



7 February 2014

Employee Share Schemes and Startups

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to comment on the Government's consultation process on 'Employee Share Schemes and Startups'.

AVCAL is the national association which represents the private equity and venture capital industries. AVCAL's members comprise most of the active private equity and venture capital firms in Australia. These firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

We support reform of the employee share option plans (ESOP) and employee share scheme (ESS) regulatory requirements for startup companies. The approach should be simple, low cost and globally competitive. To do this, the policy framework needs to utilise an appropriate definition of 'startup companies' so that it achieves the desired policy outcome, which should be to enable innovative, risk-taking Australian companies to attract and retain highly-qualified employees who are able to propel these companies into becoming the market leaders of the future.

AVCAL considers that these objectives could be achieved by the following:

- Employees of startups who receive benefits under ESOPs and ESSs only being taxed when a realisation event occurs and any gain should only be taxed as a capital gain; and
- The valuation process for both the options and underlying shares should be simple and where possible leverage off recent equity raisings; and
- The Corporations Act procedures should be simplified to minimise cost.

In AVCAL's view such a regime would represent an appropriate balance between protection of the revenue, creating incentives for employees to work in Australian startups and reducing cost and complexity.

These issues are explained in more detail in the attached submission.

If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Yasser El-Ansary', with a long horizontal stroke extending to the right.

Yasser El-Ansary
Chief Executive
AVCAL

AVCAL SUBMISSION

Employee Share Schemes and Startups

The current legislation on employee share option plans (ESOP) and employee share schemes (ESS) came into effect in July 2009. Under these rules, gains are assessed as ordinary income and can be taxed prior to the gains being realised.

These ESOP and ESS arrangements offer a less attractive environment in which companies, can operate and retain highly skilled employees. This applies across the entire corporate landscape, from startups to small business to large corporates. It is, in particular, a roadblock for small businesses that are cash-poor but with strong growth potential that they want to leverage on to reward and incentivise their employees.

Reform of the ESOP and ESS regulatory requirements for startups is a vital first step in setting the necessary conditions for adopting a broader-reaching ESOP/ESS tax framework that is more consistent with global best practice.

Startups generally operate with limited cash resources. They face a balance between paying staff and funding the research and development of their assets. Compared to staff working at a major corporate, employees at a startup are likely to be paid less and have far less security of tenure given that their employment is typically dependent on the company obtaining on-going funding to invest in the assets while in a developmental stage and the assets of the company are based usually around one idea rather than being diversified. Accordingly, the risk of the company failing is high.

The one advantage a startup can offer is that an employee who accepts some of their remuneration in options or shares may make returns on that equity that appropriately compensates them for working in a high-risk venture. In addition to reducing the cash burn, there is a better alignment of interests if startup employees have "skin in the game" and work towards ensuring that the equity and ESOP deliver value.

Startups may seek chief executives/managing directors, other experienced entrepreneurs or specialists in the relevant area of development or research where that talent is not available in Australia.

In relation to chief executives/managing directors, startups funded by venture capital may seek employees from overseas who have experience in developing companies from early stage to a position where the venture fund can exit either through an IPO or as a secondary sale to another later stage venture capital fund. There are far greater employees with this experience in the US and UK than in Australia.

Given the right conditions, the startups of today will play a key role in driving Australia's economy and employment in a post-mining boom era. As such, it is important to recognise that the key factor behind a successful startup is the management team. And as most startup success stories can attest, the key incentive for entrepreneurs and skilled, mobile workers is their equity stake in the business.

a. The 2009 changes and their effects on businesses, and current barriers to offering an ESS/ESOP

There were two main changes that adversely impacted the ability of startups to use ESOPs and ESS since 1 July 2009. These were:

- Removing the ability to elect to pay tax upfront; and
- Deferral of tax until vesting (rather than exercise of options), or cessation of employment

Previously employees could choose to be taxed up front and any eventual realised gains were taxed under the CGT regime. Under the 2009 changes to the ESS rules, employees could no longer pay tax up front.

