</sup> R&D Tax Incentive Customer Information Guide, <http://www.ausindustry.gov.au/programs/innovation-rd/RD-TaxIncentive/CIG/Pages/default.aspx>.

59. Another way to define a start-up is by exclusion that is, — a company would not be a start-up if it undertakes ineligible activities
60. The venture capital tax concessions are also available to many small businesses that share the characteristics of a small number of employees and are recently established. However, to access this concession, the company must also show that the majority of its activities are not ineligible activities. These ineligible activities are:
- |  |   |
|--|---|
| <p>a. property development or land ownership</p> <p>b. finance, to the extent that it is any of the following:</p> <ul style="list-style-type: none"> <li>– banking, providing capital to others, factoring, securitisation, or leasing</li> </ul> <p>c. insurance</p> | <p>d. construction activities (including extension, improvement or up-grading), and</p> <p>e. making investments, whether made directly or indirectly, that are directed to deriving income in the nature of:</p> <ul style="list-style-type: none"> <li>i. interest, rents, dividends, royalties, or lease payments.<sup>21</sup></li> </ul> |
|--|---|
61. Other examples of excluded activities could include mining and mineral exploration; and farming and agriculture.

## 5.2 INTERNATIONAL COMPARISON

62. The international regimes that provide concessions for ESSs use varying definitions or criteria to target the concessions to start-ups.
63. The UK Enterprise Management Incentive (EMI) is available to companies that have gross assets of no more than £30 million, less than 250 full time employees and conduct their trade or activity wholly or mainly in the UK. The company must not trade in an excluded activities, which include banking, insurance or financial activities; farming; property development; and legal and accounting services. Further details on the UK EMI are at Attachment A.
64. One element of the Singapore Equity Remuneration Incentive Scheme (ERIS) targets start-up companies. To access ERIS, the company must:
- grant the shares or options within the first three years of its incorporation;
  - have no more than 20 shareholders; and
  - not have more than SD\$100 million (approximately AUD\$85 million) in total assets.

## 5.3 PROPOSED DEFINITION

65. Drawing on the characteristics outlined above, a possible definition of a start-up company for the purposes of determining access to ESS arrangements which seek to provide concessionary taxation and reduce compliance costs is:
- a business that has 15 employees or fewer;

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21 Australian Taxation Office, 2002 venture capital tax concession: eligible venture capital investments <http://www.ato.gov.au>.

- has an aggregated turnover of less than \$5 million and is not a subsidiary, owned or controlled by another corporation;
  - has been in existence for [five/seven] years or less;
  - is not undertaking an excluded activity [OR] is providing new products, processes or services based on the development and commercialisation of intellectual property;
  - is unlisted; and
  - has the majority of its employees and assets in Australia.
66. Where a business meets this definition, the shares or rights it issues would be eligible for the ESS concessions. The employee would continue to receive the concession for those share or rights, even if their employer grew large enough to no longer meet the definition of a start-up. However, if the company developed and no longer met the definition of a start-up any future issue of shares or rights would not be able to access the ESS concessions.
67. To provide further robustness to this criterion, an application process could be introduced where a start-up would apply to a federal government body to determine whether it meets the definition.

#### Discussion Topic 5 — Definition of a Start-Up

68. What are the key characteristics of the type of start-up that is most likely to make use of an ESS?
69. What are the benefits of the proposed definition? What are the drawbacks?
70. Are there any unintended consequences from the use of this definition?
71. Is the number of employees the right metric for this definition? If so, how should employees be defined?
72. Is aggregated turnover right for this definition?
73. What is the preferred length of existence — five or seven years?
74. What is the preferred activity test — not undertaking an excluded activity or providing new products or processes?
75. Are there alternative definitions that could be legislated?
76. Are there benefits in introducing an application process for start-ups? Are there any drawbacks?

## 5.4 TAX TREATMENT OPTIONS FOR SECURITIES PROVIDED BY START-UPS

### Examples and Terms used in this section

This section contains a number of examples. These examples are highly simplified and are for illustrative purposes only. For example, where the amount of tax paid is included, this assumes a fixed income and no deductions are received by the taxpayer.

The cost base of an asset is generally what the asset costs the taxpayer. The ATO provides guidance on the definition of cost base. For ESSs that are taxed up front, Section 83A-25 of the ITAA 1997 states that the discount given is to be included in assessable income. For tax deferred schemes, Section 83A-110 of the ITAA 1997 states that the taxpayer's assessable income includes the market value of the interest at the ESS deferred taxing point, reduced by the cost base of the interest. To prevent confusion, the term 'cost base' is not used in this section. Instead the specific element (either amount paid or the value) is identified.

