

Comprehensive and Practical Equity/ESOP/ESS Guide
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Hi,

My name is Alexey.

I have structured a few ESOPs for Australian, US, and Philippines markets for several startups and a lot of learnings in this area came into sharper focus as we embarked on building [Eucalyptus](#), so I wanted to share these lessons so you can benefit from them as well. This guide was written at the date stated above, so please check this date as tax rules in this area can and do change. The principles, however, remain consistent and after reading this guide you should be in a position to ask the right questions from your lawyers and accountants.

Core Guide

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Worked Example - Founder Link

You will notice that I made a special effort to keep each section to 1 page where possible. It was not easy to be so concise, but I hope this effort pays off in terms of keeping the key operational principles in a sharper focus for you. If you want to chat about it or think there is a section missing, you can reach me [LinkedIn](#) (preferred), directly on 0402191613 or alexey@eucalyptus.vc

Without further delay, let's dig in!

How to think about the purpose of an equity plan

Why does your company need an equity plan?

There is an endless list of subjective reasons that you have already heard, they probably were stated as assumed truths ie “To retain talent”, but it is not always clear how exactly ESOP plan does it. This guide will adopt a different approach, it will trace the purported outcomes to specific mechanics of the plan itself. It’s also important to note that an equity plan only supplements your other initiatives across the business, and so far I found four distinct purposes that the plan can help with, which are:

Cash saving - is what it sounds like, and a frequent reason that is quoted as to why an equity plan should be put in place. The logic is that employees will accept a lower salary because their pay packets are supplemented by an equity component. Practically, not all employees you need can be acquired like this, nor will they be happy to be underpaid for a prolonged period of time.

Effective Recruitment - you can use a tool like an equity grant to supplement your recruitment operations. In some cases, it's done because all the major competitors provide equity, in others to paint the picture of potential riches, and yet in other cases to provide fairly certain cash payout at a predetermined point in time.

Unity building aims to take the idea of "we are all owners and in this together, so let's work together" into a practical context. Equity is not a single mechanism that brings this idea to life but can play a major role.

Employee retention is also frequently mentioned. Equity programs at times have points at which economic incentives to remain at the employer are fairly significant. This can manifest itself most vividly in a company that has undergone significant appreciation or put in place a plan for a specific exit event, like an IPO.

What goal are you trying to achieve?

Equity plans are flexible. While there could be a conventional way to implement an equity plan, the rules of a specific plan can be modified to focus on the area that you want. Outcomes above are not in conflict with each other necessarily, but they can be. For example, plans that aim to lock employees economically into their seats kind of by definition mean that leavers lose out, and that might affect your recruitment and unity building efforts.

That said, the most important point is that ESOPs are tools that allow you to enhance current financial, recruitment, team building, and retention initiatives. ESOPs don't work in isolation. So take some time to think about what you really need now and likely to need in the future.

Key ways equity plans can be structured

I wanted to make sure this guide is readable for all levels, so we'll start with the basics.

Equity is usually granted by issuing

- **Shares** - a piece of the company
- **Options** - an agreement to be able to buy a piece of the company in the future at a price that is determined now (also known as a strike price)
- **Restricted Stock Units (RSU)** - not equity really, but a derivative agreement for cash compensation that varies depending on what the share price is doing.

That's it! Everything else is simply a remix of the above core structures for tax, legal or plan purpose reasons. Once the structure is decided on, some of the common additional ingredients are:

- **Grant Mechanics** - you could simply give employees shares, options or RSUs, but in many cases, local tax or corporate securities laws don't allow you to do so without some kind of a nasty surprise. So this set of provisions looks to tailor the plan to eliminate those or to take advantage of available tax concessions. A generalised (not any particular tax jurisdiction) example of these can be loan funded share schemes, where the company grants employees loans to purchase the shares, which means employees own the shares earlier and can take advantage of local tax rules.
- **Vesting** - the idea here that an employee comes into possession of their equity after completing a particular hurdle. The vesting hurdles can be anything you can think of, with most common being time-based vesting. Time-based vesting rewards employees that stay with the company for a particular length of time, with the most common vesting schedule being 4 years with 1-year cliff i.e. 25% of the grant is vested at the 1st employment anniversary and rest is vested evenly monthly over the next 3 years. But it does not have to be this way, you can also do a backloaded vesting schedule (50% vests in the last year) or whatever else you need within your equity plan strategy.
- **Limitations** - what employees can't do with their grant. Most plans prevent employees from selling their equity unless it's part of an exit event or a defined sales process. Some plans distinguish between a good leaver and a bad leaver, dictating the circumstances of what employees can walk away with in each scenario (for example, as in the case of moving to work for a direct competitor). Yet other plans also remove employee rights in relation to voting and assign those rights to founders, this is yet another feature that has its uses whether for simplifying administration of the plan or for founder control purposes. These and many other provisions within the plan, allow you to tailor your equity plan to the purpose you think is most important.

