Deloitte.

The Treasury and The Department of Industry

Submission on Employee Share Schemes and Startup Companies: Administrative and Taxation Arrangements

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The Honourable Joe Hockey, MP
Treasurer

The Honourable Ian Macfarlane, MP
Minister for Industry

c/o Manager
Individuals Tax Unit
The Treasury
Langton Crescent
Parkes, ACT 2000

5 February 2014

Dear Treasurer Hockey and Minister Macfarlane

Re: Submission on Employee Share Schemes and Startup Companies: Administrative and Taxation Arrangements

We are encouraged by the Government's initiative to review the ESOP legislation relating to startups. However, we believe a more comprehensive review of ESOP legislation is necessary to support the business community, productivity and employee engagement more generally. In particular, a focus on the timing of taxation of ESOPs to exercise or sale should be considered for all organisations at all stages of growth, not just startups.

Please find enclosed Deloitte's submission on administrative and taxation arrangements for Employee Share Option Plans (ESOPs) in response to the Government's discussion paper, *Employee Shares Schemes and Start-up Companies: Administrative and Taxation Arrangements* ("the Discussion Paper").

Startup companies often use ESOPs to attract, retain and motivate employees and to engage other expertise on an ongoing basis. Our submission focuses on the changes necessary to better align the rules governing ESOPs to support, not hinder, the startup sector.

In developing our recommendations, we have:

- Been strongly influenced by extensive consultation with several industry bodies, corporates, startups, entrepreneurs and investors
- Incorporated input from other Deloitte member firms around the world who are familiar with similar schemes
- Analysed the results of three surveys conducted by us.

Our most recent survey, *Employee share option regulation: Barriers to Innovation in Australia ("Barriers to Innovation")*, canvassed the opinions of more than 100 startup businesses in September/October 2013 on ESOPs. The results from that survey, and two previous surveys conducted by us in 2012 and January/February 2013, show that Australia's startup and early stage business community believe that the current legislation is both difficult to administer and imposes unnecessary barriers to the use of ESOPs. This is, in turn, reducing the abilities of Australian companies to attract, retain and motivate talent in their earliest and most vulnerable stages of growth.

In developing our response, we did not canvass opinions on every question outlined in the Discussion Paper, but rather focussed on those key challenges we felt had the most relevance for the startup community.

We hope this submission will assist you in formulating changes to support the growth and competitiveness of our startup sector — a critical pillar in our continued evolution as an economy.

We would welcome the opportunity to discuss our submission with you and plan to do so with the industry. We would also be interested in undertaking any further consultation or modelling you feel is needed to develop the solution that we have proposed into the basis for legislative change. Change is needed.

Yours sincerely,

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1 Executive summary

Deloitte believes that innovation is vital to Australia. We agree that attracting, retaining and motivating skilled and experienced talent is vital for startups to grow and become globally competitive. It also has a direct impact on Australia's ability to innovate in a way that ultimately enhances our nation's productivity.

Yet our startup clients find it difficult to navigate through the increasingly rough waters of the current Employee Share Option Plan (ESOP) administration and taxation arrangements so that they can engage talented people (locally and from overseas) while optimising capital structures and efficiently managing cashflows.

We are encouraged by the Government's initiative to review the ESOP legislation relating to startups. However, we believe a more comprehensive review of ESOP legislation is necessary to support the business community, productivity and employee engagement more generally. In particular, a focus on the timing of taxation of ESOPs to exercise or sale should be considered for all organisations at all stages of growth, not just startups.

In our submission, we address the issues with the current arrangements, giving our views on the changes needed to the current ESOP system in respect of the eight discussion topics identified in the Discussion Paper.

Our proposed solution recommends:

1. A clear definition of "startup" which applies to the entities we are most seeking to incentivise
2. Amend existing tax legislation to tailor the ESOP tax rules more closely to the unique circumstances of startups
3. A simplified valuation methodology for ESOP tax purposes to reduce the costs of establishing and maintaining an ESOP
4. Standardised documentation for ESOPs (with variations limited to performance and vesting criteria to facilitate appropriate company alignment), to be accessible on the ATO's website.

Our submission also highlights the results of a recent survey *Barriers to Innovation* to identify and report on the views of a cross-section of businesses, both small and large, with an interest in innovation and growth. These survey results, combined with others completed in 2012 and early 2013 and consultation with several industry bodies, corporates, startups, entrepreneurs and investors, have influenced our development of the proposed solution outlined in this submission. It's clear that if 95 per cent of participants say they feel it is important to offer an ESOP to attract and retain talent in the medium to long term, yet 63 per cent currently do not have an ESOP, the current rules are ineffective.

We believe that our proposed solution is flexible and simple for startups to implement and administer, meets the need for ESOPs to incentivise employees, and references international ESOP schemes for competitiveness, while utilising a large proportion of the current ESOP legislation and infrastructure.

We are, however, open to further refinement of our solution through both public and private consultation in order to land on something that the Government can also accept – our primary goal is to help orchestrate change.

To this end, modelling in support of our solution could be completed by Deloitte Access Economics if Treasury were willing to provide us with access to a range of data points not otherwise publicly available.

