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Guerdon Associates
Executive Pay & Board Governance

28 May 2020

Committee Secretariat
House of Representatives Committee on Tax and Revenue
Inquiry into the Treatment of Employee Share Schemes
PO Box 6021
Parliament House
Canberra ACT 2600

By email: TaxRev.reps@aph.gov.au

Dear Committee Secretariat,

Inquiry into the Tax Treatment of Employee Share Schemes Submission

Guerdon Associates appreciates the opportunity to provide its submission on the "Inquiry into the Tax Treatment of Employee Share Schemes" (the Inquiry), noting that the Committee will inquire into the effectiveness of the 2015 Employee Share Scheme (ESS) changes to the taxation treatment and administrative arrangements for ESS.

The remainder of this submission provides brief information regarding our firm and then reviews what we see as the legislation's limitations in regard to the definition of a start-up, the restrictions imposed on the type of equity vehicles that receive concessional treatment, and the need to review taxation treatment at cessation of employment. Specific suggestions are ***italicised and bolded*** for emphasis and ease of reference.

About Guerdon Associates

Guerdon Associates is an independent[1] executive remuneration and board governance consulting firm. Our clients include 20% of the ASX 50, a significant proportion of companies in the ASX 300, and private and pre-IPO companies. The firm co-founded and is a member of the Global Executive Compensation and Grovernance Group (GECN). Based out of Switzerland our Group have affilate offices of independent board remuneraion and governance advisers across 4 continents. The firm has worked with the boards of technology and biotech start-ups, and has staff who have consulted to Silicon Valley and other US, Canadian and European technology and bio tech companies on employee compensation and equity plan matters.

The firm's submissions were among the most cited in the Productivity Commission's review of executive remuneration, and over the years it has contributed to prior Treasury consultations on other Corporations Act and taxation changes. Notably in relation to ESS tax changes, the firm's prior submissions to Treasury on the 2009 equity plan taxation changes cautioned against their impact on explorers, other start-ups, and smaller employers, as well as issues associated with ensuring that the interests of management and other employees were aligned with those of their companies' investors. Much of what we suggested then was incorporated into changes with effect from 1 July 2015, but not all. More can be done.

[1] Independence is defined as a specialist provider of consulting services to boards to minimise conflicts of interest that may result from being a broad based supplier of multiple services to both management and boards.

What is a start-up?

The first issue is the definition of a "start-up" in section 83A.33 of the Income Tax Assessment Act. A company is eligible for the proposed start-up concessions if it is an unlisted Australian-resident company that has been incorporated for less than 10 years, with aggregated turnover of less than $50m (including revenues from associated companies) in the prior tax year, and where the market value and other conditions are met for the ESS interests to be granted.

The legislation appears to assume that a listed company is in a more advanced stage of development than an unlisted company, has easier access to capital and has a "market" value for its stock.

It is true that companies are often listed to access capital, but often this is because there are no private sources of capital available after the house has been mortgaged twice, and family and friends are in as deep as they care to go, and the start-up needs more capital as it has outgrown the garage. The Australian private capital market is small compared to sophisticated, deep and wide private capital markets in the US and to an extent the UK, leaving little choice but to turn to listed company markets. But even in listed start-ups, stock liquidity is such that a true market value remains uncertain.

Public capital is required to sustain an exploration company beyond the typical 7-year commodities cycle, or to see a biotech through the painstaking 15 years or more needed to see the fruits of its research realised in clinical trials, or to achieve sufficient cash flow to expand market reach around the globe without incurring losses.

Implicit in the legislation is an assumption that listed companies are not entrepreneurial, or value employees taking risk, have access to cash for growth, and can more easily acquire skills needed.

Arguably, the terms of reference requirement to determine the effectiveness of ESS changes for the goal of bolstering entrepreneurship in Australia should probably take precedence over all other aspects if Australia is to find more sources of growth and productivity improvement. In this regard, the exclusion of listed companies that otherwise meet certain high growth criteria suggest a major limitation in the effectiveness of the "start-up" provisions. Guerdon Associates understands this from our engagement with institutional investors, and the boards and executives of the few larger entrepreneurial companies that are ASX listed.

Australian institutional investors are crying out for higher growth listed entities to balance their portfolios. They are necessary for acceptable risk-adjusted returns for all superannuation fund members, and hence, all working Australians. The absence of suitable listed high-growth companies has seen Australian superannuation money being invested offshore, and hence not contributing to our economy, or in private equity, which typically focuses on a 5-year end point to maximise returns, rather than building sustainable new industries or longer term growth platforms.

