Submission to Treasury

Employee Share Schemes

April 2019

mi-fi
Accountants + Advisors

Lewis Holdway
LAWYERS

30 April 2019

Ms Nathania Nero
Senior Policy Adviser
Consumer and Corporations Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Ms Nero,

Enclosed is our submission in response to the request for feedback and comments in relation to the Consultation Paper regarding Employee Share Schemes ('ESS') dated April 2019.

This submission is made jointly by the following parties.

mi-fi	**Lewis Holdway Lawyers**
mi-fi is an accounting and advisory firm located in Melbourne with a focus on advising entrepreneurs and professionals with smart ideas and amazing support. mi-fi's clients are predominantly startup and small to medium sized enterprises up to $50m in revenue and 200 employees.	Lewis Holdway Lawyers has been serving small to medium enterprises in the areas of dispute resolution and commercial law since 1991 and is passionately committed to providing results-focussed solutions to legal issues arising in day to day business.

Submission Structure

Our submission includes two parts as follows:

Part 1: Issues and recommendations

This part outlines the issues we see with the current legislative environment and our suggestions for improving it.

Part 2: Answers to Consultation Paper

This part directly answers the questions posed in the Consultation Paper with reference to Part 1 where relevant.

Our Experience

mi-fi's experience with ESS has been largely driven by the changes made on 1 July 2015 to taxation law including the introduction of the 'Startup Concession'. Since that time, we have implemented a number of ESSs under the Startup Concession. As a result, we have experienced firsthand the issues faced by small to medium enterprises and their advisors. Many of these the Consultation Paper seeks to address

Lewis Holdway Lawyers has had broad experience: advising listed and unlisted clients on structuring and reviewing ESSs; assisting accountants and corporate advisers to understand the connection between ESSs and disclosure and licensing laws; and assisting employees to understand offers made under ESSs.

Together, mi-fi and Lewis Holdway have worked closely together developing ESS documentation and helping SME clients navigate Tax and Corporations Legislation.

Our View

We agree with the Government's position stated in the Consultation Paper that '*small business must have the support they need to attract the right staff to help their business grow and prosper'.*

ESSs are a powerful tool to achieve this position. However, as we have found through our experience the current legislative and regulatory frameworks are not conducive to the adoption of ESS by small and medium sized enterprises.

We believe the primary aim of ESSs should be to align the goals of the employees with the success of the employer, so that all parties benefit, rather than as a tool to remunerate employees.

The structure of the legislation supporting the operation of the ESSs needs to reflect the balance between the compliance cost to the employer with the need to adequately protect employees that are offered interests in an ESS.

We welcome the opportunity to assist with reform in this area. Should you or your colleagues wish to discuss our submission in further detail, please contact us.

Yours sincerely,

Campbell King

Partner | mi-fi

e: cking@mifi.com.au t: (03) 9081 0111

Peter North

Director | Lewis Holdway Lawyers

e: petern@lewisholdway.com.au t: (03) 9629 9629

Issues and Recommendations

Issue: **Inconsistencies between Tax and Corporations Legislation increase the cost of advice for SMEs looking to implement an ESS.**

Interaction between Tax Legislation[1] and Corporations Legislation[2] is complex. When dealing with SME clients who wish to implement an ESS, advisors are often driven by a single body of legislation. Accountants by taxation legislation and lawyers by the Corporations legislation.

It is understandable that a single advisor cannot be across such a wide body of legislation and as such SME advisors may lack an appropriate understanding of the other body of legislation along with the interaction between the two. Whilst this does not absolve advisors of their obligations to educate themselves and their clients and to be diligent in their advice, it does put in place a barrier to adoption of SMEs by reducing the advocacy of ESS by advisors to their clients.

Our experience has shown that, when accountants and lawyers work closely together, companies can make the implementation of an ESS positive and affordable. However, broadly we believe that the inconsistency between tax and disclosure legislation as a core factor in reducing the affordability of an ESS for SMEs who may otherwise adopt one.

The changes to the Taxation Legislation that brought into existence the Startup Concession are commendable and our experience has been that this has resulted in an increase in clients implementing or considering implementing an ESS.

These measures were celebrated as making ESS for SMEs simpler. From a taxation perspective this has been true, with the Startup Concession improving the ease at which eligible companies can implement an ESS and the taxation treatment making ESS more attractive to employees.

However, the Corporations legislation creates a number of legislative traps for employers and their advisors that can trip up employers acting in good faith to implement an ESS.