2 Is there a better option?

2.1 The Deloitte preferred model for startup ESOPs

2.1.1 A tax-qualified plan

	Acquisition Time — tax payable	Vesting Time — tax payable	Sale or Disposal Time (exit event or ten years)
Deloitte preferred model for startup ESOPs – a tax-qualified plan*	Nil	Nil	Income tax paid at marginal rates on first $50,000 of spread (i.e. the difference between the option exercise price — being the value of the share at grant date - and the underlying value of the interest in the ESOP at the taxing point). Income tax is paid at 15% on spread between $50,000 and $180,000. No CGT discount available** Income tax is paid on the excess spread over $180,000. CGT discount available**

* If conditions are not met, ESOP tax-qualified status is lost and all taxable gains immediately become subject to income tax at the employee's individual marginal rate.

** Australian tax-resident individuals can generally discount a capital gain by 50 per cent if they hold the asset for more than one year.

Having considered a number of alternatives and variations, the Deloitte preferred model for a tax-qualified ESOP for startups would include the following conditions:

- A simple quantitative and qualitative definition of "startup". For simplicity, Deloitte proposes to define a startup as "an Australian-based business with consolidated revenue of $15 million per annum or less and providing (new) products or services for no more than ten years in Australia". (Please refer to section 4.5.1)
- Tax concessions on share options in a startup are only available to employees who have a taxable income (after adjustments) of $180,000 or less in the year of acquiring the options
- Share options are to be held for at least two years from the grant of the option. Shares acquired on exercise of the options are to be held for at least one year to qualify for the CGT discount:
  - The three-year 'requirement' of our proposed alternative is in line with current ESOP tax concessions
  - Standard market practice design in respect of vesting for performance and service is accommodated under our proposal

If the conditions for the ESOP concession are met:

- At the time of an exit event (e.g. private sale or IPO) or year 10, whichever occurs first, an individual would be subject to:
  - Income tax at their marginal rate on the first $50,000 of any gain (calculated as the spread) with:
    - No valuation for individual income tax purposes of options needed at acquisition
    - No $1,000 and no $5,000 exemption available, both of which are available under the current ESOP rules
    - Benefit available to participation in multiple unrelated company plans, in line with current ESOP tax rules
  - Income tax at 15 per cent on spread from $50,000–$180,000, and
  - Capital gains tax at a maximum 23.25 per cent tax rate on excess of spread, in line with current capital gains tax discount rules.
- If our proposed conditions for the ESOP concession are not met, tax-qualified status would be lost and all taxable gains would immediately become subject to income tax at the individual employee's marginal rate. This would act as a deterrent to the improper use of the startup concession and would result in tax

treatment in line with current ESOP rules for options
  - Limited exclusions for death, disability, redundancy, and severe financial hardship (akin to superannuation rules) would be available
- There would be simplified documentation for ESOPs tax reporting for startups to capture tax information
- No company tax deduction for a tax-qualified plan other than a statutory $1,000 deduction per year per employee to cover administration costs
- No or nominal monetary value of the employee share option at acquisition and simplified market valuation for financial reporting purposes of the company should reduce the cost of establishing and maintaining an ESOP (please refer to section 4.5.3 for more detailed information about the valuation methodology).

2.1.2 Startup-friendly ESOP documents and regulation

We believe that standardised documentation is an important component of making ESOPs a more attractive and effective tool for attracting, retaining and motivating employees. Examples of such documentation exist on the UK HMRC website (see links below). The development of a standard plan and housing this on the ATO website is also a key part of reaching a large number of startup entrepreneurs.

- Plan rules, offer document, employer and employee communications:
  - http://search.hmrc.gov.uk/kb5/hmrc/hmrc/results.page?qt=specimen+scheme+rules
- Checklist for approved ESS tax plan:
  - http://www.hmrc.gov.uk/manuals/essum/ESSUM38802.htm

However, we do not recommend government or ATO pre-approval of ESOP plan documentation. We suggest that the current ATO audit processes apply.

In addition, under ATO Interpretive Decision (ID) policy (see an excerpt from an ATO ID below), it is our view that if a company offers a plan that 'ticks all of the boxes', neither the company nor the employee participant should be subject to penalty or interest from the ATO if the plan is deemed to be later incorrect.

The following example (Example 1) shows the tax outcomes under our proposed ESOP for startups, versus under the current ESOP rules (see Example 2).

In this instance, our proposed solution results in marginally less tax paid (i.e. $2,125) when compared with the current rules.

This ATO ID provides you with the following level of protection:

If you reasonably apply this decision in good faith to your own circumstances (which are not materially different from those described in the decision), and the decision is later found to be incorrect you will not be liable to pay any penalty or interest. However, you will be required to pay any underpaid tax (or repay any over-claimed credit, grant or benefit), provided the time limits under the law allow it. If you do intend to apply this decision to your own circumstances, you will need to ensure that the relevant provisions referred to in the decision have not been amended or repealed. You may wish to obtain further advice from the Tax Office or from a professional adviser.

The development of a standard plan and housing this on the ATO website is also a key part of reaching a large number of startup entrepreneurs.

Example 1: Deloitte preferred ESOP alternative

Jill is employed by a startup, Great Idea Co. Jill earns a salary of $80,000 per year (i.e. her taxable income after adjustments for the year is less than $180,000). Under the employee share scheme run by Great Idea Co., she receives 5,000 options, which are subject to forfeiture in the event that she leaves employment before three years from the time she acquired the options.

Jill exercises her options in year four.

