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Dr Kathleen Dermody
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Senate Economics Legislation Committee
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4 June 2015

Submitted online: http://www.aph.gov.au/Parliamentary_Business/Committees/OnlineSubmission

Inquiry into Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2014

Dear Dr Dermody,

Ernst & Young (**EY**) is pleased to provide this submission to the Senate Economics Legislation Committee in relation to the *Tax and Superannuation Laws Amendment Bill (Employee Share Schemes) Bill 2015* (**Bill**).

Summary

EY made a submission to Treasury in relation to the *Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill: Improvements to the taxation of employee share schemes* and we were actively involved in the consultation roundtables with Treasury and the Australian Taxation Office (**ATO**) earlier this year.

We are pleased to note that certain issues raised in our original submission have been addressed in the Bill introduced to Parliament.

EY remains supportive of the stated aims of the proposed amendments to the laws regarding the taxation of Employee Share Schemes (**ESS**) to facilitate better alignment of interests between employers and employees and to improve the competitiveness of innovative Australian start-up companies in their ability to attract and retain key talent.

However, there are several aspects of the Bill we believe could be improved upon in order to further support the Government's agenda of improving industry innovation and competitiveness and reducing complexity. Our comments focus not just on the new "start-up" concessions, but also on the proposed changes to the broader ESS tax rules that apply to the vast majority of companies (including many early stage businesses that may not satisfy the requirements to access the "start-up" concessions).

Our submission provides comments in respect of the following areas which we suggest be subject to further consideration:

- Appropriately defining "start-up" companies;
- Extended application of refund rules;
- Introduction of transitional rules for all untaxed shares and rights (**ESS interests**);
- Amendment to the deferred taxing point for rights; and
- Removal of taxation on cessation of employment.

All statutory references contained in this submission are to the *Income Tax Assessment Act 1997*, unless otherwise specified.

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Discussion

1. Appropriately defining a "start-up" company

The proposed criteria to be met in order for companies to qualify for the "start-up" concessions may inadvertently disqualify companies which would, for practical purposes, be considered to be within the start-up phase. This may thereby limit the effectiveness of these changes in encouraging innovation and increasing competitiveness of early stage, growing Australian companies.

While EY welcomes the changes suggested in our original submission to the Exposure Draft, providing that certain eligible venture capital investments and Deductible Gift Recipients be disregarded when identifying a holding company or working out aggregated turnover for the purpose of the start-up concessions, there are still several aspects of the start-up criteria that may disqualify genuine start-up companies from benefiting from the concessions.

In particular, the requirement to be unlisted does not reflect the commercial reality of many companies who may have listed as a means of funding projects that are yet to generate revenue (e.g., junior explorers). As the proposed rules provide concessional treatment for prospective growth in the value of shares only, companies who would otherwise be considered "start-ups" by the nature and size of their business should not be disqualified from doing so merely because they are listed.

Similarly, the requirement to be incorporated for less than 10 years is likely to exclude companies who should arguably qualify for the start-up concessions, for example:

- Companies which have been incorporated but have been inactive for many years before the "start-up" business commenced;
- Companies which have acquired an older company that is not significant to the start-up company's main business;
- Companies which face long lead times by the nature of their business (e.g., explorers, biotech companies); or
- Companies whose principle business has substantially changed since incorporation and the 'new business' has not been in operation for more than 10 years.

In our experience, start-ups do not commonly offer ESS currently due to the complex tax implications for participants and onerous administrative requirements. As such, the Government receives limited revenue from employee equity plans operated by these companies. Broadening the criteria for application of the start-up concessions should serve to increase revenue, in addition to driving the competitiveness of Australian business.

Recommendation 1: Discretion should be provided for the Commissioner or another body such as AusIndustry to determine that the start-up concessions are available in cases where the company could reasonably be expected to qualify from a policy perspective.

