ESS 2015/1 - Explanatory statement -

Australian Government
Australian Taxation Office

Australian Taxation Office Legislative Instrument
Instrument ID: 2015/SBIT/0004

Explanatory Statement

Income Tax Assessment (Methods for Valuing Unlisted Shares) Approval 2015

General Outline of Instrument

1. This legislative instrument is made under subsection 960-412(2) of the *Income Tax Assessment Act 1997* ("ITAA 1997").
2. The legislative instrument provides approved valuation methods for companies making an offer of ESS interests to eligible persons (generally employees) under an employee share scheme ("ESS") which would otherwise qualify for the ESS start-up concession under sections 83A-33 and 83A-45 of the ITAA 1997.
3. The instrument is a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

Date of effect

4. The approval applies from 1 July 2015, or from the commencement of the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Act 2015*, whichever is the later.

What is this instrument about?

5. The purpose of this approval is to set out methods that can be applied by some companies that issue ESS interests and that need to work out a market value for the purposes of complying with the ESS provisions. This approval sets out methods that will be accepted by the Commissioner as providing a safe-harbour assurance for these purposes.

What is the effect of this instrument?

6. The effect of this approval is that companies wishing to make an offer of ESS interests under an ESS have certainty over what alternative valuation methods are acceptable to the Commissioner. This will help streamline the process of making an offer of ESS interests under an ESS, as well as reducing associated compliance costs for companies.
7. It is not compulsory for companies to use the approved valuation methods in the instrument for the purposes of demonstrating eligibility to the start-up concession. Eligible companies may choose an alternative market valuation method, however, they will not receive assurance from the Commissioner under this approval in relation to that alternative valuation method unless it results in an amount that is at least equal to that arising under an approved method.
8. Sections 3 and 4 of the legislative instrument identify the parties and circumstances that are covered by the approval. The approval applies only to companies that are issuing ESS interests that are eligible for the ESS start-up concession. In addition, those companies must not anticipate a change of control occurring within the period ending 6 months after the issue of the ESS interest.
9. Section 5 sets out the approved market valuation method and the further conditions affecting companies to be entitled to apply them. For companies that meet the start-up concession eligibility requirements under sections 83A-33 and 83A-45, are small business entities or have

been incorporated for less than seven years, and have not raised over $10 million in capital (either debt or equity combined) over the preceding 12 month period, the method for valuing ordinary shares is the net tangible assets ("NTA") of the company, reduced by the return required on preference shares on issue at the particular valuation time as if those shares are redeemed, cancelled, bought back or otherwise satisfied at that time (disregarding any contingencies as to the provision of that return and any return that would not rank before ordinary shareholders upon a winding up). This step will identify the preferential returns that are available to such shareholders under the terms of their preference shares. It will take into account 'loaded' returns, for example, where $100 is subscribed for a preference share but $150 is payable upon winding up in preference to ordinary shareholders.

10. The final step is to work out the value of the ordinary shares on issue by reference to the claims that ordinary shareholders have on the amount remaining after Step 3. This may take into account the extent to which any preference shares on issue are also capable of participating in the residual assets of the company upon a winding up.

Example 1 Method 1 – ordinary shares only

Two engineers, Alisa and Lloyd, are working on developing a new mapping technology which can map ocean floors with greater accuracy. They have incorporated a company, Core AL Mapping Pty Ltd, to establish a formal base for furthering their research. They have both contributed $45,000 each for a 50% ownership in the company, giving them 10,000 ordinary shares each. They have spent $10,000 on the initial start-up costs.

They have recently hired two talented staff members, Harry and Akshun, to help with the manufacturing process. Under the ESS option plan, Harry and Akshun are each granted rights to acquire 1,111 ordinary shares in the company (which if exercised would result in a 5% interest in the company), with vesting over the period to 31 December 2019.

The company wants to ensure that Harry and Akshun are eligible for the ESS start-up concession and so will need to ensure that the exercise price of the options is not less than the market value of the shares at the time of grant. The company satisfies all other eligibility conditions.