During year six, the owners of Great Idea Co. hold an IPO for the company and Jill sells her shares.

Jill will be taxed on 5,000 shares at disposal. Her gain (spread), after the cost of disposing of her shares, is $100,000.

Tax on the spread at the time of disposal of the shares will be calculated as the difference between the sale proceeds less the option exercise price less any costs of disposal. The first $50,000 will be subject to income tax at Jill's marginal rate. The next $50,000 is subject to income tax at 15 per cent.

Shown as			
Number of options	5,000		
Share price at grant	$10		
Share price at vesting	$20		
Share price at sale / IPO	$30		
Deloitte suggestion	**Income**	**Tax rate**	**Tax payable**
Salary	$50,000		
Other income	$30,000		
Adjusted Taxable Income	$80,000		
Taxable gain at sale ($30–$10) x 5000	$100,000		
First $50,000, marginal rate		38.50%	$19,250
Next $50,000, flat rate		15%	$ 7,500
Total tax			**$26,750**

Note: As the spread is less than $180,000, no opportunity to pay income tax at the discount CGT rate is available.

Example 2: Current ESS rules

Sue is employed by a startup, Disruptive Co. Sue earns a salary of $80,000 per year (i.e. her taxable income after adjustments for the year is less than $180,000). Under the employee share scheme run by Disruptive Co., she receives 5,000 options, which are subject to forfeiture in the event that she leaves employment before three years from the time she acquired the options.

Sue exercises her options in year four.

During year six, the owners of Great Idea Co. hold an IPO for the company and Sue sells her shares.

Sue will be taxed on 5,000 shares at IPO. Her gain at that time is $50,000. Her subsequent gain on selling her shares in year six, after the cost of disposing of her shares, is $50,000.

Taxable income at the time of the IPO will be calculated as the difference between the IPO price less the option exercise price. The $50,000 of income resulting will be subject to income tax at Sue's marginal rate. Assuming that the shares have been held for more than 12 months post IPO, the $50,000 gain at sale is first discounted by 50 per cent and then subject to income tax at Sue's marginal rate (i.e. an effective maximum tax rate for Sue of 19.25 per cent).

Shown as			
Number of options	5,000		
Share price at grant	$10		
Share price at vesting	$20		
Share price at sale / IPO	$30		
Current ESS rules	**Income**	**Tax rate**	**Tax payable**
Salary	$50,000		
Other income	$30,000		
Adjusted Taxable Income	$80,000		
Taxable gain at vesting ($20–$10) x 5000	$50,000	38.50%	$19,250
Taxable gain at Sale ($30–$20)	$50,000	19.25%	$9,625
Total tax			**$28,875**

Therefore, our proposed solution results in marginally less tax paid (i.e. $2,125) when compared with the current rules, but a far more palatable arrangement for the option recipient, as the timing of the tax event is matched to an exit event. In addition, the plan will be easier to administer for the company.

In the following example, Jack's tax treatment remains the same under both our proposed ESOP model and the current tax system.

Example 3:

Jack is employed by a startup, Hill Co. Jack earns salary and wages of $80,000 per year (i.e. his taxable income after adjustments for the year is less than $180,000). Under the employee share option plan run by Hill Co., he receives 8,000 options, which are subject to forfeiture in the event that he does not meet key performance indicators measured in three years' time.

After one year, Jack resigns from Hill Co. to join another company, but Hill Co.'s Directors decide at their discretion to allow Jack's options to vest and in turn for Jack to retain these options after his departure. Jack does so.

Jack will be subject to income tax at his marginal rate on the greater of the option spread value and the deemed full tax value of the 8,000 options at the cessation of employment with the company (immediately in Jack's case).

2.1.3 Disqualified ESOP

If the conditions of our proposed solution are not met, and the limited exclusions do not apply, startup tax-qualified status is lost and all gains at the taxing point are subject to income tax at the individual's marginal rate.

3 Deloitte research

3.1 Employee share option regulation: Barriers to innovation in Australia

The Deloitte *Barriers to Innovation* survey was conducted to obtain further information from the Australian business community regarding ESOPs and to address the questions in the Discussion Paper that would be best answered by quantitative and qualitative data.

One hundred and thirty companies participated in our most recent survey. Survey participants were principally headquartered in New South Wales and Victoria (81 per cent), operating in the technology, media and telecommunications (55 per cent) sector, with an annual revenue of less than $15 million (77 per cent), employee numbers of 20 or fewer (57 per cent), and were also almost an equal mix of local and global organisations.

Given the important role played by startups and small and medium-sized enterprises in fuelling economic growth, this is an issue that Deloitte has examined previously, resulting in the following reports:

- *Silicon Beach: A study of the Australian Startup Ecosystem,* November 2012, co-authored with Pollenizer, Startup Genome and Vivid Sydney and
- *ESOP survey report: Australian business' experiences with Employee Share Options,* January/February 2013, Deloitte and Norton Rose

These reports can be found on our website, www.deloitte.com.au.

One of the key findings of the Silicon Beach report was that:

"The tax environment in Australia makes ESOPs expensive to put together for both companies and employees"

"We believe that a modified tax regime for startup ESOPs would motivate more startups to implement such a scheme and thereby motivate more people to take entrepreneurial risk. Without this, many startups may continue to struggle to attract and retain the local talent pool."