77. In addition to the option of maintaining the existing tax treatment of ESSs, four options are presented below for a new tax treatment of ESS. These options are presented as examples of the types of changes which may be considered by the Government. They may not necessarily be adopted exactly as described below.
78. Two options change the taxing point and two options increase the discount available to securities provided by start-ups.
79. Under all the options presented below, securities provided by companies that do not meet the definition of a start-up will continue to be taxed in accordance with the current arrangements in the financial year in which the shares are acquired.

### 5.4.1 Defer the taxing point for securities offered by start-ups

80. Securities provided by companies that meet the definition of a start-up will be taxed at the 'ESS deferred taxing point', rather than when the securities are acquired. Any discount between the value of the securities at the ESS deferred taxing point and any amount paid for the shares will be included in the taxpayer's assessable income. There is no \$1,000 concession available. This would create deferred arrangements for start-ups that are similar to the ESS provisions that operated before 2009.
  - 80.1. ESS deferred taxing point for this option means the earliest of: when the employee exercises the options; the employment ceases; or seven years after the shares or rights were acquired.
81. Any gain on the shares or rights that accrues before the ESS deferred taxing point would be included in assessable income at the ESS deferred taxing point and therefore the CGT discount is not available to gains accrued before this time. No capital gains tax is payable if the securities are sold within 30 days of the ESS deferred taxing point because the taxing point is shifted to that later time. Where a capital gain accrues after the ESS deferred taxing point, this would be subject to CGT, including the CGT discount, if the securities have been held for more than 12 months after the ESS deferred taxing point.

### Example — Option 1

Hugh receives 1,500 shares from his employer TechCo when he joins the company in August 2011. TechCo meets the definition of a 'start-up' company.

Hugh pays \$2 per share from after-tax income, however the shares are valued at \$5. Hugh is not required to include the discount in his assessable income at this time.

On 1 September 2012, Hugh leaves TechCo and the shares are valued at \$10 each. He has received a gain of \$8 per share and therefore will include \$12,000 [ $(\$8 \times 1,500)$ ] in his 2012-13 tax return, which will be taxed at his marginal rate. He will pay \$3,900 in tax.

Hugh then sells his shares for \$12 each on 2 September 2013. He has made a further gain of \$2 per share ( $\$12 - \$10$ ). As he is eligible for the CGT discount, he includes a capital gain of \$1,500 [ $(\$2 \times 1,500) / 2$ ] in his 2013-14 tax return.

82. The benefit of this option is it allows the recipients of these securities in most cases to defer the taxing point until the securities have been realised and are able to be traded. This option also avoids the cost and complexity of valuing shares when granted to an employee. Employees of start-ups will also only be required to pay tax when they have funds to pay the tax.
83. The disadvantage of this option is no \$1,000 concession is provided to the employee as the taxing point has been deferred for potentially a significant period of time. Companies may also offer a sizable proportion of remuneration packages as ESSs instead of salary to maximise the tax benefits. This option also may present an integrity risk as more companies will try to characterise themselves as a start-up to get the deferred taxing point. The Board of Taxation saw this as the biggest obstacle in its consideration of possible deferral. However, if the definition of a start-up can be tightly defined, this risk will be minimised.

#### 5.4.2 Defer payment of tax on securities offered by start-ups

84. Under this option, the tax that is payable on the discount received on ESS interests would be deferred until the share or option is sold or exercised. At that time, any discount between the value of the securities at the ESS deferred taxing point and any amount paid for the shares will be included in the taxpayer's assessable income. There is no \$1,000 concession on the amount of tax payable.
85. In addition to the income tax payable, when the shares are sold, where there is a gain from the value of the security at acquisition, this would be subject to CGT, including the CGT discount if the securities have been held for more than 12 months.

### Example — Option 2

Hugh receives 1,500 shares from his employer TechCo when he joins the company in August 2011. TechCo meets the definition of a 'start-up' company. Hugh pays \$2 per share from his after-tax income but the shares are valued at \$5.

Hugh has received a \$3 discount per share. He does not include this in his assessable income until the share is sold.