As a result, tax would arise on vesting even though the gain was not realised at that time. Even if there were a sale restriction in respect of vested options, this would only defer tax for a maximum of 7 years from grant. In a startup, realisation may not occur within 7 years.

Including cessation of employment as a taxing point is a disincentive to accept options, particularly for overseas employees. Overseas employees may only be employed to get the product/company to a certain stage which may be well before exit.

b. What are the barriers to offering an employee share scheme? If you are a startup, 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?

The main barriers to startups offering ESS to employees include:

- Tax: In this regard there are 2 main areas that are seen as problems:
 - a. That under the Australian tax rules tax can be imposed prior to a realisation event, either at vesting or cessation of employment; and
 - b. That the gain is assessed as ordinary income rather than a discount capital gain.
- Regulatory: Unless the company falls within ASIC class order relief, the cost of issuing a prospectus is prohibitive.
- Advisory fees: Because of the complexity of the tax and regulatory settings the costs of legal, tax and valuation advice is burdensome and prohibitive. Startup companies and their investors would prefer to spend these funds on further development of their assets rather than advisors.

The costs, complexities and adverse tax settings have discouraged startup companies from offering ESS to employees. While startup companies may put in place an ESOP for the founding team, this is not usually available to all employees (who also want an equity upside) as the current regime makes it a convoluted process. Often startup companies will be migrated to the US as soon as possible, where they are able to offer stock to employees under the US regime rather than using the more burdensome Australian regime.

Companies that remain domiciled in Australia have developed complex and inefficient strategies to deal with these issues such as:

- loan plans – these plans are complicated and can lead to a number of potential adverse commercial and tax consequences; or
- issuing a series of options with an exercise price which is set at such a level to result in a zero market value under the tables in the tax regulations. For example, an option with a 3 year exercise price to have a zero value under the tables requires the exercise price to be at least 42% greater than the current market value. This does not reflect the appropriate economic bargain as it only provides the employee with a share of the growth in the value of the company once the exercise price is met, rather than the date of issue of the options (often being when they join the company).

Addressing these barriers to effective ESOP and ESS schemes and increasing incentives to grow businesses in Australia will make it more attractive for startup companies to remain in Australia.

c. What steps should be implemented to overcome these barriers?

AVCAL considers that employees of startups who receive benefits under ESOPs and ESSs should be:

- taxed on any gain only as a capital gain rather than as income;
- taxed only when a realisation event occurs; and
- simple, low cost and globally competitive.

Gain taxed as a capital gain

An option issued with a zero inherent value (i.e. the exercise price is equal to the underlying price of the share at the time of issue) under an ESOP should be deemed to have no taxable value.

Tax on any gains would then be calculated on capital account and the taxing point would only arise when the options are sold or cancelled or if the options are exercised, when the shares are sold.

This would align the tax treatment with the US, where upon making a statutory election under section 83(b) of Internal Revenue Code, the options are taxed on grant. However, the options are considered to have zero value if the exercise price equals the market value of the underlying share, determined in accordance with section 409A. Any further gains on such options are taxed on capital account on the date the property is transferred.

In AVCAL's view this would more closely align the taxation treatment with the economics of receiving ESS interests. It would also bring Australia into alignment with countries such as the US and the UK and allow local startups to compete more effectively for talent.

Taxed only when a realisation event occurs

A common option plan for startups utilises a 3-4 year vesting plan involving:

- 1/3rd of options vesting after 12 months; and
- The balance vesting each month over the next 24 months (assuming continued employment).

The exercise price is typically equal to the underlying market value of the ordinary shares so that the employee can share in growth in the value of the company from the date of grant.

Due to the inherently risky nature of startups it is uncertain whether a venture will be profitable. However, tax would arise on vesting even though the gain was not realised at that time. Taxing unrealised gains is prohibitive especially because the recipient of the benefit may never actually receive any benefit from the ESOP and ESS.