Source: *Silicon Beach: A study of the Australian Startup Ecosystem*, page 25

In our most recent survey, only 37 per cent of respondents had an ESOP as part of their staff remuneration plan. This number is also roughly consistent with the results of the earlier Deloitte/Norton Rose survey (with 37 per cent having used an ESOP in the past three years).

In addition, for the past 11 years, we have run the Deloitte Technology Fast 50 program to identify and recognise Australia's most promising, fast-growth technology companies. During the life of this program, the likes of Carsales, Seek, Ozforex, Retail Me Not, Hotels Combined, Atlassian, MYOB, Webjet, Hitwise, Vocus and Aconex have all passed through our program. This initiative has and continues to give us another very useful platform around which to better understand the journeys of these companies and to identify when mechanisms, such as simple and effective ESOPs, could have better helped them in their early years.

4 Responses to selected questions in the discussion paper

4.1 ESOPs in Australia

Discussion Topic 1 — ESSs in Australia

1. What barriers do Australian startups face in attracting and retaining staff?
2. What type of employees do startups typically seek from overseas rather than source domestically?
3. As 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?
4. What are the barriers startups face in offering an ESS, including tax and other regulatory requirements?
5. What is the relative importance of ESS arrangements to startups in Australia compared to other factors such as economic conditions or policy settings?

Participants in our *Barriers to Innovation* survey noted both big business and international competition for labour as major barriers to attracting and retaining staff. Some also noted that both larger companies (i.e. listed companies) and startups in other countries (e.g. the U.S.) were able to offer greater cash and/or offer either ESOPs or tax-qualified ESOPs to reward employees.

Of the participants in our survey, 63 per cent do not offer an ESOP, principally because an ESOP is too complex to administer and also because of the unfavourable Australian tax treatment. However, 95 per cent said they felt it was important to offer an ESOP to attract and retain talent in the medium to long term.

Meanwhile, the lack of suitable talent and difficulty in retaining talent (in total, 11 per cent) is proving to be a challenge to corporates, as is the cost of doing business more generally (15 per cent) and the prohibitive government policies/initiatives (15 per cent), but a lack of funding sources (39 per cent) was an even more significant impediment to growing a business. It is imperative that legislation is amended to remove the barriers that are hampering this sector from finding and keeping the talent it needs to succeed.

We specifically asked why ESOPs are important to organisations and their employees. The top three reasons given (companies could choose more than one response to this question) were:

- "Better firm performance (i.e. provides a unique employee incentive that drives strong company and individual alignment)" (91 per cent) This is a really important point in that it highlights the fact that an effective ESOP is as much about motivation as it is recruitment and retention.
- "Enable better quality and staff attraction and retention" (chosen by 86 per cent of respondents) and
- "Solve a funding issue" (i.e. limited resources to provide incentives via cash payments (chosen by 61 per cent).

Of the participants in our survey, 63 per cent do not offer an ESOP, principally because an ESOP is too complex to administer and also because of the unfavourable Australian tax treatment.

A sample of comments received from participants follows:

"At the startup phase of a company, it cannot afford to compete with market pay rates for the best talent. An ESOP allows future upside for a new hire taking the risk on a startup, and allows continuous incentivisation of the workforce throughout the company's life".

— Anthony Woodward, CEO, Bulletproof Networks

"Employees go the extra mile when they have skin in the game. Equity is how you attract and retain world-class talent."

— Survey participant

"Too difficult to have [an ESOP], keep it simple and affordable to manage and beneficial to employees, due to current government policy."

— Jeff Perlman, CEO, OneSaas Integrations Pty Ltd

"Finding and attracting talented employees is our greatest challenge. any policy changes that make that easier are welcome."

— Survey participant

It is imperative that legislation is amended to remove the barriers that are hampering this sector from finding and keeping the talent it needs to succeed.

4.2 Changes to taxation in Australia

Discussion Topic 2 — Changes to taxation treatment of ESSs

1. If you were a startup 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?

Our *Barriers to Innovation* survey also found that 26 per cent of companies had an ESOP prior to 2009/10, of which 32 per cent discontinued it after the Australian tax changes on 1 July 2009. Of those who responded as to the reason for discontinuing their ESOP, 100 per cent said it was because of the unfavourable changes in the tax rules.

Furthermore, 60 per cent of companies surveyed that had discontinued their ESOP after the tax changes have not replaced it.

Meanwhile, 63 per cent of organisations surveyed that do not have an ESOP cited tax changes/unfavourable rules and difficult administration as the reasons for not having an ESOP. A total of 30 per cent estimated that they lost employees (and also 40 per cent failed to attract employees) because they could not offer an ESOP. The changes implemented in 2009 have had an unintended consequence for startup organisations and were the sole reason why equity plans ceased. This has in turn added further pressure on this part of our economy in attracting and retaining talent.

Comments received from survey participants on this topic included:

"Due to the tax laws. We win no friends by issuing fully priced shares in a speculative venture if the employees must pay income tax on those shares before the company is break even."

– Mark Toohey, Director, Adroit Lawyers

"We have an ESOP outside Australia, but the tax structure in Australia does not create value for the company or the employee."

– Survey participant

"Too complicated and it's unclear that it can be done without creating unacceptable tax burdens for employees (especially prior to crystallisation)."

