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Review of elements of Employee Share Schemes: start-up, research and development and speculative-type companies

Thank you for the opportunity to make a submission to the Board of Tax on this matter.

Starfish Ventures is an Australian-owned venture capital firm with $400 million under management. Starfish Ventures invests in innovative, globally competitive technology companies with an Australian base. We are passionate believers in innovation and its ability to create high value jobs and exports for Australia.

Whilst we are sympathetic with the Government's aim of removing the abuse of employee share schemes by large corporations, the current rules in Division 13A of the Income Tax Assessment Act 1936 and the proposed rules in Division 83A of the Income Tax Assessment Act 1997 diminish the ability of early-stage, innovative Australian companies to attract and retain staff.

ESS and Staff Recruitment for Early-Stage Companies

It is a challenge to convince successful academics, entrepreneurs, technical experts and experienced executives to risk all and be involved in small, early stage companies. The benefit to balance the risks and hardships is that they might contribute to the creation of a new business and that the shares they receive may be worth something in the future. Unlike large corporations, early-stage companies do not have the cash-flow to pay employees cash bonuses and underwrite their share plans. Options serve as a strong incentive to entice potential employees to accept the risk associated with working for an early stage company.

A typical option plan for early stage companies is to issue options to an employee with an exercise price equal to the market value of the underlying shares at that date. The options will then vest periodically over a 3 year period provided the employee remains employed throughout that period. Once vested, the employee cannot exercise the options until a 'liquidity event' – when shares are sold to a trade buyer or the shares are sold into an IPO.

Proposed ESS

Under the proposed employee share scheme rules, tax on any discount on grant of options will only be deferred until the ESS deferred taxing point being the earlier of:

- removal of sale restrictions;
- cessation of employment; or
- 7 years.

The discount at the relevant ESS deferred taxing point will be assessable as statutory income rather than a capital gain.

This contrasts with the taxation of options in both the US and the UK. In the US, the value of the options is generally considered to be nominal at the time of grant so that tax is only payable on a liquidity event as a long term capital gain at concessional rates. In the

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UK, taxation of options granted to employees of spin-off companies of research institutions are only taxed as a capital gain on realisation.

Implications for Early-Stage Companies

While the proposed Australian rules may be appropriate for employees in listed companies where there is a ready market into which employees can dispose of their securities, no such market exists for early-stage companies. If employees in early-stage companies are taxed at any time other than on sale, then recruitment of quality staff to early-stage companies will become an even greater challenge for the following reasons:

- Unlike large corporations, whose employees are able to sell their shares as soon as the options are exercised, shares in early-stage companies are not liquid and may never be. This leaves employees of early-stage companies essentially penalised by paying taxes on the value of shares they aren't able to realise.
- Employees that are taxed at any stage other than sale are taxed on share prices determined by a company auditor. These valuations do not guarantee true market value and only until a liquidity event, such as an IPO, does the shareholder clearly know the value of his or her shares. Early-stage companies will need to get third party validation to confirm the valuation, creating additional expense and burden on cash and time-strapped companies.
- Employee options and share plans for start-up, research and development, and speculative-type companies are a worldwide practice and with the changes to the taxation of employee share schemes, Australia will become a much less attractive location for potential overseas employees or Australian citizens currently working overseas.
    - For example, the company may only be able to recruit someone for a short term contract (say 3 year) to advance the company's operations. If such an employee is taxed on cessation of employment or 7 years after grant if there has not been a prior liquidity event, then a critical recruitment incentive has been lost.
- The business venture may fail and the options may never actually be exercised, resulting in an employee paying taxes on an asset they never received. Unlike the executives the Government is targeting, individuals involved in start-up, research and development and speculative-type companies are unlikely to have future capital gains to offset any tax previously paid.

For innovation to turn into commercialised ventures, it is imperative that governments, investors and entrepreneurs work together as partners. We rely on each other to turn a great idea into a successful global business through policies that support innovation, capital injections to take these ideas to the marketplace, and outstanding individuals to execute the business plan and perfect the technologies. The proposed rules on taxation of employee share schemes will create a significant disincentive for individuals to be involved in an early-stage company, putting this delicate partnership at extreme risk.

If there is no change to the employee share scheme provisions for start-up, research and development and speculative-type companies it may result in high-quality entrepreneurs, academics and technology experts staying in their current roles and Australia losing out on creating new businesses and more importantly, high value jobs.

PROPOSAL

Starfish Ventures proposes that a separate tax regime be established for the employee share option schemes for companies involved in start-up, research and development and speculative-type activities that will induce employees to work in such enterprises.

Eligibility

- Companies to be eligible for a different tax treatment should be involved in innovation and research and development.
- Those companies that can access the different tax treatment are those that can access the 45% Refundable R&D tax credit, or alternatively, non-listed companies with revenue less than $20 million that are not profitable.

Recommendations

- Discounts on the value of options (and shares) granted to employees of eligible companies would only be assessed on actual realisation of any gain and be assessed only as a capital gain and not as assessable income under proposed Division 83A.
- If the option or shares are held for more than 12 months prior to the realisation of the gain, then the gain should qualify as a discount capital gain.
- Employees of eligible companies who have held the option for at least 12 months should be able to access the CGT discount regardless of whether the options are sold to a third party, cancelled or exercised and the shares immediately sold.

Finally, under the present and proposed ESOP tax rules, deferral of tax is only available if the employee holds less than 5% of the ordinary shares on issue. In certain instances, Starfish Ventures has invested in companies where the CEO holds more than 5% but less than 10% of the shares. We submit that any change to the taxation treatment for employees of eligible companies should be broad enough to enable employees who hold less than 10% of the shares to access the concessions.

By implementing such a proposal, the Australian government can continue to foster innovation, new business development and create more high value jobs in Australia. We do not believe our proposed change will have any significant impact on the Government's budgetary considerations.

We welcome the opportunity to discuss these matters with you further.

Respectfully,

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