Greenwoods
& Freehills

Review of Tax Impediments to Small Business
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

4 July 2014

Dear Sir or Madam

Employee equity in start-up and small business companies

We are writing to highlight an unfairness in the tax system that we believe is also unnecessarily hindering small business. It is most acute for start-up companies which are also the subject of the Government's 'Employee Share Scheme arrangements for Start-ups' consultation. However, the issue is not confined to start-ups, and this submission is to raise it in the broader context.

The unfairness arises essentially because equity in start-ups and small businesses is equated with equity in large listed companies for tax purposes. An equity allocation is in both cases taxed as reward for services, and yet equity in a start-up or small business is in reality usually nothing like that. It is at best usually only an opportunity for possible future benefit, allocated precisely because employees are forgoing reward. The employees are in reality investing their time rather than being rewarded for it.

Shares in a large listed company on the other hand will usually have currency of their own, and to that extent might be equated to salary and taxed as reward for services. Shares in these companies will normally provide a dividend income stream and have a readily acknowledged and relatively stable share price i.e., recognised value. A share allocation in these companies is, at least to some extent (i.e., leaving aside vesting requirements and sale restrictions), equivalent to receiving a cash salary and reinvesting it in shares; but that is not so of equity, particularly options, in a start-up or small business company at the other end of the spectrum.

Two things follow once you recognise this distinction.

Tax on realisation of value

First, as needs hardly to be said, employees should not be taxed on benefits that may never materialise. It is unfair to treat these employees as rewarded unless and until benefits are in fact realised.

Other equity holders in start-up and small business companies are not taxed, of course, until they realise value when they sell.

Also note that it is only under the employee share plan rules that people are taxed in Australia before they realise value anyway. This doesn't otherwise happen under our system, and employee participation in business ownership is therefore penalised rather than promoted.

Tax as any other investor

Second, unlike other investors, employees investing their time in start-up and small business companies are denied capital account treatment i.e., the 50% CGT discount

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and the ability to offset capital losses – and note again, employee ownership is therefore penalised rather than promoted. Fairness requires, on the other hand, that employees investing their time are treated in the same way as those able to invest capital; that is, taxed only on capital account, and only when they realise value. Both investors take on high risk in the start-up and small business sector, and yet presently only the capital investor is recognised for it.

Example

An example perhaps best illustrates the discrepancy. Consider individual A who invests $1 million in a venture and works full-time in the business, drawing only a subsistence salary so as to leave maximum funds available for its development. Value accreting to the business will ultimately be reflected in his shares (i.e., assuming a company ownership structure) and individual A will be taxed on it if and when he sells, with the benefit of the CGT discount and any capital loss shelter available to him. Individual B also works in the venture full-time, and also accepts a subsistence salary. In place of a market salary, or in other words to the extent that she is *not* being rewarded for her work, individual B is allocated options to allow her the opportunity to share in *future* success.

Why should individual B be taxed more onerously than individual A? Both individuals accept the risk of not ever being rewarded in order to support the venture. Both invest in the business: in one case time, and in the other case both time and capital. Why should the individual perhaps not able to invest capital be kept at a disadvantage?

Good economics

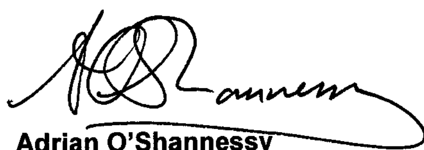
The unfairness is resolved by treating employee equity holders in start-up and small business companies as any other investors. That will at the same time remove the taxation impediment to employee participation in the ownership of start-up and small business companies, and therefore encourage all of the productivity benefits that brings.

Borderline question

Finally, we recognise that ensuring the proper treatment of start-up and small business employees, if they are to be singled out, raises the question of where and how to draw the borderline. We would encourage you not to be too circumspect. Drawing the border at the CGT small business threshold (i.e., $2 Million turnover, $6 million assets) would render any changes virtually meaningless. Requiring the business to fit within either the refundable R&D refundable tax offset threshold (i.e., $20 million turnover) or the early-stage venture capital fund investment asset limit (i.e., $250 million assets) would set a more meaningful boundary in this context.

Please call or email me if you have any questions or if you want to discuss this submission.

Yours sincerely



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