Characteristics of well-structured equity plans

Good equity plans are the ones that don't carry surprises within them!

Any surprises mean costs for the company, disgruntled employees, and headaches for you.

Some key things to look out for are:

No upfront payments are required from employees. Good plans do not require employees to expend cash at a point of grant to acquire the said grant or to cover tax obligations, unless, of course, equity is traded and liquid. The structure of the plan selected dictates what exact mechanism achieves this outcome, but in my opinion, this is a foundational requirement.

The plan considers tax legislation(s). Of the nastiest tax implications, the upfront requirement to pay tax is the one. As the employee is still employed with the company when this happens, this outcome destroys whatever purpose you have set for the equity plan. Just as painful is when tax needs to be paid, without a corresponding ability to sell the equity, although in this case, the employee is less likely to be still employed by the company. Finally, many countries have concessional treatment of capital gains (gain from assets held for longer than a predetermined period of time), so while this is usually associated with an equity sale, it would be a shame if the equity plan is taxed inefficiently because it was structured poorly.

The plan provides clarity in relation to the mechanics of the employee departure. In some scenarios, employees get to keep whatever is vested, in others, good/bad leaver provisions may apply, yet in other cases, the employee needs to take proactive action, like exercising their options. The range of outcomes here depends on the way the plan is written, however, usually all the operating provisions of the plan in relation to employee departure are buried in layers of legalese. I am of the opinion that this needs to be clearly surfaced, but sometimes plans are structured in that way on purpose.

Good plans are simple to administer. In my experience, this is dictated by the tax and legal environment of a particular country where the plan is being rolled out. So within each jurisdiction, the most common structure tends to be the simplest one possible. As soon as your company establishes international presence, the same plan structures cannot work across several jurisdictions, so you either need to tailor it to a particular country or establish a parallel equity plan, which approach is simpler depends on which countries you are in.

How much equity should you give and when?

This question is perhaps the most subtle and the answer to it is very subjective. Here are the five ways to think about it:

1. **Give it to nobody** - this option is as valid as any other. The idea here is that cash compensation is sufficient to attract needed employees. Any equity dilution saved can then be leveraged to a greater effect in subsequent fundraising rounds. An argument can be made that you will also attract different character of people or that price does not equal performance or that employee retention will suffer, but these are mostly subjective points of view. You have to decide for yourself if this way is the way for you.
2. **Give it to senior managers only** - more common in Australia even outside of startups. The idea is that only that equity is needed to secure key senior positions, with the majority of other junior employees more easily acquired with cash only compensation. It is also a valid approach that can supplement your overall approach to recruitment, compensation and culture. Will this approach create two-tier society within the company? Not by itself, it can be a contributing factor, but only if already tinted by the culture you have in place.
3. **Wealthfront equity plan model ([Link](#))** - does not actually specify how much to give to individual employees, but creates a systematic approach as to the timing of the grants within employee lifecycle and vesting schedule. Well worth 15 min to research and familiarise your self with the concepts discussed here.
4. **Give to everyone via Founder Link** - something that we have designed and implemented in Eucalyptus and has worked pretty well for us. The idea here is that the startup goes through a set of fundraising rounds and usual employee share plan allocation is 10-15% of the total equity in the company. Setting some expectations around dilution and number of executive, senior, mid and junior employees we plan to hire across our fundraising journey gives us an idea of how the plan will be used across time, employee levels and funding points. A worked example of this is provided at the end of this guide.
5. **Sprinkle to everyone** - similar to the Founder Link in that it aims to give equity to everyone, but is less focused on the economic outcome for the individual employee and more focused on the idea of common ownership. While Founder Link would eventually transition to mostly cash compensation once the business has developed, this approach would maintain equity issuance to all employees. It can be useful in terms of crafting the message, but can also be less meaningful as equity allocations are minor and often stretched once the plan is mostly allocated.

