WINDS OF CHANGE SWEEPING THROUGH THE EMPLOYEE SHARE SCHEME LANDSCAPE

There is building momentum for the Federal Government to change laws which currently apply to employees share schemes to counter the problems arising from previous changes made in 2009, and as a result, to increase the level of employee participation in employee share schemes in Australia.

Recent reports in mainstream media publications have stated that within weeks the Federal Government will revoke the controversial 2009 employee share schemes tax changes introduced by the Labor Rudd government and may also look to introduce new reforms borrowed from the United Kingdom, particularly from "Sharesave" schemes which have operated there for a number of years. These changes will form part of the Federal Government's broader National Industry Investment and Competitiveness Agenda, which will look to drive research and development and other innovation initiatives.

These reports follow on from the Federal Government's recent review of the tax and administrative arrangements for start-up companies wishing to operate employee share schemes and the Australian Securities and Investments Commission's current review of the relief it offers companies from the need to provide a prospectus or other disclosure document to their employees when offering shares or other equity to them.

WHY ARE EMPLOYEE SHARE SCHEMES IMPORTANT?

Attracting and retaining the right team of highly skilled and qualified individuals is crucial to the success of any business. Employee share schemes can serve as an effective talent retention tool and remuneration mechanism to incentivise high performing employees. This is recognised in other developed jurisdictions, such as the United Kingdom, which has a very well developed legislative framework in this area, making it simpler for companies to offer their employees the ability to share in the profits of a company as a shareholder and which as a result has led to a much higher level of employee participation.

This form of employee reward can also be particularly important for start-up companies that are often unable to reward their employees with high salaries and cash bonuses because of their initial, limited cash flow. For those companies, often the potential for individuals to be offered a share in the company will be the difference between hiring and retaining the right talent to drive the company's success and losing those individuals to competitive (and potentially overseas) companies who can offer that potential upside.

This has created an issue in the Australian market, in that an offer of equity to people living and working overseas can be more attractive than a similar offer made to employees based in Australia. This contributes to the cost of doing business in Australia and is problematic for Australian businesses looking to attract top talent from an increasingly mobile, global pool.

WHAT IS THE CURRENT TAX STATE OF PLAY AND WHAT WILL THESE CHANGES MEAN?

The current tax and legal framework for establishing and operating employee share schemes in Australia is complex and gives rise to some challenging issues. In many ways, the taxation of employee equity in Australia is out of step with other major jurisdictions around the world.

Prior to the controversial 2009 tax changes, employees could often elect the tax treatment which they wished to apply to any shares or equity they received, by electing to either pay tax up front, or defer their tax for up to 10 years from the date of grant.

Following the 2009 changes, an employee will generally be taxed at the time of receiving the equity, unless certain conditions are met that allow them to defer their tax. Tax can only be deferred for 7 years and employees can no longer elect their tax treatment.

Employees are taxed in relation to any "discount" they receive. A discount is generally the difference between what the employee pays for the equity (which may be nil) and the market value of the interest at the time it is to be taxed.

The potential of up front tax based on the discount received can be particularly problematic for start-up companies offering employees shares with no tradable market or options that can only be exercised after certain conditions are met (typically, on a private sale or initial public offering). In addition, where the value of equity is not easily determined, this can require a company to undertake a costly valuation in order to determine the tax impact of participating in a scheme.

As a result of the 2009 changes, the Australian tax treatment for an employee receiving equity will be driven by the type of employee share scheme adopted by the company, the form of equity being offered to the employee, the value of that equity, what risk there is that the employee may lose (or forfeit) that equity, and what restrictions there may be on that employee selling and realising value from that equity.

Companies looking to offer equity to Australian-based employees need to seek advice and properly consider all relevant issues as otherwise a tax liability could arise for an employee before they have any potential to realise economic value from their equity. As a worst case scenario, the employee may continue to have a tax liability even where they ultimately receive no economic value. This can result in the opposite of the intended objectives of incentivising and retaining staff.

Perhaps not surprisingly, when those changes were introduced:

- many companies suspended some or all of their employee share schemes while they sought clarity on how the then new tax regime operated;
- many schemes required significant amendment to be able to continue to operate as intended following those changes;
- the use of some types of schemes, such as traditional option plans, declined dramatically, to be replaced by new schemes offering other forms of equity such as performance rights (typically the right to acquire a share in the future, but unlike an option not requiring the payment of an exercise price by an employee);
- the use of some schemes, like salary and bonus sacrifice schemes, often used by middle management and other employees to accumulate wealth, largely ceased to operate; and
- many companies simply found the new tax regime too difficult to navigate and chose to discontinue offering equity to their employees, or found that navigating around these rules triggered significant legal and accounting expenses.

While we will need to wait to see the detail of the tax changes being contemplated by the Federal Government, and the impact of any consultation on the new laws, we would expect the changes will make the tax regime simpler to navigate, for both companies and employees.

For multinational and overseas based companies who are considering making equity offers to employees based in Australia and elsewhere, it is hoped that these tax changes will bring Australia much more closely in line with the way in which equity is taxed in overseas jurisdictions.