Recommendation: *Align the Corporations Act 2001 (Cth) and relevant regulations with the taxation legislation related to ESS for SMEs*

As an overarching principle we believe that when Corporations Legislation regarding ESS is formulated, Tax Legislation should be considered and to the extent possible, aligned.

Alignment between these bodies of law will remove barriers to adoption of ESS by SMEs, consistent with the Government's policy aims as set out in the Consultation Paper.

[1] Corporations Legislation means the Corporations Act 2001 (Cth) and any associated regulations and instruments created under it.
[2] Tax Legislation means the Income Tax Assessment Act 1997 (Cth) and/or the Income Tax Assessment Act 1936 (Cth) (as applicable) and any associated regulations and instruments created under either.

Issue: **The cost of valuing the securities for the purposes of meeting the conditions related to value in the ASIC Class Order 14/1001 ('ASIC Class Order') is prohibitive for an SME.**

ASIC Class Order for unlisted companies CO 14/1001 *Conditions related to value*	
Limit on Value per offer ('Issue Limit')	Up to $5,000 per employee per year
Maximum amount to be paid by employee ('Exercise Limit')	No more that nominal monetary consideration. If more than nominal consideration is payable on exercise of options or units, then an expert valuation must be provided.

In order to value the ESS interests being offered to ensure they do not breach the Issue Limit, an SME would be required to engage the services of a professional.

In the case of the Exercise Limit, a valuation is expressly required where 'more than nominal consideration is required'.

Given that a properly conducted professional valuation of an SME will cost thousands of dollars or more, this requirement will prohibit many SMEs from making use of the relief. At the least it will create, for the employer and their advisors, a level of uncertainty about their adherence to the conditions. In addition, it is difficult to accurately value an SME, especially in the case of a business that may be innovating with an unproven business model or product.

In the case of the Startup Concession, the Safe Harbour Valuation methods outlined in Legislative Instrument (ESS 2015/1) must be used to ensure that concessional tax treatment of an option granted to an employee. This may result in more than nominal consideration being required to be paid in connection with the offer.

A valuation under this instrument may not meet the requirements of a valuation for the purposes of meeting the Issue Limit condition. This creates a situation where an SME may be required to obtain two valuations using different methodologies, further increasing the costs and complexities involved to obtain relief from both taxation and disclosure laws.

Recommendation: *Provide a 'Safe harbour' valuation methodology or methodologies.*

The Startup Concession, Legislative Instrument (ESS 2015/1) provides a prescriptive 'Net Tangible Assets' method. This method provides small entities a simple calculation to arrive at a value of their ESS interests that the Commissioner of Taxation will accept.

Much like the safe harbour methodologies have achieved from a tax perspective, such a methodology for the purpose of accessing relief from the Corporations legislation will provide certainty and affordability for SMEs.

One option would be to align the safe harbour valuation methodologies with those provided by ATO legislative instruments. Or at least provide an alternative prescriptive methodology that is as easy to conduct for meeting the relief conditions.

Limiting the use of these methodologies to smaller entities will appropriately align to their propensity to afford a valuation.

Recommendation: *Where options are offered and the exercise price has been determined by a safe harbour valuation methodology, that only the intrinsic value of the option be counted toward any Issue Limit*

Options have both an intrinsic value determined by reference to the exercise price and a time value. Any option issued with an exercise price that is greater than its current value, by its nature has no intrinsic value. Furthermore, ESS securities are generally restricted from being traded, eroding their time value. Therefore, the value of an option with these characteristics is likely to be minimal.

In conjunction with a prescriptive safe harbour valuation method, we believe that any relief should state that any value other than the intrinsic value of an option be disregarded for the purposes of any Issue Limit. Doing so will remove the need to consider additional factors in a valuation of the options themselves and allow a company to use a single safe harbour valuation method for the purposes of determining the exercise price and the value of the options themselves.

Recommendation: *Where options are offered and the exercise price has been determined by a safe harbour valuation methodology, remove the requirement for a valuation document to be provided prior or exercise or vesting of the options as per clause 18 of CO 14/1001.*

We believe the requirement to provide a valuation document to employees each time their options vest is onerous for SMEs. It should be removed where the original offer has been made in line with relief requirements that may include a safe harbour valuation methodology.