Ways not to present equity offers

Presentation to employees is pretty important as in a way it sets many expectations of your ongoing relationship, but I have seen equity offers being presented in ways that are not great.

“You will be getting % of the company” - the easiest way to revert to, especially after the discussion between the founders, which followed this kind of a split. It does not work in employee context for a few reasons:

- 1) This approach does not put the discussion into economic context - 10% of a small business is less than 0.1% of a multibillion-dollar business. So the comparison between startups on % basis is meaningless (but that won't prevent employees from trying).
- 2) People have mental pegs on what is a large or a small number, without the context of how startups operate ie “0.5% is a very small number, I'm worth at least 20%!”
- 3) In many cases, especially if strike price on options exists, potential % ownership is not correlated to economic output.

\$ worth of options or \$ worth of shares - if effect, taking the number of options and multiplying it by a strike price or taking last investment round price per preference share and multiplying by a number of shares given. The problem with this approach is that:

- 1) It's a mental fallacy! For example, number of options multiplied by the strike price actually gives the amount employees have to pay to acquire the option. In the share example the price given is for a preference share, but ignoring that technicality, employees think that they get that much value, but in fact, they are given a window into future company appreciation. When equity is public, liquid, and slowly growing, this presentation has more merit, but at early stages, this approach is not great.

% of your salary into equity - % of your salary is converted into equity similar to the calculation in the previous example above. What can go wrong?

- 1) In a way, this approach aims to calibrate the amount of equity given to seniority level, which is implied in the salary, but practical difficulty exists when salary is adjusted and when starting salary offers rise as the startup progresses, the amount of equity given increases over time, which is counterintuitive to what you would expect.

In all of the examples above, there is a desire to link the equity offer to a \$ outcome. This is natural since it helps with the recruitment process, but this link is often not made well. The above approaches miss the point that the future exit scenarios dictate the ultimate value employee receives. But even if this logic jump is made, the usual tendency is to state the value either present or anticipated one. That is also not ideal since that value is subjective, notional, anticipated, and illiquid. Depending on how the offer is phrased and how employee expectations are set, these approaches can also lead you into the realm of financial advice and under the scope of regulation ASIC enforces. Is there a better way? I'm glad you asked.

Best way to present equity offers

The best way to present equity offers is by way of a **table of economic outcomes** (see below), which is linked closely to the **Founder Link** equity grant structure, please review the appendix for a worked example to get a complete understanding of how these two work together.

Salary (ex super)	Number of Options	Possible Exit Scenarios			
		\$0	\$30,000,000	\$90,000,000	\$1b
\$80,000	100	\$0	\$30,000	\$90,000	\$1,000,000
\$100,000	50	\$0	\$15,000	\$45,000	\$500,000
\$120,000	20	\$0	\$6,000	\$18,000	\$200,000
Additional Information					
Total Current Equity Pool: 100,000		Strike Price: \$0.01		Last Round: 10m pre	
% allocated to Employees: 15%		Expected Dilution 10-20% per investment round			

What makes this presentation so appealing? A couple of things:

- 1) The highest salary is closely matched to what the market rate for the role would be and the lowest is set at a significant discount. Not all employees you need will have the ability to select an equity heavy option (some have school fees to pay), but a proportion will, reducing your salary costs and cash burn at earlier stages at least for a time.
- 2) Exit scenarios are calculated for employees for a range of outcomes, including a \$0 option as well as billion-dollar one. The important part here is that this table allows employees to pick their own level of equity exposure, with possibilities of a high and low payout clearly defined. You are not stating what outcome will happen, nor how much equity is worth, simply providing the tool to help them understand the simplified mechanics of their grant.
- 3) The fact that they have to make a choice is also important. This helps in a lot of subtle ways, like if they have not chosen the higher equity option early on, then phrasing of "not enough equity was given" turns into "how can I perform better to get more equity".
- 4) Presenting a table that is market aligned also resets the negotiation field in a way. Usual negotiation tactic in salary discussions is to ask for more than whatever is given. It does not work well here, because you have to make a choice and if you are requesting more

and going outside of confines of the table, it comes with a clear salary vs equity tradeoff attached.

