AVCAL

The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

9 October 2009

Review of Employee Share Schemes
The Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

Review of Employee Share Schemes:
Start-up, research and development and speculative-type companies

Background

The Australian Private Equity & Venture Capital Association Limited (AVCAL) is a national association which represents the private equity and venture capital industries. AVCAL's members comprise most of the active private equity and venture capital firms in Australia. These firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

The venture capital members of AVCAL provide funds to establish and grow companies primarily in the technology and life science sectors. Without venture capital, household names such as Cochlear, Resmed and Hitwise would not be successful, established companies adding to Australia's economic growth. A snapshot of the VC industry in Australia is appended.

Venture capital backed companies are typically pre-profit. Every dollar they can raise goes into continued R&D, establishing sales and marketing and expanding into global markets. There is insufficient capital to pay market salaries to attract successful Chief Executives or Chief Operating Officers or other highly skilled employees such as senior R&D personnel. Such companies therefore use option schemes to attract skilled employees, to make up for the short-fall in cash-based remuneration and to align their interests with the success of the company. In addition, the employment is 'high risk' by its nature. On average, across the industry, of every 10 investments by venture capital funds, only 1 will make a significant return.

The use of options and shares to remunerate and provide an incentive to staff in start-up and early-stage companies is a worldwide practice and Australia has always fallen behind in its attractiveness as a domicile, because of our less favourable approach to such schemes.

Gateway Building
Level 41, 1 Macquarie Place
Sydney NSW 2000
AUSTRALIA
Telephone +61 2 8243 7000
Facsimile +61 2 9251 3808
ABN 84 056 885 708

www.avcal.com.au

Discussion

Current Situation

Options granted to employees of venture capital backed companies are usually subject to vesting conditions. Vesting is usually predicated on fulfilling certain hurdles or milestones such as clinical trials or licence deals or similar critical stage-gates. Alternatively they may vest over time, to provide an incentive for the staff to stay with the company. It would be extremely rare that options would be granted without any vesting conditions.

The options are generally not exercisable until a liquidity event for the venture capital fund, usually by way of either a trade sale or an IPO.

Based on the exposure draft of proposed Division 83A, the vesting conditions would constitute a 'real risk of loss'. Therefore, tax on any discount at grant would generally be deferred until the 'ESS deferred taxing point'. Accordingly, under the proposed rules in Division 83A tax will be imposed at the earliest of:

- removal of sale restrictions;
- cessation of employment; or
- 7 years.

The discount at the relevant ESS deferred taxing point will be assessable as statutory income rather than a capital gain.

This contrasts with the taxation of employee options of startups overseas, which are usually only taxed on realisation as a capital gain, and as a result, at a concessional rate.

While the rules regarding taxing at points prior to realisation may be appropriate for employees of listed companies they do not provide any incentive to lure highly skilled employees away from safe, secure employers to risky ventures where the chances of success are limited.

If an employee has to pay tax prior to realisation, the problems that might arise include:

1. if the options vest and there is an ESS deferred taxing point prior to realisation then the employee will pay tax on the value of unlisted, untradeable shares. The options may never be exercised and the shares never sold. The employee will then eventually be left with a capital loss.
2. the options might never vest so the employee may pay tax on something they might never receive. While it would be possible to obtain a refund this is still far less favourable than not having to pay tax at all;

3. the employee will have to undertake a valuation of the underlying shares which will create unnecessary compliance costs might never be worth buying if the price is too high and their value doesn't exceed their price, yet you've paid tax on a perceived value; and
4. the employee may not have sufficient cash to fund the tax (startup employees do not usually have any spare cash) and hence the employee may decline the offer for the options, hence reducing the attractiveness of staying with the company and moving to a safer, less innovative company with less upside for the Australian economy (and various associated negative spin off effects of losing highly skilled employees from startups).

Outcome of Current Situation

The result of the current and proposed rules will be that:

- entrepreneurs will be reluctant to leave more secure employment (such as academia) when they might get hit with an inappropriate tax bill for pursuing a high risk employment; and
- it will be difficult to attract overseas candidates to employment in Australia (whether foreign nationals or returning Australians) because the tax environment is not conducive to taking at-risk remuneration instead of salary.

AVCAL has advocated against the current burdens of the tax treatment of options for many years. A PMSEIC review in 2004 also identified this as a problem for early stage companies and a real barrier to growing new technology companies in Australia. AVCAL again raised this issue in our submission to the Cutler review into the National Innovation System.