Balance sheet of Core AL Mapping Pty Ltd as at 30 June 2015

ASSETS		EQUITY	
Cash	$80,000	20,000 Ordinary Shares	$90,000
		Accumulated Losses	($10,000)
Total Assets	$80,000	Total Equity	$80,000

The company is eligible to apply the NTA method (Method 1), as it qualifies as a "small business entity" under section 328-110 of the ITAA 1997 (or has been incorporated less than seven years), has not had a capital raising of more than $10 million within the previous 12 months, prepares relevant financial reports, and it does not anticipate a change of control within the period ending 6 months after the issue of the ESS interest. The company is also able to choose to apply Method 2 instead.

Using the NTA valuation method, the value of an ordinary share is $80,000/20,000 or $4.00 per share. Provided the company sets an exercise price of the options at $4 or more, the company will be entitled to rely on this valuation method to enable Harry and Akshun to become eligible for the ESS start-up concession.

By 30 June 2018, the company has developed a substantial product to be marketed and distributed in the next financial year. It has recently received a large order from an Australian

maritime company. To manage this order, they bring on another employee, Sally, offering options to acquire 100 ordinary shares with vesting over the period to 31 December 2022.

Balance sheet of Core AL Mapping Pty Ltd as at 30 June 2018

ASSETS		EQUITY	
Cash	$130,000	20,000 Ordinary Shares	$90,000
		Retained Earnings	$40,000
Total Assets	$130,000	Total Equity	$130,000
Net Assets	$130,000		

Alisa and Lloyd are not sure whether the company will still qualify as a small business, but as it has been incorporated for less than 7 years and has not raised more than $10 million in capital in the past 12 months, the company can still use the same NTA valuation method (Method 1) as before.

Using the NTA valuation method, the market value of an ordinary share as at 30 June 2018 is $130,000-$0/20,000, which is $6.50 per share. Provided the company sets an exercise price of the options at $6.50 or more, Sally is eligible for the ESS start-up concession and the valuation of the ordinary shares will satisfy the safe harbour.

Example 2 Method 1 – ordinary shares and preference shares on issue

Two brothers, Peter and Paul, have a great idea for a possible business. They work up a pitch for an investor, Alister who agrees to contribute to their cause. Peter and Paul incorporate a company as Two Little Birds Pty Ltd and invest $30,000 each for 2,000 ordinary shares (1,000 shares each). Alister invests $100,000 for a 10% interest (222 preference shares). At this time, the company has assets of $160,000 in cash.

The preference shares rank above ordinary shares upon winding up, but are not classified as financial liabilities for accounting purposes. They have no claims that rank equally with ordinary shares.

By the end of the year, the company has spent $35,000 but they do not have a viable product. Peter and Paul realise they will need to hire an employee (Michelle) to drive further product development if the company is to have any chance of success. The company offers Michelle options to acquire 100 ordinary shares, vesting in three years' time.

In order for the company to ensure that Michelle is eligible for the ESS start-up concession, the exercise price of the options offered to Michelle should not be less than the market value of the shares at the time of grant.

Balance Sheet of Two Little Birds Pty Ltd as at 30 June 2015

ASSETS		EQUITY	
Cash	$125,000	2,000 Ordinary Shares (Peter and Paul)	$60,000
		222 Preference Shares (Alister)	$100,000
		Accumulated Losses	($35,000)
Net Assets	$125,000	Total Equity	$125,000

The company is eligible to apply the NTA method (Method 1) as it qualifies as a small business under section 328-110 of the ITAA 1997 (or has been incorporated less than 7 years) and has not had a capital raising of more than $10 million within the previous 12 months, and prepares relevant financial reports. The company could choose to apply Method 2 instead.

Using the NTA method, the market value of ordinary shares is ($125,000-$100,000)/2,000 or $12.50 per share. Provided the company sets an exercise price of the options at $12.50 or more, the company will be entitled to rely on the ATO's approved valuation method and Michelle will be eligible for the ESS start-up concession.

Method 2

11. Companies that are not eligible to use the NTA method, or are eligible but choose not to, but still meet the eligibility criteria to provide the ESS start-up concession in section 83A-33, may choose to apply the alternative comprehensive method set out in sub-section 5(4) of the instrument.
12. Under the alternative comprehensive method, the valuation of ordinary shares must be performed by either:
    a) the chief financial officer of the company; or
    b) a person having the knowledge, experience and training to perform such valuations.
13. In addition, the valuation must be in writing and take into account:
    a) the value of tangible and intangible assets of the company;
    b) the present value of anticipated future cash flows;
    c) the market value of similar businesses, including the use of earnings multiples; and
    d) uplifts and discounts for control premiums, lack of marketability and key person risk.