– Survey participant

Of those who responded as to the reason for discontinuing their ESOP, 100 per cent said it was because of the unfavourable changes in the tax rules.

A total of 30 per cent estimated that they lost employees (and also 40 per cent failed to attract employees) because they could not offer an ESOP.

4.3 ESS valuations

Discussion Topic 3 — ESS valuations

1. What difficulties and costs do startups face in valuing shares or options for an ESS?
2. If you are a startup, do you use an independent valuation? Why?
3. As a startup, 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?

In our experience, most startups do not have the requisite skills (or interest) to formally value shares or options for an ESOP.

As addressed in the Discussion Paper below and at 4.5.3, the cost involved in the valuation of startup entities may be relatively high as it is often difficult to access relevant information, including company, competitor, technical, and external market information.

In addition, short-cut or formulaic valuation techniques (such as valuations based on earnings multiples) are difficult to employ or, for ESSs, tax tables (where there are performance hurdles incorporated) are inequitable. These tables have been developed with more mature companies in mind and not necessarily startups.

As a result, the level of work involved in supporting and arriving at a conclusion on value is significant, as is the cost. We only see a limited number of startups requesting share valuations. Although we have no empirical evidence, we sense cost is a key reason behind the low level of enquiry in relation to startup ESOP valuations.

Our proposal would make it simpler for startups because no or nominal value of the employee share option is attributable at acquisition. Furthermore, our suggestion for a simplified market valuation methodology of the company should also reduce the cost of establishing and maintaining an ESOP.

Comments received from survey participants on this topic included:

"Pricing ESOPs is a minefield. If an ESOP is out of the money motivation by the employees drops significantly..."

– Jason Perkins, CEO, Tractile Pty Ltd

"Current ESOP [rules make] it difficult to reconfigure equity split in the future, as well as potential capital gains tax events from issuing new equity."

– Andrew Tweedie, Director, iSapien

In addition, recent comments by Inspector-General of Taxation Ali Noroozi (quoted in BRW on 19 November 2013) raised concerns about how the subjectivity of valuations can lead to unnecessary disputes between the ATO and taxpayers. He said: "Critically, valuations are inherently subjective and can be a source of significant uncertainty leading to ATO disputes which can be frustrating, time-consuming and costly."

As the valuation of growth stage companies is often more uncertain than for more mature companies, we believe that the Inspector-General has a valid point and that his comments support our contention that imposing the current valuation methodology for shares in startup companies is too onerous. As such, the existing valuation methodologies need to be simplified for startup companies. For Mr Noroozi's additional comments, please see the link below.

www.brw.com.au/p/professions/subjective_nature_tax_valuations_1cfOfga4ZZbwjXkmAzD7uL

4.4 Other regulatory requirements

Discussion Topic 4 — Other regulatory requirements

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

We note that on 14 November 2013 the Australian Securities and Investments Commission ("ASIC") released its consultation paper 218 *Employee incentive schemes* in relation to relief for employee share schemes from the disclosure and licensing requirements in Class Order [CO 03/184] *Employee share scheme* and its guidance in Regulatory Guide 49 Employee share schemes (RG 49). This consultation paper covers a wider range of employee incentive schemes than before. We welcome that ASIC is seeking to respond to the difficulties that it identified in its review process of [CO 03/184].

However, we believe the detailed specifications of ASIC's proposed relief (among other things, for example, one class of shares on issue, direct offers only, a 5 per cent share capital limit and that disclosure is made for performance rights at time of vest) may act against employee participation in startups.

In our view, a simple fix for employee participation would be to allow relief in all cases where employees can acquire options, performance rights and the underlying shares for no more than nominal monetary consideration for the entire offer or acquisition (e.g. the exercise price of the options is one cent per option and the employee holds 50,000 options). There would be relief given to both the grant of options and the exercise of the options in the example.

We believe that an employee has sufficient information in respect of the market value of his or her continued services, without needing to take into account the monetary value of "blue sky" possibilities of a startup employee incentive scheme. It is only when employees look to dispose of ownership interests on IPO or another exit event that a reliable alternative market price against which to compare the value that they will receive is needed. That is the time that there must be a quoted price, an independent expert report or a prospectus or offer information statement in accordance with ASIC relief.

Comments received from survey participants on the topic of why their company does not have an ESOP included:

"Private company; legal framework to build and run an ESOP was deemed too expensive/onerous last time it was investigated."

– Anthony Woodward, CEO, Bulletproof Networks

"It was far too complicated. Everyone loves the idea until someone tries to put it into practice."

– Survey participant

"We can't afford the legal and accounting work necessary to set it up so that our employees aren't liable for tax on their options from the day they're granted. We can't afford to lend our employees the money. ESOPs as they stand are a burden on our company and a burden on our employees and that's nuts."

– Alan Jones, Chief Hindsight Officer, The New Agency

4.5 Options for reform

4.5.1 Definition of a startup

Discussion Topic 5 — Definition of a startup

1. What are the key characteristics of the type of startup 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 startups? Are there any drawbacks?

For simplicity, Deloitte proposes to define a startup as "an Australian-based business with consolidated revenue of $15 million per annum or less and providing (new) products or services for no more than ten years in Australia". Startups typically take several years to grow into more established businesses.

Comments received from survey participants on this topic included:

"Pre-profit growing business that has a viable plan to achieve profitability based on attainment of scale."

