AusBiotech response to the review of Employee Share Schemes (ESS)

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Introduction

AusBiotech is a well-connected network of over 3,000 members in the life sciences, including therapeutics, medical technology (devices and diagnostics), food technology and agricultural, environmental and industrial biotechnology sectors, supporting the biotechnology industry.

AusBiotech is pleased to submit the following comments to this review of employee share schemes (ESSs), based on submissions and comments from AusBiotech members.

Most start-up companies are funded by means other than sales revenue, such as venture capital or share issues, and require those funds to conduct research and development and prepare a product to earn revenue. In this 'cash pressed' state they often rely on the support of ESSs to attract quality employees, and are an important support in enabling innovative start-up companies to establish. ESSs complement cash remuneration, making a salary package appear more substantive and attractive, in addition to mutual benefit of giving employees a vested interest in the success of the company.

The importance of ESSs is especially poignant and amplified in the biotechnology sector, where the pre-revenue phase is typically extended by the need to clear regulatory hurdles before revenue can be earned – sometimes by more than a decade – and the cash required to reach regulatory approval.

When the changes to Employee Share Schemes (ESS) were announced in 2009, the measures were predicted by industry to result in less incentive for employees, greater administrative costs for companies, and subsequently result in companies turning away from the use of such schemes. It was feared that the changes would therefore undermine innovation in start-up biotechnology companies and there was a significant ground swell of opposition.

Anecdotally, many start-up companies in the biotechnology sector reported grudgingly turning to alternative, less satisfactory, methods to retain, incentivise and reward employees.

The far-reaching changes to the taxation of shares, options and other rights were made at a time when Australia was becoming more cognisant of the importance of supporting small to medium-sized innovative businesses, due to the spillover benefits to the Australia's economic development.

In the months after the changes were implemented, AusBiotech spoke with key accounting firms and made a submission to the Government in 2009 on behalf of its members. This new burden on companies seemed to be aimed at the top end of town and had wrongly captured small, rapidly-growing companies that often do not have the ability to reward employees with cash and so use shares and options as incentives and future rewards. AusBiotech supports a more sympathetic treatment of start-up companies, to support the growth of the innovative sector in Australia.

The Board of Taxation in 2009 explored two issues: how best to determine the market value of employee share scheme benefits; and whether shares and rights for a start-up, R&D or speculative focussed company should have special tax arrangements.

How to define 'start ups'

AusBiotech notes that the defining a 'start-up' is fraught with issues, however it seems sensible to use a pre-determined framework that is: (a) familiar to the Australian Taxation Office (ATO) and to companies; and (b) fits the intent to support innovation.

While the use of staff numbers might be useful as a surrogate measure, the use of company age would not be helpful to the biotechnology sector, due to the well-documented very long pre-revenue phase.

AusBiotech suggested in its 2009 submission to the Board of Taxation, and continues to believe, that the definition used for the Research and Development (R&D) Tax Incentive for companies to be eligible for the 45% refundable tax credit, that is those with turnover under $20 million, ought to be exempt from paying tax on employee share packages. The exemption recognises the difficulty innovative start-up companies face in developing their technologies, while retaining highly-skilled workers.

Equity does not equal cash

The Board of Taxation has previously explored how best to determine the market value of employee share scheme benefits. AusBiotech recommends that this problem be solved by taxing shares at the time of liquidation/realisation, when market valuation is known, rather than at the time of issue, when value is uncertain.

Many employers in a start-up context cannot offer market salaries, so an ESS enables them to compete for appropriately-qualified talent. ESSs in their pre-2009 form were effective as an incentive to lure and reward staff, with a relatively small cost to the employer – providing a 'win-win' situation. The employees have a vested interest in the company's success and this sense of ownership often drives innovation and productivity.

An ESS works best as an incentive when tax is paid on success. If tax is charged pre-success or pre-gain, the shares come as a cost to the employee, with the tax payable before any value is generated. It is even worse when the share loses value, becomes worthless, or is diluted when more shares are issued (which is often required when projects run late to keep the company funded). In this way the employee is penalised, despite being hard-working and staying with the company through the long and difficult start-up period. This risk is intolerable for many staff and they, understandably, won't risk having to pay for upfront taxes in exchange for an unknown outcome.