While the few high-growth listed entities making it to major superannuation portfolios do not have trouble raising capital to fund growth from local sources due to their rarity, they have continuous struggles attracting and retaining technical skills, often sourced from offshore markets. Prospective highly-skilled migrants' have concerns with leaving their more established home labour markets which are ostensibly better for their careers, and losing their much lower tax on their equity grants in their home country. Australia needs to step up and, at least, provide taxation that is comparable. Why relocate to Australia when our existing, entrepreneurial, high growth listed entities needing more scale can only offer equity taxed at a 49% marginal rate when Singapore offers 20%, the US 25%, or the UK, under its various schemes, as low as 15%?

There are multiple examples of Australian incorporated companies seeking to list, and relocate, elsewhere due to the combination of unavailability of skills, and less incentive to attract employees relative to the incentives they could receive in other markets. Atlassian may be an example of "one that got away".

Therefore, Guerdon Associates suggests that the listed status of an entity is irrelevant to whether it is a start-up, and that this condition be deleted.

We also have concerns that the $50m turnover limit encompasses associates and affiliated companies. There will be instances whereby start-up founders are capitalised by a major seed capital or private equity investor who takes a majority stake but has income from other companies that exceeds the $50m threshold. Also, the arbitrary $50m limit, while it will encompass most start-ups, will exclude the next Amazon, Uber, Tesla and Facebook, which had high turnover but no profit for a long gestational period. There are also local examples including, "heroes" that have now gone onto be larger, successful listed companies that are, by most measures, still entrepreneurial and high growth such as Xero, NearMap, Afterpay, and Zip Co. Across these, and similar companies, the greatest shared constraint on growth is the shortage of talent, and global competition offering tax advantaged equity.

Guerdon Associates suggests that, at a minimum, the $50m turnover limit for start-up and associated entities be re-considered, and that the turnover of the standalone start-up entity be the size consideration. In addition, consideration is given that it apply in conjunction with the period of incorporation condition and our suggested profitability condition (see below), on the basis that a company must meet two of these three conditions to be eligible for the start-up concessions.

The condition that a 'start-up' company must have been incorporated for less than 10-years is too limiting. Biotechnology companies typically have development cycles that exceed 10 years. In fact, it is difficult to envisage a biotech as having a development cycle less than 10 years. Explorers formed in the trough of a commodity cycle may require two cycles that are each typically 7 or more years to realise value for their investors. Also, assuming that the requirement to be unlisted is removed, the 10-year limit would not take into account the practice for a back door public exchange listing as a cost effective method to access further funding. A start-up that is effectively acquired by an already listed entity in a back door listing could be excluded from eligibility for the start up concessions if the listed entity has been incorporated for some years.

Therefore, Guerdon Associates suggests that the maximum period from incorporation be extended from 10 to 15 years. In addition, consideration is given that it apply in conjunction with the turnover condition (above) and our suggested profitability condition (see below), on the basis that a company must meet two of these three conditions to be eligible for the start-up concessions.

It is curious that the proposed start-up eligibility conditions do not consider company profit, given the amendments are intended to assist companies that do not have sufficient cash flow to pay talented employees what they are worth in salary. An eligibility condition that the company does not make a taxable profit is more relevant than the 10-year incorporation and unlisted conditions. The level of taxable profit is readily ascertainable and certain via ATO records.

To ensure the concessions are utilised only by companies that are considered start-ups, we suggest that a company that meets any two of a) years since incorporation, b) turnover and/or c) profitability conditions to be eligible for the start-up concessions.

Therefore, Guerdon Associates suggests that a taxable income test be added, on the basis that a company must meet any two of the maximum period of incorporation condition, the turnover condition and the taxable profit condition to be eligible for the start-up concessions.

Continuing tax deferral beyond cessation of employment

Division 83A currently provides that unvested equity subject to tax deferral is assessable for income tax on cessation of employment (see ITAA 83A.115). Guerdon Associates, and many others, have advocated that this taxing point be removed in prior submissions to Treasury. One of the recommendations made by the Productivity Commission following its inquiry into executive pay was to remove cessation of employment as a taxing point for unvested tax-deferred equity.

Taxing unvested equity on termination of employment does not encourage good governance and risk management. Most companies ensure unvested equity lapses on termination of employment, even if the individual is considered a "good leaver", to ensure (former) employees do not have to pay tax at cessation of employment on equity that has not vested, and that may never vest. Alternatively, they structure the ESS interest to provide for cash settlement rather than equity-settled. This latter practice does not fully align the interests of employees with shareholders. For high-growth, entrepreneurial companies this cash could be better employed in growing the business, and it makes more sense to issue equity in these circumstances if the tax laws did not discourage it.

