



Link Market Services Limited  
ABN 54 083 214 537

**All correspondence to:**  
Locked Bag A14  
Sydney South NSW 1235  
Australia

Review of Employee Share Schemes  
The Board of Taxation  
C/- The Treasury  
Langton Crescent  
CANBERRA ACT 2600

9 October 2009

Dear Sir or Madam,

The Treasury invited Link Market Services Limited ("Link"), via email, on 7 September 2009 to provide a submission to the Board of Taxation in relation to certain aspects of employee share schemes, namely:

- How best to determine the market value of employee share scheme securities; and
- Whether shares and rights under an employee share scheme that are provided by start-up, research and development and speculative-type companies should be subject to separate tax deferral arrangements outside of those proposed by the Policy Statement.

The invitation requested consideration of the following aspects:

- Whether the existing rules for valuing unlisted rights to acquire shares properly reflect market value;
- Whether special rules are appropriate or necessary to determine the market value of employee share scheme shares and rights (listed and unlisted);
- Whether there are suitable alternative mechanisms for determining market value;
- Whether it is appropriate or necessary to provide separate deferral arrangements for employees of start-up, research and development and speculative-type companies receiving shares or rights under employee share schemes; and
- Possible options to provide assistance to start-up, research and development and speculative-type companies.

## **Background**

Link is an Employee Share Plan advisor helping clients design, implement and administer employee share schemes. Link currently administers employee share plans for over 100 clients, 270 plans for over 550,000 employees within Australia and globally. Link is an unlisted company that is owned by a private equity company, Pacific Equity Partners ("PEP") and is able to provide background and information on the unlisted company environment and the issues facing unlisted companies when implementing employee share schemes.

The following paper has been carefully considered in consultation with our existing and potential clients as well as our own experience.

## **The Existing Rules for Valuation of Unlisted Rights**

The current valuation method under Division 13A of the *Income Tax Assessment Act 1936* (Cwlth) (“the Tax Act”) is practical in situations where the underlying shares have an easily definable market value and no exercise price is being paid for the right. Ostensibly this is because it is relatively easy to determine a value where shares in a company are traded in the market. In this situation the unlisted rights’ value is the same as the underlying listed share. This is and continues to be an appropriate valuation (save for the comments below which relate to the current valuation for market value of listed shares).

Providing a fair value for options (rights with an exercise price) and shares where the underlying shares are not listed is more open to interpretation and therefore involves a more complicated valuation process.

Options under the Tax Act are valued using the methodologies described in subsections s139FC, s139FJ to s139FN of the Tax Act. This methodology is based on a modified Black Scholes valuation (an accepted form of option valuation). However, after the Tax Act was implemented in 1995 there are now other methods that are used by companies such as the Binominal and Monte Carlo valuation methods. It is therefore recommended that part of the process includes a review of the current tables and calculations in s139FJ to s139FN to ensure that they are still appropriate and applicable.

## **The Special Valuation Rules Requirements for Employee Share Schemes (Listed Securities)**

Employee Share Schemes are generally accepted to be useful vehicles to attract, incentivise, reward and retain staff. There should be a distinction between a normal valuation provided for reporting purposes and a valuation provided for individuals participating in an employee share plan for tax purposes.

For listed securities, currently the market value or taxation value for listed securities is based on s139FA of the Tax Act and is a weighted average price for a one week period up to and including the taxation date, otherwise known as Volume Weighted Average Price (“VWAP”). Employee share plans by their nature have many transactions where ownership of securities are transferred off market or where the taxation point applies due to the restriction or forfeiture condition concluding.

The current VWAP methodology has a complication as it is calculated up to and including the date of the transaction/taxation point. This can make the acquisition process difficult as the true value can not be determined until the market has closed on the date of acquisition. Where this is a purchase (from an administration perspective) there is therefore an artificial purchase and reconciliation the day after the acquisition occurs. Likewise the valuation impacts and creates complexities for disclosure under ASIC Class Order 03/184.

Link’s recommendation is that the VWAP value is calculated up to the date of acquisition/taxation, i.e. determined the day before. By ensuring that valuations occurred on market values up to the day before acquisition/taxation point it would greatly improve a company’s ability to correctly acquire securities as well as lessen the time it takes to make market disclosures related to issues and director movements.

## **The Suitable Alternative Mechanisms for Employee Share Scheme Securities (Unlisted Securities)**

Valuation of a share that is not listed is problematic due to the fact that the share needs to be valued by either a person qualified to value shares (and provided in an approved format) or by a methodology that has been accepted by the Tax Commissioner.

