Law Council
OF AUSTRALIA

Capital gains tax reforms—arrangements for innovative start-ups

The Treasury

17 July 2026

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Acknowledgements

The Law Council of Australia thanks:

- the Taxation Committee of its Business Law Section; and
- the Law Institute of Victoria

for their contribution to the preparation of this submission.

Recommendations

The Law Council recommends that Treasury:

- **expand the concession beyond its current narrow focus on early-stage investment through amendment to the rigid age and turnover thresholds;**
- **permit access for genuine secondary transactions and employee ownership arrangements;**
- **introduce a binding innovation certification framework;**
- **create objective qualification pathways;**
- **create founder safe harbours;**
- **create transitional safe harbours for existing ventures, including to preserve and grandfather existing employee share scheme interests;**
- **introduce continuity rules for rollovers, restructures and genuine commercial transactions;**
- **reconsider the structure and amount of the proposed $10m lifetime cap; and**
- **establish ongoing consultation and review mechanisms.**

Introduction

1. The Law Council of Australia welcomes the opportunity to make this submission to Treasury in response to the consultation paper, *Capital gains tax reforms—arrangements for innovative start-ups*, released on 18 June 2026 (**Consultation Paper**).

2. The Consultation Paper concerns the proposed Innovative Business CGT Concession (**IBCC**), which is intended to preserve, in targeted circumstances, access to a 50 per cent capital gains tax (**CGT**) discount for certain equity interests in innovative start-ups.

3. The Law Council commends the policy objective of ensuring that the Australian tax system continues to support innovation, entrepreneurship, employee ownership and long-term productive investment.

4. However, the Law Council considers that the proposed IBCC, as presently framed, is too narrow and insufficiently integrated with the existing employee share scheme, venture capital and CGT regimes. It is also overly complex, reliant on subjective eligibility criteria and insufficiently responsive to the practical realities faced by founders, employee shareholders and growing Australian businesses.

5. This submission should be read together with the submission of 9 June 2026 by the Taxation Committee of the Law Council's Business Law Section to the Senate Economics Legislation Committee in relation to the *Treasury Laws Amendment (Tax Reform No. 1) Bill 2026* and related measures.[1]

6. That earlier submission raised broader concerns about the design, completeness and implementation of the proposed CGT reforms. Those concerns remain directly relevant to the IBCC because the concession is not a standalone measure. It is a targeted exception to a broader reform, which would replace the existing 50 per cent CGT discount with cost base indexation and a 30 per cent minimum tax.

7. The Law Council's principal concern is that the IBCC seeks to mitigate, for a limited class of interests, adverse consequences that arise from the broader reform. It does not yet provide a coherent or comprehensive framework for the taxation of eligible shares attributed to founders, employees, early investors, venture capital funds, employee share trusts, scale-up investors or growth-stage investment.

8. The Law Council recognises the significant contribution of the Taxation Committee of its Business Law Section to this submission, as well as input provided by the Law Institute of Victoria.

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[1] Law Council of Australia Business Law Section, Submission to the Senate Standing Committees on Economics, Parliament of Australia, *Treasury Laws Amendment (Tax Reform No. 1) Bill 2026* (9 June 2026).

Overview of Law Council response

The Law Council supports the objective of encouraging innovation and long-term investment

9. The Law Council supports the policy objective of ensuring that Australia's tax system continues to encourage innovation, entrepreneurship, employee ownership and long-term investment in productive businesses.

10. The Law Council acknowledges Treasury's recognition that the broader CGT reforms would otherwise have a disproportionate impact on founders, employees and investors in innovative businesses whose equity often has a low or nil cost base and derives most of its value from future growth rather than invested capital.

11. The proposed IBCC is therefore a welcome acknowledgement that innovative businesses occupy a distinct position within Australia's economy and require different treatment to passive investments and more liquid asset classes.

The concession is constructive but too narrowly targeted

Relevant consultation questions: Questions 1, 2 and 6

12. The Law Council supports the introduction of a targeted concession for innovative businesses. However, the concession is presently too narrow in scope and does not adequately support the full innovation funding lifecycle. Rigid age and turnover thresholds may produce a funding cliff and may encourage capital to rotate towards lower-risk and more liquid investments.

