Taxing unlisted shares – the impact on Australian innovation

A submission to the Australian Government Treasury on the Reform of the Taxation of Employee Share Schemes

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1. Overview

This paper identifies how taxing securities in unlisted early-stage companies, discourages R&D in Australia.

It urges Treasury to amend Division 13A to either: (1) defer the taxation of securities in "small proprietary companies" (as defined in the Corporations Act) until those securities are sold, at which point income tax on the gain would be payable; or (2) introduce a regulation making power to enable a regulation to be made to achieve this outcome.

If Treasury's declines to do so, the Australian Tax System – instead of encouraging people to work in Australian innovation – will discourage people from joining it. At a time when the contribution of R&D and innovation to Australia's future prosperity is increasingly being appreciated, Treasury is urged to make the changes necessary to ensure that in reducing the possibility of tax evasion under Division 13A, it does not "throw the baby out with the bathwater" and harm Australian innovation in the process.

The problems identified in this paper are widely acknowledged within the Australian R&D communities as requiring urgent attention. They are also the subject of a separate submission by AVCAL, representing Venture Capital and Private Equity in Australia.

2. The challenge facing early stage ventures

Two characteristics apply to most early-stage ventures in Australia and to the commercialisation of new ideas.

The first is that cash is scarce in the early years of a company's operations. The second is that securing good management is critical to the venture's success.

These factors combine to create an important challenge for commercialising new ideas in Australia: how do you attract good people to early-stage businesses when you can't pay them the salaries they could earn elsewhere?

The solution which is adopted in the US, the UK and in other countries (but which cannot be adopted in Australia because of Division 13A) is to remunerate people with 'sweat-equity' in lieu of cash, to incentivise their involvement with the company.

3. Taxing shares and options as if they were cash

Unfortunately, this option is <u>not</u> available in Australia.

This is because shares and options are taxed in Australia as if they are cash, under Division 13A of the Tax Act.

The problem with levying tax on securities in unlisted, early-stage companies, is two-fold:

1. The securities may ultimately prove to be worthless (for example, if the R&D fails and the technology never gets to market). In this case, tax will have been paid on 'income' that never eventuates; and
2. Even if the technology proves to be viable, it can be many, many years before the unlisted securities can ever be sold.

The existing deferral provisions in Division 13A are of no assistance, because they cease to apply when the person leaves the employ of the company. In this event, the employee would be required to pay tax on shares that are unsaleable at the time employment ceases, and which may ultimately prove to be worthless.

Illustration

To understand how this works in practise, the problem is illustrated with an example:

> New Pty Ltd is an Australian company commercialising breakthrough renewable energy technology. Like most start-ups, the company has found it difficult to raise capital. After several months of intense fundraising, an investor agrees to invest $100,000 into the company at 10 cents per share.
>
> New Pty Ltd identifies Grey as someone with the right expertise to help get the technology to market. Given the company's financial position, and entrepreneurial spirit, Grey agrees to accept his salary in two parts: 50% as cash and 50% as shares. Grey leaves the company after two years, by which point the technology is significantly progressed but is not yet ready for market.
>
> Under Division 13A, Grey must pay tax on his shares (at 10 cents a share - being market value). The tax will be payable at the end of the financial year in which his employment ceased.
>
> Grey is required to pay this tax:
>
> - even if the shares ultimately prove to be worthless (because the technology never gets to market); and
> - even though Grey can't sell his shares to pay the tax when his employment ceases (because there is no liquid market for sale of his unlisted securities).

Instead of Grey being rewarded for his efforts, Grey now faces a tax bill which could make him bankrupt.

4. The solution

A simple solution exists which could address this problem. The solution is to tax the securities if and when they are sold, in which event tax would be payable on the gain.

It is important to stress that this approach has nothing to do with tax avoidance. It is only to ensure that tax is payable when the gain is real.

This solution could be achieved by inserting a new "deferral" into Division 13A, for securities in "**small proprietary companies**". The new provision would defer the taxation of securities in "small proprietary companies" until the security is sold.

"Small proprietary companies" are a suitable category of company to be eligible for this deferral, for these reasons:

(a) The term is defined in section 45A of the *Corporations Act 2001* (copy attached), and is well understood and widely applied;

(b) "Small proprietary companies" are considered small enough to warrant exemption from a range of requirements applying to other companies (such as preparing annual financial reports, and audit); and

(c) "Small proprietary companies" (which must meet two of three tests: have revenues less than $25m per annum, gross assets of less than $12.5m, and have fewer than 50 employees) are small enough that deferring the taxing point for securities in these entities is unlikely to have any material impact on the Revenue.

If thee three tests in (c) are considered too permissive, a new category of "R&D company" could be inserted into Division 13A with tighter criteria (such as those referred to in the budget papers – which determine eligibility for the R&D concession – see copy attached).