From Link’s experience, the process of having a methodology accepted by the Tax Commissioner is irregular, not time-efficient and is also of additional expense.

Some companies do not require audited accounts meaning that a valuation by an auditor, the most commonly qualified person used by unlisted companies, becomes an additional cost and expense. For an unlisted company that already has Corporation Act boundaries, (based on s706/708 and the prospectus disclosure requirements and exemptions) this can add additional cost and complexity meaning it is likely that the company will use an alternative to shares.

Most unlisted companies have an internal mechanism for valuation of shares because of the nature of the business, i.e. they are looking for an eventual trade sale or Initial Public Offering (“IPO”) (see the recommendations section below for details about using these valuations as a substitute for the current sections).

### **Suitable Deferral and Other Arrangements for Employees of Start-up, Research and Development and Speculative-type companies**

“Enterprise” broadly encompasses small start-up, research and development and speculative-type companies. Companies of this nature normally rely heavily on specialist “human capital” to form part of the key staff within the company. It is of note that overtime successful enterprises have substantially contributed to productivity gains in the national output.

As companies of this nature are normally “cash-poor” the award of shares and rights can form a very significant part of key staff’s remuneration package. It effectively acts as a ‘top-up’ mechanism that retains staff and ties them into a key corporate event when the company becomes more mature and has greater cashflow.

The current proposed Exposure Draft would usually accelerate the taxing point for many securities held by employees of enterprise companies. Taxation of these shares or rights before an enterprise company has the opportunity to establish itself in the market would ultimately impact the value of the employee share schemes, in turn discouraging individuals from joining and remaining with the company.

Taxation of this type could stifle innovation, reduce competition and ultimately reduce Australia's overall productivity by restricting Enterprises with the ability to attract and retain appropriate staff. At present, the government recognises the benefits of Enterprise in the corporate tax concessions that these companies receive. It follows that in order to ensure that this type of business attracts and retains the highest quality staff the concessions should be extended to the employees of the company.

Link’s suggestion is that employee share schemes for these specific Enterprises are structured to enable option plans that can be exercised and largely taxed as a capital gain when the individual leaves employment or the shares or rights are disposed.

The United Kingdom (“UK”) currently has such a scheme in place that is referred to as an Enterprise Management Incentive (“EMI”). Essentially a select number of individuals from an enterprise company can be eligible for up to GBP125, 000 income tax concession provided the company has gross assets less than GBP30 Million. This scheme was introduced with the purpose to foster ownership through options, encouraging talent to work within Small and Medium Enterprises (“SME's”) and to allow remuneration to be subsidised by equity.

The levels used in the UK need to be appropriately examined and reviewed to understand the cost versus the benefit of the plans. Alternatively a modification of the previous option plan taxation structure is optimal, i.e. a percentage of the option exercise price is paid as income tax at grant. If the option is priced above the market value of the underlying share there may be no income tax to pay. A majority of the gains are taxed as capital gains at the disposal event, which is the earliest of cessation of employment or disposal.

### **Recommendations**

We respectfully recommend the following:

#### **The Existing Rules for Valuation of Unlisted Rights and Suitable Alternative Mechanisms (Unlisted Securities)**

- Use of a number of the standard accepted methodologies that are accepted by the Board of Taxation. For example, a multiple of Earnings before Interest, Taxes, Depreciation and Amortisation (“EBITDA”) multiple is simple to calculate and generally gives a fair reflection of a companies fair value. There are some specific companies or sectors, such as research and development companies, where EBITDA is not applicable because the nature of these companies is that during the development period they will have negative EBITDA. Another generally accepted specific methodology may be appropriate in this case;

- That there should also be the ability for the company to define through its Chief Financial Officer (“CFO”) a valuation mechanism and for this mechanism to be approved by the Board. This gives companies the flexibility to tailor appropriate methodologies that have been appropriately approved. This is to cover situations where the generally accepted methodologies above are not applicable to certain specific circumstances. This allows flexibility with a proper approval process.

#### **The Special Valuation Rules Requirements for Employee Share Schemes (Listed Securities)**

- That for listed securities, market valuations are provided up to one day prior to the valuation date. Further, that the current option valuation methodology be reviewed.

#### **Suitable Deferral and Other Arrangements for Employees of Start-up, Research and Development and Speculative-type companies**

- That individuals who hold rights and shares in start-up, research and development and speculative-type companies have their growth taxed largely as a capital gain.

Yours faithfully,



**Phillip Muhlbauer**  
Chief Executive Officer  
Link Market Services Limited



**Angela Perry**  
Employee Share Services  
General Counsel  
Link Market Services Limited