Hugh then sells his shares for \$12 each in September 2013, making a gain of \$7 per share (\$12-\$5). He will be eligible for the CGT discount as he has held the shares for more than 12 months.

In Hugh's 2013-14 tax return he includes:

- \$4,500 [(\$3 x 1500), being the value of the discount when he acquired the shares. He pays \$1,462.50 in tax; and
- \$5,250 [(\$7 x 1,500) / 2], being the capital gain, including the CGT discount.

86. This option means that employees would not have to include the discount in their assessable income before they are able to trade or sell their shares. An employee will also not be required to pay tax if an option is not exercised or the share is not sold.
87. The disadvantage of this option is there is no \$1,000 concession as the taxing point has been deferred for potentially a significant period of time. Companies may also offer a sizable proportion of remuneration packages as ESSs instead of salary to maximise the tax benefits. This option also may present integrity risks as more companies will try to characterise themselves as a start-up to get the deferred taxing point and employees can determine their selling point to maximise the tax benefits. However, if the definition of a start-up can be tightly defined, this risk will be minimised. This option still requires employers to value the securities at the time of granting the shares. This option will also increase complexity and compliance costs for employees and employers.

### 5.4.3 Tax the securities offered by start-ups at a lower tax rate

88. Under this option, income tax would continue to be paid on any discount between the value of the share or option at the time of acquisition and the amount paid. The discount would be included in the taxpayer's assessable income in the financial year in which the shares are acquired, but will be taxed at a discounted rate, of, for example, 15 per cent, with a \$1,000 concession available.
89. When the shares are then sold, where there is a gain from the value of the security at acquisition, this would be subject to CGT, including the CGT discount if the securities have been held for more than 12 months.
90. The existing deferred taxing point arrangements which apply where an employee has a real risk of forfeiting their ESS interests or they are acquired through a salary sacrifice arrangement would remain.

### Example- — Option 3

Hugh receives 1,500 shares from his employer TechCo when he joins the company in August 2011. TechCo meets the definition of a 'start-up' company. Hugh pays \$2 per share from his after-tax income but the shares are valued at \$5 and he is eligible for the \$1,000 concession.

Hugh has received a \$3 discount per share. He will include \$3,500  $[(\$3 \times 1,500) - \$1,000]$  in his 2011-12 tax return, which is taxed at 15 per cent. He will pay \$525 in tax.

Hugh then sells his shares for \$12 each in September 2013. He has made a gain of \$7 per share  $(\$12 - \$5)$ . As he is eligible for the CGT discount, he includes a capital gain of \$5,250  $[(\$7 \times 1,500) / 2]$  in his tax 2013-14 tax return.

91. The benefits of this option are it reduces the tax burden faced by the recipients; it is simple to understand and it maintains the policy objective of taxing the discount received on securities upfront, but recognises that employees of start-ups may not have the cash to pay a significant tax bill.
92. The disadvantage is the taxing point occurs before the securities have been realised and employees would continue to be required to pay the tax before the securities can be traded. This option also does not remove the need for a valuation and this option may also be costly for the ATO to administer.

#### 5.4.4 Increase the concession provided for securities offered by start-ups

93. Under this option, income tax, at marginal rates, would be payable on any discount between the value of the share or option at the time of acquisition and the amount paid. The tax would be paid in the financial year in which the shares are acquired and the current \$1,000 concession would be increased to \$5,000 for start-ups.
94. When the shares are then sold, where there is a gain from the value of the security at acquisition, this would be subject to CGT, including the CGT discount if the securities have been held for more than 12 months.
95. The existing deferred taxing point arrangements which apply where an employee has a real risk of forfeiting their ESS interests or they are acquired through a salary sacrifice arrangement would remain.

#### Example — Option 4

Hugh receives 1,500 shares from his employer TechCo when he joins the company in August 2011. TechCo meets the definition of a 'start-up' company. Hugh pays \$2 per share from his after-tax income but the shares are valued at \$5. Hugh is eligible for the \$5,000 concession.

Hugh has received a \$3 discount per share. However, he will not include anything in his 2011-12 taxable income as the concession is greater than the value of the shares [ $(\$3 \times 1,500) - \$5,000$ ] and therefore pays no tax.

Hugh then sells his shares for \$12 each on 2 September 2013. He has made a gain of \$7 per share ( $\$12 - \$5$ ). As he is eligible for the CGT discount, he includes a capital gain of \$5,250 [ $(\$7 \times 1,500) / 2$ ] in his tax 2013-14 tax return.

