Tech Council of Australia
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Tech Council

25 August 2021

Directors
Market Conduct Division and
Individual and Indirect Taxation Division
The Treasury

Dear Directors,

Response to The Treasury's Exposure Draft Legislation to Reform Employee Share Schemes

Thank you for the opportunity to make a submission to the Employee Share Scheme Draft Legislation Review. The Technology Council of Australia (TCA) welcomes the Federal Government's commitment to improve the operation of Australia's Employee Share Scheme (ESS) regulatory framework. These reforms are vital to the creation of new jobs and the attraction of talent within the tech sector.

We support the changes proposed, subject to some targeted amendments to clarify the application, operation and implementation of the scheme. This will help Australian companies to scale, by attracting skilled employees whilst allowing employees of successful companies the needed mobility to join new and or create the next generation of Australian companies.

About the Australian Tech Sector and the TCA

The TCA is Australia's peak industry body for the tech sector. The Australian tech sector is a pillar of the Australian economy, contributing $167 billion per annum to the Australian economy, and employing 861,000 people. This makes the tech sector equivalent to Australia's third largest industry, behind mining and banking, and Australia's seventh largest employing sector.

As a sector that depends heavily on being able to attract high quality talent, employee share scheme reform is of critical importance to tech sector companies. This is because it is a crucial mechanism used by tech companies to attract and reward workers.

Ensuring a competitive and efficient ESS framework in Australia is essential to incentivise job creation by tech firms. It is also critical to building a world-class tech sector in Australia. This is because successful ESS frameworks allow younger companies to attract talent. They also reward employees in firms that successfully scale. This enables those employees to leave and found their own companies with the capital they accrue from holding shares in a successful scale-up firm. That enables them to work for, and / or invest in new firms that will gain from their expertise without a financial penalty. This creates a virtuous circle that accelerates jobs and growth in the tech sector ecosystem.

This effect has been critical to the formation of tech ecosystems globally, such as Silicon Valley and Israel. However, there are aspects of the ESS scheme in Australia that have inhibited the economic benefits of ESS offers, particularly the use of cessation of employment as the deferred point of taxation.

Improving Australia's ESS framework to address these limitations is timely because the tech sector is maturing, and rapidly growing jobs and successful scale-up companies. In the last five years, Australia has successfully grown a strong pipeline of 99 companies with valuations of $100 million or more.[1] Further, the number of companies being created in each of the last three decades is increasing rapidly, as Table 1 below shows.

Table 1

Decade of company formation	Current no. of companies founded in that decade presently valued at $100m+	Example companies
2000s	24	Domain, iSelect, Atlassian, Tyro, Health Engine, Finder, Red Bubble, Campaign Monitor, Envato, Hotels Combined, InfoTrack
2010s	67	Airwallex, Deputy, Brighte, 99designs, Airtasker, Koala, Stake, Prospa, Culture Amp, Compass, Sendle, Freelancer, Flare, Canva, Expert360, Afterpay, Judo Bank, Shippit
Total	91	

