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5 June 2015

The Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Sir or Madam

Improving taxation of employee share schemes Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015

The initiatives in the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* to improve the taxation of employee share schemes, particularly for start-up companies, will significantly improve the ability of Australian enterprises to compete for and retain global talent and is to be commended. Many companies are planning to utilise these reforms and we recommend that the Bill be passed without delay.

We are writing to request your attention to three matters. The first two require minor but important adjustments to clauses currently proposed by the Bill, and the third is a matter that is not currently addressed by this Bill.

1. Start-up companies: 3 year holding requirement[1]

We recommend that proposed new section 83A-45(5) of the *Income Tax assessment Act 1997* be amended as follows:

83A-45 Further conditions for reducing amounts included in assessable income

...

(5) An *ESS interest's minimum holding period is the period starting when the interest is acquired under the *employee share scheme and ending at the earlier of:

(a) 3 years later, or such earlier time as the Commissioner allows ~~if the Commissioner is satisfied that:~~

[1] This submission assumes that "subsections (2) ~~and~~to (4)" in s 83A-33(7) will be corrected as here marked so that it is consistent with the explanatory memorandum (para 1.88). The age of VCLP and ESVCLP investors in start-up companies could otherwise prevent them satisfying the 10 year rule.

~~(i) the operators of the scheme intended for subsection (4) to apply to the interest during the 3 years after that acquisition of the interest; and~~

~~(ii) at the earlier time that the Commissioner allows, all *membership interests in the relevant company were disposed of under a particular *scheme~~; and

(b) when the acquirer of the interest ceases being employed by the relevant employer.

Start-up companies typically include 'drag-along' and 'tag-along' rights in their employee equity offerings.

Drag-along rights ensure that founder shareholders can realise value when an opportunity arises. Venture capital providers, which are typically 'closed-end' funds, also require the ability to exit investments to comply with their investment mandates. Absent drag-along rights employee shareholdings could operate as blocking stakes.

Tag-along rights ensure that employees can participate in these significant value realisation events ('exit' events), rather than being left holding potentially illiquid minority investments.

The 3 year rule as currently written would inhibit the operation of these rights, and therefore the ability of participants to realise value from start-ups, other than in whole of company sales. However, it is not uncommon for a start-up company to go through several exit and recapitalisation events, and often therefore value is realised incrementally eg., seed funding venture capitalist A exits and expansion venture capitalist B invests.

For the most successful start-ups exit events may occur within 3 years of establishment. For a start-up using an ongoing employee equity programme, exit events will inevitably occur within 3 years of at least the most recent grants.

Founders and venture capital investors should not be fettered in their ability to seek out these opportunities. Nor should employees be locked out of participating in them. Employers will often limit employee participation to a proportionate level, but industry efficiency requires that these ordinary market forces be allowed to operate, and not be artificially constrained by a tax rule.

We appreciate that the legislation is designed to promote genuine (not fleeting) employee equity participation, and not simply tax benefits; but that can be assured by leaving waiver of the 3 year rule to the Tax Commissioner's discretion.

Suitable guidelines, by way of examples, could be included in the explanatory memorandum to the Bill. Waiver would be appropriate, for example, in at least all cases where a 'significant stake' in the company changes hands;[2] and note, finally, that as currently framed the 3 year rule would prevent even a founder shareholder buying-out all of the other shareholders, because that would not be a whole of company sale.

2. All companies: refund rule

We recommend that the changes made by the Bill to allow tax refunds if previously taxed rights and options ultimately lapse (items, 28, 29 and 30) be extended to rights and options still on foot at 1 July 2015; rather than being confined to rights and options issued after that date. This change is not one of policy, but a correction of an unintended flaw in the existing legislation. Fairness requires that all of those flaws are corrected, and not just some of them.

The existing rule was designed to deny refunds for forfeitures resulting from employee choices, other than choices to cease employment. It was first introduced in 2009 as part

[2] The CGT scrip rollover rules in section 124-783(6) of the *Income Tax Assessment Act 1997* define a significant stake as a 30% holding.

of Division 83A. The policy underlying the change was simply that tax outcomes should not be a matter for individual employee choice. The choice to be taxed up-front was also removed at the same time.

However, the Parliament clearly did not then recognise that in combination with moving the taxing point from exercise of rights to vesting, this measure could have and indeed has had the effect of taxing employees on value they never see. That aspect of this change was, we submit, an unintended consequence rather than deliberate policy.

It is true in these cases that employees may be entitled to a capital loss (having been taxed on revenue account). Again though, the Parliament clearly did not intend to create a system whereby employees would purchase capital losses through the income tax system; capital losses which they may never use.

In summary, the policy to remove the ability of employees to influence tax outcomes by individual choice had a more far reaching effect than was contemplated by the Parliament. The inappropriateness of this over-reach is now recognised, as is evident in its correction for rights to be issued under the regime commencing 1 July 2015.

We submit as mentioned that the correction should extend to all ESS rights and options from 1 July 2015, regardless of when they were issued. Probably the employees most affected are those participating in global plans implemented by foreign company groups investing in Australia. The unfairness of not also correcting for these employees what is clearly acknowledged to be inappropriate, when there is an opportunity to do so, will again send a negative message to these employees and their companies.

The correction will of course have some cost to the Commonwealth revenue – because affected employees will not be taxed on value they never realise. That cost would be impossible to quantify, but it would be very marginal and not material to anyone other than the employees concerned.

3. All companies: tax on cessation of employment

Employee share schemes, including rights and option plans, are in essence an instrument for alignment of employee values with shareholder values. They are to promote long term rather than only short term mindsets in the interests of genuine growth and value rather than just short term risk taking.

Taxing employees at cessation of employment works directly against these objectives. It is a policy setting that, particularly since commencement of the employer reporting regime introduced in 2009, has outlived its usefulness. Employers need to allow access on cessation of employment to equity that would otherwise only vest sometime later (perhaps on a pro rata basis), or cause employees to be taxed on value they can't access and may never realise. Note that the employee share schemes tax rules are the only rules in our legislation that tax employees on unrealised value.

Tax on cessation of employment also puts us out of step with other countries such as the US and the UK. It was originally to assist tax collections from, for example, employees leaving Australia on termination of employment. Other countries deal with this by imposing withholding obligations on employers, but only once the employees otherwise reach a taxing point. We understand that New Zealand, for example, is currently considering a withholding regime.

Bodies such as the Productivity Commission have long recommended that employee equity remain subject to full vesting requirements regardless of cessation of employment.[3] Best practice governance and market expectations often now require it.

Ironically, the employees most affected are those ceasing employment on agreed terms, for example at retirement or because of a redundancy ie., 'good leavers'. Employee's that resign normally forfeit unvested equity. The tax legislation otherwise provides for concessional treatment of good leavers, and yet this rule works against that policy.

[3] See for example the Productivity Commission's Inquiry on Executive Remuneration in Australia, April 2010.

Please call us if you have any questions.

Yours sincerely

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