– Neil Bourne, Director, Nextec Strategic Capital

"A company whose ownership structure is strongly orientated to attract, retain and motivate world-class talent/staff towards aggressive growth."

– Survey participant

"ESOPs should be categorised to size of company turnover like R&D tax concessions and provide greater incentives to startups, then small companies, then medium-sized companies, then large businesses. The issue is cashflow to pay taxes upfront."

– Jason Perkins, CEO, Tractile Pty Ltd

Deloitte proposes to define a startup as "an Australian-based business with consolidated revenue of $15 million per annum or less and providing (new) products or services for no more than ten years in Australia".

4.5.2 Tax reform options

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 ESSs for startups?
3. What is your preferred option? Why?
4. What do you anticipate would be the financial impact on your startup (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?

Of the alternatives set out in the Discussion Paper, as extracted below, and absent other possible alternatives, we believe that Option 2 best meets the need to reward the employee for his/her own investment in a startup, to apply some tax on the option to the value realised by the employee and also deal with the issues of timing around when any tax is applied.

However, for the reasons cited herein (refer to the earlier section of this paper), we believe that Option 2 does not go far enough to ease the burden on startups presented by the current tax regime of ESOPs, nor does it improve the attractiveness of options to employees.

Extract from the Discussion Paper:

ESS Taxation options summary			
	Acquisition time	Vesting time[1]	Sale or disposal time
Current arrangements[2]	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.

[1] Vesting is a substitute for the ESOP deferred taxing point, which may differ from the vesting date in certain circumstances for integrity reasons.

[2] Tax-deferred Schemes and ESOP interests not subject to concessional tax treatment have a different tax treatment.

The survey participants were asked to comment on the ESOP tax alternatives set out in the Discussion Paper.

The alternatives that proposed tax at sale were preferred over tax at acquisition, vesting or exercise, and overwhelmingly (chosen by 64 per cent of respondents) ESOPs taxed as a capital gain at a maximum rate of 23.25 per cent at the time of sale was the preferred approach.

However, it was also clear from responses to this part of our survey that the alternatives are not fully understood.

Comments received from survey participants included:

"Need my accountant to jump in and help answer."

– Survey participant

"Tax should ONLY apply at the time of enjoyed benefit – i.e. at the time of share (or rights) SALE (and consideration received), *NO* other options are acceptable."

– Survey participant

4.5.3 Valuation methods

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 startups, 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'?**

As outlined above, in Deloitte's view, the following would significantly simplify the complexity and compliance costs for startup companies setting up an ESOP:

- Employee share option valuation — No or nominal (e.g. one cent per option) value of the employee share option at acquisition
- The spread is calculated as being the difference between the value of the share at the time of the exit event or year 10 and the value of a share at the date of the acquisition of the option (the exercise price):
  - At the date of acquisition, the value of the share (the exercise price) would be determined by reference to the valuation of the company at that date. The valuation of the company would be based on the greater of:
    - Net assets calculated and determined in line with Australian accounting standards (allowing for the dilutionary effects of the rights being granted and those that have already been granted) or
    - The price paid in a recent capital raising or transaction where there are third-party investors and it is possible to reasonably conclude that the parties are dealing at arms' length
  - At the time of exit, the value of the share would be determined by reference to the price being paid for the shares by reference to the exit event

- At year 10 (if required), the value of the share would be determined by reference to the valuation of the company at that date. The valuation of the company would be based on the greater of:
  - The price paid in a recent capital raising or transaction where there are third-party investors and it is possible to reasonably conclude that the parties are dealing at arm's length
  - A valuation undertaken by an independent, suitably qualified firm and in line with the market valuation guidelines issued by the Australian Taxation Office.

It should be noted that valuations undertaken to enable compliance with The Australian Accounting Standards Board Standard No. 2 (AASB 2) *Share based Payment* may not reflect market value as non-market hurdles (such as earnings hurdles or other milestone hurdles) are not incorporated into the valuation.

4.5.4 Standard documentation

Discussion Topic 8 — Standard documentation

1. **Would your startup 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 startups to use the standardised documents?**

While access to simple valuation services and standard documentation is needed, the priority for startups is better tax rules for ESOPs (78 per cent chose better tax rules as the most important issue for ESOPs for startups) and simplified prospectus exemptions (22 per cent as the number one issue).

In our view, none of the above alternatives alone are sufficient to lead to an increase in ESOPs amongst startups. It is our view that the entirety of Deloitte's suggested proposal is needed to improve the climate supporting startups and potentially increase the number of startups willing to offer ESOPs to their employees. We believe a standard plan housed on the ATO website is a step in the right direction and a key part of reaching a large number of entrepreneurs.

5 About the survey

The insights and comments included in this submission were partly derived from: *Employee share option regulation: Barriers to Innovation in Australia* a survey of 100+ companies (of varying maturity) across multiple sectors. This survey was conducted in September/ October 2013 — with the kind support and interest of the Australian Information Industry Association (AIIA) and AusBiotech.