Issue: **The current structure of relief mechanisms in the Act and ASIC Class Order 14/1001, results in a trade-off between using relief for raising capital and relief to issue ESS securities.**

Class Order 14/978 modifies the Corporations Act 2001 (Cth) to include the following clause in section 708(5) after paragraph (a):

"(aa) do not need a disclosure document because of an instrument made under section 741".

Class Orders 14/1000 and 14/1001 are instruments made under 741.

To avoid using up the cap available under section 708 an entity seeks to rely on ASIC Class Order 14/1001, if possible. This ensures that the company's ability to raise capital through personal offers is not constrained.

However, clause 29 (b) of ASIC Class Order 14/1001, restricts the offer of ESS securities made under the class order to:

(i) an immediate family member of the eligible participant;

(ii) a company whose members comprise no persons other than the eligible participant or immediate family members of the participant;

(iii) a corporate trustee of self-managed superannuation fund (within the meaning of the Superannuation Industry (Supervision) Act 1993) where the eligible participant is a director of the trustee;

As a result, employees are restricted from using a discretionary or family trust as an entity to hold their ESS securities. Likewise, they are restricted from using a self-managed superannuation fund where the trustees are individuals.

Such a restriction imposes an unnecessary burden on an employee by restricting them from choosing the most appropriate vehicle for their needs. It may also reduce the attractiveness of an ESS to an SME where it is required to make personal offers to employees in order to access disclosure relief. This may come at the expense of their ability to raise capital under the same relief.

Furthermore, this situation may create an uneven playing field amongst SMEs depending on their ability to issue ESS interests where the individual employee is not able to meet the requirements for the relief.

Recommendation: *The definition of eligible offer should be expanded to include offers to a corporate or individual trustee of a discretionary trust of which the employee is a beneficiary or an individual trustee of a self-managed super fund of which the employee is a beneficiary.*

An eligible offer would still be limited to the Issue Limit condition currently contained in ASIC Class Order 14/1001 (or any future equivalent relief).

We believe that employees should be free to choose the most appropriate structure to hold their ESS securities according to their circumstances. They should not be restricted by the relief. Doing so puts the employee and employer at odds and undermines the ability of a company to make offers of ESS securities that result in a positive outcome for all participants.

It would be reasonable to continue to treat offers that exceed a value limit as counting toward the personal offer cap contained in s708 where another exemption did not apply. Offers made in excess of the value limit, especially those requiring monetary consideration, are likely to take some form of capital raising and therefore should be treated as a personal offer.

Issue: **The term 'Nominal' is ambiguous and likely to cause uncertainty among SMEs looking to make use of the ESS relief.**

We believe the term 'Nominal' has the potential to be misunderstood by SMEs and creates uncertainty.

Recommendation: *We recommend that the word 'nominal' be removed from the requirement for relief, and that more proscriptive language is used in the relief so that SMEs can be confident that they have met the condition.*

Issue: **The relief does not distinguish between contribution plans and loan plans.**

We believe that there is a difference between an ESS that requires monetary contributions and an ESS that uses a loan from the employer to the employee to acquire shares in circumstances where the loan is a non-recourse loan secured only against the ESS interests.

We believe that ASIC's current position of considering a loan as a monetary contribution in such circumstances is incorrect and unnecessarily restricts employers from structuring an ESS as a share plan.

Recommendation: *We recommend that loan funded share plans be distinguished from those requiring a contribution in the form of cash or wages and allowed under the relief.*

Loan funded shares plans are a useful way for employers to structure an ESS that allows them to issue shares to employees without the need for the employee to make

a monetary contribution in cash in circumstances where the loan is a non recourse loan secured against the ESS interests only.

We believe that appropriate restrictions, such as non-recourse conditions on a loan, can remove the risk of loss to an employee.

Answers to Consultation Paper questions

Consolidating and simplifying existing exemptions and ASIC relief

1.1 Do you support consolidating and simplifying the statutory exemptions and ASIC Class Order [CO14/1001] in the Corporations Act?

Yes.

1.2 Does the complexity of the current regulatory framework for ESSs create significant difficulties for businesses looking to offer an ESS?

Yes.

As highlighted in the issues identified earlier, our experience has shown that the current regulatory framework adds costs in time, money and the potential to get it wrong.

This means SMEs are less likely to adopt an ESS and where they do, there is a high potential to be tripped up by the current framework.

1.3 Would there be significant benefits or risks for business in consolidating and simplifying the current regulatory regime?

We believe that significant benefits for business would arise through consolidation and simplification of the current regulatory regime.