The use of cessation of employment as a taxing point should also be removed, as this is significant disincentive to accept options, as outlined in section (a) above. The scheme needs to be flexible enough to incentivise employees who, by nature of their skills would command attractive salaries in more established companies, without unduly penalising them for leaving the startup after their period of service.

Simple to administer, low cost and globally competitive

The ESS/ESOP tax framework needs to be simple, low cost and globally competitive. To do this, it needs to:

- Utilise an appropriate definition of 'startup companies' so that it achieves the desired policy outcome, which should be to enable innovative, risk-taking Australian companies to attract and retain highly-qualified employees who are able to propel these companies into becoming the market leaders of the future;
- Use an appropriate approach to valuation; and
- Consider the policy framework used in jurisdictions such as the US, UK and Singapore as a starting point for what would constitute a workable ESS/ESOP tax framework for Australian startups. The experience of the UK's Enterprise Management Incentive (EMI) scheme is an example of how a tax-advantaged share option scheme can be designed to target small, higher risk companies attract and retain valued employees.

d. What would be the broader economic benefits in implementing these steps?

Startups are critical to Australia's future productivity and economic growth. The factors cited above are interdependent and vital for the Australian startup eco-system to grow and develop to maturity.

It is also expected that the reforms proposed above will be revenue-neutral for the federal budget, given that most startups domiciled in Australia do not currently use ESS/ESOPs for the reasons cited above. This contrasts sharply with startups which move to other jurisdictions such as the US and UK which do typically utilise ESS frameworks. Any uptake in the use of such

schemes in the domestic would ultimately result in a tax revenue gain from successful new businesses and their employees paying more tax contributions than they would otherwise.

e. What is a startup? What are the key characteristics of the type of startup that is most likely to make use of an ESS?

It is important that the proposed definition of a startup is not prohibitively narrow, which will quickly become irrelevant for fast-growing startup companies.

A requirement that the company has no more than 15 employees, for example, would be too restrictive as it automatically excludes many of the very companies that the policy should be targeting. For example, on 5 August 2010 the Australian Financial Review published an interview with Mike Cannon-Brookes, co-founder of software developer Atlassian, who was quoted as stating the following:

“If you look at the big tech companies of the world that have grown, it’s not the first 10 people – they get it off the ground – but it’s people 10 to 1000 that drive it into the stratosphere,” he said.

“If you’re trying to create an environment where you get a lot of really small companies that sell for a few million dollars, you’re not going to build an industry off the back of that.

“Startups are only useful because they migrate into high-growth technology companies... the growth phase is where most of the wealth is created.”¹

That article also cited SEEK co-founder Paul Bassat who “described the current situation as “absurd”. He said many startups do not implement a share scheme until they’ve hired more than 15 people. Mr Bassat estimated that up to 20 early employees of the jobs site made more than \$1 million on listing to the sharemarket as a result of the scheme. “The reality is that companies do issue option plans at different stages of their evolution. “It’s just such a vital form of currency that anything that’s too restrictive, too technical or puts too many roadblocks in the way is just going to create an issue,” Mr Bassat said.

A broader definition of a startup company should be considered, preferably utilising an existing definition. In this regard AVCAL submits using one of the following:

- a company eligible for the 45% refundable Research and Development tax offset; or
- a company that would constitute an eligible investment for an Early Stage Venture Capital Limited Partnership.

f. Any other costs or issues associated with the implementation of an employee share scheme

Valuation

It is inherently difficult for startups to be valued. Often the value of startups is intangible. Unlike more established companies most of their value does not derive from physical assets. This makes traditional methods of valuation inappropriate in pricing shares and options in startups. In

¹ http://www.afr.com/p/technology/labor_start_up_share_scheme_too_DSx1vxrLG2scbp3GK6PlqK

valuing shares, the share price used in a recent transaction is usually a good indicator of value for the purposes of pricing a company; however, such a share price will not always be available. In valuing options, a number of factors will be relevant such as the intrinsic value of the option but this will be difficult to ascertain especially if the underlying shares are unlisted and have a long lead up to exercise.

