EMPLOYEE SHARE SCHEMES

INCENTIVISING STAFF IN A TIGHT JOB MARKET

Setting up Employee Share Schemes (ESS) in private companies can be a complicated process. We have outlined three alternatives that seek to reduce complexity.

START-UP CONCESSIONS

CASE STUDY | FINTECH COMPANY

Start-up concessions are incredibly helpful for businesses that qualify. Our Fintech client wanted to retain their personnel, but could not offer competitive salary packages because of start-up cash restraints. There were no immediate plans to list or sell the business.

BDO proposed implementing an ESS, something the business had not previously considered.

The client issued options, which satisfied the start-up conditions*. From the client's perspective, the impact of the start-up concessions was clear, as:

- ESS interests are ordinarily taxed upon issue, with the employee liable to pay tax on any discount provided
- Being able to access the start-up concessions meant the unrealised gains were not taxed on issue or exercise of the ESS interest
- Instead, the unrealised gains were taxed at a later point being the ultimate disposal of the shares
- The ESS interests were taxed on capital account rather than the employee's marginal tax rate, resulting in a 23.5% saving on the gains.

OUTCOME

Ultimately, the client used the start-up concessions to improve the attractiveness of its ESS scheme and incentivise its employees to improve performance and retain key staff.

START-UP CONDITIONS

**For start-up concessions to apply, the following conditions must be met:*

- *The concessions must relate to ordinary shares*
- *The company must be an Australian resident taxpayer*
- *The ESS interests must not be from a listed company or be in a group of companies with another listed company*
- *The issuing company must have been incorporated for less than ten years*
- *The aggregate turnover of the issuing company, together with the group, must not exceed $50 million*
- *There must be broad availability of the scheme to at least 75% of permanent employees with at least three years' service*
- *The ESS interests must relate to ordinary shares*
- *Where the ESS interest is a share, the discount must be no more than 15% of its market value when provided*
- *Where the ESS interest is a right, the amount paid to exercise the right must be greater than or equal to the market value of an ordinary share in the company when provided*
- *The employee must hold the ESS interests for a minimum of three years or until the employee ceases employment*
- *The employee must not beneficially own shares in the company, or control its voting power, beyond a 10% limit.*

TAX-DEFERRED OPTION PLAN

CASE STUDY | BIOTECH COMPANY

Our biotech client wanted to use start-up concessions, but could not meet the basic criteria as it was a listed company. Instead, BDO advised the client that the terms of the ESS could be altered, entitling employees to defer the taxing point on their ESS interests.

In particular, options were issued with a requirement that:

- The employee must remain employed up to exercise date in order to entitle the employee to exercise the options (real risk of forfeiture)
- There was a restriction on the disposal of the shares until a liquidity event occurred or the sale received Board approval (further disposal restriction).

Although employees were still subject to tax on the options issued at their marginal tax rate, employees could cover their tax liability without the need to spend their savings on shares they may not have seen a return on.

OUTCOME

Employees would not be out of pocket with this approach, thus helping the client ensure its key employees would remain with the company and work towards common goals.

TAX-DEFERRED CONDITIONS AND TAXING POINT

This alternative is usually undertaken with options, and tax on these ESS interests will be deferred until a liquidity event or Board approval occurs. The following conditions must be present:

- *Options will be forfeited if the employee leaves before the vesting date (thereby resulting in a real risk of forfeiture)*
- *Exercise price can be $nil or an amount less than the market value of the shares at grant date of the options*
- *Sale of the shares is restricted, even where options are exercised (thereby resulting in a further disposal restriction).*

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2,141
PEOPLE
12 OFFICES
245 **PARTNERS**
FIGURES TAKEN AS AT 01 APRIL 2022

EMPLOYER LOAN FUNDED SHARE PLAN

CASE STUDY | TOURISM COMPANY

A common challenge faced by many industries is an incredibly competitive hiring market. One option which is available to more established businesses is to offer an employer loan funded share plan.

This plan requires employers to make an interest-free limited recourse loan to employees, allowing them to purchase shares in the employer for market value. As a result, no discount is subject to tax at the employee's marginal tax rate.

Our client in the tourism industry faced this situation and was seeking to retain its key employees while limiting its cash outlay. As a more established business, the client saw the benefit of this option as there was less risk associated with the fluctuation of the share's market value.

The client issued the employees with shares at market value (as advised by BDO), which meant no tax was payable on the issue because the ESS provisions did not apply.

More importantly, because the client was providing a loan equal to the exercise price, the employee was not out of pocket for any immediate tax liability or for the exercise price. Any subsequent uplift in the share price was subject to tax under the capital gains tax provisions.

OUTCOME

From the client's perspective, they were able to incentivise and retain their employees to ensure the success of their business. Similarly, employees could acquire shares and pay back the loan over time, all while sharing in the success of the business.

EMPLOYER LOAN FUNDED SHARE PLAN

The ESS provisions will not apply to the shares because they have not been provided to the employee at a discount.

Division 7A should not apply because the loan has been provided to the employee prior to them becoming a shareholder.

The employee will need to repay the loan to the employer per the relevant conditions of the loan agreement between the parties.

The following conditions must be met for this to apply:

- *The purchase price is the market value of the shares at the time of grant*
- *The loan is provided to the employee prior to shares being issued (and the employee must not already be a shareholder)*
- *The loan can be interest-free (subject to commercial arrangements between the parties) on the basis that the otherwise deductible rule applies for Fringe Benefits Tax (FBT) purposes.*

CONTACT US

A range of factors need to be considered when determining the best approach for a company. If you need support or would like to discuss your situation, contact a BDO Tax adviser to find out what would suit your company best.

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