Source: Airtree

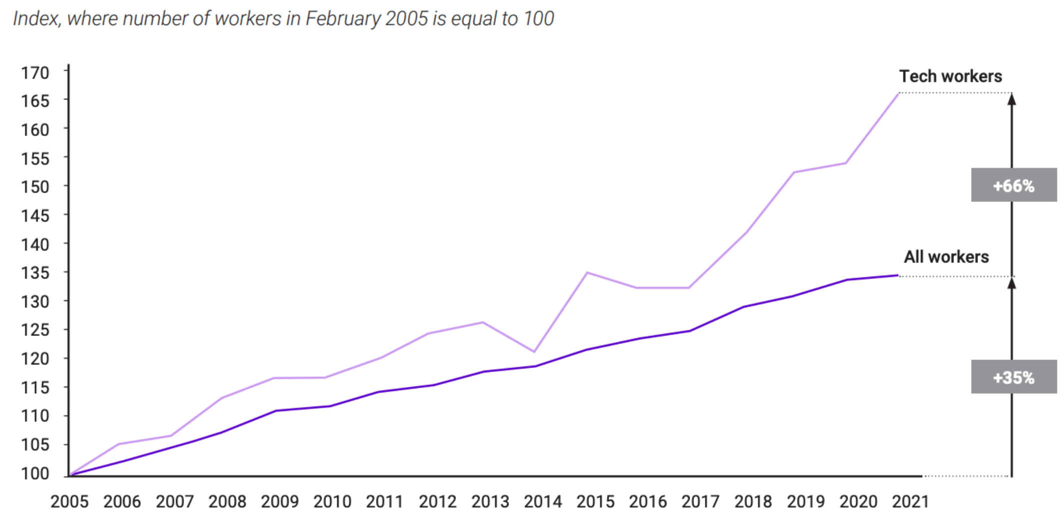
There will be many employees in these firms with employee share interests. Therefore, making changes to the ESS framework now is critical to remove barriers to those employees leaving successful firms, and starting their own companies, or to invest in and / or work for other emerging firms. Australia is also facing a significant shortage in workers for tech jobs. Amending the regime now is critical to help attract workers. Finally, simplifying the current model will make it easier for emerging firms to navigate and use, helping them to grow.

Making these changes can have a positive impact on jobs and economic growth in Australia. The TCA has set the goal of employing 1 million people in tech related jobs by 2025, and

[1] Australian tech companies valued at $100M+ | by AirTree | AirTree | Aug, 2021 | Medium.com

growing the sector's contribution to GDP to $250bn per year by 2030. These ambitious goals recognise that Tech Sector jobs growth is already strong, increasing by 54 percent between 2005 and 2019 (see Exhibit 1 below), considerably higher than the average growth of 25 percent across the economy. As businesses and governments have rushed to adopt technology during the pandemic to keep their organisations operating remotely and workers in jobs, the tech sector has experienced a further surge in activity. This has led to an additional 65,000 new software and application developer jobs added in Australia in the past year alone.

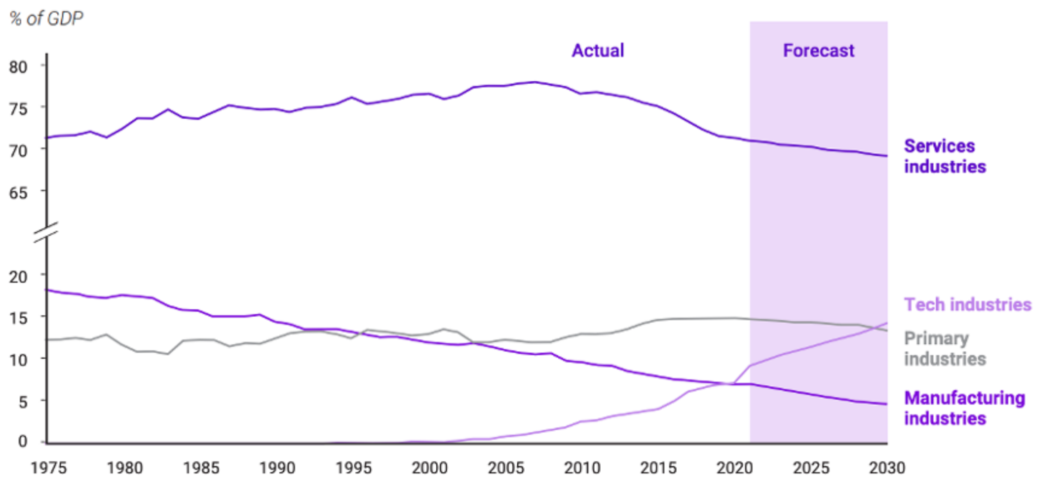
Exhibit 1: Growth in number of workers in the tech sector and overall economy



Sources: ABS Labour Force, 2016 Census, Accenture analysis

Analysis by Accenture forecasts that the contribution to GDP of tech industries in Australia already surpasses manufacturing, and will surpass primary industries by 2030 (see Exhibit 2)

Exhibit 2: Australian economy by sector



Source: Accenture analysis of ABS 5204.0 Australian System of National Accounts, 2021

The members of the TCA have committed to work with governments at all levels to ensure that Australia and Australians can take advantage of the vast opportunities technology brings.

