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EQUITY-BASED COMPENSATION FOR NEW-ECONOMY COMPANIES

Equity-based compensation has long been used as a tool to attract, retain and motivate key employees and management. With the increase in new-economy companies in Hong Kong, how is equity-based compensation changing?

Equity-based awards issued to employees by Hong Kong companies have historically revolved around traditional awards such as share options and the award/purchase of shares. The proliferation of new-economy companies and professional investors backing these companies have resulted in a growing appetite for alternative arrangements, which align employee and shareholder interests, while managing dilution of control.

What is Equity compensation?

These are gains from any employee share options are taxable when the options are exercised, assigned or released. There are specific provisions governing the taxation of employee stock options. Other employee share-based benefits (such as share awards) are also subject to Hong Kong salaries tax.

Tax Implications

Equity-based awards provided to employees will typically attract income tax and capital gains tax. Capital gains and investment returns are typically taxed at lower rates compared to employee compensation. This is particularly pronounced in Hong Kong, where capital gains derived by individuals are generally not subject to tax.

Take for example, an award of ordinary shares to an employee in Hong Kong at no cost. This would typically attract a salaries tax charge on the value of the shares. Future events such as dividend distributions and capital gains should be outside the scope of taxation. While this may seem like a reasonable outcome, depending on the valuation of the shares at the time of the award, the salaries tax charge on the award could be significant without there being a short-term avenue for the employee to realise the value of the shares. This could result in a significant tax burden on the employee. Another example is a share option. A share option is ideal for flexibility and aligning an income tax charge with the realisation of value. The downside is that the economic benefit from the option is subject to income tax as opposed to capital gains.

Accounting perspective

The accounting for equity-based awards starts with the fair value, which is derived from the company's enterprise value on the grant date. Although recent funding transactions may serve as a point of reference for the enterprise value, it is important to note that shares issued in funding rounds are typically preferred stock with unique rights regarding dividends and access to the proceeds at liquidation. Discounting the value of such preferential rights is therefore

necessary. In the absence of funding round valuations, companies could consider using a discounted cash flow model, which is often challenging for high-growth pre-profit or pre-revenue companies.

Following the determination of the company's enterprise value at the grant date, further adjustments may be required to reflect the particular terms of the share award scheme. If the awards granted are share options, the fair value of the awards is typically estimated using an options pricing model, with the enterprise value as one of the inputs.

After the fair value of the awards is established, the amount is generally recognised as salary costs in the statement of income over the relevant vesting period, if any. In practice, it is common for companies to grant share options with different vesting conditions and periods – a graded vesting scheme. It is important to keep track of tranches that vest over different periods, and properly recognise the related expenses of each tranche of vested grants in the financial statements.

Companies sometimes include a forfeiture clause in the grant agreements to ensure that only company employees can hold company shares or share options. It is worth noting that in the case of subsequent forfeiture of share awards or options already vested, expenses previously recognised as salary costs during the vesting period would not be reversed in the income statement.

The Opportunities

Other jurisdictions, such as the UK, have been using more sophisticated awards such as growth shares, which can obtain similar economic outcomes to share options, but are viewed as having more preferential tax treatment. These types of awards may also be effective in other locations. The asset management industry, particularly private equity, has also been using co-investment and carried interest arrangements for key executives.

Key is to establish early and plan for the future. Valuations are typically lower in a company's earlier stages, and therefore present the best opportunity to align tax outcomes and mitigate future risks. Companies will also need to work with, and potentially educate, investors to agree upon the size of an employee equity pool which is fair and fit for the future.

Sticking with the theme of planning ahead, establishing an equity compensation scheme which has the flexibility to grant different types of awards is desirable, as the perceived value of different types of awards will also change as the company value grows and gets closer to an exit. For example, a fair market value option (i.e. requiring the employee to pay the fair market value set at the award date) may not be as attractive to an employee when a company is close to an exit event.



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