AusBiotech response to the review of tax impediments facing small business

To: The Board of Taxation
Australian Government
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Introduction

AusBiotech is a well-connected network of over 3,000 members in the life sciences, including bio-therapeutics, medical technology (devices and diagnostics), food technology and agricultural biotechnology sectors. AusBiotech supports the biotechnology industry, which is characterised by small and start-up companies developing new technologies.

AusBiotech is pleased to submit the following comments to this review to identify features in the tax system that are hindering or preventing small businesses from reaching their commercial goals, based on submissions and comments from AusBiotech members.

This submission identifies two tax schemes that currently discriminate against small business (Employee Share Schemes and changes to the Research and Development (R&D) Tax Incentive) and two new tax measures that will assist.

Employee Share Schemes (ESS)

Employee share incentive schemes are an excellent way to attract high-calibre, experienced staff to a small business, providing an important support for companies.

When the changes to Employee Share Schemes (ESS) were announced in 2009, the measures were predicted by industry to result in less incentive for employees, greater administrative costs for companies, and subsequently result in companies turning away from the use of such schemes.

As predicted, the 2009 changes have reduced employee participation and reduced employer offerings. Industry's concerns proved to have substance with:

- Over 90% of all plans suspended during the first year, and 30% suspended for up to two years (the majority have not been reinstated); and
- The number of employees participating in, and the amounts they've invested in, employee share ownership plans substantially diminishing since 2009.

Hardest hit were start-up and small companies that typically have limited ability to reward employees in cash, and so rely on shares and options to provide employees a share in future rewards. The changes forced these companies to pay more cash salaries, restricting their capacity to attract staff, innovate and develop.

Most technology start-up companies are funded by means other than sales revenue, such as venture capital or share issues, and require those funds to conduct research and development and prepare a product to earn revenue. In this 'cash pressed' state they often rely on the support of ESSs to attract quality employees, and are an important support in enabling innovative start-up companies to establish. ESSs complement cash remuneration, making a salary package appear more substantive and attractive, in addition to mutual benefit of giving employees a vested interest in the success of the company.

The importance of ESSs is especially poignant and amplified in the biotechnology sector, where the pre-revenue phase is typically extended by the need to clear regulatory hurdles before revenue can be earned – sometimes by more than a decade – and the cash required to reach regulatory approval.

AusBiotech made a submission to the Treasury's review of Employee Share Schemes (ESS) in February 2014 (please see attached document). The key points are:

- The 2009 change introduced a disincentive to staff by moving to compulsory taxation of shares and options prior to the realisation of any value; and
- The requirement for valuations of pre-revenue technology companies provides an unnecessary impost on small business and is almost meaningless for R&D companies.

The Board of Taxation has previously explored how best to determine the market value of employee share scheme benefits. AusBiotech recommends that this problem be solved by taxing shares at the time of liquidation/realisation, when market valuation is known, rather than at the time of issue, when value is uncertain.

Many employers in a start-up context cannot offer market salaries, so an ESS enables them to compete for appropriately-qualified talent. ESSs in their pre-2009 form were effective as an incentive to lure and reward staff, with a relatively small cost to the employer – providing a 'win-win' situation. The employees have a vested interest in the company's success and this sense of ownership often drives innovation and productivity.

An ESS works best as an incentive when tax is paid on success. If tax is charged pre-success or pre-gain, the shares come as a cost to the employee, with the tax payable before any value is generated. It is even worse when the share loses value, becomes worthless, or is diluted when more shares are issued (which is often required to keep the company funded). In this way the employee is penalised, despite being hard-working and staying with the company through the long and difficult start-up period. This risk is intolerable for many staff and they, understandably, won't risk having to pay for upfront taxes in exchange for an unknown outcome.

This is comparable to paying income tax before you earn any income or paying tax in advance for an income that you may or may not receive. This method of taxation is a disincentive and disadvantages start-up innovative companies during the establishment and development phases.

Taxing upfront on risky and often uncertain ventures is a disincentive to attract Australia's brightest talent to new sunrise industries, like biotechnology.

