AUSTRALIAN INVESTMENT COUNCIL

10 June 2020

Standing Committee on Tax and Revenue
PO Box 6021
Parliament House
Canberra ACT 2600

Email: TaxRev.reps@aph.gov.au

Submission to the Standing Committee on Tax and Revenue on the Tax Treatment of Employee Share Schemes

Dear Sir/Madam,

As the voice of private capital in Australia, the Australian Investment Council is pleased to present its submission to the inquiry into the Tax Treatment of Employee Share Schemes.

Private capital investment has played a central role in the growth and expansion of thousands of businesses and represents a multi-billion-dollar contribution to the Australian economy. Our members are the standard-bearers of professional investment and include: private equity **(PE),** venture capital **(VC)** and private credit **(PC)** funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers. Our members include both Australian domestic and offshore-based firms.

Private capital fund managers invest billions of dollars into Australian companies every year. Australian-based PE and VC funds under management reached $33 billion in 2019, which represents a growth in available capital to support investment into businesses across every industry sector of the economy. The industry now has a combined total of around $13 billion in equity capital available to be invested in the short-term.

Given the recent impact of COVID-19 and the uncertain times that lay ahead, each and every day businesses are adjusting to the 'new world' economy and are finding ways to provide security to their employees, to increase productivity and to grow their businesses. In this context, the Australian Investment Council is supportive of the Employee Share Scheme (**ESS**) regime as it plays an important role in remunerating and incentivising staff, particularly in start-ups, scale-ups and other high growth companies.

We provide the following submission for consideration by the committee and look forward to participating in any future discussion about the themes set out in this submission as part of the government's work on employee share schemes.

If you have any questions about specific points made in our submission, please do not hesitate to contact me or Brendon Harper, the Australian Investment Council's Head of Policy and Research, on 02 8243 7000.

Yours sincerely

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Introduction

ESS play an important role in remunerating and incentivising staff, particularly in start-ups, scale-ups and other high growth companies. ESS can be an important component of staff remuneration for these companies due to often having limited resources, despite the potential to grow into large and sustainable businesses. While reforms in this area over recent years have significantly improved the ESS regime, the Council believes there are still opportunities to further enhance how these schemes operate and how companies are able to remunerate their staff.

We provide the following feedback to the committee in response to the specific items in the inquiry's Terms of Reference. The comments below echo those provided by the Australian Investment Council in our 30 April 2019 submission on ESS, which is available on our website.

1 How effective the changes in 2015 have been in their goal of bolstering entrepreneurship in Australia and supporting start-up companies.

The experience of our members anecdotally is that the 2015 changes have improved the ability for businesses to align employees and employers' incentives, particularly for start-ups, scale-ups and other high growth companies.

There has been a widespread adoption of employee option plans for the companies as:

1) Cash flows are often limited and directed to growth, development and innovation;
2) The tax treatment of options for employees is considered to be favourable and attractive;
3) The provision of open source documents, simplification of qualifying rules and the safe harbour valuation methodologies have driven down the cost for companies to establish option plans and make grants to employees.

However, there are several anomalies in the tax provisions that could be improved. For example, the prospectus provisions in Corporations Law could be reformed to enable companies in the growth stage to make option grants when employee numbers are growing rapidly.

2 The costs and benefits of these concessional taxation treatments, and deferred taxing points for options, to the broader community.

As noted above, for companies in the start-up phase, the costs of accessing these provisions and making grants has been simplified. It is too early to accurately assess all of the benefits that have arisen from the 2015 changes as there have been a limited number of exits where employees were granted options which qualified for the start-up concessional tax treatment.

However, there are significant costs and complexities involved in implementing option grants for companies that do not qualify for the start-up concessions, or for founders who are not able to access the start-up concessions because they hold more than 10%.

3 Whether the current tax treatment of ESS remains relevant to start-up companies and whether any changes are appropriate to ensure the taxation treatment remains relevant.

As stated above, ESS continue to play an important role for start-ups, scale-ups and other high growth companies. To further increase the support of the program to Australian businesses, we provide the following recommendations for the committee's consideration.

3.1 The 10-year incorporation requirement

Under current rules, a company must have been incorporated for less than 10 years (before the end of the most recent income year) before the ESS interest is acquired to be eligible. Our members have seen a number of companies failing this requirement because a founder has used a corporate entity from an earlier venture, and subsequently started up a new business through that entity (a common occurrence often known as ‘pivoting’) which has then grown successfully. As a result, at the point of success the entity may be more than 10 years old but ineligible for start-up concessions. It is the Council’s view that this unfairly penalises employees who would otherwise have been able to access an ESS. We therefore recommend that the 10-year incorporation requirement is removed to better accommodate the evolution of many start-ups as businesses that had limited success in earlier ventures but have grown and succeeded later on.