96. The main benefit of this option is it reduces the tax burden faced by the recipients of the securities.
97. However, the main disadvantage of this option is the taxing point occurs before the securities can be traded. In addition, the company still needs to be valued at the point of acquisition.

## ESS Taxation Options Summary

	Acquisition Time	Vesting Time <sup>22</sup>	Sale or Disposal Time
Current Arrangements <sup>23</sup>	Income tax paid at marginal rates on the discount received. \$1,000 concession available.	Nil.	CGT is paid on the difference between sale price and acquisition value. CGT discount may be available*.
Option 1 — Defer the taxing point	Nil.	Income tax paid at marginal rates on the market value at vesting less consideration paid. No \$1,000 concession.  No CGT if sold within 30 days of vesting.	CGT is paid on the difference between the sale price and the vesting price. CGT discount may be available*.
Option 2 — Defer payment of tax	Income tax at marginal rates is calculated (but not paid) on the discount received.		Income tax (as calculated at acquisition) paid at marginal rates. No \$1,000 concession.  CGT is paid on the difference between sale price and acquisition value. CGT discount may be available*.
Option 3 — Reduced rate of taxation	Income tax paid at 15 per cent on the discount received. \$1,000 concession available.		CGT is paid on the difference between sale price and acquisition value. CGT discount may be available*.
Option 4 — Increased discount	Income tax paid at marginal rates on the discount received. \$5,000 concession available.		CGT is paid on the difference between sale price and acquisition value. CGT discount may be available*.

\* CGT discount is available if the security is held for more than 12 months

### 5.4.5 Revenue Impact

98. Any change to the current tax arrangements will have an impact on the Government's taxation revenue. Deferring the taxing point or payment of tax would mean that the revenue that would otherwise be collected in coming years will be deferred and there may be a loss of revenue where shares or options are not sold or exercised. Reducing the rate of taxation on ESS discounts or increasing the up-front discount will also reduce the revenue the Government

22 Vesting is a substitute for the ESS deferred taxing point which may differ from the vesting date in certain circumstances for integrity reasons.

23 Tax-deferred Schemes and ESS interests not subject to concessional tax treatment have a different tax treatment.

currently receives. There is also a risk of further loss of revenue as the concession may undermine the integrity of the broader ESS arrangements. In addition, any change to a taxpayer's assessable income may also have flow-on effects for eligibility of family assistance payments.

99. However, this cost may be offset by an increase in the tax paid through an increase in employment opportunities or an increase in the profitability of new firms leading to greater company tax being paid. While there is currently very little empirical evidence in Australia on the benefits that may accrue to the economy through the increased use of ESSs, the Australian Government's policy of encouraging the wider use of ESSs are generally considered to provide benefits to the wider economy. International research has shown that employees involved in an ESS have improved performance which leads to increase sales, employee retention and growth of the business.<sup>24</sup>

### Discussion Topic 6 — Tax reform options

1. What are the benefits and risks of each option?
2. Are there any unintended consequences from changing the tax arrangements for ESS for start-ups?
3. What is your preferred option? Why?
4. What do you anticipate would be the financial impact on your start-up (if relevant) if there were a change in tax arrangements?
5. Would you start offering an ESS if one of these options was adopted?
6. What do you anticipate would be the financial impact on employees if there were a change in tax arrangements?
7. Would there be any broader economic gain to offset the loss of tax revenue from adopting one of these options? If so, how can this be quantified?
8. Is there a better option?

## 5.5 VALUATION OPTIONS FOR START-UPS

100. In order for the current ESS provisions to operate effectively, it is necessary to obtain a value of the start-up that is providing the securities.
101. While it is beneficial to use market value to value unlisted securities, in practice it can often be difficult to ascertain a market value of unlisted and start-up companies without the assistance of a formal valuation. This comes at a cost to the company.

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24 The National Center for Employee Ownership (NCEO) <http://www.nceo.org/articles/esops-improve-performance-employee-benefits>.

102. Many start-up companies use ESS as a method of remunerating employees while their cash flows are low and the need to pay for a market valuation of their company is difficult in these circumstances. Therefore, it is important to consider the costs incurred by start-up companies in valuing their interests against protecting the interest of employees.
103. In addition to the option of maintaining the existing valuation methods, three options are presented below as alternative valuation methods that seek to reduce costs and complexity by determining the market value using information the company already has.

