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Deloitte/Norton Rose ESOP survey report

Australian business' experiences with Employee Share Options

Introduction

As Deloitte Private and the other authors argued in the report of November 2012, *Silicon Beach: A study of the Australian Startup Ecosystem*, Employee Share Option Plans (ESOPs) could be a potentially helpful, flexible and low-cost way for startup businesses to compensate employees. However, in Australia, the tax rules surrounding ESOPs make them unfortunately quite difficult – and expensive – to use, in contrast to many other jurisdictions whose businesses make much more common use of them.

As a follow up to that earlier report, and to gain a better understanding of this important issue and of the Australian technology community's views on the value and complexity of ESOPs in incentivising employees, Deloitte and Norton Rose conducted a survey of 104 businesses – from startups to established companies – in late January and early February 2013. The survey's results, presented here, are illuminating.

The same or better rules that apply in the U.S. and the UK should apply in Australia

Survey Participant

Startups are usually – and of necessity – intent on preserving their limited capital and therefore looking for low-cost solutions to paying for their business costs. ESOPS have been shown to be very useful, especially in the United States, as a way to attract, motivate and share the rewards of success with the dedicated employees who help build the business from the beginning.

Yet, in the Australian taxation environment, ESOPs are cumbersome to set up, and require a good deal of expensive professional help to comply with all of the regulations to which they are subject. More importantly, the taxation of ESOPs in the hands of the employee at the time of issue, rather than at the time they received the proceeds, is the main obstacle to more widespread use.

There are some significant issues with compensating startup employees: it is still difficult to establish a simple employee share option plan (ESOP) which can motivate the entrepreneurial talent essential to startup innovation

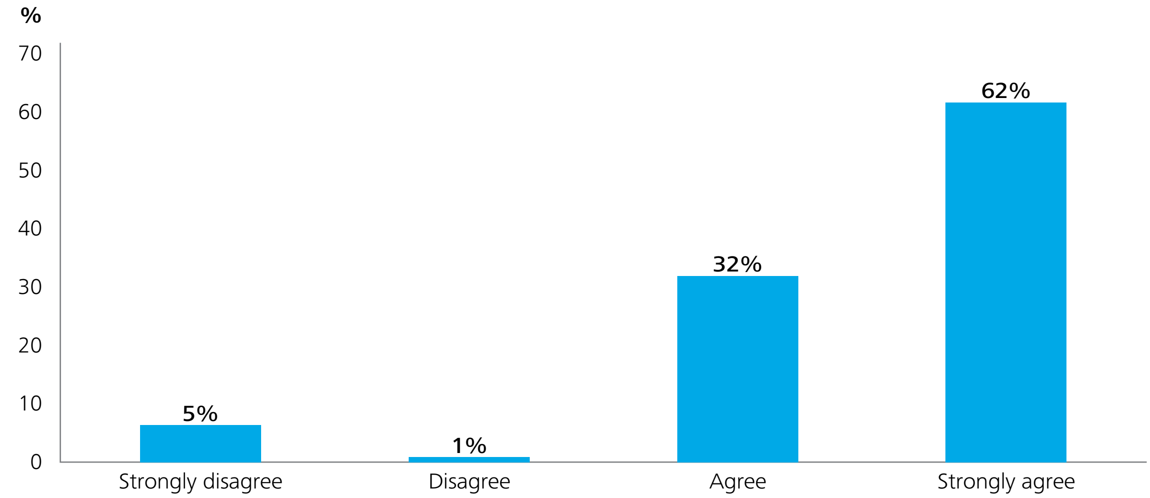
Deloitte Private, Pollenizer, From Little Things, Startup Genome and Vivid,
Silicon Beach: A study of the Australian Startup Ecosystem, p. 25

Survey results

Deloitte and Norton Rose found in our survey that there is a real appetite on the part of startups (94 per cent of whom agreed or strongly agreed) to use ESOPs and that they are viewed as potentially very helpful to incentivise employees and to attract the calibre of employees necessary to get their businesses off the ground.

