YOUR Knowledge

Should you give your employees shares in your company?

There is a lot being written about employee share schemes (ESS) right now. And rightly so. Reforms before Parliament will make these schemes more attractive with a common sense approach to how they are taxed and special incentives for start up companies to share the rewards of growth with the people who help create that growth.

As the reforms apply to shares and options issued from 1 July 2015, it's important that employers do not issue new shares or options prior to this date if they want the new rules to apply to those shares or options. If the shares or options are issued prior to this date they will be caught under the current, more onerous rules.

What does an employee share scheme do?

Employee share schemes are a way for businesses operating through company structures to provide employees with an ownership stake and share in the growth of the company or its parent. The main purpose of employee share schemes is to align the interests of employers and employees as both parties will be working towards a common goal.

Under an ESS, employers issue shares (an ownership stake) and/or options (a right to acquire shares at a later date) to their employees at a discount to the market value of the shares or rights.

A range of conditions generally applies to determine when and how the employee can access those shares. For example, in many cases employees will not have full access to the shares until they have been employed by the company for a certain number of years or certain performance targets have been satisfied. These conditions can lead to reduced staff turnover and higher levels of productivity. This is because the employee would generally forfeit the shares if the conditions are not met.

A shareholders agreement may also be put in place to control when, how and who the shares can be sold to once the employee is able to exercise the rights.

The reforms before Parliament address how and when employees are taxed on those shares and the regulation of share schemes.

How will the new rules work?

At a very high level, when an employee receives shares or rights under an employee share scheme they are taxed on the discount they have received.

The discount is taxed much in the same way as salary or wages. 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 Depending on the way the scheme has been structured, the employee may be able to defer the taxing point until a later point in time (many years later in some cases) and concessions may also be available to reduce the amount that is subject to tax.

As with the current rules, it will still be necessary to work through a number of conditions to determine whether an employee is able to defer the taxation of the shares or rights they have received. If these conditions are met and the employee has been provided with shares, the taxing point will be the earlier of:

- When the employee leaves the employer;
- 15 years after the shares were acquired; or
- The point where the employee can sell the shares without restriction.

If the conditions are met and the employee has been provided with options to acquire shares then the taxing point will be the earlier of the following:

- The employee leaving the employer;
- 15 years after the right was acquired;
- The point where the employee can sell the rights without restriction; or
- The right is exercised and there is no real risk of the employee forfeiting the resulting shares and there are no restrictions on the employee selling the shares.

In general, the new rules enable the taxing point to be deferred for a longer period of time until the point at which it becomes clear that the employee will actually derive some economic benefit

Quote of the month

"Experience is simply the name we give our mistakes."

Oscar Wilde

from the shares or options they have received.

The reforms also introduce special incentives for start up companies. Start up companies are unlisted companies that have been incorporated for less than 10 years and have an aggregated turnover of $50m or less in the income year prior to the introduction of the share scheme. Where the start up is part of a corporate group, all companies in the group must also meet these requirements. There is a carve out for certain venture capital funds from this turnover test and 10 year incorporation rules for start up companies.

One of the concessions that will be available for employees of these start-up companies is that small discounts received in relation to shares or rights are not taxed at all under the ESS rules. For shares, the discount offered cannot be more than 15% of the market value. For rights, the strike price must be equal to or greater than the market value of ordinary shares in the company at the time the right is acquired. If the relevant conditions are met the discount should not be taxed but it will still be necessary to deal with the capital gains tax implications on eventual disposal of the shares or rights.

The new rules also tidy up the interaction with the capital gains tax (CGT) system for employees of start-up companies to make it easier for them to access the 50% CGT discount. Normally, when someone exercises an option to acquire shares, the 12 month holding period rule is reset, which means the shares need to be held for another 12 months to access the CGT discount on sale. Under the new rules, the 12 month period will be measured from when the rights were acquired.

When should your company contemplate an employee share scheme?

Share schemes are typically used as an incentive to retain and attract key team members. They can be particularly useful in a start-up environment where there is not necessarily the cash available to attract top quality employees with high salaries. As team members cannot realise the value of the shares for an agreed period of time, the scheme locks them in for this period or they lose any benefit. Beyond the 'golden handcuffs', offering employees the ability to invest their talent in a tangible growth asset rather than just receiving a salary is a powerful incentive.

It's important that there are strong rules and documentation around how share schemes are managed. For example, if an employee holds shares acquired through an ESS but then leaves the company, can they sell the shares to anyone or will they be restricted to selling the shares back to the company or existing shareholders based on an agreed valuation formula? The risks to the company of having a broad array of shareholders need to be carefully thought through.

How do you establish an employee share scheme?

It's really up to the company and its current owners to determine how the ESS is structured. However, the scheme is more likely to be successful in aligning the interests of employers and employees if it is structured in a way that is tax effective for the employees who will be participating in the arrangement.

For example, in order to access many of the concessions that are available under the rules there are some common conditions that need to be met. These are:

- The scheme should not result in any one employee holding more than 10% of the shareholding or controlling more than 10% of the voting power of the company;
- The shares offered under the scheme need to be ordinary shares;
- The company's main business must not be share trading; and
- The individual needs to be employed by the company issuing the shares or one of its subsidiaries.

Before implementing an employee share scheme it is important to ensure that both the commercial and tax issues have been fully considered. You will need professional support including commercially aware legal advice and documentation, tax advice and business structuring advice. Generally a valuation of the business would also need to be undertaken to establish the discount that is being offered. There is no one size fits all method.

The Australian Tax Office is working on standard employee share scheme documentation and valuation safe harbours. While companies do not have to rely on these documents they will go some way to standardising how these schemes are implemented and the minimum requirements and standards.

Contact us to explore whether an employee share scheme is right for your business and how to structure it to get the right result.