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17 July 2009

Re: Inquiry into Employee Share Schemes

Thank you for the opportunity to make a submission to the committee on this matter.

Starfish Ventures is an Australian-owned venture capital firm with $400 million under management. Starfish Ventures invests in innovative, globally competitive technology companies with an Australian base. We are passionate believers in innovation and its ability to create high value jobs and exports for Australia.

Whilst we are sympathetic with the Government's aim of removing the abuse of employee share schemes by large corporations, the proposed rules will have the unintended consequence of adversely impacting the ability of early-stage, innovative Australian companies to attract and retain staff.

It is a challenge to convince successful academics, entrepreneurs, technical experts and experienced executives to risk all and be involved in small, early stage companies. The benefit to balance the risks and hardships is that they might contribute to the creation of a new business and that the shares they receive may be worth something in the future. Unlike large corporations, early-stage companies do not have the cash-flow to pay employees cash bonuses and underwrite their share plans. Options serve as a strong incentive to entice potential employees to accept the risk associated with working for an early stage company.

Under the proposed employee share scheme rules, tax on any discount on grant of options will only be deferred where there is a 'real risk of forfeiture'. Even then deferral is only available until the earlier of:

- vesting of the options (unless subject to further sale restriction);
- removal of sale restrictions;
- cessation of employment; or
- 7 years.

While these rules may be appropriate for employees in listed companies where there is a ready market into which employees can dispose of their securities, no such market exists for early-stage companies. If employees in early stage companies are taxed at any time other than on sale, then recruitment of quality staff to early-stage companies will become an even greater challenge for the following reasons:

- Unlike large corporations, whose employees are able to sell their shares as soon as the options are exercised, shares in early-stage companies are not liquid and may never be. This leaves employees of early-stage companies essentially penalised by paying taxes on the value of shares they aren't able to realise.
- Employee options and share plans for start-up companies are a worldwide practice and with the changes to the taxation of employee share schemes, Australia will become a much less attractive location for potential overseas employees. For example, the company may only be able to recruit someone for a short term contract (say 3 year) to advance the company's operations. If such an employee is taxed on cessation of employment or vesting alone, then this will severely limit the ability of early-stage companies to recruit quality staff whether from Australia or overseas.
- Employees that are taxed at any stage other than sale are taxed on share prices determined by a company auditor. These valuations do not guarantee true market

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value and only until a liquidity event, such as an IPO, does the shareholder clearly know the value of his or her shares. Early-stage companies will need to get third party validation to confirm the valuation, creating additional expense and burden on cash and time-strapped companies.

- The business venture may fail and the options may never vest, resulting in an employee paying taxes on an asset they never received. Unlike the executives the Government is targeting, individuals involved in start-up companies are unlikely to have future capital gains to offset any tax previously paid.

For innovation to turn into commercialized ventures, it is imperative that governments, investors and entrepreneurs work together as partners. We rely on each other to turn a great idea into a successful global business through policies that support innovation, capital injections to take these ideas to the marketplace, and outstanding individuals to execute the business plan and perfect the technologies. The changes to the taxation of employee share schemes will create a significant disincentive for individuals to be involved in an early stage company, putting this delicate partnership at extreme risk.

We fear that the changes in the employee share scheme will cause high-quality entrepreneurs, academics and technology experts to stay in their current roles and Australia will lose out on creating new businesses and more importantly, high value jobs.

PROPOSAL

Starfish Ventures proposes that a separate tax treatment be established for the employee share option schemes for companies involved in innovation under which taxation of options would only arise on sale of the options or underlying shares.

We suggest the existing definition of companies that can access the new R&D Tax Credit, or alternatively non-listed companies with revenue less than $20 million that are not profitable, could be used for this purpose.

By implementing such a proposal, the Australian government can continue to foster innovation, new business development and create more high value jobs in Australia. We do not believe our proposed change will have any significant impact on the Government's budgetary considerations.

We welcome the opportunity to discuss these matters with you further.

Respectfully,

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