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Senate Committee on Tax and Revenue
PO Box 6100
Parliament House
Canberra ACT 2600

19 March 2020

Dear Committee Secretariat

Inquiry into the effectiveness of the 2015 Employee Share Scheme (ESS) changes

KPMG Australia welcomes the opportunity to comment on the effectiveness of the 2015 Employee Share Scheme (ESS) changes following a referral from the Treasurer, The Hon Josh Frydenberg MP, on 6 February 2020.

As a leading professional services firm, KPMG Australia is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also investors, employees, Governments, regulators and the wider community. We strive to contribute to debate that seeks to develop a strong and prosperous economy and welcome the opportunity to provide a submission to this inquiry.

KPMG Australia has worked with many companies at all stages of their development from early stage start-ups to ASX-listed companies. The changes to the taxation of ESSs in 2015 were well-received, aiming to boost start-up activity in Australia and encouraging the use of ESSs as a form of remuneration.

Our submission explores three key recommendations for further regulatory reform to continue to encourage increased uptake of ESSs in Australia and help increase Australia's competitive advantage when being considered as a base for start-up companies.

Recommendations:

That the Committee recommend that the government consider:

1. Remove from the ESS start up concessions the requirement that a company should have been incorporated for less than 10 years;
2. Remove cessation of employment as a taxing point for the ESS tax regime in general; and
3. Amendment of the Corporations Act disclosure regime to remove barriers to the grant of ESS awards.

Background and Executive Summary

In 2015, a number of changes to the ESS taxing scheme were implemented including changes to the deferred taxing point for ESS interest which are rights, and introduction of concessions for start-up

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companies. The intent of these changes was to encourage employee share ownership, as well as to simplify the tax system. The changes were welcome reforms to the tax regime. In particular:

- Changing the taxing point for rights to the point of exercise better aligns the taxing point for participants with when they are able to realise the economic benefit of their interests. This also brings Australia's tax regime into line with global practice.
- Introducing the start-up concessions was very well received amongst the start-up community as it provides a simple and effective remuneration tool in an environment where the company is typically cash poor.

KPMG Australia supports the continued uptake of ESS in Australia as this encourages alignment between employee and shareholder interests. Whilst the 2015 changes were effective in promoting ESS in Australia, there are some additional amendments to the regulatory framework which may assist further with achieving the Government's goals.

In order to further promote ESS in Australia:

- In reviewing the requirements to qualify under the start-up concessions, we suggest that the requirement to be incorporated for less than 10 years should be removed. Companies that fit the other criteria for being a "start-up" should not be penalised for being incorporated for more than 10 years, as different companies have different trajectories for growth.
- For ESS in general we recommend the removal of cessation of employment as a taxing point. Being taxed on ESS interests at cessation of employment potentially misaligns the taxing point and the economic benefit for employees, especially in an environment where ASIC and APRA guidance is to keep the vesting schedules of ESS awards on foot past cessation of employment. Taxing ESS interests at cessation of employment is out of line with global practice. In addition the risk of revenue loss should be minimal as employers have been required to report all ESS income since 2009.
- Whilst the tax regime supports the uptake of ESS amongst start-up companies, the disclosure regime in the Corporations Act 2001 continues to be a significant impediment. We suggest that a change to the Corporations Act 2001 (Cth) (Corporations Act) disclosure is required for the value of the taxation concessions to be fully realised by start-up companies. The exemptions for disclosure requirements in the Corps Act and ASIC Class Orders do not adequately cover unlisted companies (including start-ups), especially where employees are unlikely to be sophisticated investors.

We explore these recommendations in further detail below.

The 10 year age limit on start-up companies

KPMG Australia supports the premise that start-up companies should be offered concessional tax treatments to promote the growth of start-up companies in Australia. Currently, the start-up concessions for ESS only apply for companies that satisfy the following requirements:

- Have no equity interests listed on a stock exchange;
- Are incorporated for less than 10 years;
- Have an aggregated turnover of less than $50 million; and
- The employing entity is an Australian resident company.

KPMG Australia suggests that the 10 year limit be removed, as companies that satisfy the other requirements should still be considered start-ups. Different companies have different trajectories

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for growth. The fact that some companies take longer to achieve growth compared to others should not disqualify them from benefiting from this regime. In addition a number of companies take a significant amount of time to commence business operations (including the hiring of more employees) from the time of incorporation which means that access to the start-up concessions are unduly limited.

Cessation of employment as a deferred taxing point

Cessation of employment has historically been a taxing point for ESS under the Australian tax regime. However we consider that this has strong potential to result in a misalignment of the taxing point for individuals with the economic benefits the employees receive both in timing and in quantum.

Taxing employees at cessation of employment where they do not have access to their awards can result in significant cash flow impacts for the participants, as they need to fund a tax liability without being able to realise the value of their ESS interests.

In addition there is strong potential for mismatch in the value the employee is taxed on compared to what they actually receive. By way of illustration, where an employee ceases employment but has ESS interests which continue to be subject to vesting conditions, the employee is required to value the interests (which may, in and of itself, present challenges, especially for private companies) as of the day employment ceased. In the event that the interests vest at a future date at a lower value, then the employee will have ended up paying tax on a greater amount than the economic value they receive from the interest. Whilst the employee would be entitled to a capital loss in this situation, many employees would not be able to benefit from the capital loss.

We note that there is a potential for the removal of this taxing point to result in a deferral of revenue however we consider that this impact will not be significant. In our experience, whilst it is common for there to be a larger amount of ESS income reported at cessation of employment, typically this is due to employers allowing the employee's ESS interests to vest early (which would still be a taxing point where taxation at cessation of employment is removed).

Trends in corporate governance policies and APRA/ASIC guidelines encourage (and sometimes require) that an employee's ESS awards continue to remain on their existing vesting schedules post cessation of employment. This is particularly acute for companies subject to the Banking Executive Accountability Regime (BEAR) which promotes deferral of long term incentives for up to 7 years. The draft financial accountability regime (FAR) also contemplates mandatory deferral of a minimum of 40 per cent of variable remuneration for 4 years across all APRA regulated entities, with an expectation that in the future the FAR regime will expand to other ASIC regulated entities. As such, it will become a legal requirement for a significant portion of variable remuneration (which are often ESS interests in listed companies) to be deferred beyond cessation of employment.

The practice of taxing ESS interest at cessation of employment is almost unique amongst developed economies. It results in globally inconsistent outcomes particularly in the case of globally mobile employees (i.e. the same award being taxed at two different points in time) which can have a significant impact on the ability to claim appropriate foreign tax credits in different jurisdictions to avoid double taxation.

Corporations Act disclosure regime

The disclosure regime on the issuance of equity is unnecessarily complicated in the context of ESS awards.

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Ensuring compliance with disclosure and other requirements in the Corporations Act can be costly for unlisted companies (including start-ups) from both a monetary and time perspective. In addition, this disclosure regime restrict an unlisted company's ability to offer ESS awards where the relevant Corporation Act exemptions or ASIC class order relief is not available. In particular where a company is seeking to establish an employee share scheme for its broader employee population, this regime will typically restrict the company's ability to offer awards to a value of $5,000.

We have attached our prior submission in response to the *Treasury Consultation Paper of ESSs* (April 2019) with our views on how the disclosure regime may be amended.

Thank you for inquiring into this important matter and we look forward to working with you as the Committee progresses its final report and recommendations.

Yours sincerely,

Ben Travers

Partner

KPMG Australia