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EMPLOYEE SHARE SCHEME TAX REFORM FINALLY HERE!

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Legislation has finally passed both houses of Parliament to improve the taxation treatment of Employee Share Schemes (“**ESS**”) and in particular provide some concessions to startups looking to implement an ESS.

ClarkeKann recently spoke with startup tax adviser, Cole Wilkinson, Partner at Pitcher Partners, about the changes and what it means for startups and other companies alike. Here is what Cole had to say:

Since 2009, cash strapped Australian employers have been restricted in the ways they can attract and incentivise talented employees. Changes were made to the taxation of ESS in 2009 that made the granting of employee shares costly to employees and difficult for employers to implement. In an increasing global employment market, employers from many other countries have been able to attract some of Australia’s brightest minds through the offer of ownership in fast growing companies via share or option plans.

WHAT IS AN EMPLOYEE SHARE SCHEME?

Most effective in high growth businesses, an ESS is a method for providing new and future employees with a small ownership stake in your business as an alternative incentive to cash wages. Generally the ESS consists of providing employees with shares or options meaning they are only effective where your business is structured as a company.

In order to get the most out of an ESS, the shares or options are usually tied to some form of performance criteria (often referred to as vesting conditions).

Depending on the employee you are looking to incentivise, this may take such forms as:

- specified length of service;
- meeting individual Key Performance Indicators (“**KPIs**”)
- meeting divisional or companywide KPIs

Remember, as with all incentives linked to KPIs, the KPI should be Specific, Measurable, Achievable and Time based.

ISSUES UNDER THE EXISTING TAXATION LEGISLATION

Under the current rules, employees are taxed upfront on the discount they receive on the ESS interests (shares or options) unless they are subject to a “real risk of forfeiture”. The discount refers to the difference between the market value of the interests and the amount they have paid for them (which is usually nil).

This situation is generally unpalatable to the employee as they have not realised any cash from the shares at this stage in order to fund the tax liability.

Therefore, employers have been forced to engineer schemes which ensure a deferral is available under the

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"real risk of forfeiture" clause resulting in expensive to implement and complex schemes.

WHAT ARE THE NEW RULES – FOR STARTUPS?

Discount received on the shares or options are tax free provided that:

- For Shares: a discount of less than 15% of market value applies;
- For Options: the exercise price is greater than the current market value of the underlying shares;
- there is a requirement in the plan that the shares/options are held for more than 3 years; and
- the scheme is available to 75% of employees with 3 years or more service.

In order to qualify as a startup for the purposes of the new legislation, your company (including related companies) must:

- be less than 10 years old;
- have less than $50 million turnover; and
- not be listed on a recognised stock exchange.

The ATO has now released safe harbour valuation techniques and simplified plan documentation.

WHAT ARE THE NEW RULES – FOR ALL OTHER COMPANIES?

Under the deferral concession, the taxing point can now be deferred until the point where there are no longer genuine disposal restrictions in place up to a maximum of 15 years (up from 7 years).

The changes will also allow option schemes to be deferred providing:

- the scheme genuinely restricts the employee disposing of the rights; and
- the scheme expressly states that the scheme is subject to deferred taxation.

Whilst professional advice and guidance is still needed to navigate the rules and put in place an effective Employee Share Scheme, these changes serve to considerably improve the process and help make Australian startups become more competitive in the global employment market place.

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