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A Guide to Employee Share Schemes & Stock Option Plans

Motivating Employees and Managing Tax

Contents

Competition for top talent, a boom in entrepreneurship and employment law reforms have seen the implementation of employee share schemes become a popular and accessible strategy for growing Aussie businesses in recent years.

For many of our clients, and at BlueRock, the model is an effective approach for attracting and rewarding key people, and an important part of good business succession planning.

This guide takes you through the basics of how employee share schemes work, for business owners and employees, as well as the complexity of tax concessions and the process for getting started.

What is an Employee Share Scheme?

An employee share scheme (ESS) is an arrangement under which an employer allocates a portion of a company's ownership, or the right to acquire ownership, to their employees, often at a discount to the current market value, and in many cases for free.

Why would an employer choose to implement an ESS?

Employee share schemes allow employers to be more competitive in attracting the best employees, preserve the employer's cash by paying non-cash remuneration, align the interests of employees with the employer and give employees an incentive to remain with the employer.

Some methods of funding acquisition of equity under an ESS include:

- Salary sacrifice
- Loans from an employer
- Full up-front payment
- Applying performance bonuses

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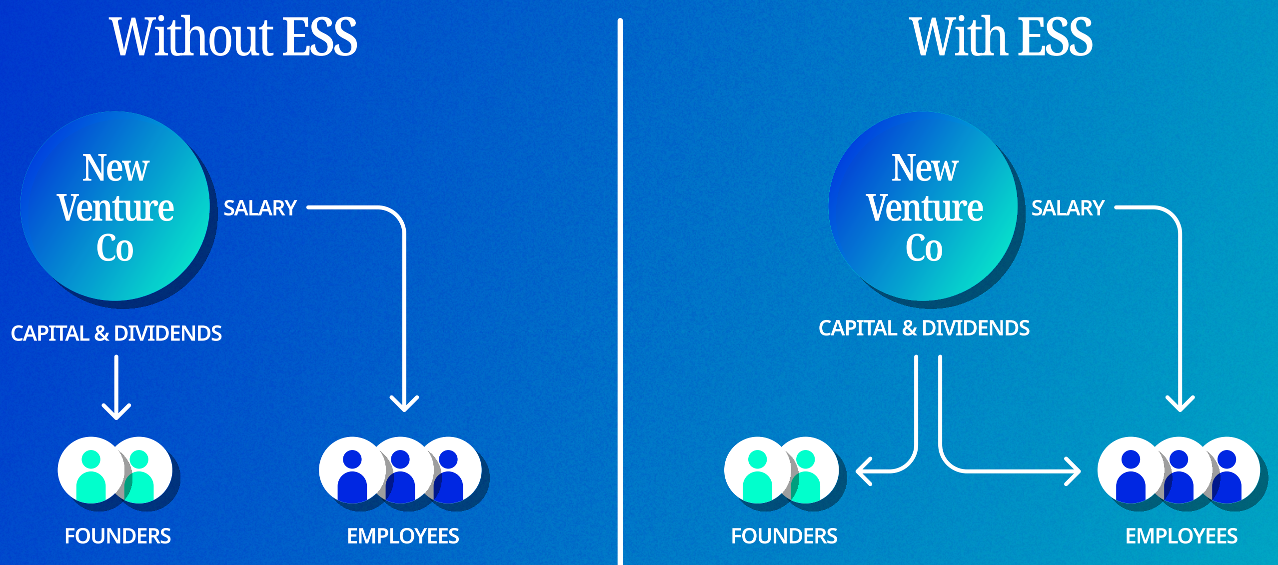

Wealth has increased from more income and capital assets in shares.

There are typically 3 kinds of Employee Share Scheme interests offered under a scheme:

Shares (ESS)

Shares represent a direct ownership interest in the capital of a company. Employees benefit from any growth in the value of the shares.

Stapled Securities

A stapled security is created when two or more different securities are legally bound together so they can't be sold separately. At least one of the securities stapled together must be an ordinary share in the company.

