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Senate Select Committee on Financial Technology and Regulatory Technology (the **Committee**)
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By Email

Dear Chair

Re: Response to Questions on Notice from the Public Hearing on 5 March 2021

Thank you for the opportunity to provide further information in relation to the questions raised at the Committee's hearing on Financial Technology and Regulatory Technology on Friday, 5 March 2021.

The Committee requested that Herbert Smith Freehills and Greenwoods & Herbert Smith Freehills respond to three additional issues in relation to:

1 the taxation treatment for equity issued to employees as part of their remuneration;

2 the disclosure obligations for equity issued to employees as part of their remuneration; and

3 suggestions to improve the dual-listing regime for Australian businesses.

Below we set out our responses for each of the above issues.

1 Taxation treatment for equity issued to employees as part of their remuneration

Currently employees of companies that qualify as start-ups under section 83A-33 of the *Income Tax Assessment Act 1997* (Cth) are entitled to concessional tax treatment so that any gains are taxed as a discount capital gain at sale rather than income tax at a deferred taxing point under subdivision 83A-C. These concessions are important for start-ups given the role such offers often play in remunerating staff at a time when company cash-flow is limited and every spare dollar is being invested back into the business.

Treasury should consider a range of other reforms in order to further improve and refine the employee share scheme (**ESS**) regulatory framework.

Provided below are a set of recommendations that aim to further improve the eligibility rules for companies to gain access to ESS start-up tax concessions and remove unnecessary impediments and complications in the rules.

Recommendation 1: Removal of the 10 year rule

Under current rules, a company (and its subsidiaries) must have been incorporated less than 10 years before the end of the most recent income year before the ESS interest is acquired to be eligible.

It is common for companies that might otherwise be considered a 'start-up' to be incorporated more than 10 years ago given the time it may take for some companies to turn profitable. This can be due to the relevant business taking a significant number of

years to become profitable, or the relevant founder utilising an existing corporate structure for a new venture. This was the case with SafetyCulture where Luke Anear utilised a pre-existing company rather than incur the $600-1,000 of additional cost to incorporate a new company. Similarly, biotech companies can often take more than 10 years to bring their products to market due to complex regulatory approval processes in Australia and overseas..

Consequently, we submit that the $50 million turnover threshold should be the sole bright-line test for a company to qualify as a start-up.

In addition the definition of a start-up should be amended to include companies that are research intensive and highly regulated that have a considerably longer timeline to bring their products to market and technology enabled e-commerce businesses..

To do otherwise would unnecessarily disadvantage a large cohort of technology rich, high turnover but low margin companies from benefiting from the new ESS regime.

Recommendation 2: Removal of 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. We believe that there needs to be a mechanism to grant founders (who typically hold large stakes in start-ups) or other senior executives 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 or the initial allocation of equity among founders does not properly reflect their roles. Removing the no more than 10% requirement would address that issue and appropriately incentivise founders of start-ups to use their skills, knowledge and experience to help build and grow the businesses that they had established.

Recommendation 3: Removal of 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 (unless the Commissioner waives this requirement or the limited exceptions apply). 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. It is difficult to understand what risk this rule is designed to address or behaviour it is seeking to encourage.

It is not possible for a company to run a sale process with a guaranteed outcome that will last more than a few months let alone a year.

The 3 year restriction does not serve any retention purpose as:

- ESS grants are almost always subject to time based vesting conditions; and
- the restriction is lifted if an employee ceases employment.

However, the 3-year sale restriction has become an issue where the company is a target for acquisition by other investors or corporations in that time. Seeking a waiver of this restriction creates:

- an unnecessary risk – it is necessary to explain to the ATO that boards often entertain M&A discussions during their lifecycle with most going nowhere but these discussions must be disclosed to the ATO;
- delay (at least 6 weeks for filing and approval); and
- expense (between $15,000-25,000 in applying for the ruling).

It may also serve to discourage overseas investors 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 thus recommend that the 3-year sale restriction is removed.

Recommendation 4: Amendment of the buy-back rules for unlisted companies

In the US buy-backs are often used in start-ups to:

- buy-back the unvested shares of a founder who leaves prior to the agreed vesting period for nominal value; or
- facilitate a secondary sale transaction where founders can realise the value of some of their shares, financed by an incoming later stage investor subscribing for shares. The buy-back proceeds in that case are taxed as long term capital gains.

In Australia these type of transactions are not viable from an Australian tax perspective.

The buy-back provisions in Division 16K of the *Income Tax Assessment Act 1936* (Cth) deems a seller to receive market value consideration regardless of the consideration actually received and whether the parties are acting at arm's length.

Further, if a new investor invests funds which is used to buy-back another party's existing shares the entire amount is deemed to be a dividend.

These provisions should be amended for unlisted companies.

Recommendation 5: Clarification of investment company prohibition

Section 83A-45(3) of the *Income Tax Assessment Act 1997* (Cth) contains a relatively little known 'integrity provision' which prevents any tax concessions (start-up or general tax deferral) for 'share trading and investment companies'.

The Explanatory Memorandum enacting this provision is unclear as to what mischief it was designed to achieve and there is little ATO guidance. On its face it could prevent any person who is employed (including as a director) of both the holding company and any subsidiary from accessing the ESS concessions. It is likely to also have potential impact for fintech companies, such as neo banks, from being able to access the provisions.