2. Extended application of refund rules

A consequence of the implementation of *Division 83A* in 2009 was that options may be subject to tax at the date of **vest** (i.e., prior to exercise of the options) based on a valuation under the regulations, even where the exercise price was greater than the share price at the date of vest. Where these options were remained 'underwater' for the life of the exercise period and the options expired, the participant was unable to recover the tax paid at vest, despite never receiving an economic benefit.

EY welcomes the proposed change to remove this adverse tax impact; however we note that the new "refund" rules are only to apply to grants made on or after 1 July 2015. On the basis that the proposed deferred taxing point for options will once again be at exercise, the changes to the refund rules are likely to have limited application for grants made after 30 June 2015. As such, it would appear inconsistent

with the objectives in the new rules not to allow the amendments to the refund rule to apply to all rights (that have not yet been subject to tax) from 1 July 2015, regardless of the grant date of the rights.

Recommendation 2: The new refund rules allowing income tax refunds where participants choose not to exercise options that have previously been taxed should apply to **all** ESS interests that are forfeited on or after 1 July 2015, regardless of the grant date.

3. Introduction of transitional rules

The Government stated in the *Industry Innovation and Competitiveness Agenda* that the changes to *Division 83A* are intended to 'unwind' some of the changes made to the ESS taxing regime in 2009. We understand that the proposed legislative changes are intended to apply to ESS interests granted on or after 1 July 2015 and submit that the new regime should also apply to any ESS interests where the taxing point has not yet arisen, including those granted prior to 1 July 2015.

This amendment will increase the effectiveness of the changes in reversing the adverse impact of the 2009 changes, in particular for options which have not yet been taxed. It will also reduce the burden on employers to administer the reporting requirements and for employees to understand the taxation point under three different regimes, being *Division 13A Income Tax Assessment Act 1936*, the current *Division 83A* and *Division 83A* after the proposed changes.

Recommendation 3: The proposed changes should apply to all ESS interests where the taxing point has not arisen prior to 1 July 2015.

4. Amendment to the deferred taxing point for rights

The Explanatory Memorandum to the Bill states that the proposed amendments are intended to alter the taxing point for rights to the point when the right is actually exercised, rather than the point at which a right can be exercised.

However, *s83A-120(4)* remains unchanged in the Bill. This section provides that rights will be subject to tax on vesting where the rights are not exercised. This outcome is inconsistent with the key objective of the changes to move the taxing point for rights to exercise.

Recommendation 4: *s83A-120(4)* should be removed or amended to reflect that the deferred taxing point for rights is the exercise of the right (as set out in *s83A-120(7)* and in line with the stated intention in the Explanatory Memorandum).

5. Removal of taxation on cessation of employment

The Bill does not address 'cessation of employment' as a deferred taxing point. The Australian Government Productivity Commission's draft report on *Business Set-up, Transfer and Closure*, released in May 2015, recommended that legislative changes be made to remove the cessation of employment as a trigger for the payment of tax on ESS interests. This report noted that the imposition of tax on cessation of employment may result in employees paying tax on interests before they are able to be disposed of. This conflicts with the commercial objectives of many schemes and is out of step with most of Australia's major trading partners.

We believe the retention of the taxing point on cessation of employment is inconsistent with encouraging the long-term ownership of shares and the premise that employees should only be taxed on equity awards when they are able to realise a benefit. It is also inconsistent with the taxation treatment of equivalent cash-based incentive awards, which are generally only taxed when the participant receives the cash pay out, rather than at termination of employment.

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It is understood that the intention of this provision is to avoid situations where the income arising from an ESS interest is not reported as taxable where the participant terminates employment prior to receiving the ultimate benefit of the ESS interest under a deferral scheme. However, this risk is already minimised by the reporting requirements introduced in 2009. This objective could also be met by requiring companies to operate Pay As You Go withholding in relation to ESS interests where the deferred taxing point would arise after the participant has terminated employment.

Recommendation 5: Cessation of employment should be removed as a deferred taxing point for ESS interests.

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If there are any areas of this submission that you would like us to expand upon further, we would be pleased to discuss these with you.

Yours sincerely

Chris Galway
Partner

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Partner