As a sector that depends heavily on being able to attract highly skilled talent, the ESS is a matter of critical importance to our membership as a key enabler to attracting that talent and securing greater employee investment in firm success. The ESS framework also alleviates cashflow challenges of early-stage tech companies, whose operational expenditure is often weighted towards salaries & wages, being cashflow positive in early stages of growth.

This makes the ESS framework a critical part of Australia's tech sector success. Amending the ESS framework, particularly in relation to cessation of employment, is a key part of further incentivising this job and company creation cycle in Australia over the next decade.

Supported changes to the ESS draft legislation

The TCA welcomes the changes to the ESS regulatory framework and congratulates the Federal Government on proposing the reforms. The proposed changes will be particularly beneficial for early-stage unlisted companies. In particular, we welcome and support changes to:

- Remove the cessation of employment as a deferred taxation point
- Withdraw the Corporations Act 2001 requirements for ESS offers to employees who do not pay or incur debt to participate in these schemes and increasing the value cap from $5,000 to $30,000 for all other ESS offers of unlisted companies. This will streamline the process for unlisted companies to attract high quality talent and consequently continue to grow the contribution of the tech sector in Australia
- Clarify where disclosure documents are required under the Corporations Act.

While these changes are positive, we believe there is an opportunity to further optimise the proposed approach to ensure the scheme remains a catalyst for Australia's rapidly growing tech sector.

TCA proposed amendments to the ESS draft legislation

The TCA recommends a set of targeted amendments to the draft legislation to maximise the benefits of the reform. These amendments would ensure the reforms do not penalise employees with existing shareholdings from leaving fast-growing firms. They would also better target eligibility for the scheme, and improve its operation.

These amendments are:

- Amending the wording of the removal of the cessation of employment as a deferred taxing point so that it applies to interests where the employee ceases employment post Royal Assent, rather than applying to new interests granted post Royal Assent. The the latter approach means existing interest holders will still be taxed once their employment ceases.
- Increasing or removing the proposed $30,000 regulatory relief cap for unlisted companies offering equity where employees pay or incur debt to enable more employees within companies to voluntarily access share offerings

- Amending and simplifying the qualifying criteria for the start-up concession to a sole, bright-line turnover threshold of $50m
- Removing the three year sale restriction on interests offered by eligible start-ups

Making these amendments to the draft ESS legislation will achieve the reform's objectives of reducing red tape and enabling early-stage companies to create jobs and attract top talent. These amendments will also encourage labour mobility and new company formation by employees with current shareholdings in successful, scaling companies.

Critically, making these amendments will not impact the taxation revenue derived from the scheme.

I. Cessation of employment taxing point implementation amendment

Currently, an employee with interests in the form of rights or shares issued under an ESS is taxed at the earliest of different triggers specified in the legislation, including when the employee ceases employment.

The TCA welcomes the legislation's proposal to remove cessation of employment as a deferred taxing point for both shares and rights issued under ESS schemes. This is an important change because cessation of employment is currently often the first trigger for deferred taxation. If the value of the company has risen fast, it either disincentivises an employee to leave a firm, or requires them to forfeit their interests, which may be the only possible option to avoid a sudden and high tax bill, which they may well not have the capacity to pay where shares or options are not liquid.

The proposed legislation would apply to *interests granted* in the income year commencing following Royal Assent. However, we are concerned this would exclude interests already held by existing, longer tenured and highly skilled employees. It also creates an unnecessary administrative burden for employers.