The provision should be amended to clarify exactly what mischief it is aimed at without inadvertently bringing in other legitimate employee equity plans.

Recommendation 6: Amendment to the direct value shifting provisions

The direct value shifting rules should be reviewed entirely as they create arbitrary uncertainty as to whether a company can issue equity to employees (and undertake other transactions) without crystallising unrealised gains.

The provisions are:

- extraordinarily complex – as the Tax Institute stated in its Senate submission when the rules were enacted "the value shifting provisions.. are an overreaction and represent a pinnacle of complexity in the tax law... Never has so much legislation been written for so few people dealing with such a limited issue."
- arbitrary – they only apply if a company has a controller i.e. a 40%+ shareholder. Accordingly, a company with 3 unrelated founders holding equal shares is not caught but a company with 2 brothers and a third party, or 2 equal founders with a 20% investor are caught.

It is impossible to think of a deliberate scheme that is caught by these provisions that could not be dealt with under the general anti avoidance rules in Part IVA. Instead taxpayers are lumbered with provisions that are opaque, create unnecessary risk and inadvertently subject more companies to the provisions than any targeted integrity

provision should. The provisions should only apply where parties are not acting at arm's length and the de minimis should be increased materially.

2 Disclosure requirements for employee equity offers

It is our view that employees of start-up entities will receive options as part of their remuneration. A failure to offer options can make an Australian start-up entity globally uncompetitive. It is our view that the existing disclosure obligations required by section 706 of the *Corporations Act 2001* (Cth) (**Corporations Act**) are not fit for purpose in respect of employee equity offers. We consider that amendments could be made to the disclosure obligations of the Corporations Act to more efficiently facilitate employee equity offers in Australia.

Recommendation 1: Permit companies to prepare a short form disclosure document in respect of offers of equity to employees.

An Australian entity that wishes to offer shares or options to employees must prepare either a prospectus or an offer information statement (**OIS**) in the absence of any applicable exemptions to the disclosure obligations under the Corporations Act. There is a significant cost for a company to engage professional advisers to prepare documents that comply with the requirements of the Corporations Act. It is our view that the Corporations Act should be amended to permit offers to employees and contractors of a business under a short form disclosure document, particularly in circumstances where the offers of equity are not seeking to raise additional capital from third parties. We consider that this could take a form similar to the existing OIS requirements with an amendment to, or removal of, the lifetime $10 million cap on such documents, together with a removal of the requirement to lodge Audited Accounts with the Australian Securities and Investments Commission (**ASIC**). The alternative would be to increase the small scale offering exception in section 708(1) of the Corporations Act from 20 to 150 in the case of offers to employees or contractors of a business. Finally, a simplified regime similar to the 'simple corporate bonds' process where the offer is limited to ordinary shares or options for ordinary shares (or overseas equivalents) for Australian based employees could be utilised.

Recommendation 2: Permit companies to withhold commercial-in-confidence information from being publicly available via ASIC for disclosures made in connection with employee equity offers

Employees often have access to non-public and commercial-in-confidence information in respect of their employer. We acknowledge the strong policy incentive that employees are fully and adequately informed in respect of equity offers they receive, but consider that there is very little benefit in making such information available to the general public.

We recommend that an amendment be considered which removes the disclosure obligation to provide audited accounts to ASIC and/or limits a company's obligation to provide commercial-in-confidence information to ASIC in respect of employee equity offers made pursuant to an OIS. Doing so may permit a company to maintain its competitive difference and avoid disclosing confidential information to its material disadvantage.

3 Dual-listing regime

A company that is listed on a foreign exchange can also list on ASX either by seeking a full ASX Listing or ASX Foreign Exempt Listing. An ASX Foreign Exempt Listing is preferential for companies listed on overseas exchanges. A company that dual lists on the ASX by way of an ASX Foreign Exempt Listing (**Foreign Exempt Company**) is exempt from a majority of ASX's Listing Rules, and only needs to comply with the rules of its home exchange. This greatly reduces the compliance burden on Foreign Exempt Companies.

However, in our view, the ASX Foreign Exempt Listing regime in its current form is too restrictive as, among the other conditions, only those companies which are either "qualifying NZ entities" or who have an operating profit before tax of at least $200 million and are listed on an exchange that is acceptable to ASX may seek an ASX Foreign Exempt Listing.

We note that a qualifying NZ entity is a foreign entity that is formed or established in New Zealand whose home exchange is the NZX and whose securities are admitted to quotation on the main board of NZX.

Recommendation: Expand the "qualifying NZ entity" concept and / or create an analogous concept to facilitate the dual-listing of emerging Australian companies

We recommend that the "qualifying NZ entity" concept be broadened to, at a minimum, capture Australian incorporated companies whose home exchange is the NASDAQ, the NYSE or the TASE (Tel Aviv Stock Exchange). In our view, such an amendment to the ASX Listing Rules would encourage the dual-listing of Australian companies who prior to such an amendment would have been either (a) not eligible for an ASX Foreign Exempt Listing because they failed to meet the profitability threshold requirements or (b) discouraged from seeking a full dual ASX Listing because of the compliance and administrative burden.

Yours sincerely

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