FINANCIAL REVIEW

Opinion

Start-up workers' share schemes at risk under tax changes

The government's overhaul threatens to trap the workers with massive tax bills on paper gains they can't actually cash out.

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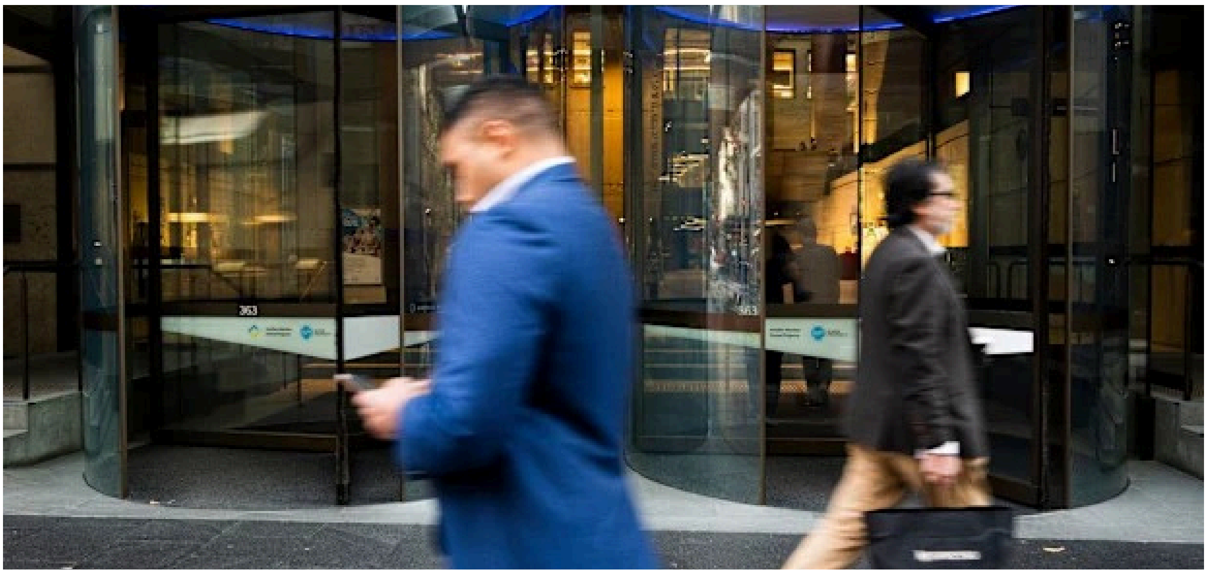
Spare a thought for the humble start-up option. For more than a decade, it has carried the aspirations of risk-taking Australians on its shoulders, persuading talented people to leave the safety of their PAYG employment for a chance to get in on the ground floor of Australia's next unicorn.

Until recently, explaining the tax treatment of a start-up option was easy. No tax on grant, vesting or exercise, and the 50 per cent capital gains tax discount would generally apply to reduce any capital gain when the resulting shares were sold.



Now is not the time to dim one of the economy's bright lights: our start-up sector and the employees who sacrifice so much to work in it. **Louise Kennerley**

The maximum effective rate was 23.5 per cent. A fair bargain for the risk. That simplicity ended in June when the government legislated its tranche 1 tax reforms.

From July 1, 2027, the 50 per cent discount will largely be replaced by cost-base indexation and a 30 per cent minimum tax on real gains.

For founders of new Australian companies, the changes are diabolical. For employees of start-up companies holding share options, the new rules are considerably more complex and create a dry-tax trap.
Take an employee who is granted a qualifying start-up option today with a 1¢ exercise price. The discount on grant is disregarded and the option is then held as a CGT asset. Assume the market value of the option is $100 on June 30, 2027. The CGT transition rules deem the option to be sold and reacquired at its market value at that time. That preserves the
pre-July gain for the 50 per cent discount and establishes the starting point for future indexation.

The notional $100 gain is then quarantined until a later “realisation event”.
Here is the trap. Exercising the options is itself a realisation event that would trigger tax on the $100 notional gain. For example, if the employee exercises the options in September 2027, roughly $100 of deferred gain would be pulled into the

employee’s 2027-28 tax return even though the employee has received no cash and still holds an illiquid share.

There may be an escape hatch. If the employee holds the option until a liquidity event and has it cancelled for cash instead of exercising it, the taxing event would at least coincide with the liquidity.

But that outcome may not be available. Many employees will still have to exercise their options into illiquid shares and risk being caught out.

The impact of taxing ‘phantom’ gains

Treasury’s tranche 2 exposure draft legislation, released on August 3, recognises that the original definition of a realisation event is too broad. It excludes several CGT events that do not involve a substantive realisation.

But it does not exclude the exercise of an employee option. Rather, it acknowledges that employee share schemes will be addressed in later tranches. That omission should be fixed now. Exercise should roll the deferred gain and transition cost base into the resulting share, with tax arising only on a genuine liquidity event such as a sale.

Waiting for a third tranche would prolong uncertainty for companies designing plans today. History offers a useful warning. In 2009, the Rudd-Swan government damaged the employee share schemes landscape by introducing a regime that taxed employee options at vesting – even if they weren’t exercised or in-the-money at that time. Taxing these “phantom” gains crushed the sector.

It wasn’t until 2015 that the tax rules were redesigned. The reforms reversed many of the 2009 missteps and, crucially, introduced a start-up concession regime that moved qualifying options onto capital account and preserved access to the 50 per cent capital gains tax discount.

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In the context of these frenetic tax reforms, the simplest solution risks being overlooked: leave the start-up option rules functioning exactly as they are and retain the CGT 50 per cent discount for employees of eligible start-up companies.

Treasury’s proposed innovative business CGT concession is too narrow and overly complex. It proposes a mash-up of the start-up option rules and the early-stage investment company (ESIC) rules with a battery of additional conditions such as a $50 million maximum turnover test, demanding innovation tests, a five-year holding period and a $10 million lifetime gains cap.

The proposal risks creating a Frankenstein tax architecture that few advisers can understand, and even fewer companies can apply.
Employee ownership is not a loophole. It aligns workers with investors, conserves scarce capital and gives more Australians a stake in the businesses they help build.

With productivity a major issue for the nation, now is not the time to dim one of the economy's bright lights: our start-up sector and the employees who sacrifice so much to work in it.

If the government does not preserve workable tax treatment for employee share schemes, it risks repeating the mistakes of 2009, this time with a larger start-up sector and far more capital, talent and productivity at stake.

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