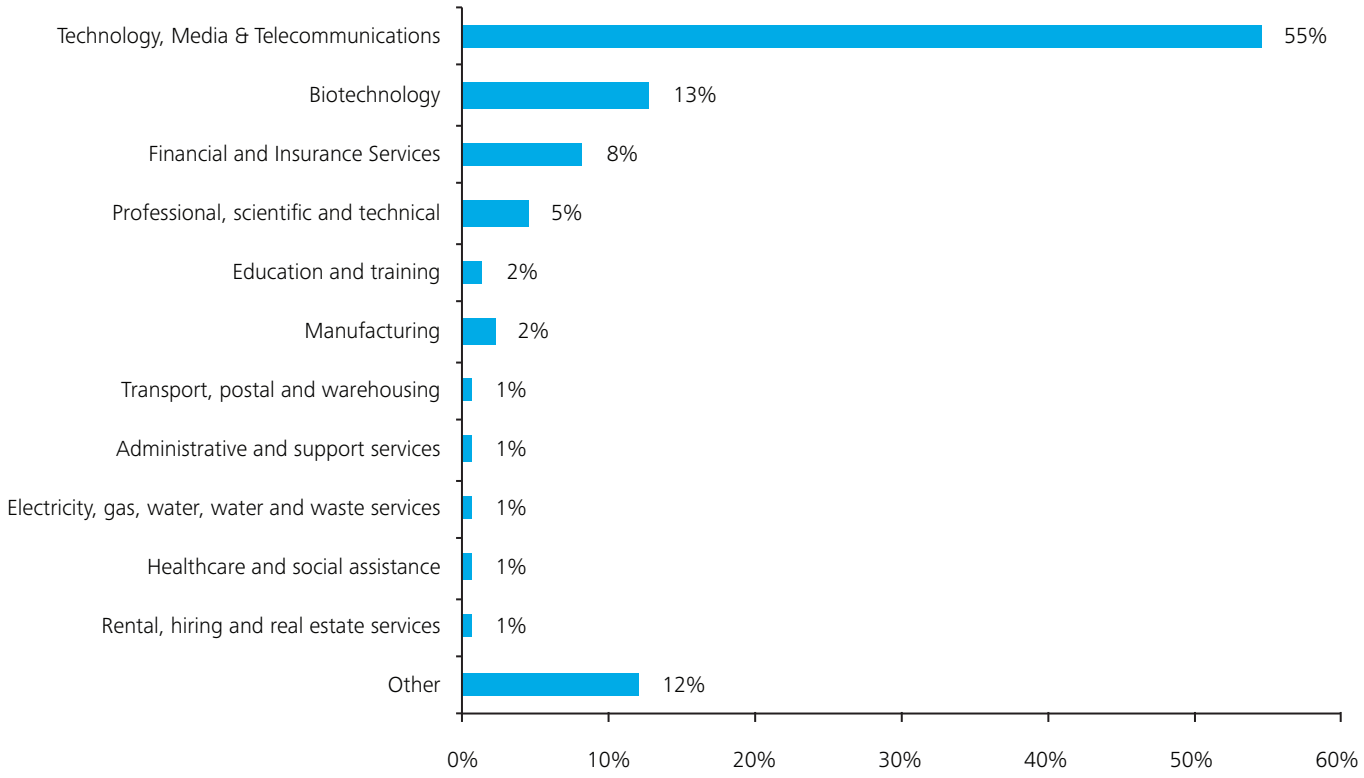
Survey respondents were drawn from five states and one territory, with 60 per cent from NSW and 21 per cent from Victoria.

The top three industries represented in the survey were Technology, Media and Telecommunications (TMT), comprising 55 per cent, followed by Biotech (13 per cent) and Financial and Insurance Services (8 per cent).

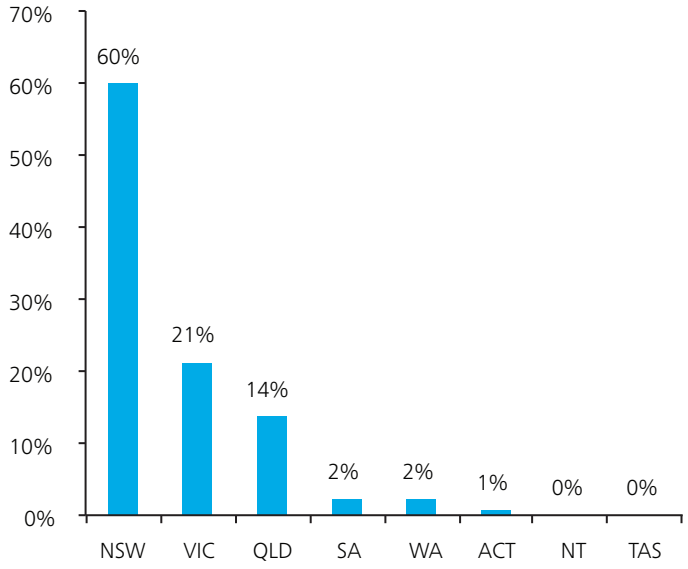
The majority (62 per cent) of the companies had annual revenues of less than $5 million.

Nearly 50 per cent of companies surveyed have 15 employees or more.