It is generally prohibitively expensive for startups to obtain a professional valuation. These costs would usually start at around \$15,000. In comparison, in the US for the purposes of section 409A of the Internal Revenue Code the cost could be as low as USD1,998.² This is due to the greater volume of transactions (and therefore greater competition among valuers) and the limited assumptions needed.

AVCAL submits that In relation to determining the market value of the underlying shares:

- Allow the market value of the underlying shares to be determined on the last arm's length price for the issue or acquisition of shares, provided that that issue/acquisition occurred within 12 months of the grant of the option and the startup does not expect the company will undergo a change in control event within the 90 days or make a public offering of securities within the 180 days following the grant of the options; and
- If the criteria are not satisfied then the market value of the company can be undertaken using a 'safe harbour' set of assumptions in a way similar to the 'safe harbour' provisions in section 409A of the US Internal Revenue Code which has regard to a number of finite measurable factors to make compliance more accessible for startups. In this regard:
 - a. In the US, valuations are based on a general rule (the fair market value of the stock as of a valuation date is the "value determined by the reasonable application of a reasonable valuation method" based on all the facts and circumstances) and safe harbour valuation methods (valuation by independent appraisal, reasonable good faith written valuation of a startup, formula-based valuation). (s 409A, Internal Revenue Code)
 - b. The good faith written valuation of a startup (the Startup Method) is particularly relevant to startup companies. This approach only applies to the valuation of the stock of a private company that is less than 10 years old that do not reasonably anticipate a change of control event or public offering at the time of the grant, if done reasonably and in good faith and evidenced by a written report. Such a valuation will be presumed reasonable if the following requirements are satisfied:
 - the valuation takes into account the valuation factors considered in relation to the general rule (including the value of tangible and intangible assets, the present value of anticipated future cash flows, the market value of stock or equity interests engaged in a similar business, recent arm's length transactions and control premiums or discounts for lack of marketability)

² For example, see <http://simple409a.com/>

and, events subsequent to the valuation that may render an earlier valuation inapplicable are taken into account;

- the valuation is performed by a person with significant knowledge, experience, education or training in performing similar valuations. "Significant experience" generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the company operates;
- the stock being valued is not subject to any put or call right, other than the company's right of first refusal or right to repurchase stock of an employee (or other service provider) upon offer to purchase by an unrelated third party or termination of service; and
- the company does not reasonably anticipate, as of the time the valuation is applied, that the company will undergo a change in control event within the 90 days following the grant or make a public offering of securities within the 180 days following the grant.

Valuations should also only be required once every 18 months for startup companies in the absence of any recent capital raisings or other exceptional circumstances.

Other costs

To mitigate cost and effort given their limited resources, startups should be allowed to put an ESS in place without becoming obliged to issue a disclosure document.

This typically means ensuring that all participants can be offered their equity under the exemptions contained in s708 of the Corporations Act, the most useful of which are:

- the '20/12' rule – which allows up to \$2m to be raised from up to 20 people in any rolling 12 month period, as a result of personal offers;
- 'senior manager' – for issues to executives who are concerned in, or take part in, the management of the company, regardless of the person's designation and whether or not they are a director of the company. Generally, this exemption will cover the CEO and his or her direct reports (and their immediate family members and vehicles);
- 'accountant's certificate' – for managers whose accountant can certify that they have 2 years gross income of \$250,000 or above, or net assets of \$2.5m or above; and
- 'gold card' – for managers investing \$500,000 or more (disregarding any funds lent to them by the company).

However, obtaining advice on fitting within these exceptions can be expensive and, if the '20/12' requirement is relied on, may limit further fundraising.

It would be desirable if a specific exemption could be developed for startups issuing options to employees where the exercise price is equal to, or greater than, the market value of the shares.