Either way, a small and clearly enough defined category of company should be able to be provided for, to ensure that the measures aimed at tax avoidance at the 'top end of town' do not inadvertently damage the settings applicable to early stage companies involved in innovation in Australia.

As an alternative short term measure, Division 13A could be amended to provide for a **regulation-making power,** so that a regulation can be made soon to provide for the deferral referred to above.

5. Conclusion

A practical solution exists to solving a problem which poses a significant practical barrier to the commercialisation of new technologies in Australia. Treasury is urged to address this problem in its amendments to Div 13A.

Division 5A—Types of company

45A Proprietary companies

(1) A proprietary company is a company that is registered as, or converts to, a proprietary company under this Act.

Note 1: A proprietary company can be registered under section 118 or 601BD. A company can convert to a proprietary company under Part 2B.7.

Note 2: A proprietary company must:

- be limited by shares or be an unlimited company with a share capital
- have no more than 50 non-employee shareholders
- not do anything that would require disclosure to investors under Chapter 6D (except in limited circumstances).

(see section 113).

Small proprietary company

(2) A proprietary company is a small proprietary company for a financial year if it satisfies at least 2 of the following paragraphs:

(a) the consolidated revenue for the financial year of the company and the entities it controls (if any) is less than $25 million, or any other amount prescribed by the regulations for the purposes of this paragraph;

(b) the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is less than $12.5 million, or any other amount prescribed by the regulations for the purposes of this paragraph;

(c) the company and the entities it controls (if any) have fewer than 50, or any other number prescribed by the regulations for the purposes of this paragraph, employees at the end of the financial year.

Note: A small proprietary company generally has reduced financial reporting requirements (see subsection 292(2)).

Large proprietary company

(3) A proprietary company is a large proprietary company for a financial year if it satisfies at least 2 of the following paragraphs:

(a) the consolidated revenue for the financial year of the company and the entities it controls (if any) is $25 million, or any other amount prescribed by the regulations for the purposes of paragraph (2)(a), or more;

(b) the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is $12.5 million, or any other amount prescribed by the regulations for the purposes of paragraph (2)(b), or more;

(c) the company and the entities it controls (if any) have 50, or any other number prescribed by the regulations for the purposes of paragraph (2)(c), or more employees at the end of the financial year.

When a company controls an entity

(4) For the purposes of this section, the question whether a proprietary company controls an entity is to be decided in accordance with the accounting standards made for the purposes of paragraph 295(2)(b) (even if the standards do not otherwise apply to the company).

Counting employees

(5) In counting employees for the purposes of subsections (2) and (3), take part-time employees into account as an appropriate fraction of a full-time equivalent.

Accounting standards

(6) Consolidated revenue and the value of consolidated gross assets are to be calculated for the purposes of this section in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned).

PART 2: EXPENSE MEASURES

Innovation, Industry, Science and Research

An Innovation and Higher Education System for the 21st Century — Research and Development Tax Credit

	Expense ($m)				
	2008-09	**2009-10**	**2010-11**	**2011-12**	**2012-13**
Australian Taxation Office	-	120.4	411.1	432.4	452.5
Department of Innovation, Industry, Science and Research	-	4.7	6.4	10.2	9.8
Total	-	125.1	417.5	442.6	462.3
Related revenue ($m)					
Australian Taxation Office	-	-	55.0	400.0	400.0
Related capital ($m)					
Australian Taxation Office	-	-	1.3	-	-

The Government will provide $1.4 billion over four years to replace the existing Research and Development Tax Concessions with a new Research and Development (R&D) Tax Credit with effect from 1 July 2010. This measure is expected to be partially offset by the revenue gain over the same period from abolishing the existing R&D Tax Concessions. On a underlying cash basis, the ongoing measure (the R&D Tax Credit) is expected to be revenue neutral over its first four years of operation.

The R&D Tax Credit will consist of a 40 per cent non-refundable tax credit and a 45 per cent refundable tax credit for firms with a turnover of $20 million or less. The new refundable tax credit will not be subject to an expenditure cap. The definition of R&D that is eligible for the new R&D Tax Credit will be tightened to ensure that the support is better targeted. R&D expenditure undertaken in Australia by foreign-owned firms will be eligible for the 40 per cent non-refundable tax credit.

Since the program does not start until 1 July 2010, as an interim measure the Government will lift the expenditure cap on eligible R&D that can be claimed under the existing R&D Tax Offset from $1 million to $2 million with effect from 1 July 2009.

This funding includes $31 million over four years to the Department for Innovation, Industry, Science and Research and $7.2 million over four years to the Australian Taxation Office to administer the new R&D Tax Credit.