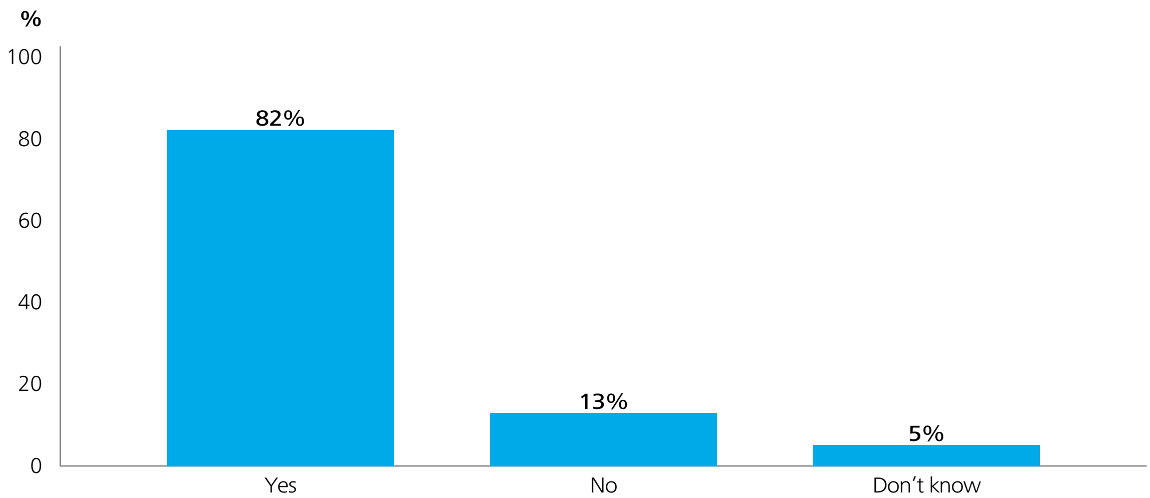
> *"The rules need to be flexible enough to permit start-up and innovation entities to issue share options to employees so that the taxing point coincides with when the employee realises or has control of the financial benefit. The non-cash benefit of share options is an excellent benefit for cash strapped enterprises to use to attract high-potential candidates/personnel whose rewards will only be recognised if returns are achieved for shareholders"*
>
> Survey Participant

Do you think that share options are a valuable way to incentivise employees?

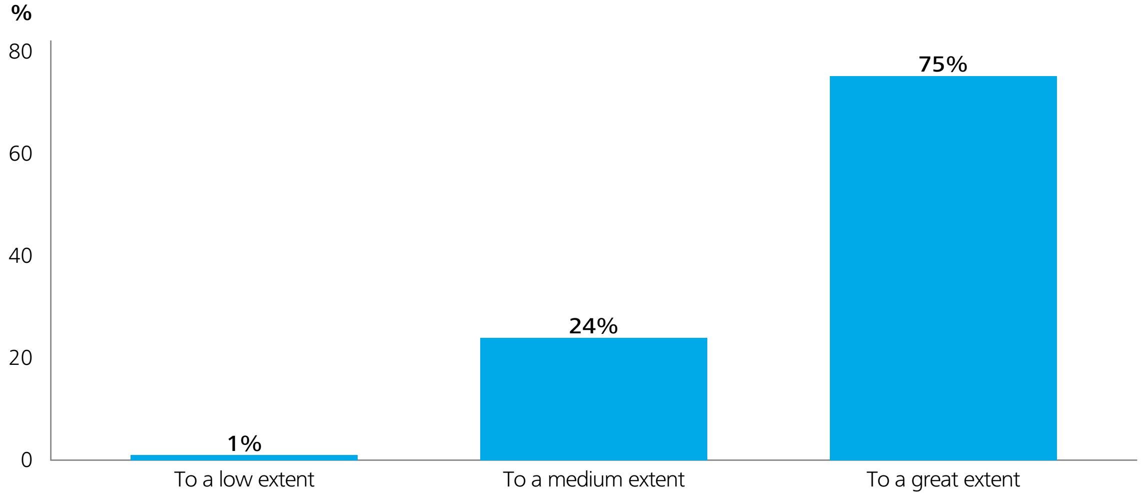


In the main, however, startup entrepreneurs were of the view that ESOPs were too expensive and cumbersome to use, with the result that staff compensation costs burn through more startup capital than would be necessary if ESOPs could be used more efficiently to offset compensation expenses.

Do you consider the issuing of share options to Australian employees so complex that it is a disincentive to issuing share options?



