

SO WHAT MAY CHANGES TO THE EMPLOYEE SHARE SCHEME LANDSCAPE LOOK LIKE?

In our recent [article](#) from 4 August 2014 we noted the building momentum for the Federal Government to change the laws which currently apply to Australian employee share schemes.

Recently a mainstream media publication has reported the Australian Treasurer, Joe Hockey MP, as stating that the Federal Government is determined to address the problems arising from the 2009 employee share schemes tax changes (introduced by the Labor Rudd government) and the resulting decrease in the level of employee share participation in Australia.

As part of that coverage, it has been reported that the Federal Government is looking to the types of approved schemes operating in the United Kingdom for inspiration, and in particular, UK Enterprise Management Incentive (**EMI**) plans. These plans have proven well suited to, and popular with, small and medium sized companies operating in the UK.

For Australian companies that are starting to think about what the future Australian employee share scheme landscape may look like, we have summarised how UK EMI plans operate below (and what the Federal Government may look to introduce in the future).

WHY HAVE UK EMI PLANS PROVEN POPULAR?

Options issued under UK EMI plans attract very favourable UK tax treatment. The structure is designed specifically for small to medium-sized, higher-risk trading companies, with the policy goal of helping these companies recruit and retain high calibre employees.

As noted in our previous [article](#) from 4 August 2014 the Federal Government released a discussion paper and announced that it would review the tax rules and other laws which apply to employee share schemes operated by start-up companies. The approved UK EMI plan structure has been specifically designed with many of those issues in mind.

WHAT REQUIREMENTS NEED TO BE MET BY A COMPANY IN ORDER TO UTILISE A UK EMI PLAN?

A UK EMI plan can only be operated by a company if the following requirements are met:

- the gross assets of the company must not exceed £30 million at the time of grant (or if the company is part of a group, then that level applies to the group as a whole);
- the company must be a company, or the parent company of a trading group, with a "qualifying trade" - as the purpose of UK EMI plans is to encourage risk taking and entrepreneurship, not all companies can qualify to use them. To qualify, a company must exist to carry on a "qualifying trade" or be preparing to do so. A qualifying trade is business undertaken on a commercial basis with a view to making profits, and which does not (to a substantial extent) consist of certain excluded activities. Those excluded activities include matters such as dealing in land or securities, financial activities, property development and professional services;
- the company must be independent - the company must not be majority owned by any other company or otherwise be under the control of another company or any person connected with that company;
- the company must only have subsidiary companies that are controlled by it (and not by a third party);
- the company must have a UK permanent establishment; and
- the company must have fewer than the equivalent of 250 full-time employees.

While UK EMI plans are considered to be relatively straightforward to implement, companies can (but do not have to) seek advance clearance from the UK tax regulator (HMRC) that they meet the above requirements, taking away some of the compliance risk.

What different threshold levels will apply if the UK EMI plan structure is adopted in Australia (and consequently what companies can participate) is unclear. In determining this issue, the Federal Government will need to balance between the goal of addressing the problems arising from the 2009 employee share schemes tax changes and making it easier to implement employee share schemes, and ensuring that the Federal Government's tax revenue base from employee share schemes is not materially decreased.

WHICH EMPLOYEES CAN BE GRANTED OPTIONS UNDER A UK EMI PLAN?

EMI options can be granted to employees of the relevant company (or one of its qualifying subsidiaries) who satisfy minimum working time requirements and who do not hold a material interest in the company.

This second requirement means that the employee cannot, either directly or together with one or more of their associates (which includes business partners, spouses/partners, and family trusts), hold a beneficial ownership in, or exercise control over, more than 30% of the shares of the company or an entitlement to more than 30% of assets on a winding up.

These two requirements, which appear to be sensible features which could be incorporated into any new Australian plan structure, require participants to be actively involved in the business but not already be substantial shareholders.

WHAT CAN BE OFFERED TO ELIGIBLE EMPLOYEES UNDER A UK EMI PLAN?

EMI options are a right to acquire a fully paid up, ordinary share in the company (or in the case of a group of companies, in the parent company) in the future. It is also possible for EMI options to be granted over a special class of employee shares (which can have reduced voting and/or dividend rights).

EMI options can be made to only be exercisable where certain conditions have been met, including the satisfaction of performance hurdles and requiring the employee to execute a shareholders' agreement prior to exercise. These types of exercise conditions are typical in an unlisted company environment.