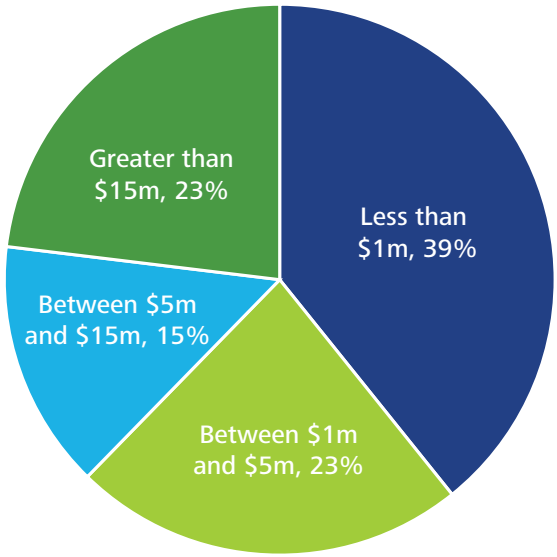
By Industry Sector



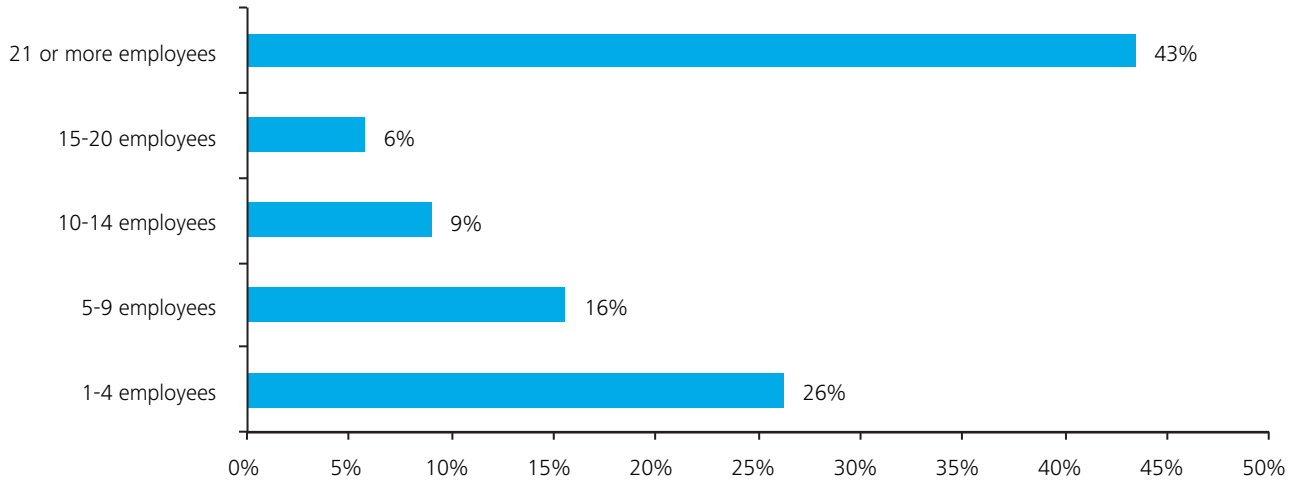
By State



By Revenue Levels



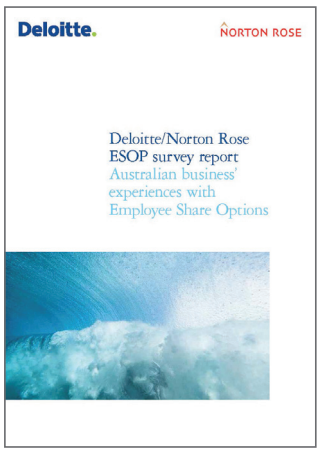
By Employee Numbers

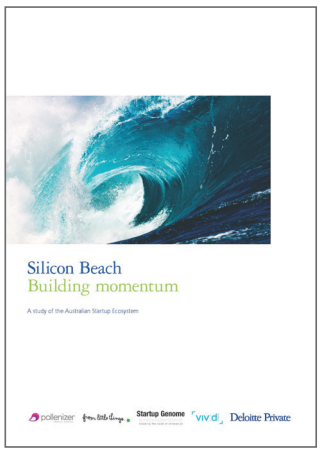


Sample of companies that participated in the survey

Adroit Lawyers	e-channel online	Optimation
Adslot Ltd	Elcom Technology	ParcelPush and Mint Wireless
Adventure Capital	EnviroPoint Systems	Pharmaxis
ANSARADA	Facet Consulting	RedBalloon
AstraZeneca	Favourit Global	S2M
BigAir Group	Flowers Corp	Teleprot Corp Pty Ltd
BlueChilli	Foundry	The New Agency
Booodl	hipages Group	Tigerspike
brandsExclusive	Ilum-a-Lite	Tractile
Bulletproof Networks	isapien	Treadstone enterprises
Calpain Therapeutics	iSentia	TTG Transportation Technology
Catalitx Consulting	KFSU	Tyro Payments
Catapult Sports	MiniFAB Aust	Vocus Communications
CertainEdge	MitchelLake Group	Wisetech Global
Clarinox	Nextec Strategic Capital	Zetta
CodeNgo	OneSaas Integrations	Zookal

Related Deloitte thought leadership





Deloitte/Norton Rose ESOP survey report can be downloaded at:
http://www.deloitte.com/view/en_AU/au/industries/tmt/c2699bf14666d310VgnVCM2000003356f70aRCRD.htm#

Deloitte' Silicon Beach — A study of the Australian startup ecosystem can be downloaded at:
http://www.deloitte.com/view/en_AU/au/industries/tmt/1bf8ba210181b310VgnVCM2000003356f70aRCRD.htm#

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