### 5.5.1 Net Asset Backing Valuation Method of Start-ups

104. Under the net asset backing method, the company's balance sheet is used to determine the net asset amount. Then, the net asset amount is divided by the number of issued shares that give access to the capital of the company upon wind-up. The value of each shareholding is calculated according to the number of shares held. This method could be used as a 'safe harbour' methodology where it is not possible to obtain a market valuation.
105. The advantage of this option is it uses information that all start-ups should readily have available and the valuation should be obtained at no additional cost to the company.
106. The main disadvantage of this option is that it will generally produce a value that is materially less than fair value/market value. However, the taxpayer will pay CGT on the difference between the acquisition value and the sale price.

### 5.5.2 Australian Accounting Standards Board Standard No. 2

107. Australian accounting requirements for share-based payments are set out in The Australian Accounting Standards Board Standard No. 2 (AASB 2) *Share-based Payment* in accordance with an international framework which has been adopted in over 100 countries. As such, AASB 2 has the same requirements as the International Accounting Standards Board's IFRS 2 Share-based Payment.
108. AASB 2 deals with accounting for all share-based payment transactions, including those related to acquiring employee services, which typically involve shares or options to acquire shares.
109. In respect of employee services, the AASB 2 model is designed to result in employee expenses being recognised as the relevant employee services are provided. This generally occurs evenly over the vesting period. In the case of options to buy shares, adjustments are made at each accounting date to reflect the best estimate of the number of options expected to eventually vest, unless the vesting condition is a market condition only.
110. The expense is measured at the fair value of the equity instruments as at their grant date. A market price for shares or options to buy shares would be used as the basis for determining fair value when available.
111. It is common for market prices to be unavailable for options to buy shares that have the same terms and conditions as those granted to employees, in which case a valuation model must be applied. AASB 2 requires generally-accepted option pricing models to be applied that take into account, as a minimum:
  - exercise price;
  - option life;

- current price of underlying shares;
- expected share price volatility;
- expected dividends, if any; and
- risk-free interest rate over the option life.

112. The main disadvantage with AASB 2 is that for options to buy shares with relatively short contractual lives, or that must be exercised within a short period of time after vesting date, the Black-Scholes-Merton formula may produce a more appropriate valuation.

### 5.5.3 Alternative Formula-Based Valuation Methodologies

113. There are widely accepted alternative valuation methodologies that exist for valuing rights, including the Monte Carlo option pricing model and the Binominal option pricing model.

114. These option pricing models attempt to attribute a value to the right, with the outcome largely reflective of the market value of the underlying share and, depending on the model used, other variables such as expected volatility in the underlying share, time to expiry of the right, potential dividend yield, risk free rate of interest, and so on.

115. However, the main disadvantage with these pricing models is they are often based on complex formulas which are difficult to understand and utilise in practice. In addition, the price of the right as determined by the models remains highly dependent upon the factors that are inputs into the models.

116. Accordingly, the accuracy of the models may be somewhat restricted in the case of unlisted rights where the requisite information may not be readily available, for example, where the company is newly incorporated and does not have reliable historic data or future forecasts in relation to its share price movements or dividend distributions.

#### Discussion Topic 7 — Valuation Methods

1. What are the benefits and risks associated with the options for changing valuation methodologies?
2. Will the methodologies outlined above provide a fair value of unlisted interests in start-ups, at a reasonable cost?
3. Are there other methodologies that could be used?
4. What further guidance would assist in valuing unlisted companies?
5. Will these options adequately protect the interests of employees?
6. Should assets be valued at 'cost' or 'fair value'?

## 6. SIMPLIFYING THE CREATION OF AN ESS

117. Start-ups have raised concerns with the cost and complexity involved in setting up and operating an ESS. Apart from the valuation costs discussed above, there may also be the need

to engage an accountant and a lawyer to advise on the establishment of an ESS and oversee the ongoing administration. In comparison, it has been suggested that the costs of establishing an ESS in the US are quite low, as there are many standard documents available for use.