- 5) Introduction of the concept of dilution, which does affect the economics of equity payouts, is important so if employees are not familiar with it, they can understand it at this stage.
- 6) Fully diluted number of shares is public via ASIC, so providing it upfront simplifies the discussion. Employees, if they wish, can figure out the % of ownership, but doing so comes from the point of understanding the economic outcomes of the equation. Now if they are comparing two offers they won't compare it solely based on a percentage basis and will need all the information above from other company to make a choice. And since you are much better prepared for this discussion you will come across as a more open and put together startup.

How would we link all of these into a job offer email? Here is an example:

Hi Robert,

I'm very excited to offer you the position of a Junior Developer!

<Tech Lead> mentioned that you aced your pairing programming session and we are all excited about the experiences you bring to the team!

The way we do offers at Global Corp is a bit different, kind of choose you our own adventure and level of equity exposure. The options are summarised in the table below:

Table

The level of experience with equity instruments varies greatly, so our Finance Lead (cc'd) is available to answer any questions you have or, if needed, book in a longer session to explain how options work.

Steps from here:

- 1) Let us know your preference from the table above
- 2) HR Team prepares your employment contract for our signature
- 3) We send your equity choice to our board for approval (each grant needs to be approved individually, but we batch them into a monthly process)
- 4) Your equity documents (offer letter + plan rules) will be ready for you on your first day!

I'll give you a call tomorrow around X to have a chat about the offer, please let me know if this works?

Current AU tax rules around equity plans

As of January 2020, Australian Tax Office (ATO) has a [lot of information dedicated](#) to employee share scheme (ESS) regime. We are most interested in a subdivision of this regime that came into effect in 2015 called [ESS Startup Concessions](#).

In effect, if you structured you plan correctly, these concessions allow for taxation point to coincide with the eventual sale of the equity, thus providing the capital needed for employees to pay their taxes. Conditions that you must meet, verbatim, are:

- the ESS interests you provide are in a start-up company
- your company (which may not be the company issuing the ESS interests) must be an Australian resident taxpayer
- for an ESS interest that is a share – the discount must be no more than 15% of its market value when you provide it
- for an ESS interest that is a right – the amount that must be paid to exercise the right must be greater than or equal to the market value of an ordinary share in the company when you provide the ESS interest
- the scheme is operated so that employees must hold the ESS interests (or any share acquired as a result of exercising the interest) for a minimum of either three years or your employee ceases employment

What is a start-up company you ask? This is [defined](#) as

- The company that grants the ESS interests (Options in this case) must have had an aggregated turnover of less than \$50 million in the income year prior to the year the interests are granted.
- The company (and its corporate group) must not have any interests listed on an approved stock exchange in the income year prior to the ESS interest being offered.
- The company (and its connected entities) must have been incorporated for less than 10 years.
- The employing company (which can be a subsidiary of the company granting the ESS interests are being offered) must be an Australian resident taxpayer.

Another part of the ESS framework that we are interested in is called [Safe Harbour valuation methodology](#). It's important because taxation depends on the “market value” which is set as part of equity offers. If you set it too low, upfront tax on a grant is a possibility and if you set it too high, then the employee would be missing out on potential value.

For unlisted securities, ATO provides the framework for you to apply to get the “market value” which they will accept as being correct. One of the methods allowed is what is known as the **net**

asset test. In summary, and I am butchering and shortening the application of the framework for the sake of the key point, this allows you to take the net assets, less rights of the preference and divide it by the number of common shares outstanding. In practice, this means that if your startup raised capital and not yet turned a profit the value per common share will be negative or in effect \$0.01. This is very beneficial to early-stage startups, but you need to be careful and keep an eye on when you are too big and can't use the framework anymore because at that point you need to get a professional valuation done so that you can continue issuing grants.

Just to show how complex the layering of different tests is so far we had to keep track of

- 1) ESS Startup Concession eligibility criteria (provided above)
- 2) Definition of a startup company (summary above)
- 3) Safe Harbour valuation methodology eligibility criteria ([Link](#))
- 4) If you go with net asset test - definition of a small business entity ([Link](#))

You can read the tests on the links provided, but in summary, you need to watch out for how large your turnover is, how long you have been registered for and how much capital you have raised, all these can be triggers that make you ineligible for some parts of the regime. Phew... it seems that all this complexity is in place just to make sure accountants are employed.

What does all of this mean?

