Appendix A

Commentary on the ESS regime generally

The multiple benefits of employee ownership are well research, well documented and (in other jurisdictions, particularly the US and the UK) widely acknowledged for the benefits they are capable of mobilising.

Central to all employee share schemes is the powerful alignment in interests of employees and equity stakeholders.

In my opinion, the ability of a share scheme to do this is unrivalled where the right employees are participants in the right ESS.

This point is important because share schemes are not suitable for all and I believe they should be created with that in mind from a legislative perspective. In my view, they fall into three broad categories:

a) Listed entity schemes for 'all employees'.

   The complexity of these is not understood by employees, in the main, however they are relatively popular because the professional assistance provided by the employer simplifies the complexity, the employees believe they are tax advantaged (which usually they are to a small extent), and because ultimately the employee is able to take the information he or she needs from a year end tax summary and enter it onto an income tax return.

b) Schemes serving as LTIP's for directors/key personnel of larger more sophisticated entities.

   The selected participants in these schemes are generally financially sophisticated individuals who understand the principles (if not the detail) and have access to good financial advice. They are still more common in listed entities than unlisted, where the expectation at director level in particular is that these come with the 'package'.

c) Schemes for unlisted companies and in particular those with growth aspirations

The comments below are directed principally at c) above being the area in which I have the predominant practical experience and where there is very significant opportunity, especially at this 'cross-roads' in time brought about by Covid-19. This is because share prices are low, cash is scarce, and attracting/retaining talent is fundamental to getting businesses (and the economy) looking to the future with optimism.

I also focus on share options rather than direct share awards as my experience is that these are by far the most common because of the ability to set performance targets that align the employer and employee interests.

Share Value

However, one area that applies to all share schemes and in my view adds the most **significant complexity** across the board is the **valuation of a share option**. For Australian tax purposes this

is a function of the value of the share at a particular point in time together with the exercise price and date.

It is accepted that this is a genuine method of 'valuation' of a right to receive a future asset.

However, it is conceptually difficult to understand and employees at all levels find the complexity a major downside that they feel unable to properly grasp. In my experience, the inability of intelligent people to understand this in simple terms or to calculate this value without professional assistance[1] deters businesses from getting beyond initial contemplation of an employee share scheme that would otherwise have many commercial upsides.

My strongest recommendation therefore is to remove this valuation mechanism and to instead base the tax charge at any point in time simply on the difference between the market value of the share and the exercise price.

This is the method adopted in the UK, which has had enormous success with its share scheme models in the last 15 years. This single change would remove a significant hurdle which is a serious impediment to getting share schemes off the ground.

My **secondary recommendation** is that Schemes for unlisted entities have better ability to access the CGT regime without first triggering an (often unfunded) income tax liability. This could be achieved by the ability for any income tax liability triggered by exercise/other cessation event to be deferred until sale of the shares (by election). This will give better access to CGT reliefs on future value growth and avoids the need to structure exit arrangements for unlisted companies before they are absolutely required.

My **third recommendation** is that access to CGT treatment and the CGT general discount should be made more easily available to employee shareholders. For example, consider new legislation giving CGT treatment (and therefore access to the 50% CGT discount) where the employing company buys back (and cancels) shares from qualifying employee shareholders once they have been held at risk (i.e after exercise of any option) for a minimum period of time (eg 5 years). This will give an easier and more tax advantaged exit regime for employee shareholders of unlisted companies which still aligns interests for the medium term. It avoids the need for costly and complex share trusts to structure an exit which attracts CGT treatment, or the need to find a willing buyer of usually illiquid shares.

My **final recommendation** would be to make the tax advantages as bold as the entrepreneurs who drive the companies that are going to drive our economy through this rough terrain. This includes giving corporate tax relief to the employing company which mirrors the value on which income tax is payable by the employee.

The points included within your terms of reference are dealt with below.

---

[1] Despite the existence of an ESS calculator on the ATO website, which still requires professional assistance due to lack of understanding of terminology.

Appendix B

Commentary in relation to the Terms of Reference

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

- The amendments to the general rules have had limited or poor impact. They have not removed sufficient complexity nor made ESS more attractive. It has been viewed as ‘tinkering at the edges’ of a complex and not particularly tax advantaged set of rules.