118. While there have been some moves by industry stakeholders to standardise documents or share an ESS model to reduce costs, this has not been wide-spread. Stakeholders have also noted that industry led documents will only go so far in reducing costs, where they are not endorsed by the Government for use in complying with tax and other regulatory requirements.
119. To mitigate the costs associated with the initial set up of an ESS, standardised documents or templates could be developed for a basic ESS. The standardised documents would provide a template for ESS and the employer would insert the details relevant to the company, including any risk associated with the investment. The use of standardised documents would significantly reduce the professional costs associated with establishing an ESS.
120. The (then) Department of Employment and Workplace Relations previously produced standardised documents, which included an ESS plan summary, a taxation summary, notice of entitlement and the standard plan rules.
121. However, there was little take-up of these documents. Therefore, further guidance, promotion and ongoing support may be needed to assist start-ups in understanding and utilising the standard documents.

#### Discussion Topic 8 — Standard documentation

1. Would your start-up benefit from using standardised ESS documentation?
2. Are you aware of any existing standardised ESS documentation offered by advisers or industry organisations?
3. What other support/guidance would be required to allow start-ups to use the standardised documents?

## 7. NEXT STEPS

122. As part of the consultation process, officials from the Treasury, DIICSRTE and DBCDE will meet with a number of stakeholders later in the year. Please indicate in your submission if you would be interested in participating in this consultation.
123. The Treasury and DIICSRTE will report back to Government on the outcome of the consultations and review by December 2013.

## 8. SUMMARY OF CONSULTATION QUESTIONS

### Discussion Topic 1 — ESS in Australia

1. What barriers do Australian start-ups face in attracting and retaining staff?
2. What type of employees do start-ups typically seek from overseas rather than source domestically?
3. As a start-up, do you offer shares or options through an ESS to your employees? What other benefits do you offer your employees? Are these sufficient to retain or attract the necessary employees? If you do not offer an ESS, what are the major reasons why not?
4. What are the barriers start-ups face in offering an ESS, including tax and other regulatory requirements?
5. What is the relative importance of ESS arrangements to start-ups in Australia compared to other factors such as economic conditions or policy settings?

### Discussion Topic 2 — Changes to taxation Treatment of ESS

1. If you were a start-up prior to 2009-10, did you change your ESS arrangements following the 2009-10 Budget changes? If so, how?
2. What were the impacts on your business of the additional tax withholding and reporting requirements introduced in 2009-10?
3. Are there other impacts from the changes in 2009-10?

### Discussion Topic 3 — ESS Valuations

1. What difficulties and costs do start-ups face in valuing shares or options for an ESS?
2. If you are a start-up, do you use an independent valuation? Why?
3. As a start-up, how often do you carry out valuations for ESS purposes?
4. Do you require a valuation of your company for other purposes? What type/s do you use?
5. Do the current tables in the Regulations for unlisted rights assist? Do they reduce compliance costs?

### Discussion Topic 4 — Other regulatory requirements

1. What difficulties do start-up companies face with respect to corporate regulation of ESS?
2. Are there other regulatory requirements that impose costs or difficulties for start-ups wanting to offer an ESS?

### Discussion Topic 5 — Definition of a Start-Up

1. What are the key characteristics of the type of start-up that is most likely to make use of an ESS?

2. What are the benefits of the proposed definition? What are the drawbacks?
3. Are there any unintended consequences from the use of this definition?
4. Is the number of employees the right metric for this definition? If so, how should employees be defined?
5. Is aggregated turnover right for this definition?
6. What is the preferred length of existence — five or seven years?
7. What is the preferred activity test — not undertaking an excluded activity or providing new products or processes?
8. Are there alternative definitions that could be legislated?
9. Are there benefits in introducing an application process for start-ups? Are there any drawbacks?

#### **Discussion Topic 6 — Tax reform options**

1. What are the benefits and risks of each option?
2. Are there any unintended consequences from changing the tax arrangements for ESS for start-ups?
3. What is your preferred option? Why?
4. What do you anticipate would be the financial impact on your start-up (if relevant) if there were a change in tax arrangements?
5. Would you start offering an ESS if one of these options was adopted?
6. What do you anticipate would be the financial impact on employees if there was a change in tax arrangements?
7. Would there be any broader economic gain to offset the loss of tax revenue from adopting one of these options? If so, how can this be quantified?
8. Is there a better option?

#### **Discussion Topic 7 — Valuation Methods**

1. What are the benefits and risks associated with the options for changing valuation methodologies?
2. Will the methodologies outlined above provide a fair value of unlisted interests in start-up, at a reasonable cost?
3. Are there other methodologies that could be used?
4. What further guidance would assist in valuing unlisted companies?
5. Will these options adequately protect the interests of employees?