Furthermore, the current situation of pre-gain tax means that companies must provide valuations of their capitalisation value, for use by the ATO. Biotechnology companies are notoriously difficult – and therefore expensive - to value. It is an inexact process, fraught with uncertainty. This requirement places a further, unnecessary, impost on start-up companies. There is no accounting formula that can achieve an accurate, reliable and fair valuation of pre-revenue R&D start-ups.

No loss of revenue

Furthermore, the Federal Government's rationale for implementing the 2009 changes was reported as a $200 million saving to Treasury and the hesitation in repealing them is now attributed to a potential loss of revenue.

AusBiotech suggests the actual figures be investigated and forecast, as it appears more logical that while there would be a short term re-adjustment, in the long run there should be no loss of revenue and a cogent argument can made for an up-lift. Indeed the large accounting firms have conducted modelling, which demonstrates a net gain to the Government if employees return to ESS.

Firstly, as previously stated, small companies have en masse exited from the use of ESSs. If the environment improved, making such schemes more attractive, a large number of companies would re-engage, leading to revenue being paid to the ATO that is not currently being paid.

Additionally, the core of an ESS is to reward employees for effort that result in an uplift in share price or company value. Logically then, taxing when shares are redeemed would be more profitable, as the tax employees would be seeking to pay would be commensurate with efforts to maximise their profit.

The other avenue for potentially losing tax revenue was said to be from 'leakage' (companies 'gaming' the system). Since the introduction of the R&D Tax Incentive in 2011, the level of reporting has been increased to ensure the appropriate use of the scheme and to stop such leakage. The government ought to now have a higher level of comfort than in 2009, when the ESS changes were made. The amount lost to non-compliance in the current reporting environment would surely be trivial.

Research and Development (R&D) Tax Incentive

The 1.5% reduction to R&D Tax Incentive, which was announced in the May 2014 Federal Budget, is expected to be neutralised by the 1.5% reduction to the corporate tax rate (effective 1 July 2015). This expectation fails to take account of the impact on the many pre-revenue small companies that are in tax loss (and therefore don't pay corporate tax). For them, this is a permanent and potentially-damaging reduction to the support available for R&D as they will not get any benefit from the planned corporate tax reduction.

This change is consistent with the policy intent, and therefore appears to be an unintended consequence that will discriminate against small business. AusBiotech, therefore, argues for an adjustment for pre-revenue companies that equals the benefits enjoyed by companies obtaining any future corporate tax reduction.

New tax incentives

AusBiotech is advocating for tax reform that introduces end-to-end incentives that keep us internationally competitive and encourage desired economic activity and growth. AusBiotech has been advocating on the basis of fours pillars to tax reform. Two of these are mentioned above – repair the ESS provisions to support small companies and retain the R&D Tax Incentive intact. A further two pillars include:

- The introduction of the Australian Innovation and Manufacturing (AIM) Incentive, a 'patent box'-style incentive to keep home-grown intellectual property (IP) once it reaches commercialisation, as well as associated manufacturing, in Australia; and
- The introduce of a fiscal incentive for investors in pre-revenue companies, such as a model based capital gains tax exemption, share flow-through scheme or the UK's, Enterprise Investment Scheme.

A copy of AusBiotech's position paper on the AIM Incentive is also attached to this submission.

Australia needs innovation to continue productivity growth and encourage new industries to supplement declining industries. If Australia's tax system does not provide a conductive environment with competitive incentives for small and start-up companies, these technology ventures are undermined and Australia's best ideas and the resulting economic benefits are then developed, manufactured and managed in other countries.

Australia's development as a knowledge economy means that our (intangible) assets are becoming more globally-mobile than ever before. Companies, small and large, can move the advantages of their IP around the world to enjoy the most favourable tax treatments and incentives. The spillover benefits of managing, developing and monetising IP, such as jobs, manufacturing, exports, clinical trials and associated service businesses go too. If Australia is serious about being internationally competitive, tax incentives need to keep up with the provisions of our major trading partners to maintain international competitiveness by introducing a patent box-style incentive.