Practically it means that early-stage startups would follow a very standard structure when issuing equity to their employees. In fact, ATO provides a [standard set of equity plan documents](#) for you to use. These are ok to use as is, but in a lot of cases, docs are also tailored to allow for things like bad/good leaver provisions and any other requirement that you might have. It comes with a cost of course, but don't let any lawyer fool you in the fact that they are designing the whole plan from scratch. Also because of [Corporation Act Section 113](#) proprietary companies in Australia are limited to 50 shareholders, emphasis on the **share**. Thus option plans are the most common at early stages, as they allow for equity to be issued without triggering listing requirements based on the shareholder limit.

Congrats! This was a pretty heavy section, but you made it!

Before we move on to another heavy ASIC section, let's just quickly chat about the ATO reporting requirements that come with issuing equity.

ATO Reporting requirements for equity plans

Overview

What to report and the format of reporting is covered in Annual ESS Reporting Guide ([link to ATO Guide](#))

The idea here is that you tell ATO when you grant equity to your employees so that when the time comes and employees sell their equity ATO has a nice list of all the people equity has been granted to and who are now liable to pay tax.

You also need to provide a copy of the report you lodge to the employee and guide specifies the deadlines as to when these need to be lodged each year.

Practical Steps

Ways to lodge with ATO

1. Via [ATO business portal](#) (you or your accountant should have access to this).
2. Via specialised reporting software if you have more than 50 employees to report on. Most larger accounting firms can provide this service, and most of them do it through a company called ADP (payroll outsourcing company, but outsourcing payroll is another story).

Ways to provide this information to employees

1. [Download the form on ATO portal](#) and then add manually or transfer into MSword and do Mail Merge if you have a lot of entries to go through.

If you have 10 employees, lodging manually and providing copies to employees takes about an hour or two due to the manual nature of the ATO portal form. If you have more than that to lodge, it's worthwhile to see if your accountant can do it for you.

State Reporting requirements for equity plans

At least in Australia, some states require for the value of the equity grants to be included in payroll tax calculation. How this concept of "value" is calculated across the range of states is out of scope for this guide, but the point here is this - make sure you check federal and state reporting obligations.

Now for another juicy part - ASIC reporting requirements!

ASIC Reporting requirements for equity plans

General Principles

Any fundraising (and issuance of equity to employees is viewed as such) in Australia requires a disclosure document unless an exemption applies. [The list of exemptions is provided here.](#)

The usual practical sequence of applying exemptions is then as follows

- 1) **Sophisticated Investor** ([Corps Act Link](#)) - if the amount invested is more than \$500,000 or if a qualified accountant can provide a sophisticated investor certificate based on a person's assets or income.
- 2) **Senior Employee Rule** ([Corps Act Link](#)) - senior employee, [defined](#) as someone who has the capacity to significantly affect organisations financial standing.
- 3) **The 20/12/2 rule** ([Corps Act Link](#)) rolling 12 months exemption that counts the number of grants and amount raised as its key thresholds. Keep in mind that this is combined with any angel non-sophisticated offers you make in your fundraising journey. So if you raised from 19 angels, not a lot of room for grants.

Also of note is the fact that offers to overseas people don't count into the amounts, but you may have foreign regulations to abide by (we'll cover this concept in another section later)

Once exemptions are exhausted it's time to prepare an Offer Information Statement (OIS)!

OIS is a short form prospectus, it has a scripted set of information that needs to be provided, unlike a prospectus that needs to cover pretty much everything. A full description of the instrument can be seen in [ASIC's regulatory guide 254](#). The most important points of OIS is that it requires **audited** financial statements with **6 months balance date freshness at the time of lodgement with ASIC**. This for most companies means that you need to lodge it by 31 December if your annual year is 30 June, **if you don't make the timeline you won't be able to issue grants for at least 7 months**. You can use the OIS for 13 months, but in practice, it's refreshed annually because of the peculiar lodgement timing. Keep in mind that OIS also has fundraising limits of \$10 million, so your fundraising outside of ESOP can affect the thresholds.

It costs somewhere between 10-15k to prepare an offer information statement via a corporate securities lawyer.

Key principles of granting equity in other countries

Good job! We are almost at the end and it becomes an easier read from here!

So far you have learned that Australia has two governing bodies that regulate how equity is issued - ATO for tax and ASIC for corporate securities law. This structure is pretty much replicated in other countries - IRS and SEC, FCA and HMRC, etc. So the first rule of getting ready to issue equity in overseas jurisdictions is:

P1: Understand what tax authority and corporate security authority is in the country you wish to issue equity in and what requirements they have in relation to equity grants.