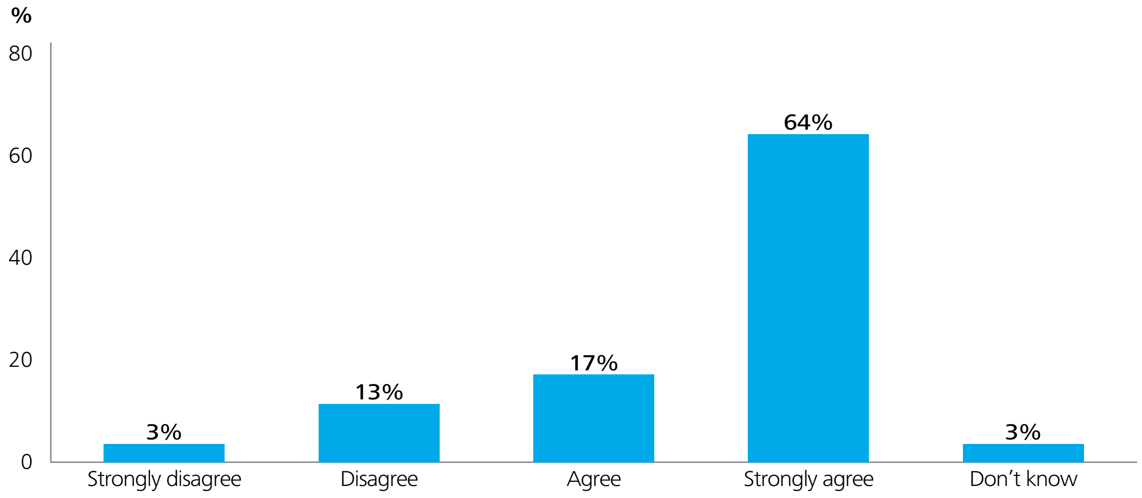
To what extent do you consider the issuing of share options so complex that it is a disincentive to issuing share options?



As a consequence of the unfavourable tax implications of ESOPs, only 37 per cent of respondents had used them in the last three years. Of those who had not issued ESOPs in the past three years, 81 per cent agreed or strongly agreed that tax considerations were the main consideration for their reluctance to utilise them, while 82 per cent agreed that tax considerations were a disincentive to their use.

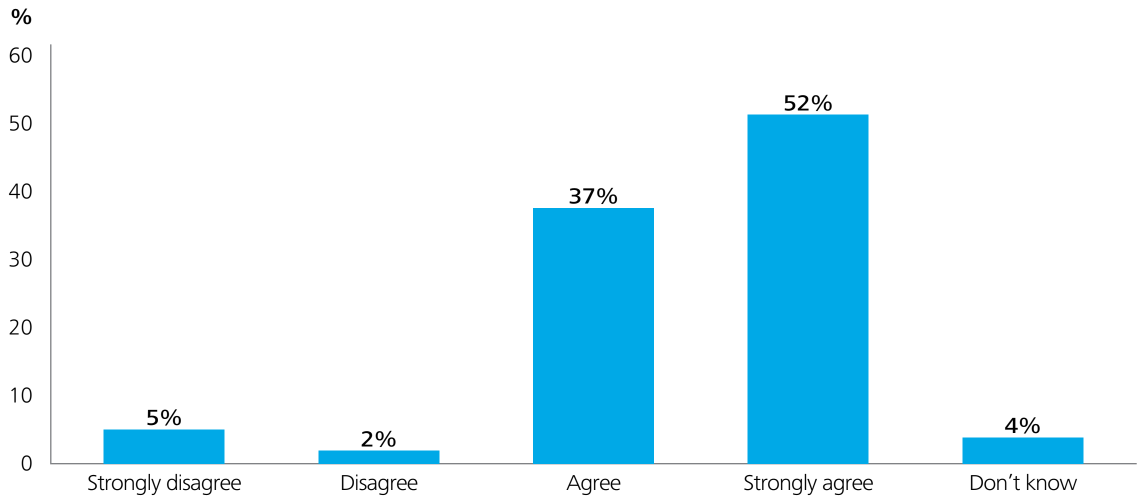
In addition, of those 81 per cent of respondents who felt that tax considerations of issuing share options were a disincentive, 75 per cent felt that the complexity was a disincentive to their use to a great extent, with a further 24 per cent of the view that it was a disincentive to a medium extent. Only 1 per cent felt it was a disincentive to a low extent.

Were the tax consequences on the employee a significant reason for not issuing share options?



There was a clear consensus among respondents as to the main obstacle to the use of ESOPs: the vast majority – fully 89 per cent – of respondents would be more inclined to issue share options if employees were taxed on financial gains at the time of ESOP proceeds rather than earlier.

If employees were taxed on financial gains made at the time the ESOP proceeds were actually received rather than earlier, would you be more inclined to issue share options?