Recommendation 1: *Align ESS with industry practice*
The Australian Investment council recommends the removal of the 10-year incorporation requirement to better align the ESS regime to industry practice.

3.2 The no more than 10% requirement

Another eligibility provision is that the employee must not hold a beneficial interest or voting power of more than 10% in the entity immediately after acquiring the ESS interest. The Council believes that there should be a mechanism to grant founders (who typically hold large stakes in start-ups), or other senior executives, access to additional equity without creating an immediate tax liability. This need arises as founders take on different roles within a start-up as it grows – particularly where one co-founder leaves and the remaining founder(s) have to perform additional duties for which cash compensation may not be available. Removing the ‘no more than 10%’ requirement would address that issue and incentivise founders of start-ups to use their skills, knowledge and experience to help build and grow the businesses that they have established.

Recommendation 2: *More flexibility with ownership structures*
The Australian Investment council recommends the ‘no more than 10%’ ownership requirement be reviewed to provide greater flexibility, particularly to founders as companies grow.

3.3 The 3-year sale restriction

An employee is currently not permitted to dispose of the ESS interest for a period of 3-years starting from when the ESS interest was acquired (although there are limited exceptions to this rule). We believe that this requirement is unnecessary. One of the primary benefits for an employee to gain access to the start-up concessions is that they are taxed on capital account and can access the capital gains tax discount. They can only access the benefit if they were granted their options at least 12 months prior to any disposal.

However, the 3-year sale restriction may become an issue if the company is a target for acquisition by other investors or corporations during that time. It may also serve to discourage investors (both local and overseas), such as VC funds, from providing capital to a start-up as these investors generally want to ensure that there is a ‘clean path’, especially from a tax and regulatory perspective, to enter or exit their investment if required. We therefore recommend that the 3-year sale restriction be removed.

Recommendation 3: *Remove 3-year sale restriction*
The Australian Investment Council recommends the removal of the 3-year sale restriction to reduce barriers to investment into start-ups, scale-ups and other high growth companies.

3.4 Safe harbour valuation: net asset valuation methodology

There are several technical aspects of the net asset valuation methodology which we feel could be optimised. These include:

1) The calculation is undertaken on the basis of the issuing company’s standalone accounts, rather than on a consolidated basis. If intellectual property is held in a wholly owned subsidiary, the value of the intellectual property is reflected in the holding company’s accounts as investment in a subsidiary, which is a tangible asset for accounting purposes. However, if the intellectual property is held by the holding company directly then the intangible assets are effectively ignored. It seems anomalous that there should be a different outcome under the safe harbour valuation depending on which entity in a wholly owned group holds the intangible asset.
2) Start-up companies often raise funds via either a convertible note or a Simple Agreement for Future Equity **(SAFE).** While the safe harbour methodology backs out debt (such as funds raised via a

convertible note) it does not take into account funds raised by a SAFE. The Council believes these instruments should be taken into account either as equivalent to a debt or by calculating.

Recommendation 4: *Review safe harbour methodology*
The Australian Investment Council recommends the safe harbour methodology is reviewed to provide more consistent outcomes.

4 How companies currently structure their ESS arrangements and how taxation treatment affects these decisions.

Start-up companies will generally adopt the concessional regime for the reasons explained above. However, for companies that do not qualify for the start-up concessions, or for founders who are not able to access the start-up concessions because they hold more than 10%, there are significant costs and complexities involved in implementing option grants. Typically, this will involve using one or more of the following structures:

1) **Premium priced options** – options that are priced so far out of the predetermined sale price that they have no value under the income tax regulations. This is a different economic reflex than the start-up concessions;
2) **Loan plans** – usually limited recourse and interest free. However, there are significant complexities with these structures including potential issues under the deemed dividend provisions in Division 7A of the ITAA 1936 or FBT; and
3) **Deferral schemes** under sub-division 83A-C of the ITAA 1997. These provisions are drafted primarily for listed companies and are difficult to navigate in an unlisted environment, where there is no liquid market for employees to realise value at a deferred taxing point.

5 The challenges faced by companies in setting up an ESS arrangement and how the standard documents by the Australian Taxation Office, and introduced in 2015, assist this process and whether additional improvements should be made.

See above.