If unvested equity was not taxed on cessation of employment, and companies permitted the equity to remain on foot post cessation, employees (including management and executives) would be encouraged to build and maintain a good post-employment legacy, in order to maintain or improve company value. The lapsing of unvested equity on termination only encourages management to be more short term in their plans, strategies and actions, and is thus contrary to the requirements of a majority of company investors.

As it stands, companies wishing to encourage good governance practices, and that have sufficient cash flow, permit the settlement of equity instruments in cash for good leavers at some time after the cessation of employment, providing performance and/or other conditions are met. However, there are many companies that are cash constrained that would prefer to settle post employment vesting in shares, on the same basis that applies for employees who continue in employment.

While removing cessation of employment as a taxing point under the tax deferral arrangements may lead to a delay in tax collected, the net tax position for the government over time would be unchanged. It would also simplify tax administration by avoiding situations where tax paid on cessation of employment has to be refunded because the equity does not ultimately vest. Current reporting requirements that leverage off the company's registry records can be maintained for former employees, ensuring the integrity of tax reporting and collection is maintained.

To our knowledge, Australia is one of only two OECD countries that taxes unvested ESS interests on cessation of employment.

Therefore, Guerdon Associates suggests that cessation of employment be removed as a deferred taxing point for unvested equity to enhance consistency and simplicity, reduce administrative costs and, most importantly, improve governance by encouraging management to ensure their enterprises are sustainable over the longer term.

Salary sacrifice arrangements

The COVID-19 pandemic has brought a focus on the salary sacrifice arrangements that could be improved for the benefit of the economy and many employees. A relatively simple action that the government could take will assist some employers to save jobs for their employees, and for the companies themselves to stay alive until conditions improve.

Beyond COVID-19, the additional flexibility will enable Australian companies to tailor remuneration to the needs of current and prospective employees, increase ownership and enhance the country's attractiveness to migrants with rare and needed skills.

The following describes the issue and the action the government can take. This action will not be a cost to revenue and can, in fact, generate tax revenue in coming years. The only major difference is in the timing of revenue received.

- Many employers would like to allow their employees to sacrifice salary in return for equity in the company.
- A salary sacrifice provides an exchange of cash salary for equity in the company. The more salary that employees choose to sacrifice for equity, the more cash the employer has to keep others employed who cannot sacrifice salary because of their ongoing commitments to pay cash for rent or mortgage or food, or to invest to employ more people.
- Division 83A of the Income Tax Assessment Act limits the employee to sacrificing no more than $5,000. This limit was due, in part, because tax collection by the ATO could be deferred with every salary sacrifice. Now, of course, with every salary sacrifice another employee's services are being retained. Without salary sacrifice more employees would be laid off, so the revenue would not be much impacted at this current time. In future, better, times, the company would utilise the cash for further investment, and additional employment.
- There are many employees who would be prepared to sacrifice more than $5,000 and even up to 100% of their salary to assist their employer avoid layoffs of the wider employee group, or assist the company invest in growth, and/or in the belief that such an investment will eventually reap returns.
- The government could facilitate this – at no cost to revenue – by temporarily removing the $5,000 cap.
- To measure the impact of this measure on employment and growth in companies that utilise it, this change could be temporary, and have a sunset date of 30 June 2023 subject to testing the impact on revenue and growth.

The benefits of this proposal include:

- Government taxation revenue will benefit in 2, 3 and 4 years when employees realise on the growth in value of their employer shares and are liable for income tax at that time
- Employees will become more focussed on working with their employer to survive the crisis, or in future, benefit from growth in company value
- The sacrifice arrangements are voluntary

- Most employers are familiar with salary sacrifice arrangements and would be well-placed to implement these proposals.

Therefore, Guerdon Associates suggests that the salary sacrifice arrangements be amended to remove the $5,000 cap. This change could be made as a temporary or a permanent measure.

Concluding remarks

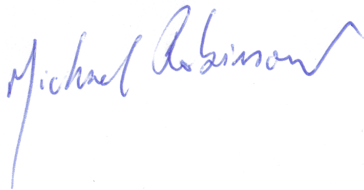
Guerdon Associates suggests improvements can be applied to improve the definition of a start-up, remove cessation of employment as a taxing point, and enable more flexibility to attract and retain rare skills, and better utilise cash for investment and economic growth.

Some of the changes are revenue neutral, at worst. We believe others are likely to contribute significantly to economic growth by facilitating entrepreneurialism, and importing and/or keeping high levels of knowledge and skills that will result in revenue growth offsetting tax foregone.

We believe that our suggestions are reasonable and practical, and would also be easily administered and monitored.

We would be pleased to respond to any queries you may have in relation to this submission.

Yours faithfully



Michael Robinson
Director