- The Start-Up Scheme had considerably more initial interest. It is easily understood, more tax advantaged, and the simplifcations/concessions relating to administration and simplified share valuations were well received.

- That said, the tax benefits of the Start-Up scheme have not been generous enough to promote the more widespread interest it deserves.

- In addition, the restrictions on which companies qualify are to narrow.

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

- Deferring a taxing point is a financial necessity (for many) to align the tax charge with the availability of funds. Without it, many schemes are not viable. This should not be considered a concession, it is a fundamental.

- Under current rules, other than to design a scheme a particular way, the employee has no choice about whether to defer (or not). I recommend that this **choice should be given in the form of an election** to give an employee control over whether he/she would prefer to pay tax upfront (with the usual consequence of simplifying later tax treatment) or to defer all tax until later trigger points apply.

- For unlisted entities, where there is no ready market for shares, **consider giving the employee the ability to defer a triggered income tax charge** (eg on exercise of the option or on cessation of employment). The deferral should be until the date of sale of the shares. The tax charge on the gain that is the subject of the deferral would be quantified at the trigger time and would remain ultimately taxable as income. This **would very simply address the key issue for unlisted entity share schemes that there is no cash to pay a tax liability on exercise**. At present, the triggering of a tax liability on exercise/cessation of employment usually means that shares need to be sold to fund the liability – diminishing the raison d’etre of a share scheme i.e. a longer term alignment of the employee and employing company.

- The above suggestion would also make ESS more attractive as it gives better ability for employees to continue to hold all of their shares after exercise/other trigger event. They are then more able to obtain the benefit of the 50% CGT discount on the subsequent value growth as they are more able to retain the shares for the required 12 month period prior to sale. This would give significant tax relief to employee shareholders.

- Tax deferral is not necessarily regarded by the audience as a concessional tax treatment. This is because deferral usually means that more of the value is liable to income tax (rather than capital gains tax). CGT treatment, in particular the 50% discount, is the tax concession that most employee shareholders are interested in. This requires consideration of how to sell shares, who to and for what value. In the absence of a buyer or the 'will' to set up a share trust the usual exit route is the buyback of shares by the company, which in general is taxed as income. The employee shareholder commonly struggles to get access to the benefits of CGT treatment (including the CGT discount). The lack of exit tax efficiency makes unlisted share schemes significantly less attractive as an employee retention and reward strategy.

- A new regime allowing CGT treatment to be obtained by certain employee shareholders (say <10%) for shares held 'at risk' for more than 5 years (say) where they are bought back by the company would provide a tax efficient exit strategy for unlisted entities and make them a significantly more attractive proposition.

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

- The Start – Up scheme is received with great interest by many companies and has excellent tax attributes that address many of the impediments raised above.
- **It should be more widely available.**
- The 10 year age restriction should be removed and the turnover threshold of $50m should be raised (doubled or more).
- Employees value certainty. There should be an advanced share value agreement procedure put in place with the ATO so that share values can be quickly and simply agreed up front, prior to the grant of options or award of shares. This will fix in place one of the moving parts and pieces of uncertainty of a share scheme.[2]
- **Corporate tax relief** should be available for the value on which employees are taxed as income. It is possible to obtain corporate tax relief presently by implementing an employee share trust but the complexity and cost of such structures is only suited to larger companies.[3]

---

[2] It is my experience in the UK that this is a valued part of the ESS process and advance valuation agreement was obtained in most cases.

[3] The UK ESS scheme became the share scheme of choice when corporate tax relief of this nature was introduced a number of years after it was first implemented.

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

- Please refer to comments included above
- Unlisted growth companies need to structure ESS to enable a taxing point to coincide with the availability of cash (i.e sale of shares). However, this invariably means that advantageous CGT treatment is not then available. Neither does this sit well with the overarching imperative of the ESS arrangement to promote medium to long term share ownership and therefore alignment of interests.

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.

- Key challenges include:
  - Complexity in understanding share option valuation
  - Obtaining tax advantaged capital treatment (which is a common aim) when the deferred taxing rules effectively force a sale of shares at a taxing point when there is no ready market for the shares and which is an income tax charge.
  - The **Div 7A rules** act inappropriately and a blanket exemption for all such charges connected with employee share ownership should be implemented. This should be the case whether share entitlements fall within Div 83A or not.