ESOP (Options)

An option is the right but not the obligation to acquire a share or stapled security. Options generally have an expiry date, which is the date the option lapses. Options also have an exercise price, which is the predetermined price that the employee will pay for the shares or stapled securities when they exercise the option. Options also have an option premium, which is the price an employee must pay to buy the option. In some cases, this option premium may be $0.

Issue Limitations

1

Issue Cap

There is no cap on issues made for no monetary consideration. Where there is monetary consideration, a 20% limit of issued shares can be allocated to employees of an unlisted company and 5% of a listed company.

2

Monetary Cap

The total a participant can pay for their shares or options cannot exceed $30,000 on offers over a 12-month period ($150,000 accrued over 5 years for unexercised options), plus 70% of any dividends and 70% of cash bonuses received in that year.

Trust Arrangements: Employee Share Trust

In an employee trust arrangement (EST), the underlying shares are held for employees either on an allocated (i.e., held for specific employees) or unallocated basis (i.e., in a pool for participating employees).

A trust arrangement that is an EST is useful because:

- They avoid the requirement to cancel shares if the issuer of the shares were to buy back shares
- Forfeited equity from employees can be recycled, avoiding the need to issue new equity (thus avoiding the dilutive effect on existing shareholders) and having to seek shareholder approvals
- Only one shareholder (the trustee) is recorded on the share register, instead of each employee shareholder, enabling privacy
- Employee trust arrangements are disregarded for most CGT purposes, as equity is broadly treated as owned directly by the beneficiaries of the trust
- Contributions made by the employer company to the trust are exempt from fringe benefits tax.

The Benefits of Employee Share Schemes (ESS/ESOP)

Attract talent with competitive salaries

To build great products and services you need great talent, and that can come at a price. In industries where there is high competition for skilled labour, the best employees can quickly become out of reach for a business; for instance, those that experience tight cash flow as a result of ambitious growth plans.

Businesses that have high potential future value but limited access cash can offer employee share/option schemes to attract employees with the prospect of future wealth, as a partial substitute for current market wages. Simply put, a higher market value of shares = higher personal net wealth for employees.

Retain talent

When employee share schemes are linked to the length of tenure of an employee, a lock-up period can exist that prevents an employee from selling their shares or receiving income for several years.

To access the increased wealth, an employee must stay connected to the business for a defined period. In short, it ties them to your business for a certain length of time, allowing better capacity and capability planning for the future.

Shift the mindset from employee to business owner

To encourage staff to go beyond their daily tasks and pursue an active role in building the business, a stake in the business can be used as motivation. It helps to grow the pie, so everybody can have a piece of a bigger pie.

You may think of this scenario as 'Agency Costs', and effective employee share/option schemes will help to reduce these costs significantly.

In this case, employee share schemes can be issued based on key metrics for the business being reached by either the business as a whole or a particular individual reaching key milestones in a defined period of time.

Enjoy the Benefits of Tax Concessions

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$1,000 up-front concession

The discount on a share or right to acquire shares under an employee share schemes is generally included in the employee's assessable income. The amount may be reduced by $1,000 if certain conditions are met.

Start-up concessions

Instead of the discount on the equity received being included in the employee's assessable income, the share is taxed as a capital gain when the share is disposed of with their cost base being reset to their market value on acquisition and the general 50% CGT discount being available if the share has been held for at least 12 months.

For options, the discount is not taxed upfront, the options are subject to the CGT rules and have a cost base equal to the employee's cost of acquiring them.

This concession is intended to enable start-ups to set aside more cash for growing the business, which may have previously been used to remunerate key employees. The ultimate goal is to make Australia more attractive to innovative start-ups.

Note that companies that are eligible for start-up concessions cannot access the $1,000 up-front concession.

Tax deferral

When a business is not eligible for start-up concessions, business owners may still be able to provide an employee with tax deferral on employee equity. This means the employee isn't taxed until certain milestones are met, such as they become eligible to sell the shares or their employment ceases.

This avoids unintended consequences where an employee is provided shares or options and then receives a hefty tax bill without the cash to fund it, despite holding shares or options of value.