13. The Law Council recommends that consideration be given to mechanisms that soften these cliff edges.

Transitional requirements should be relaxed to ensure that existing ventures are not required to satisfy new conditions retrospectively

Relevant consultation questions: Questions 4 and 7

14. The Law Council is concerned with the proposed application of innovation and active business requirements to ventures established prior to the introduction of the concession. Many founders, employees and investors have made commercial decisions years before the IBCC was contemplated or existed. They could not reasonably have anticipated that future tax outcomes would depend upon demonstrating satisfaction of innovation criteria that had not yet been proposed.

15. The Law Council recommends a simplified transitional pathway for existing ventures and a presumption or certification mechanism that avoids retrospective testing wherever possible.

The interaction with employee share scheme rules is a critical design issue

Relevant consultation questions: Questions 1, 2, 4 and 7

16. The Law Council considers that the interaction between the proposed concession, the broader CGT reforms and Division 83A of the *Income Tax Assessment Act 1997* (**ITAA 1997**) is one of the most significant issues raised by the Consultation Paper.

17. The existing start-up employee share scheme concession is a foundational component of Australia's innovation ecosystem.

18. Under the proposed framework, companies determine whether they satisfy the innovation requirements when issuing shares, but employees may hold those shares for many years before accessing the concession, exposing them to uncertainty and the risk that eligibility is subsequently found not to have been met.

19. The proposed changes therefore risk materially reducing the value of existing employee share arrangements by reducing the start-up concession from a meaningful employee ownership incentive to a mere timing deferral mechanism. This would undermine the policy objective of supporting innovation and weaken one of Australia's most effective mechanisms for attracting and retaining talent in early-stage businesses. The risk is compounded by the fact that employee taxpayers may be neither best placed nor able to assess eligibility for the concession.

The existing employee share scheme architecture does not fit comfortably within the proposed CGT framework

Relevant consultation questions: Questions 2 and 7

20. The Consultation Paper frames the IBCC as a specific standalone concession which is to be implemented as part of the broader CGT reforms announced in the 2026–27 Federal Budget.

21. The Law Council considers that the IBCC as it is presently framed does not adequately support the coherent application of the new CGT reforms and preservation of the discount capital gains regime to employee share schemes.

22. Division 83A and Subdivision 130-D of the ITAA 1997 determine acquisition time, taxing points and cost base outcomes by reference to a series of different statutory events occurring over the life of an interest. The proposed transition rules assume that a relevant asset, being the eligible shares, exists at 1 July 2027 with an identifiable cost base. For many employee share scheme interests this assumption is incorrect.

23. The Law Council is concerned that the transitional provisions as described in the Consultation Paper do not appropriately accommodate the breadth of employee share interests that will exist as at 1 July 2027. This could create arbitrary outcomes where eligibility for the IBCC turns on the structure or form of the employee interest, rather than whether it is an interest in a genuinely innovative start-up business which creates a misalignment with the policy objectives of the concession.

24. The Law Council recommends that the transitional provisions be reframed to accommodate the existing employee share scheme architecture.

The innovation testing framework requires significant reform

Relevant consultation question: Question 4

25. The Law Council supports Treasury's objective of restricting the concession to genuinely innovative businesses.

26. However, the current innovation testing framework is likely to produce substantial uncertainty and compliance costs. The Law Council is concerned that these requirements are inconsistent with the objective of encouraging entrepreneurial activity, and may be difficult to apply with certainty in practice.

27. The Law Council recommends:

    - objective qualification pathways;
    - greater reliance on measurable criteria;
    - transitional safe harbours;
    - expanded use of points-based tests; and
    - the introduction of a binding certification framework.

Founders require specific protection

Relevant consultation questions: Questions 4 and 7

28. The Law Council is concerned that the concession may not be available to founders who are unable to satisfy the proposed innovation tests at the time they acquire their shares before business activities commence. The Law Council considers it anomalous that the individuals responsible for creating innovative businesses may be unable to satisfy rules intended to encourage innovation.

29. Specific founder safe harbour provisions should therefore be introduced. Those provisions should reflect that founders' shares may be acquired before the company that issues them is an active, innovative start-up.

The proposed five-year holding period is excessively rigid

Relevant consultation question: Question 5

30. The Law Council accepts that a minimum holding period can serve a legitimate integrity purpose.

31. However, a rigid five-year holding period does not adequately accommodate the realities of innovative businesses. The Consultation Paper also acknowledges that the proposed five-year period would be longer than current minimum holding periods under the ESIC and ESS start-up regimes.