1.4 Would compliance be significantly easier if the obligations applying to ESSs were all contained in the Corporations Act?

Yes.

However, we believe that ASIC should retain some ability to set regulation with regard to ESS, allowing it to consider changes to taxation laws regulations and where appropriate align the relief with those laws and regulations.

For example, if a safe harbour valuation method were to be adopted, the methodology would be better contained in an ASIC Class Order than within the Corporations Act itself.

1.5 Are there significant advantages or disadvantages in using ASIC class orders as opposed to primary legislation to regulate ESSs?

Our experience has shown that multiple sources of regulation creates considerable work in considering if disclosure relief is available and which area of relief is most appropriate to be used on a case by case basis.

By containing the majority of regulation within the primary legislation we believe it will significantly reduce the time and costs in issuing ESS securities and therefore increase adoption.

As noted in our answer to question 1.4, ASIC should retain the ability to set regulation for ESS where required.

1.6 Are there any requirements or conditions of the ASIC class order that should be removed or amended as part of the consolidation?

Yes.

Please refer to the issues outlined in part one of this submission. In summary, we believe the following amendments should be made to the current class order as part of the consolidation:

- Expand the entities that an eligible participant may renounce an offer in favour of to include:

    - discretionary trusts with either individual or corporate trustees of which the employee is a beneficiary; and
    - individual trustees of self-managed superannuation funds of which the employee is a beneficiary.
- Amend the condition regarding maximum amount to be paid by an employee to:
    - remove the word 'nominal' and provide more prescriptive language; and
    - remove the need for an 'expert valuation' for eligible SME's and replace this with a safe harbour methodology or methodologies aligned with the ATO safe harbour methodology.

  Loan funded share plans should be distinguished from contribution plans and allowed under the relief in circumstances where the loans are non-recourse loans secured against the ESS shares only.

1.7 Should ASIC be given an additional power to determine that a company should not be permitted to rely on a statutory exemption for an ESS?

No.

We believe that appropriately drafted legislation will ensure that those who are eligible to receive relief will do so. Providing ASIC with such a power will undermine the confidence of companies who wish to implement an ESS.

Increasing the offer cap per employee

2.1 Do you support increasing the offer cap per employee?

Yes.

2.2 What are the benefits or risks of increasing the employee offer cap?

We believe that ESS should be a tool of alignment rather than remuneration. However, offers of equity interests may be considered in lieu of payment for at least some portion of services provided by an employee. As such, in some circumstance's issues of ESS securities may be similar in nature to a monetary contribution by an employee.

We are cautious that securities in SMEs are high risk and lack liquidity and therefore increasing the cap may result in an employee foregoing a higher monetary portion of their salary.

Furthermore, they may be taxed on the receipt of the ESS securities as ordinary income at the time they are received or at a time for which they have not received any cash benefit. This may further erode their take home earnings in a given financial year.

2.3 Is a $10,000 limit per employee per year appropriate or is a greater increase appropriate?

We believe that a $10,000 limit is reasonable at this time.

A higher cap could be considered where additional safeguards are in place that the employee is not foregoing higher earnings or that the participation in the ESS is not in lieu of more than the cap in wages.

2.4 Should senior managers (within the meaning of s9 of the Corporations Act) be excluded from this cap?

Yes.

On the basis that senior managers are already exempt from disclosure under s.708 of the Corporations Act, it is reasonable to exempt them from the cap.

2.5 Is the level of disclosure currently required by the ASIC class order for unlisted companies sufficient to address any risk associated with an increased employee cap? Is any additional disclosure or protection necessary or desirable?

In our view, the current level of disclosure is sufficient to address the risk of an increased employee cap. No additional disclosure is required in our opinion.

2.6 Are there any significant advantages or cost savings for business as a result of an increased cap per employee? Please provide details.

No comment.

Facilitating the use of contribution plans

3.1 Do you support contribution plans being able to be used to fund the acquisition of financial products for an ESS of unlisted companies?

Yes, in certain circumstances.

We are cautious that ESS may be used by early stage, high risk ventures to raise capital from their employees. Furthermore, increasing the employee offer cap has the potential for companies to view their employees as a source of monetary capital which in some circumstances may be at odds with the intention of ESS. We believe it is important to distinguish between an employee participating in an ESS and the same person who may wish to make an investment of that kind.

We believe that the current small-scale offer provisions adequately allow for an employer to access relief if looking to raise capital from individuals who may also be an employee of the company.