6. Should assets be valued at 'cost' or 'fair value'?

#### **Discussion Topic 8 — Standard documentation**

1. Would your start-up benefit from using standardised ESS documentation?
2. Are you aware of any existing standardised ESS documentation offered by advisers or industry organisations?
3. What other support/guidance would be required to allow companies to use the standardised documents?

## ATTACHMENT A- — INTERNATIONAL COMPARISONS

1. The following review of International comparisons of share arrangement for start-up companies is sourced from the Board of Taxation's *Review into Elements of the Taxation of Employee Share Scheme Arrangements*.

### 8.1 UNITED KINGDOM

2. There are four types of arrangements in the UK that offer tax preferred treatment of shares or rights issued under ESS type arrangements, one of which is the Enterprise Management Incentive (EMI) scheme. The EMI scheme is a tax advantaged share option scheme designed to help small, higher risk companies recruit and retain employees who have the skills to help them grow and succeed. It is also a way of rewarding employees for taking a risk by investing their time and skills to help small companies achieve their potential.<sup>25</sup>
3. In order to qualify for this concession, the company must not be more than 51 per cent owned or controlled by another company; the company's gross assets must not exceed £30 million at the date of the grant of the option; must have less than 250 full-time equivalent employees at the date the option is granted; and must carry out commercial trade activities and not be carrying on to any substantial extent certain specifically excluded trade activities.
  - 3.1. Excluded activities are:
    - dealing in land, commodities or futures, shares, securities or other financial instruments;
    - dealing in goods, otherwise than in the course of an ordinary trade of wholesale or retail distribution;
    - banking, insurance, money-lending, debt-factoring, hire purchase financing or other financial activities;
    - leasing (including letting ships on charter, or other assets on hire) or receiving royalties or other licence fees;
    - providing legal or accountancy services;
    - property development;
    - farming or market gardening;
    - holding, managing or occupying woodlands, any other forestry activities or timber production;
    - shipbuilding, producing coal and producing steel (with effect from 21 July 2008);
    - operating or managing hotels or comparable establishments, such as a guest house or hostel, or managing property used as a hotel or comparable establishment;

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<sup>25</sup> 'Enterprise Management Incentives: A guide for employees, employers and advisors', HM Revenue & Customs, at <http://www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm>.

- operating or managing nursing homes or residential care homes, or managing property used as a nursing home or residential care home;
- providing services or facilities for a business carried on by another person if:
  - the business consists to a substantial extent of excluded activities; and
  - a controlling interest in the business is held by a person who also has a controlling interest in the business carried on by the company providing the services or facilities;

There are two exceptions to the excluded activities for the receipt of some royalties and licence fees and some ship chartering.<sup>26</sup>

4. To constitute a qualifying employee, the employee must have been granted options in the qualifying company and meet the following conditions:
  - 4.1. be an employee of the company or a qualifying subsidiary of the company;
  - 4.2. be required to spend at least 25 hours each week, or at least 75 per cent of their working time, as an employee of the company or its qualifying subsidiary; and
  - 4.3. not have a material interest (broadly defined as the ability to control, directly or indirectly, more than 30 per cent of the ordinary share capital of the company) in the company or any other group company.
5. If the above qualifying conditions are met by both the employer and the employee, tax advantaged share options with a market value of up to £120,000 (£100,000 prior to 6 April 2008) may be granted to a qualifying employee subject to a total share value of £3 million under EMI options to all employees. The grant of the option is tax-free and there will normally be no tax or National Insurance Contributions (NICs) for the employee to pay when the option is exercised.

## 8.2 UNITED STATES<sup>27</sup>

6. The US does not offer a scheme that is directly aimed at start-up or speculative-type companies.
7. The US tax code recognizes two general types of employee options — qualified and nonqualified. Qualified (or 'statutory') options include 'incentive stock options,' which are limited to US\$100,000 a year for any one employee, and 'employee stock purchase plans,' which are limited to US\$25,000 a year for any employee.
8. Employee stock purchase plans must be offered to all fulltime employees with at least two years of service; incentive stock options may be confined to officers and highly paid employees.
9. Qualified options are not taxed to the employee when granted or exercised (under the regular tax); tax is imposed only when the stock is sold. If the stock is held one year from purchase and

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<sup>26</sup> UK Enterprise Management Incentive, <http://www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm#3>, accessed 26 June 2013.