Treatment of equity-based remuneration for start-ups:

In order to make it more attractive for employees to take on a high risk employment with start-ups, the taxation of equity based remuneration should be as favourable as possible. Accordingly, the taxation of the benefit should be on the capital account so that the employee can access the discounted capital gains tax treatment.

It would seem odd that if the investment is made through a VCLP the manager's carried interest will be taxed as a capital gain but the employee's gain on their equity remuneration will be treated as income. Accordingly it is submitted that proposed Division 83A should not apply to the taxation of equity remuneration of employees of eligible start-ups.

Who should it apply to?

AVCAL submits that any concessional rules should only apply to those industries which the Government is looking to promote. In this regard the Government already encourages companies undertaking eligible research activities. Accordingly this concession could be limited to companies that will be entitled to the R&D Tax Credit. That is a company that is:

- incorporated in Australia;
- undertake R&D activities in Australia.

The concession could be further limited to only those companies that are entitled to the Refundable R&D Tax Credit, being one which has a group turnover of less than $20m.

Alternatively, as the Government has already created incentives for investors and managers of VCLPs and ESVCLPs, the concessions should be limited to employees of eligible venture capital investments (potentially limited to investments made by ESVCLPs rather than VCLPs).

Recommendation

For employees of eligible companies we recommend that:

1. taxation of equity remuneration only occurs when the benefit is actually realised;
2. the taxable benefit is on the capital account; and
3. if either the options or shares have been held for longer than 12 months then the CGT discount should apply. That is, even if the options are exercised immediately prior to the liquidity event, the deemed date of acquisition of the shares is the date of acquisition of the options rather than the date of exercise of the option.

We would be delighted to discuss these issues in more detail if you have any queries.

Yours sincerely,

K Wood Thorpe

Dr Katherine Woodthorpe

Chief Executive

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VENTURE CAPITAL

— September 2009

Innovation nation.

Australia is part of an elite group of innovation-driven economies with pioneering scientific research institutions and world-class R&D facilities. Some well-known products that have emerged from Australian-grown technologies include the flu drug Relenza, cervical cancer vaccine Gardasil and solar panel manufacturer Solahart.

Proven track record.

The industry has a good track record in commercialising world-class products and services. Many VC firms have now been active for over 10 years, and those with significant track records are now active on the global stage. Companies such as Moldflow, ResMed, Compumedics, Cap-xx and Hitwise have benefited from VC backing to grow from early-stage companies to the international players they are today.

Growing cleantech sector.

Cleantech is a rapidly growing area of VC investment. Australian-grown cleantech firms such as Memcor (previously Memtec), Geodynamics and Ausra are globally recognised for their innovative clean technologies.

Bridging the financing gap.

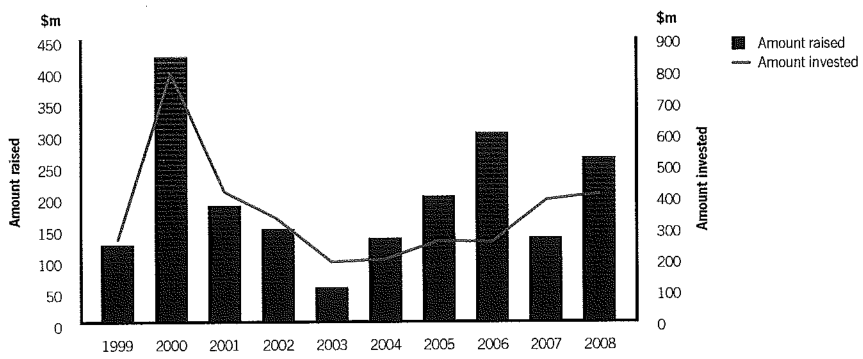
With the global financial crisis constraining the flow of government and institutional funding to promising VC portfolio companies and new investments, potential investors now have the opportunity to obtain exposure to Australian VC at time of unprecedented access into an innovation-rich environment.

Venture Australia

The Australian venture capital (VC) industry holds over $2b in funds under management. Australia is a leading VC market in the Asia Pacific region, with now-global brands such as Cochlear, Compumedics, Ausra, ResMed and Hitwise emerging from VC portfolios.

It is estimated that around half of all active Australian VC firms have now been in business for over ten years, and those with significant track records are competing on the global stage. Around 30% of their investees are Australian-grown hi-tech companies now domiciled in the US.