Example 3 Application of Method 2

Following on from Example 1.

Core AL Mapping Pty Ltd has been in existence for more than eight years and has performed very well, increasing annual turnover to $5 million. Harry and Akshun have both exercised their options to buy shares, but Sally has not. The company is hiring an extra 10 staff members to meet the growing demand. Alisa and Lloyd want to offer each of the new employees options to acquire 40 ordinary shares. To determine the exercise price, they must first work out the value of an ordinary share in the company.

As the company has been incorporated for more than seven years (but less than 10 years) and is no longer classified as a small business entity (as its annual turnover exceeds $2 million), the company cannot use Method 1 but may apply the comprehensive valuation method (Method 2).

The company must have a valuation performed by a person with knowledge, experience and training to perform such a task. That person must take into account the value of tangible and intangible assets of the company, the present value of anticipated future cash flows, the market value of similar businesses, including the use of earnings multiples, and any uplifts for control premiums, and discounts for lack of marketability and key person risk.

The company arranges for their accountant, who has the knowledge, experience and training to perform such valuations to undertake a valuation for them, taking into account all of the above matters on a reasonable basis. Alisa and Lloyd (who are the only directors of the company) sign off on the valuation provided by resolution. This valuation will be accepted as having satisfied the requirements under the instrument.

Example 4 Method 1 not available

Four years ago, Shannon and Jane started a company developing and selling computer chips. It is now generating turnover of $30 million a year, has made up all its past losses and has $1.5 million in retained earnings. The company has just secured a $125 million investment from a venture capital firm for 10% of the company with a 100% liquidation preference. The company plans to issue options to all 25 of their employees.

Although the company has been incorporated less than seven years, the high turnover of the company and the significant investment the company has received mean that the company can only choose to apply the comprehensive valuation method (Method 2) to determine the value of shares.

Other matters

14. Importantly, if a company uses a different method to those provided in the instrument and obtains the same or a higher value compared to what would have arisen under an approved method that the company could have applied, the ATO will treat that valuation as an approved method.
15. The net tangible assets of the company takes on its ordinary meaning and refers to the total assets less intangible assets less liabilities (disregarding any preference shares accounted for as financial liabilities) as recognised by the company in its financial reports prepared in compliance with the accounting standards. The value of those net tangible assets is required as at the time that the valuation is required for the ESS provisions, but these values will usually be found practically in the company's most recent financial statements.

Background

16. In the absence of this instrument, a company that needs to work out the market value of its shares for the purposes of complying with its obligations under the ESS provisions would need to perform a full market valuation of its shares. This can be an expensive process.
17. This instrument has been developed to ensure that the process of offering ESS interests is easier and more attractive for start-up companies. In particular, this instrument works to ease the financial and compliance burden with regard to valuing unlisted shares.

Consultation

18. The ATO consulted extensively in the preparation of this instrument. A number of consultation sessions were held in Brisbane, Sydney and Melbourne in April 2015, with key industry representatives that have extensive experience in the valuation of shares and companies. Various valuation methods were tested with hypothetical and real life examples.

Stephen John Vesperman
Deputy Commissioner of Taxation
23 June 2015

Legislative references:

Corporations Act 2001

Human Rights (Parliamentary Scrutiny) Act 2011

Income Tax Assessment Act 1997

Legislative Instruments Act 2003

Tax and Superannuation Laws Amendment (Employee Share Schemes) Act 2015

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Income Tax Assessment (Methods for Valuing Unlisted Shares) Approval 2015

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Legislative Instrument

The purpose of this instrument is to identify a class of companies that can use an approved valuation method to value unlisted ordinary shares for the purposes of an Employee Share Scheme, and to outline the types of valuation methods that have been approved by the Commissioner.

Human rights implications

This Legislative Instrument does not engage any of the applicable rights or freedoms as it simply sets out the methodologies for valuing unlisted shares that will be accepted by the Commissioner.

Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.