"ESOPs allow startups to offer employees a share in the increase in business valuation that they contributed to. A well-structured ESOP allows a company to conserve cash burn while at the same time reward employees for their efforts. The tax environment in Australia makes ESOPs expensive to put together for both companies and employees. We believe that a modified tax regime for startup ESOPs would motivate more startups to implement such a scheme and thereby motivate more people to take entrepreneurial risk. Without this, many startups may continue to struggle to attract and retain the local talent pool."

Silicon Beach: A study of the Australian Startup Ecosystem, p. 25

Implications:

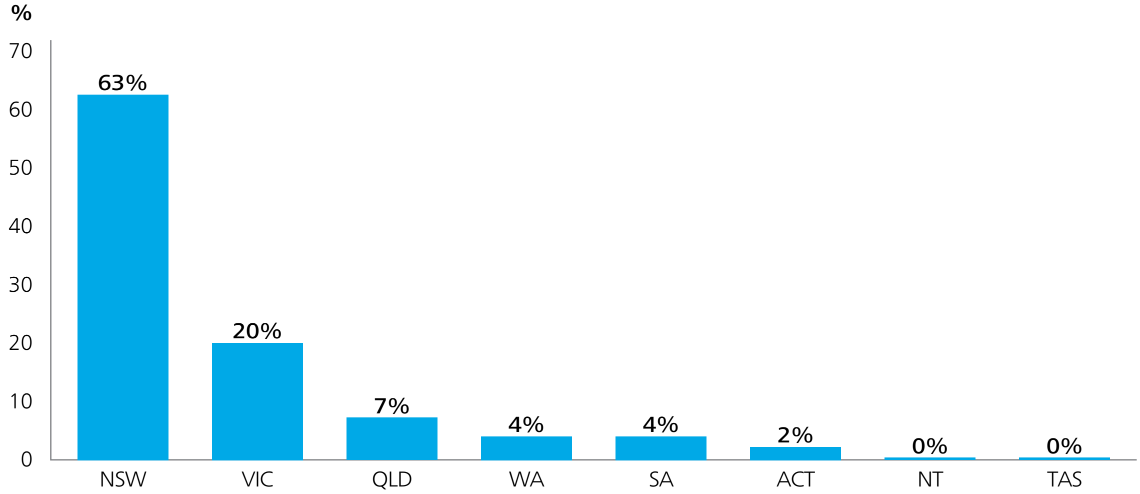
What this means for Australia is that as a nation we risk losing valuable startups to friendlier jurisdictions that offer greater flexibility and make it easier to reach a larger scale. The Silicon Beach report found that Australian startups were already considerably less likely to reach scale as U.S. startups. The natural advantages offered by economies of scale in larger markets such as the U.S. and Europe cannot be discounted, but Australia is further disadvantaging its startup entrepreneurs by imposing unnecessary obstacles to the use of flexible arrangements, such as ESOPs, to help them grow their businesses here.

Those obstacles boil down to two main issues: the complexity – and therefore expense – to set up an ESOP, and the current rules regarding the taxation of ESOPs in the hands of employees at the time they are awarded, rather than at the time the proceeds are received. If Australia is to compete on a level playing field, retain talented Australian entrepreneurs and generate a strong pipeline of startups, then these two issues must be addressed.