With ASIC equivalent entities, their primary concerns are that the ways equity is granted follows the due process. So rule here is

P2: Don't forget corporate securities laws also have an effect on how you issue equity.

In practice, it means you are looking for plan lodgement requirements, disclosure document requirements or information that needs to be provided to public or employees about the equity on offer.

As for tax, we have seen previously in AU the two primary concerns ATO has are when employees are taxed and that you let it know about the fact that you have provided grants to employees. This is pretty much the things you are looking for in other jurisdiction.

P3: Understand what taxation approach to equity grants is and what notification requirements are.

A useful way to think about how taxation works is by way of possible tax points for each instrument as per the table at the end of this section. What approach is taken by each individual tax authority is anyone's guess, but hopefully, this can serve as a useful map as you go about interrogating local accountants, which brings me to the last point.

P4: You will need to spend some \$\$\$ on local lawyers and accountants.

Implementing equity plans in an international context is not simple or, in the scheme of things, common. Very few accounting or law firms would have exposure to multinational context, so some local advice \$\$\$ is needed, alongside combining or rolling out a parallel equity plan.

	Restricted Stock	Stock Options	Restricted Units
Value at grant	Yes	No* if strike price is set right	No (in the eyes of most tax authorities)
Value at Vesting	Sometimes	No	Yes**
Transfer of shares timing	At the start	Upon exercise	At settlement
Tax point	At grant or at vesting and at subsequent sale	Can be at grant, but usually at exercise***	At vesting
Capital Gain available?	Generally yes	Yes, but ****	No
Costs to Employee	Minor if structured right, fixable exposure at vesting	None if structured right, but strike price could be an issue	None if structured right, fixable exposure at vesting
Company sale considerations	Treatment of unvested shares	Treatment of outstanding options	Outstanding RSUs and their unsecured creditor status
Other			You may need to pay payroll taxes as RSU usually treated as a form of compensation

* Options do have “time” value even if strike price equals the market price, but this is generally ignored by most tax authorities.

** But vesting conditions do not have to be contingent upon time passing, this could be set as a liquidity event

*** Some tax authorities allow for tax to be paid on the sale of shares, not at the exercise point

**** Most tax authorities take the approach that tax should be paid on the sale of an asset, options are an asset, if options are exercised then the asset is gone and shares are received, shares are also an asset and waiting periods for the capital gains discount may be reset. Some countries work the carry over into their tax laws, but not all.

Ways equity is granted based on the company stage

This is an excerpt from an article called "[Startup Equity: Restricted Stock, Stock Options, RSU? What's best?](#)" that I have done about 3 years ago. The whole article is still a good read, but the narrative section I wanted to share is below. Please note it's not written for AU context, but still illustrates the rolling nature of equity structures quite well.

Meet Bob!

As a budding entrepreneur, Bob, decides to finally pursue his dream of building the next Uber for That-super-cool-industry. He develops a flashy pitch deck and was able to secure interest from some angel investors. Angel investors tell Bob that he needs to set up a company before they invest the money into his idea. Bob gets his lawyer/accountant friend to set the company up, Bob sets the company up without considering the future IP that will be generated by the business or caring much about classes of stock. A lost opportunity or a mistake? Time will tell.

Anyway, Bob has a company now and he gets some investment into it. Bob also realises that while his flashy pitch desk is very slick, he has to build a prototype and needs some technical talent on his team - a Technical Co-Founder (!!!).

Bob can't really pay a market salary for the required skills, so he decides to offer some equity to his co-founder. Bob does not really want to give away equity without some conditions attached to it, like say vesting (!). So which plan should Bob use? RSU can be paid in cash or stock, but are taxed at a point of vesting or, if Bob has the foresight, at a liquidity event. But who knows when that be? Also since we are talking about Uber for That-super-cool-industry, the shares, although not worth much now, will be worth a fortune in the future so tax at vesting sounds like a not so great idea. Maybe options then? These sound reasonable in that mechanism of operation is fairly simple, but complexity with ISO and NSO, strike prices and associated tax rules is a bit off-putting. How about the Restricted Stock then? Well, that sounds pretty good - shares are valued at cents to the dollar, recent investment by the angels pushed the price of shares up but by a small amount. Bob can get the vesting conditions he wants, let's say four years with one year cliff (!), and the tax component seems fairly simple, provided the Tech co-founder lodges his/her 83(b) election. Yep, restricted stock sounds like a suitable solution and upon a quick check with his lawyer to see if there are any regulations surrounding the issuance of securities, Bob gets the plan in place.