We recommend a minor change so that the amendment applies to interests where the employee ceases employment *post* Royal Assent, regardless of when the ESS interest was granted. This would confirm that employees that already hold interests issued by successfully scaling companies (such as those referenced in Table 1 in the overview section) will not trigger a high tax bill when they cease employment (see the explanation in Box 1 of this effect). These employees are likely to go on to create their own companies in the short-term, triggering further jobs and growth in the sector, or to join other younger companies and provide the benefits of their expertise and experience to them. Therefore, it is particularly important that the reform to remove cessation of employment applies to cessation of employment for employees that currently hold interests. It is in Australia's interests for these employees to be mobile.

If the amendment only applies to ESS interests granted in the income year commencing after Royal Assent it will create an unnecessary administrative burden for employers who will be required to track different taxing points depending on when the ESS interest was granted. This is likely to lead to:

- additional unnecessary cost;
- employers and employees inadvertently confusing when the appropriate taxing point arises; and
- deferral of grants in the lead up to the changes taking effect.

It would be preferable to create a clear rule about the taxing points for all grants going forward.

Box 1: Employee shareholdings and tax liabilities in a fast-growth firm

This case study shows the tax liability accrued by an employee at *a hypothetical Australian unicorn company on a 2x Year on Year trajectory. It shows the tax liability for several archetypal employees, each of whom received a new hire shareholding grant worth $50,000 at the time of hire with a deferred taxing point and not eligible for the start-up concession. In 2021, a liquidity event (e.g., an IPO or acquisition of the company) is not anticipated and liquidity of the interests is uncertain. All assume the highest tax bracket of 47%.*

Sample historic share price
2015 – $15
2016 – $30
2017 – $60
2018 – $120
2019 – $250
2020 – $500
2021 – $1,000

Employee 1 [2015] - 3,334 shares, now worth $3.3M (tax bill of $1.5M)

Employee 2 [2017] - 834 shares, now worth $834k (tax bill of $358k)

Employee 3 [2019] - 200 shares, now worth $200k (tax bill of $64k)

Should Employee 1 cease employment with the Australian unicorn, they would be liable to $1.5m of tax; however, they would not be eligible to liquidate their ESS interests to cover this expense and if they had insufficient savings and or access to debt financing to cover the tax liability, their alternative may be to forfeit these interests and or remain with their current Australian unicorn until a liquidation event occurs.

Recommendation: Amend the wording of the removal of the cessation of employment as a deferred taxing points amendment so that it applies to interests where the employee *ceases employment* post Royal Assent, rather than applying only to *new interests granted* in the income year following Royal Assent. The latter approach means existing interests holders will still be taxed once their employment ceases. This amendment would not impact the revenue base of taxation of interests, simply the timing of that revenue.

II. Increasing the regulatory relief cap

Proposed changes to the Corporations Act 2001 to streamline the process for unlisted companies in their offer of ESS interests to employees are welcome modifications. Ultimately these requirements are there to protect Australian employees from accepting lower wages in exchange for ESS interests that are difficult to value and could be inflated by employers seeking to attract talent. Employee risk would be heightened where employees are required to contribute their own capital (through savings and or debt financing) to the scheme thus raising further capital for their employer.

The proposed relief from the Corporations Act 2001 requirements for unlisted companies that offer ESS interests to employees who do not pay or incur debt to participate in these schemes is a favourable outcome for the Australian tech sector.

However, for other ESS interests, the proposed legislation includes regulatory relief for unlisted schemes where the participant is paying to participate, but is receiving less than $30,000 worth of interests (previously the cap was $5,000). While the increased cap is welcome, we recommend the cap be increased to allow for unlisted companies to offer meaningful amounts of equity to employees who are experienced in investing and wish to fund a higher share allocation.