Figure 1: VC funds raised in Australia (1999 – 2008)
Source: Thomson VentureXpert



Australian innovation on the global stage

Widely-recognised names such as the cervical cancer vaccine Gardasil, flu drug Relenza, 30-day contact lenses, web traffic solutions firm Hitwise, Hong Kong's Octopus smart card transit system, solar water heating company Solahart and many others testify to the global potential of Australian entrepreneurship and innovation.

According to the World Economic Forum's Global Competitive Index 2008-09, over the last ten years Australia's innovation score has increased by an average of 5% p.a., compared to 3.6% p.a. in the US. Australia is ranked among the top 10 countries globally for strong intellectual property protection laws and has the 5th highest number of patents granted per capita among OECD countries. The quality of scientific research institutes in Australia is ranked 8th globally.

Figure 2: Selected highlights in Australian innovation over the last 15 years

1995
- Exelgram (an optical anti-counterfeiting technology now used on banknotes) developed by CSIRO
- Orbital engine technology developed; today its licensees include GM Motors, Ford and Fiat

1996
- CSIRO's US patent for technology that would later be classified as **IEEE 802.11A** and **802.11G** is authorised; these are now used by almost every wireless LAN device
- ANU researchers win Nobel prize for discoveries in cell mediated immune defence

1997
- Perth-based ERG Group designs and implements HK's **OCTOPUS** smart card transit system: the first widespread use of smart cards
- CRC for Vaccine Technology develops a cost-effective melanoma vaccine

1998
- CSIRO researchers develop the RAFT process (controlled polymer synthesis): currently one of the world's most cited patents in chemistry and related sciences
- **PEPLIN** is formed to advance Queensland researchers' work on skin cancer treatments. Today it is US domiciled and undergoing Phase-3 trials

1999
- CIBA Vision and Novartis (USA) launched **NIGHT&DAY** lenses, based on technology developed by the CRC for Eye Research & Technology
- Flu drug **RELENZA** developed by CSIRO and Biota

2000
- Sydney Olympics Athletes Village becomes the world's largest solar-powered community

2001
- **CELLSPRAY** spray-on skin developed & commercialised

2002

2003
- Food Science Australia develops **MICROMAX**, a technology for the efficient production of microencapsulated omega-3 powders and emulsions

2004

2005
- Perth researchers win Nobel prize for discovery of Helicobacter pyllori bacterium which causes stomach ulcers and gastritis leading to its successful treatment

2006
- Cervical cancer vaccine which was developed by U of Queensland scientists is released to the market under the name **GARDASIL**
- Australia is announced as one of the 2 countries shortlisted to host the **SQUARE KILOMETRE ARRAY:** the astronomical equivalent of the Large Hadron Collider

2007

2008
- CSIRO develops system to screen for inhibitors to the progression of Alzheimer's disease

2009
- Melbourne scientists create the world's first genetically-modified strain of malaria which can be used as a live vaccine against malaria
- **GOOGLE WAVE** is launched by Google's Australian team, led by the Rasmussen brothers who created Google Maps

State of play

In its recent Federal Budget announcement, the Australian Government proposed a $3.1b boost in the nation's research and innovation funding over the next four years.

However, the last 18 months have presented unprecedented challenges to the global VC industry. The global financial crisis has significantly affected the flow of funding to calibrate the innovation pipeline at the commercialisation end. As a result, the supply of commercialisable technologies is outstripping the availability of funds.

This imbalance is expected to rise even further in the coming years as increased federal investment in R&D bears fruit, and as existing VC funds reach their termination dates. It is estimated that around a third of current active funds (representing a fifth of VC capital under management) will be wound down over the next two years.

Moving Forward

Australia boasts the following:

- a cohort of experienced, globally-focused VC fund managers with a strong investment track record
- a broad base of globally-focused researchers, entrepreneurs and VC investors
- a history of early adoption of new technologies and world's-firsts in many high-tech sectors, making it an ideal breeding ground for new projects
- clusters of world-class talent in ICT, life sciences and cleantech across the country
- world-class research institutions such as the CSIRO and 48 Cooperative Research Centres

It is envisaged that these factors will continue to place Australia at the forefront of new investment opportunities. What this means is that potential investors now have the opportunity to obtain exposure to Australian VC at time of unprecedented access into an innovation-rich environment.