A few months pass, the initial prototype was a success and did not take long to build due to the Lean Startup methodology Bob heard about, version 2.0 is in the pipeline and an additional round of investment is closed. 409a valuation just came back and the shares jumped in value from a few cents to a few dollars. Cause to celebrate? Perhaps, but there is much work still to

be done and the restricted stock awards now cause some upfront tax pain for the new employees. 83b election causes employees to get a tax liability at the time of grant, and with a few dollars to a share, this is now a significant inconvenience. If the success keeps up the pace these restricted stock awards will become problematic. Would RSU work? Liquidity is still a way off, and taxation upon vesting is still not great. How about options? Well if Bob structures it right, employees don't have to pay tax or contribute at the point of grant. They still get access to capital gains in some circumstances and the complex tax treatment is still there, but Bob now can spend the cash to get proper specialist advice, there is also some flexibility for employees to decide when to crystallize their gain and while options that Bob will grant will have their strike price equal 409a value, there is still plenty of growth left in the company to make these valuable in the future (or so Bob hopes). Cool! Options plan it is, Bob just needs to check with the lawyer on the process for issuing these grants to so many employees!

Fast forward a few years and Bob's (although not really his but his along with a few VC firms) company is now a Unicorn! Success! Champagne! And during one of the celebration canapes, investors broach the subject of listing and liquidity. What a great idea! Another badge of success and Bob wants it, but he has a problem key employees have vested into their options and stock awards and Bob needs the key staff to prepare the company for listing, also new staff do not see that much value in options since the company is arguably passed its super growth stage (Bob does not agree with this nonsense as there are plenty of new blue waters to explore, but new employees simply don't get that). Regardless, if employees don't want options perhaps RSU will work? A liquidity event is just in sight, RSU can be structured so that taxation point occurs alongside the IPO and some of those proceeds can be used to settle some of the RSU. There are some drawbacks, such as lack of capital gains treatment for employees, but they also get certain value (as opposed to now possible value in an option). These employees have to stick around for a few years until the IPO, but that's exactly what this company needs!

Let's wrap up Bob's story.

The point behind the story? There are probably a few if you can see them, but one is that the method of issuing equity or equity-linked compensation depends on a few company-specific things. As circumstances, tax and corporate securities legislation changes so should your option plans. Additionally, equity plans can be tailored, this opens a range of possibilities in affecting employee behaviour.

/end article

Other topics

This Guide is designed as an introduction for early-stage startups on how equity is granted, taxed, and regulated in Australia. There are however many other dimensions that can also be explored at later stages. I have listed these below alongside a short summary but decided not to include them to keep the guide focused and concise.

Things to consider when granting equity to advisors

Advisory grants are a common feature in Australian startups, on the surface, they usually have a different vesting schedule, but if you dig deeper a separate framework for what kind of advisors are needed, how much they are compensated and how to get useful advice from them needs to be developed.

ESOP Communications rollout plan

When you are just starting out and rolling out a plan to a handful of employees, it is pretty easy to make sure they understand how equity works. If you have to roll out the plan to a dozen employees, then explaining how the plan works, what can and cannot be done with equity instruments etc. becomes a bigger project.

Granting equity in a specific jurisdiction (PH, US, UK)

The general principles discussed in this guide for international plans hold true, but Australian startups often have ties to the United States, Philippines and UK. Each country has its own set of tax and corporate securities laws. So a deeper dive into what those are can take another 10 pages.

Things to consider if you have US citizens as employees in AU

US citizens are taxed on their worldwide income, but it also means that an AU grant would be looked at through a US tax law lens. At minimum, you need to make sure US citizens employed by you get proper tax advice, as an extra step you could provide a pathway within your plan to satisfy the US tax regime.

Useful habits in Recruitment and Board processes

Secretariat is often an ignored function at early stages, it can be extremely useful and company secretaries, among other things, would administer all aspects of equity issuance and communication across recruitment, HR, Management and Board. How they do it efficiently can be a guide on its own.