IS THE POSITION DIFFERENT FOR START-UP COMPANIES?

In August 2013 the Federal Government released a discussion paper entitled "*Employee Share Schemes and Start-up Companies: Administrative and Taxation Arrangements*", and announced that it would review the tax rules which applied to those companies in consultation with key stakeholders. That review was designed to determine the most effective measures for addressing issues faced particularly by start-up companies in establishing employee share schemes in Australia.

A number of potential reforms were considered in the Federal Government's paper, and during the consultation process, including:

- allowing different tax treatment (with some concessions) for equity granted by start-up companies under an employee share scheme, with four possible tax treatments discussed;
- introducing a definition of "start-up company", which has been generally been criticised by experts as limiting the effectiveness of any reforms; and
- implementing measures to reduce the complexities and costs of structuring and operating employee share schemes for start-up companies to help them be more internationally

competitive. Measures that were discussed included simplifying the valuation methodology of unlisted equity issued by start-up companies under such schemes, and developing standardised documentation for a basic scheme.

Despite it being anticipated that the recent Federal Budget could include an announcement of the above reforms, no such announcement was made. It remains to be seen whether reforms of this type will be introduced specifically for start-up companies, or whether the potential tax changes referred to above will sweep aside the need for any specific reforms for these companies.

ARE THERE OTHER REGULATORY REFORMS IN THE WIND?

In addition to having certainty around the likely tax position for employees receiving equity, companies making offers to their employees need to ensure that they meet all other legal requirements and seek expert legal and tax advice to ensure their employee shares schemes are properly structured.

In addition to being aware of general employment law obligations and the interplay with other employee benefits and entitlements, employers need to understand reporting obligations to both the Australian Taxation Office and employees holding equity, and privacy and data protection issues.

Also, companies (whether foreign or domestic) offering options, shares or other forms of equity to employees in Australia must comply with the disclosure requirements of the *Corporations Act 2001* (Cth). Those requirements normally include the need for the company to issue a prospectus or other disclosure document to those employees, unless the company can rely upon an exemption.

Broadly speaking, a company may be exempted from issuing a prospectus/disclosure document if an equity grant will be made to fewer than 20 people (including employees) in 12 months raising less than AU$2 million, and/or the grant will be made only to management-level employees of the company or sophisticated/professional investors.

In addition, relief from those requirements can also be obtained where a company meets the requirements set out in the Australian Securities and Investments Commission's Class Order 03/184. While Class Order 03/184 provides some relief for listed companies offering specific forms of equity to employees, the relief provided to unlisted companies under Class Order 03/184 is very limited.

In November 2013, ASIC released a consultation paper on its proposed changes to its prospectus/disclosure relief for securities issues under employee equity schemes. It also published a new draft updated Regulatory Guide 49 which aims to provide general guidance on ASIC's views on prospectus/disclosure relief and includes details of a new Class Order that it is proposed will replace Class Order 03/184.

In general terms, ASIC has proposed updating and broadening its current employee share scheme class order relief and regulatory guidance in response to developments in market practice and the need for clarity. Specifically, potential reforms being considered by ASIC include:

- expanding and clarifying the classes of financial products offered under employee equity schemes that will have relief under the new class order (e.g. performance rights);
- providing guidance on the types of employment or employment-like remuneration arrangements that are excluded from relief under the new class order (e.g. to exclude commission and bonus arrangements);
- broadening the categories of participants in employee equity schemes that will have relief under the new class order (e.g. to include prospective employees, casual employees, contractors and non-executive directors subject to meeting certain conditions);
- extending relief to offers made by listed companies under employee equity schemes to employees of their "associate bodies corporate", and not only their "related bodies corporate";
- changing the requirements for trust, contribution and loan arrangements to obtain relief under the new class order, which provides companies with greater flexibility for structuring employee equity schemes;
- expanding the types of offers made by unlisted companies under employee equity schemes that will have relief under the new class order (e.g. offers of shares valued at $1,000 or less, options and performance rights subject to meeting certain conditions); and
- reducing some of the administrative requirements currently imposed by Class Order 03/184 (e.g. replacing the current requirement to provide offer documents to ASIC with a simpler notification requirement).

We expect the final form of the new regulatory guide and the new class order will be released shortly, given ASIC's previous indications around timing. Together with the Federal Government's potential tax changes in this area, this change to Australia's securities law framework will only further enliven the opportunity for companies to offer equity to their employees.

WHAT SHOULD COMPANIES DO?

Implementing employee share schemes involves ensuring compliance with laws in a number of different areas, including securities laws, employment laws and tax. The existing rules can create confusion for employees and employers in relation to the equities offered, and if not properly understood and complied with, may trigger counter-productive outcomes.

Although an announcement in relation to the proposed tax changes seems imminent, any changes will likely involve a review of the existing rules and proposed rules, which will include a consultation process. Accordingly, it is not clear when the proposed rules will apply.

Companies should continue to seek expert assistance when setting up a new employee equity scheme or making new offers under an existing scheme in Australia, while keeping abreast of these developments.

We will continue to keep you informed of any major developments in these areas of reform.

MORE INFORMATION

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