It is common in other forms of share investing to take out margin loans to acquire interests, and this is not typically capped by law, other than ensure that the amount loaned is prudent and doesn't create a credit risk. Increasingly, employees in start-ups may have both experience in investing and, particularly for senior staff, the means to incur debt to do so. We believe it would be beneficial for unlisted companies to be able to easily offer these kinds of employees meaningful amounts of equity.

While we recognise the need for this threshold to reduce the risk of employees being exploited, we believe that there is greater opportunity to engage middle management than there is risk of more junior or inexperienced staff being negatively impacted or exploited.

Recommendation: To increase the impact of the value cap, we recommend that it is increased substantially, to a minimum of $100K.

III. Simplify the eligibility criteria for the start-up concession

We recommend simplifying the eligibility criteria for companies to qualify as a start-up, to better target the scheme to early-stage companies, and to reduce red tape.

Under current eligibility criteria, the definition of a start-up is effectively age-based, as the start-up concession is awarded when:

- A company has not been incorporated for over 10 years
- Annual turnover does not exceed $50million
- A company has not been listed

However, it is common for companies that might otherwise be considered a 'start-up' based on their staff or growth trajectory to be incorporated for more than 10 years.

This can be because some businesses take a significant number of years to become profitable, especially research-intensive and / or highly regulated firms with long lead times to get products to market. It can also occur if a founder utilises an existing corporate structure when starting a new venture. For example, this was the case with SafetyCulture where founder Luke Anear utilised a pre-existing company when he founded SafetyCulture, rather than incur the $600-1,000 of additional cost to incorporate a new company.

To address these issues, we recommend amending the qualifying criteria for a start-up to be a firm under the $50 million turnover threshold and deleting the reference to a company that has not been incorporated for over 10 years.

Recommendation: Amending qualifying criteria for the start-up concession to be a sole, bright-line turnover test of $50 million.

IV. Removal of the 3-year sale restriction

Currently, employees with interests granted from a company qualifying for the start-up concession are prevented from disposing of their ESS interest for a period of three years starting from when the ESS interest was acquired (unless the Commissioner waives this requirement, or the limited exceptions apply).

This can be problematic for employers if the company is approached for acquisition by investors or corporations, as it means they must disclose to the Australian Taxation Office that they are entertaining a merger and acquisition discussion, irrespective of how likely the deal is to proceed. Whilst it is possible to have this restriction waived, the process is costly (often in excess of $15,000 - $20,000) and lengthy.

This provision can also be problematic for employees who have been a part of a high-growth firm, but who are then restricted from realising the full value of their assets should their firm be targeted for investment.

Our view is that this requirement does not serve a clear purpose, especially given there is no tax benefit to employees if they sell their shares within 12 months of grant of the options, and would be better to be removed.

Recommendation: Remove the three-year sale restriction provision.

TCA Recommendations

The TCA commends the Federal Government for proposing reforms to the ESS regulatory framework. We support the changes as they will simplify the scheme’s operation and reduce red tape, without incurring greater risk.

We recommend a small number of minor amendments to help ensure the reform achieves its key objectives of reducing red tape and driving growth, without increasing risks associated with ESS arrangements. We therefore recommend:

- Amending the wording of the removal of the cessation of employment as a deferred taxing point so that it applies to interests where the employee ceases employment post Royal Assent, rather than applying only to new interests granted post Royal Assent, as the latter approach means existing interest holders will still be taxed once their employment ceases
- Amending and simplifying the qualifying criteria for the start-up concession to a sole, bright-line turnover threshold of $50m
- Increasing or removing the proposed $30,000 regulatory relief cap for unlisted companies offering equity where employees pay or incur debt to enable more employees within companies to voluntarily access share offerings
- Removing the three-year sale restriction on interests offered by eligible start-ups

Thank you for the opportunity to make a submission to the ESS draft legislation review. We would be pleased to discuss our comments with the Treasury.

Yours sincerely,

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