The Risks of Employee Share Schemes

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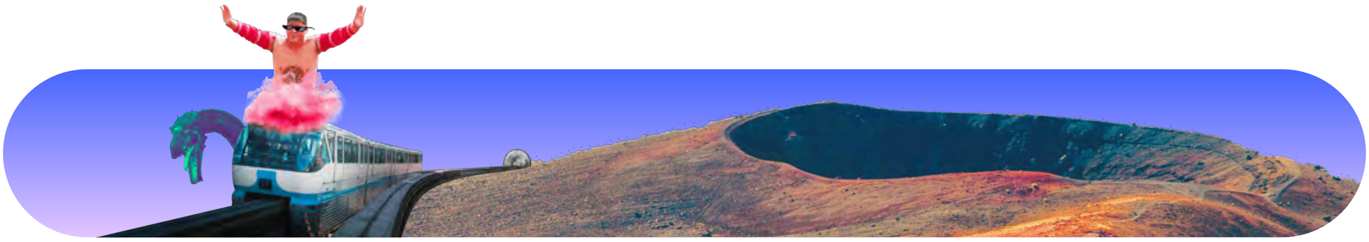
While there are countless benefits to an effective ESS, there are some pitfalls to watch out for if an employee share scheme is not managed or implemented in accordance with the rules.

De-motivation

If the employee can't influence the share price based on their day-to-day role, motivation can often wane, and have the opposite of the desired outcome.



Dilution of equity

The introduction of an employee share scheme means existing shareholders will often experience dilution of their ownership. If the process and communication around why an employee share scheme is being introduced is mismanaged, it can cause resentment and tension between shareholders.

Misunderstanding

If an employee or existing owner doesn't understand the terms, conditions and/or implications of an employee share scheme, then it can put a strain on relationships within a business. Ultimately, as with everything, communication is key.

10 Steps to Implement an Employee Share Scheme

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1

Discovery session

Before an ESS can be considered, all key stakeholders should gather with an ESS expert to hash out the finer details of whether an ESS is the right plan for your business. Consider things such as the business' commercial drivers, the strategy of the business, key stakeholder priorities from a business and personal standpoint, succession planning, and the owner's view of the business valuation.

2

Entity valuation

Prepare a valuation for the entity in question (can be high level). If the company is a genuine start-up and there is no current value, then the approach will be quite different to an established company with significant value.

3

Build a current capital table

The directors will need to determine what percentage or company value will be available for employees to participate in the ESS and how this will affect current shareholders over the period in question. There is a 20% limit on the number of underlying shares that may be issued under the offer, when aggregated with offers made under an ESS in the previous three years.

4

Shareholder agreement

If you don't have one, get one prepared. The shareholders agreement will set the ground rules for the broader shareholder group. This document governs how decisions are made, dividends are declared and disputes are resolved. Incoming minority shareholders will need to be a party to this agreement.

5

Tax advice

Ensure the appropriate tax advice is in place for both the employer and the employee. There are several pathways to explore when it comes to ESS, so it's important to obtain advice to maximise the opportunity for all involved.

6

Plan documentation

These documents are the backbone of how the scheme is to work. Employees can understand the trigger events that need to occur for them to participate in the ESS, restraint requirements among the nuts of bolts of price determination and discounts.

7

Employment contracts

Review and update these to ensure they are consistent with the ESS policy.

8

Offer document

The offer document must be clear on what instrument is on offer (e.g. shares or options), the conditions of entitlement under the offer, and key terms such as exercise price and discount to market value.

9

Shareholder's register

All changes in shareholdings must be recorded on the member's register and lodged with ASIC.

10

Ongoing compliance

Employers are required to lodge annual ESS Statements with the ATO for employees at various stages throughout the scheme.

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Get in Touch with our Experienced Employee Share Scheme Advisors

Employee share schemes are a fantastic way to incentivise your staff and align them with your company vision, but it's important to structure and implement your ESS correctly to avoid costly mistakes when it comes to the complexity of legal, accounting and tax implications.

BlueRock has both real-world experience and expert advisors who can talk through the details of employee share schemes and how they can work for your business.

Reach out for a free consultation on employee share schemes.

Get in Touch

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