This is comparable to paying income tax before you earn any income or paying tax in advance for an income that you may or may not receive. This method of taxation is a disincentive and disadvantages start-up innovative companies during the establishment and development phases.

Taxing upfront on risky and often uncertain ventures is a disincentive to attract Australia's brightest talent to new sunrise industries, like biotechnology.

Furthermore, the current situation of pre-gain tax means that companies must provide valuations of their capitalisation value, for use by the ATO. Biotechnology companies are notoriously difficult – and therefore expensive - to value. It is an inexact process, fraught with uncertainty. This requirement places a further, unnecessary, impost on start-up companies. There is no accounting formula that can achieve an accurate, reliable and fair valuation of pre-revenue start-ups.

Cap gains tax is sufficient

The Australian biotechnology community needs a positive system for start-ups to encourage company creation. It is entirely appropriate for the Australian Government, and the Australian economy, to share in the prosperity of a capital gain, but only when it occurs.

Taxing at the time of liquidation - or realisation of a gain – is the only way forward for small innovation companies. It provides an important incentive for companies and employees and solves the issue of valuation. It also simplifies the administration from both the perspective of the ATO and from the issuing company.

No loss of revenue

The Federal Government's rationale for implementing the 2009 changes was reported as a $200 million saving to Treasury and the hesitation in repealing them is now attributed to a potential loss of revenue.

AusBiotech suggests the actual figures be investigated/forecast, as it appears more logical that while there would be a short re-adjustment, in the long run there should be no loss of revenue and a cogent argument can made for an up-lift.

Firstly, as previously stated, small companies have en masse exited from the use of ESSs. If the environment improved, making such schemes more attractive, a large number of companies would re-engage, leading to revenue being paid to the ATO that is not currently not being paid.

Additionally, the core of an ESS is to reward employees for effort that result in an uplift in share price or company value. Logically then, taxing when shares are redeemed would be more profitable, as employees would seek to maximise their profit.

The other avenue for potentially losing tax revenue was said to be from 'leakage' (companies 'gaming' the system). Since the introduction of the R&D Tax Incentive in 2011, the level of reporting has been increased to ensure the appropriate use of the scheme and to stop such leakage. The government ought to now have a higher level of comfort than in 2009, when the ESS changes were made. The amount lost to non-compliance in the current reporting environment would surely be trivial.

Harmonise with international practice

As Australia seeks to be globally competitive for trade and business, its tax regime is recognised as being of the utmost importance. So too harmonisation, or at least parity, with competitor countries is understood to be critical in the ability for Australian companies to compete and thrive in increasingly global markets. AusBiotech has been advocating for broader taxation reform to support innovation companies, and in doing is looking to international best practices.

AusBiotech is advocating for a tax system that supports innovation with four pillars:

- Retain the R&D Tax Incentive, which is a top priority for the life sciences industry;
- Introduce the Australian Innovation and Manufacturing Incentive, a 'patent box'-style incentive to keep home-grown intellectual property (IP) once it reaches commercialisation, as well as associated manufacturing, in Australia;
- Introduce fiscal incentives for investors in pre-revenue companies; and
- Adjust the ESS provisions to support start-up companies.

The UK has grappled with the need to support innovation and have addressed it with recent reforms to their tax system to compete globally. Reforms include support for IP attraction and retention, with the Patent Box, as well as the Enterprise Investment Scheme (EIS), where capital gains on some assets can be deferred by investing into EIS shares.

Conclusion

Employee share incentive schemes are an excellent way to attract high-calibre, experienced staff to a start-up company, providing an important support for start-up companies. However they only work when tax is charged on success. If tax is charged pre-success the shares are a cost to the employee with an unknown outcome. This risk is intolerable for many staff and provides a disincentive. The Australian start-up biotechnology community needs an encouraging tax system, which enables success sharing at the time it happens.

Australia needs innovation to continue productivity growth and new industries to supplement declining industries. If Australia’s tax system does not provide a conductive environment with competitive (comparable) incentives, these new ventures are undermined and Australia’s best ideas and the resulting economic benefits are then transferred to other countries.