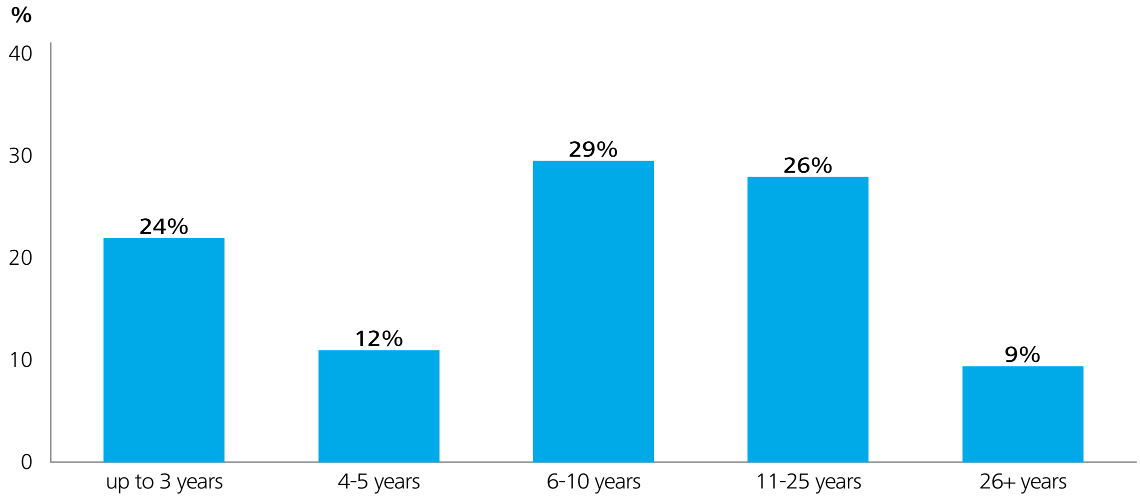
Profile of survey respondents

Survey respondents were drawn from five states and one territory, with 63 per cent from NSW and 20 per cent from Victoria. They ranged in age, but nearly two-thirds were under 10 years old and 62 per cent had fewer than 30 employees, and more than half had revenues of less than $5 million, while only 25 per cent had revenues greater than $15 million.

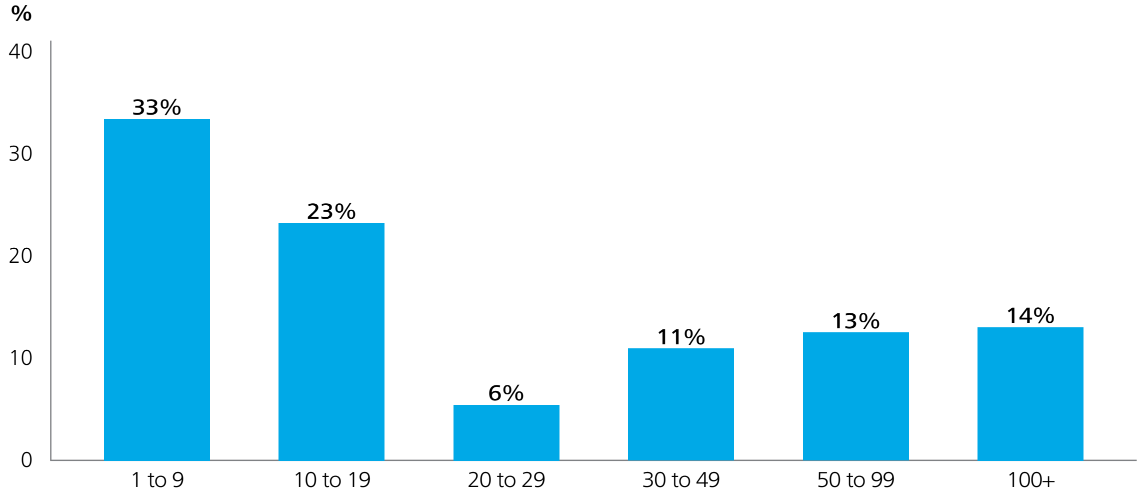
By State



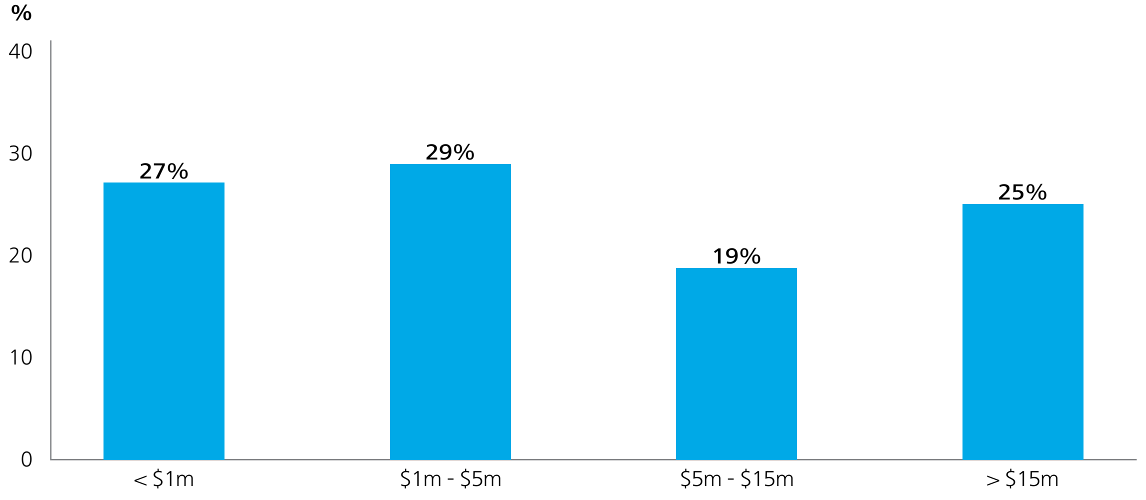
Age of companies



Number of employees



Average revenue size of companies



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