For that reason, we believe that there should be restrictions on the use of contribution plans for smaller unlisted entities. Without providing specific recommendations in this submission we support thresholds that would allow an unlisted entity to use a contribution plan.

3.2 What are the benefits or risks of allowing unlisted companies to offer contribution plans as part of their ESS?

We believe it will provide more flexibility in the creation of an ESS that aligns with the needs of an individual. The current prohibition on contribution plans under the ASIC Class Order restricts the ability of employers to take advantage of the relief when shares are being offered under the Startup Concession.

As stated in the answer to question 3.1, contribution plans for 'smaller' or earlier stage companies could be high risk investments for employees.

We believe that there are alternative types of ESS adequately cater to this type of company with less risk to the employee i.e. an option plan under the Startup Concession.

3.3 Are any additional protections necessary for employees participating in contribution plans? For example, capping monetary contributions at $10,000 per employee per year or requiring an independent valuation where a contribution plan is offered, or the $10,000 cap is exceeded. Please provide details.

Where a contribution plan is allowed for unlisted companies, we believe limiting the amount contributed per employee is important. We also believe that any cap should be informed from time to time by data on the salaries of employees in companies that are using ESS requiring monetary consideration

For an employee on a salary of $100,000 per year this would equal 10% of their pre-tax earnings. For an employee on a salary of $50,000 per year this increases to 20%.

Whilst we appreciate that a fixed limit is an easier mechanism to use broadly, we believe there may be merit in considering a variable limit based on an employee's salary. Doing so, would ensure that those with the capacity to do so can participate while limiting their risk.

Keeping in mind that employees on higher salaries are likely to be considered senior managers or sophisticated investors and therefore exempt from disclosure under other provisions. Based on this a cap of $10,000 would seem appropriate and align with existing crowd sourced funding provision and the proposal to increase the cap in the existing relief available under the ASIC Class Order.

3.4 Are there any significant advantages or cost savings for business as a result of allowing contribution plans?

Whilst the purpose of allowing contribution plans ought not be fundraising and the cap provides that limitation, allowing contribution plans assist SMEs to offset the cost of complying with ESS regime.

Where the cost of allowing an ESS at the least cost neutral, there will be a more significant uptake in the scheme by unlisted employers.

Allowing contribution plans will also improve the ability of employers to offer an ESS in the form of shares. This will increase the flexibility of an employer to create an ESS that aligns with their needs. Furthermore, considering the discount available on shares issued under the Startup Concession, the tax benefits for employees may be improved when participating in share plan as opposed to an option plan under the Startup Concession.

Expanding the exemption from public access to disclosure documents

4.1 Do you support expanding the types of ESS eligible for the exemption from public access to disclosure documents?

Yes.

4.2 What are the benefits or risks of expanding the types of ESS eligible for this exemption?

We agree with the reasons stated in the consultation paper.

4.3 Are there any other changes to the scope or availability of this exemption that are necessary or desirable? Please provide details.

We agree with the reasons stated in the consultation paper.

Listed companies

5.1 Do you support simplifying and consolidating the relief for listed companies in the Corporations Act?

Yes.

5.2 What are the potential benefits or risks of consolidating the relief for listed companies in the Corporations Act?

We consider that incorporating the relief in the Corporations Act is more streamlined and that the listed and unlisted companies should both obtain the benefit of this approach.

5.3 Are there any requirements or conditions of the ASIC class order that should be removed or expanded as part of the consolidation? If so, please explain why.

We have no view on this at this time.

5.4 Are there any other barriers or costs for listed companies offering ESSs?

We have no view on this at this time.

Other reforms

6.1 Are there any other regulatory barriers to small businesses offering ESSs?

Yes.

The current structure of relief mechanisms in the Act and ASIC Class Order 14/1001, results in a trade-off between using relief for raising capital and relief to issue ESS securities. Please refer to part one of this submission for further details.

Furthermore, we believe that the requirement for SME's to notify ASIC of their reliance on relief (as per clauses 15 and 16 of CO 14/1001) is onerous and should be removed.

6.2 Are there any other reforms to the regulatory framework for ESSs that would further facilitate or reduce costs for small businesses offering an ESS?

Yes.

We believe that the introduction of safe harbour valuation methods should be introduced for the purposes of valuing interests offered under an eligible ESS.

This would reduce the cost and uncertainty for employers wishing to implement an ESS.

Please refer to Part One of this submission for further details.