AusBiotech submission regarding the draft legislation to improve the taxation of employee share schemes (ESS)

To: General Manager
Law Design Practice
The Treasury
Australian Government
Langton Crescent
Parkes ACT 2600
Email: taxlawdesign@treasury.gov.au

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From: AusBiotech Ltd
ABN 87 006 509 726
Level 4, 627 Chapel St
South Yarra VIC 3141
Telephone: +61 3 9828 1400
Website: www.ausbiotech.org

Introduction

The Government is to be commended for its Industry Innovation and Competitiveness Agenda (IICA). In particular the biotechnology industry warmly welcomes improvement to Employee Share Schemes (ESS): to reverse some of the changes made in 2009 to the point at which rights issued as part of an employee share scheme are taxed for employees of all corporate tax entities; and to introduce a further tax concession for employees of certain small start-up companies.

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 consultation on the draft legislation for ESS, based on submissions and comments from AusBiotech members.

The importance of ESS 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 – often by more than a decade – and the cash required to reach regulatory approval.

Start-up companies are rarely funded by sales revenue, even after listing, and rely on venture capital or share issues to conduct research and development and prepare a product for registration and to earn revenue. In this 'cash pressed' state they often rely on the support of ESS to attract quality employees, and are an important support in enabling innovative start-up companies to establish. ESS complements cash remuneration, making a salary package appear more substantive and attractive, in addition to the mutual benefit of giving employees a vested interest in the success of the company.

When the changes to ESS were announced in 2009, companies in the biotechnology sector fled these schemes. One result was to undermine innovation in start-up biotechnology companies. There was a significant ground swell of opposition, and in consultation with industry CEOs, it remains amongst the top public policy issues impacting companies' development. Anecdotally, many start-up companies in the biotechnology sector have grudgingly turned to alternative, less satisfactory, methods to retain, incentivise and reward employees.

AusBiotech supports a more sympathetic treatment of start-up companies, to support the growth of the innovative sector in Australia and has made numerous submissions and representations on ESS since 2009. The key attributes of the II&CA policy for the taxation of employee equity in start-up companies, from an industry perspective, were:

- Taxation of employees upon realisation of benefits; and
- Taxation of benefits as capital gains rather than as income.

The policy recognises that start-up company employees are investors of their time rather than being remunerated for it, and therefore that they should be taxed as any other investors. Employees of start-up companies in competitor countries are taxed on essentially this basis and Australia would benefit from equivalent treatment of start-ups' employees.

However, some aspects of the proposal as outlined in the II&CA announcement and the ensuing draft legislation could in practice prevent this excellent policy realising its intent. These are outlined below:

Defining 'start ups'

The definition of a start-up in the proposed legislation is unhelpful for a number of biotechnology companies. Under the definition in the draft legislation a start-up company means an Australian tax resident employer that offers for acquisition ESS interests in an unlisted company with an aggregated turnover not exceeding AU $50 million, and having been incorporated for less than 10 years.

The requirement for all three conditions to be met to be an eligible start-up, will exclude many biotechnology companies, notably those who list on the Australian Securities Exchange early in their life cycle to raise capital for their research programs, despite having no or negligible turnover and yet to make profits. It is often assumed that listed companies are liquid and have ready access to capital. That's not the case in the biotechnology sector and these companies can remain start-ups in every other sense.

Further, the condition that the company be under 10 years old is very restrictive for the biotechnology sector, as many start-up companies would not have reached the point of sales revenue by this time. For example, the development of a new therapy can take 15 years before it is approved for the market. Extending this time to 15 years would be more appropriate.

While acknowledging that defining a 'start-up' is fraught with issues, for this eligibility definition to fit the intent to support innovation without being too broad, AusBiotech suggests the following as a workable solution.

Use the existing definition (with an extension to 15 years) and also allow for listed companies that meet the eligibility criteria for the refundable R&D Tax Incentive (aggregated turnover under $20 million) to be included. While this would allow an expanded access to ESS, it would support legitimate R&D companies in their early phase and limits the eligible population to a justifiable cohort.

The exemption for start-up companies is critical as it recognises the difficulty innovative start-up companies face in developing their technologies, while retaining highly-skilled workers. It is also critical that it be appropriately targeted. The current definition will inadvertently exclude the type of company it seeks to assist.

The II&CA does not explain its denial of start-up status to small listed companies. It is hard to see a justification.

A significant practical effect of this rule would be to disqualify highly innovative sources of future growth for our economy.

12-month rule for CGT discount

In ordinary circumstances a pre-requisite for the 50% CGT discount is that the asset in question has been held 12 months prior to sale. This is broadly to ensure that the primary benefit of CGT treatment is only available for genuinely patient capital. In ordinary circumstances therefore, shares acquired on exercise of employee options must be held for 12 months to qualify for the 50% CGT discount.

We submit that it would not be appropriate to apply this rule to shares acquired on exercise of employee options issued by start-up companies.

The measure of success of a start-up company, and therefore a common vesting condition for start-up company options, is that the company is able to be sold. Employees in these cases are required to exercise their options and immediately sell their shares, to ensure that a whole-of-company sale is possible. A further 12 months holding requirement would in practice therefore frustrate the operation of the II&CA policy in many cases – putting the policy at odds with its intent.

Three-year holding rule

The requirement for employees of start-up companies not to sell shares within three years of acquisition, or within three years of grant of options, will require a 'carve out' in appropriate cases in order that large parts of the start-ups sector are not disqualified from the concession because of the need to retain the ability to sell the company at any time.

Employees of start-up companies are very often required to sell their shares when the company is able to be sold, to ensure that a whole-of-company sale can occur and that company value is not compromised by minority shareholders unwilling to sell. Employees therefore hold their shares or options subject to so-called 'drag-along' sale requirements and the legislation should reflect this practical reality.

The three year holding requirement will need to be appropriately ameliorated for these sorts of sales if the II&CA policy is to be workable in practice.

The rule will also need to cater for sales pursuant to 'tag-along' rights. To ensure that in practice employees of start-up companies are able to realise value when it is available, they are often given rights to participate in a sale of an unlisted company's shares to a buyer of a controlling interest in the company. If the three year holding rule prevents these sales it would in practice mean that companies could not offer qualifying options to employees.

10% limit on employee holdings

While the proposed legislation relaxes the significant ownership and voting rights limitations by doubling the existing 5% test to 10%, it is still nonetheless too restrictive and unhelpful in the start-up context.

In many cases start-up companies commence with a cornerstone capital investor and one or two key employees devoting large amounts of time to a venture for little current remuneration. It is not uncommon for these employees to be given more than 5% (or 10%) of the equity in the company. That does not make them any less 'employees', or otherwise warrant denying them access to the new regime.

The new tax rules should consider this limitation and look to ensure there is an appropriate carve-out for start-up companies of at least 30%, for the change to be meaningful.

$1,000 exemption on tax up-front

Some employees are entitled to reduce the amount included in their assessable income by $1,000 if they meet certain conditions, which has not changed since the 1990s. On an international benchmark this amount is extremely low and AusBiotech advocates for it to be raised to a more competitive level of $10,000. For example, (these figures are not directly comparable due to differing provisions, but indicative) the US provides US$ 25,000 as an exemption and the UK provides for (under the Company Share Option Plan) up to £30,000 or allows £6,000 (under the Save As You Earn Plan).

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 so 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.

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 the conditions are right. The Australian start-up biotechnology community needs an appropriate and workable 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.