There is a £3 million overall limit on the value of shares in a company (valued at the relevant dates of grant) that can be subject to unexercised EMI options. There is no limit, however, on the number of employees that can hold EMI options, and as a result, it is possible to use an EMI plan as an "all employee" scheme if employee numbers and/or option grants are relatively small.

Importantly, an eligible employee may only hold EMI options with a value up to the EMI individual limit, with the current EMI individual limit being £250,000. Once this limit is reached, further EMI options may only be granted after 3 years (and then only to the extent that the original EMI options have been exercised or have lapsed). It is reasonable to assume that the Federal Government will also look to introduce both total and individual limits.

SHARE VALUATIONS ARE VERY IMPORTANT FOR EMI OPTION GRANTS

Share valuations remain an important aspect of the UK EMI plan structure. A company and participating employees need to know the market value (at the grant date) of EMI options to determine the tax treatment on exercise of those options, and to manage the total and EMI individual limits.

The Federal Government's discussion paper and review recognises that it is critical to introduce measures to reduce the complexities and costs of structuring and operating employee share schemes for start-up companies and that this includes the need to simplify the valuation methodology to be used by those companies. Requiring small and medium sized companies to undertake a valuation in order to introduce an employee share scheme can create an unnecessary compliance burden.

WHAT IS THE TAX TREATMENT FOR AN EMPLOYEE WHO RECEIVES OPTIONS UNDER A UK EMI PLAN?

The Australian tax consequences of issuing options to employees under a structure based on the UK EMI plan structure are likely to be markedly different to the UK tax consequences where a UK EMI plan is in fact used. However, there may be some important pointers as to what tax changes the Federal Government may look to introduce.

There are generally no UK tax implications for the employee when an EMI option is granted.

On exercise of the EMI option, the tax consequences will largely depend on comparing the exercise price of the options as against the market value of the company's shares at the grant date:

- if the exercise price is at least equal to the market value of the company's shares at the grant date, exercise will generally not give rise to a UK income tax liability, as long as the option is exercised within ten years after the grant date; and
- if, however, the exercise price is below the market value of the company's shares at the grant date, then there will be UK income tax liability on the difference

between the market value of the shares at the grant date and the sum of the exercise price and any amount paid by the employee for the option.

On the sale by the employee of the shares acquired on the exercise of the EMI options, the difference between the market value at the time of sale and the cost base of the shares will be a chargeable gain for UK CGT purposes (and "CGT entrepreneurs' relief" may also be available).

Favourable UK EMI option tax treatment may be lost (in whole or in part) in various circumstances including where there is a "disqualifying event" and the EMI options are not exercised within 90 days after this disqualifying event. Disqualifying events can include where the issuing company becomes a subsidiary of another company, the company ceases to meet the trading activities requirements, the employee ceases to satisfy the minimum working time requirements, or where the employee ceases employment (there are no special provisions to maintain favourable tax treatment for "good leavers").

The company's gross assets reaching more than £30 million, any subsidiary ceasing to be a qualifying subsidiary, and/or an employee acquiring a material interest in the company, will not be disqualifying events in relation to previously granted EMI options.

Companies whose shares are subject to EMI options at any time during a tax year are required to deliver an information return about those options to HMRC.

WHAT NEXT?

With the Federal Government poised to release its National Industry Investment and Competitiveness Agenda in the next few weeks, a welcome announcement to the regulation of employee share schemes in Australia should not be far away ...

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

MORE INFORMATION

For more information, please contact:



Brett Feltham

Partner

T +61 2 9286 8257

brett.feltham@dlapiper.com

CONTACT YOUR NEAREST DLA PIPER OFFICE:

BRISBANE

Level 29, Waterfront Place 1
Eagle Street
Brisbane QLD 4000
T +61 7 3246 4000
F +61 7 3229 4077
brisbane@dlapiper.com

CANBERRA

Level 3, 55 Wentworth Avenue
Kingston ACT 2604
T +61 2 6201 8787
F +61 2 6230 7848
canberra@dlapiper.com

MELBOURNE

Level 21, 140 William Street
Melbourne VIC 3000
T +61 3 9274 5000
F +61 3 9274 5111
melbourne@dlapiper.com

PERTH

Level 31, Central Park 152-158 St
Georges Terrace Perth WA 6000
T +61 8 6467 6000
F +61 8 6467 6001
perth@dlapiper.com

SYDNEY

Level 22, No.1 Martin Place
Sydney NSW 2000
T +61 2 9286 8000
F +61 2 9286 8007
sydney@dlapiper.com

www.dlapiper.com

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