<sup>27</sup> Source: <http://www.fas.org/sgp/crs/misc/RL31458.pdf>, Summary, accessed 16 July 2013.

two years from the granting of the option, the gain is taxed as long-term capital gain. The employer is not allowed a deduction for these options.

10. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction. The value of incentive stock options is included in minimum taxable income for the alternative minimum tax in the year of exercise; consequently, some taxpayers are liable for taxes on 'phantom' gains from the exercise of incentive stock options. In 2008, law changes included provisions that provided abatement of any taxes still owed on 'phantom' gains.
11. Nonqualified options may be granted in unlimited amounts. They are taxed when exercised and all restrictions on selling the stock have expired, based on the difference between the price paid for the stock and its market value at exercise. The company is allowed a deduction for the same amount in the year the employee includes it in income. They are subject to employment taxes also. Although taxes are postponed on nonqualified options until they are exercised, the deduction allowed to the company is also postponed, so there is generally little if any tax advantage to these options.

### 8.3 SINGAPORE

12. Singapore operates an Equity Remuneration Incentive Scheme (ERIS) for new start-up companies. In order to access the ERIS, a qualifying company has to grant the options or shares within the first three years of its incorporation to a qualifying employee to acquire ordinary shares in the qualifying company.
13. To be a qualifying company for ERIS purposes, the company issuing the shares or options must:
  - 13.1. be a Singapore resident;
  - 13.2. carry on business activities in Singapore;
  - 13.3. have total share capital beneficially held by no more than 20 shareholders, all of whom are individuals, or at least one of which is an individual holding at least 10 per cent of issued ordinary shares; and
  - 13.4. aggregate value of total assets held by the company at the date of grant does not exceed \$100 million.<sup>28</sup>
14. To be a qualifying employee under the ERIS, the employee must have been granted shares or options by a qualifying company, and also meet the following requirements at the time of grant:
  - 14.1. be exercising employment for the qualifying company;
  - 14.2. committed working time per week with the company must be at least 30 hours per week; and
  - 14.3. does not have effective control over the qualifying company.<sup>29</sup>

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<sup>28</sup> IRAS Circular, 'Equity Remuneration Incentive Scheme (Start-ups)', Inland Revenue Authority of Singapore, at p 5-6.

<sup>29</sup> Ibid., at page 6.

15. If the above qualifying conditions are met by both the employer and the employee, the employee is entitled to a tax exemption of 75 per cent of up to \$10 million of gains accruing to the employee participating in the ESS arrangement over a 10-year period.
16. Gains from disposal of the shares or rights are taxable to the employee at the time the options are exercised, the shares are granted or vested, or when the moratorium on the disposal of the shares is lifted.

## 8.4 CANADA

17. In Ontario, Canada, the Ontario Research Employee Stock Option<sup>30</sup> (ORESOS) credit was available as an incentive to help Ontario high technology companies find and keep highly skilled research employees. The credit was available to offers made to employees between 21 December 2000 and 18 May 2004.
18. In order to access the ORESOS, the employee was required to be an eligible employee at the time a stock option was granted. To be an eligible employee, the employee must:
  - 18.1. spend at least 30 per cent of their time on scientific research and experimental development for the employer;
  - 18.2. be employed by the eligible employer for at least six consecutive months;
  - 18.3. be a full-time employee; and
  - 18.4. not be an incorporated employee providing services on behalf of a personal services business.
19. In addition, to qualify for the ORESOS, the employer was required to carry on a business in Ontario, directly undertake scientific research and experimental development and incur at least 10 per cent of total revenue on eligible expenditures.
20. Where the qualifying conditions were met by both the employer and the employee, the ORESOS credit was available and the employee could reduce or eliminate their income tax on up to \$100,000 of taxable income each year.
21. The ORESOS credit was withdrawn in 2004. The 2004 Ontario Budget Paper C: Ontario's revenue plan, contained the following statement in respect of this withdrawal:
  - 21.1. Several tax expenditures were assessed to determine whether they are meeting their objectives effectively and whether they are consistent with current priorities. Some were found to be ineffective or had very low take-up. Some may be delivered more effectively through other programs. Others simply do not measure up to current priorities.
22. In the same Budget Paper, the Ontario government committed to further improve the climate for venture capital investment to support the growth and development of entrepreneurial technology firms by working more closely with the federal government.

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30 Ontario Ministry of Finance Income Tax Related Programs Branch Information Bulletin 'Ontario Research Employee Stock Option Credit' February 2002.