Transitional arrangements from startup equity concessions

At one point, startup concessions no longer apply as business becomes too big, but startup equity can still be illiquid. What options are available at that stage to continue granting equity and how these can be implemented. Please note that there is [pending legislation on this](#).

Final Thoughts

I sincerely hope that you have enjoyed reading this guide. I sometimes forget how dry all the tax and corporate legislation is, but I also remember how exciting it is to build startups! And equity plans are an integral part of that journey, so I try to move some of that excitement into my mind when I'm reading all the legislation.

As with all guides, I have neglected some areas and summarized the others. I hope I have not missed too much, but if you think there is an area that you would like to explore further, please let me know! We most certainly will have a delightful chat about it and I'll add it in or create another guide depending on overall demand for the topic.

Happy building!

~Alexey

Appendix

Worked Example - Founder Link

Before we dig into Founder Link, let's have a look at how shares reserved for the equity plan work across fundraising rounds.

Let's assume your company has 2 founders and each holds 10,000 shares. Cap table at founding would look like this.

Shareholder	Shares Held	Percentage Held
Founder 1	10,000	50%
Founder 2	10,000	50%

Next founders decided to raise some funds and implement an employee equity plan of 15%. The fundraising was done on 4.5 million pre-money and 500k was invested, investors now own 10% (which does not include the dilution of the equity pool yet to be implemented).

Shareholder	Shares Held	Percentage Held
Founder 1	10,000	45%
Founder 2	10,000	45%
Investor 1	2222	10%

Now the employee equity pool is being introduced

Shareholder	Shares Held	Percentage Held
Founder 1	10,000	38.25%
Founder 2	10,000	38.25%
Investor 1	2222	8.5%
Reserved for Employees	3920	15%

As you can see you have 3920 shares that are available for you to do your recruitment. Each fundraising round the plan gets additional shares added to is as for it to remain at 15%. For example, we have another investment round with 9m pre-money valuation and 1m invested. Investor 2 would want for the ESOP plan dilution to hit before the investment is being made so that they own 10% of the final captable like so

Shareholder	Shares Held	Percentage Held
Founder 1	10,000	33.75%
Founder 2	10,000	33.75%
Investor 1	2222	7.5%
Investor 2	2973	10%
Reserved for Employees	3920+520	15%

So you can see that the plan has expanded a bit with 520 additional shares reserved.

Now we layer the important concepts. First one is employee seniority, second is employee choice and finally risk stage.

Employee seniority is pretty self-explanatory. We'll have four levels in our example

Junior
Mid
Senior
Executive

For employee choice, we'll have three options

Junior	Equity heavy
	Balanced
	Salary heavy
Mid	Equity heavy
	Balanced
	Salary heavy
Etc.	

Lastly the concept of Risk

At Eucalyptus, we tied the concept of risk to equity rounds (Seed, Series A, Series B), but it does not have to be like this, so for example, in a research-heavy startups it can be tied to technical proof points. At each stage risk decreases, hence the amount of equity given reduces. This allows us to construct a table of outcomes for each level and choice like so

		Founder Link	Founder Equity	Junior Shares
Junior - Seed (risk factor 1)	Equity heavy	10	10000	1000
	Balanced	20	10000	500
	Salary heavy	50	10000	200
Junior - Series A (risk factor 2)	Equity heavy	20	10000	500
	Balanced	40	10000	250
	Salary heavy	100	10000	100
Junior - Series B	Equity heavy			
	Balanced			
	Salary heavy			

Founder Link in this example determines how many more times founder is better off compared to this employee and their choice at that stage, depending on the risk factor.

Pretty simple in isolation!

But you have to remember the constraints that are in place which are

- 1) The total size of the pool at each stage
- 2) The number of employees you are to hire, at which level, and what point in time. For example, I think Series B can be anywhere from 60 to 120 employees, with senior to Junior ratios of 1 to 4.
- 3) Some shares should be left to reward exceptional performance and for top-up grants.
- 4) Some teams (like developers) are hard to recruit, so their allocation is set for example to double what a general pool employee would get.

Once you have this giant table constructed, this exercise forces you to plan through next 3-4 years of equity allocations within the constraints you have. All of a sudden, by virtue of having to balance long term and short term, you will come to a consistent view of what reasonable grant is based on team, choice, employee level, and startup stage. You would then review and calibrate it according to how your recruitment efforts are going and what choices employees are making.