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. “With the proliferation of new-economy companies and professional investors backing these companies, we have seen a growing appetite for alternative arrangements, which align employee and shareholder interests, while managing dilution of control. Given the new listing regime in Hong Kong, we expect to see this trend continue,” said David Siew, Partner, Global Mobility Services, KPMG China.

Alternative arrangements are also being driven by diversity. Executives are importing business practices from other locations and industries, such as Silicon Valley, but at the same time, also need to navigate the views of investors in the region.

When awarding equity to executives (including founders), it is important to understand the implications as there can be unforeseen surprises if not managed correctly.

The tax angle

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.

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The 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. "We usually advise founders to plan their share or option grants around the time of fundraising activities in order to make it easier to establish the fair value of the shares or share options for financial reporting purposes," said Irene Chu, Head of New Economy and Life Sciences, KPMG China.

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.

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The opportunities

According to Siew, “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.

Areas to watch out for

When dealing with a diverse talent pool, a range of complexities may arise.

Where US taxpayers are involved, awards need to be structured carefully to manage the risk of being regarded as ‘non-compliant’ for US tax purposes, which can be subject to punitive taxes/penalties, rendering an award completely unattractive.

Documenting any valuations, supported by robust methodologies, will be key to a defence in case of a tax audit. “One should remember that tax authorities always have the benefit of hindsight when assessing tax, and the valuation of an unquoted share is a subjective matter,” Siew explained. “Valuations used for funding rounds are typically the best starting point of reference where awards are granted within a certain period of funding. An independent valuation can help bolster a defence,” he continued.

“Accounting for employee equity awards is often overlooked by private companies because there is no cash impact. Not accounting for these awards properly in the financial statements could result in material errors that usually take a lot of time and effort to correct at a later stage, especially when companies start planning for an IPO. It is therefore important for founders to understand the financial consequences of employee equity awards, and plan accordingly,” said Chu.

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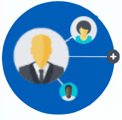

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