32. The Law Council considers that a three-year holding period, aligned with the existing start-up concession framework, would be more appropriate.

33. At a minimum, broad carve-outs should be introduced for genuine commercial transactions. The Law Council considers that this may assist to prevent artificial structuring of investment, exit and employment decisions to bring investors within the concession otherwise created by the rigid holding period.

Significant issues remain unresolved for venture capital and fund structures

Relevant consultation questions: Questions 1 and 6

34. The Consultation Paper leaves important questions unanswered regarding:

    - venture capital limited partnerships;
    - early-stage venture capital limited partnerships;
    - trust structures;
    - carried interest;
    - fund-level tracing;
    - mixed investment portfolios; and
    - waterfall distribution arrangements.

35. The Law Council considers that further consultation with venture capital and private capital participants is required before legislation is introduced.

The proposed $10 million lifetime cap should be reconsidered

Relevant consultation question: Question 6

36. The Law Council understands the rationale for limiting access to the concession through a lifetime cap.

37. However, innovation ecosystems are characterised by highly asymmetric investment returns. A relatively small number of exceptional successes generate the vast majority of economic value and ecosystem returns. Founders and early employees who contribute to the creation of highly successful Australian businesses may lose access to the concession precisely because the business has achieved significant growth.

38. The Law Council recommends that Treasury reconsider the level and structure of the cap, including whether a higher cap, an indexed cap, or a differently structured cap (for example, one that preserves a meaningful concession for near-nil-cost-base equity above the cap) would better achieve the policy objective.

Policy context

The IBCC should not be considered in isolation

39. The IBCC is proposed against the background of a broader and significant change to Australia's CGT regime.

40. Under the broader reforms, the existing 50 per cent CGT discount for individuals and trusts would be replaced, for future gains, with cost base indexation and a 30 per cent minimum tax.

41. The reform is substantial and changes the taxation of long-term capital growth, including growth arising from entrepreneurial effort, employee participation and venture-backed risk capital.

42. The Law Council's concern is that the IBCC is being designed as a narrow exception to a broader regime that remains incomplete. These issues should be resolved as part of the design of the IBCC, not left to later guidance or subsequent legislative tranches.

43. The Consultation Paper also specifically notes that the IBCC sits alongside and is directed toward complementing the increase in turnover threshold from $2m to $10m for the small business CGT concessions.

44. While the Law Council welcomes the increase to the turnover threshold from $2m to $10m for the small business CGT concession, the practical expansion of eligibility is more limited and the increase to the turnover threshold is unlikely to materially extend the tail of the small business CGT concessions in many cases. This is because the small business CGT concessions have historically been accessible through either the turnover test or the $6m maximum net asset value (**NAV**) test.

45. By way of example, on a 15 per cent EBIT margin and 4.0x EBIT multiple, a business with $10m of turnover would have EBIT of $1.5m and an implied enterprise value of $6m. The amendment therefore primarily benefits businesses with turnover between $2m and $10m whose net assets exceed $6m, which are likely larger small businesses which are profitable or valued highly enough to exceed the maximum NAV test, rather than creating a wholly new class of eligible taxpayers.

46. In this context, the Law Council considers that it is particularly important that the IBCC appropriately support investment in innovative start-ups through the life cycle of those businesses.

Innovation requires both financial capital and human capital

47. The Law Council considers that innovation policy must recognise two distinct but equally important forms of capital.

48. First, innovative businesses require financial capital. This is provided by founders, angel investors, venture capital funds, private capital funds and strategic investors.

49. Secondly, innovative businesses require human capital. This is provided by founders, employees and management teams who accept below-market cash remuneration, career risk and illiquidity in exchange for equity participation.

50. A tax regime that supports venture capital but weakens employee equity incentives would be incomplete. Financial capital and human capital are complementary. Both are required for a functioning innovation ecosystem.

51. The start-up employee share scheme concession has been a central part of the regime for attracting, retaining and motivating human capital.

The IBCC is too narrowly targeted

Relevant consultation questions: Questions 1, 2 and 6

The innovation economy extends beyond early-stage start-ups

52. The Law Council supports targeted relief for founders, early employees and early-stage investors.

53. However, the proposed concession does not adequately reflect the lifecycle of innovative businesses.

54. Innovative companies commonly require capital at multiple stages:

- pre-seed investment;
- angel investment;
- seed funding;
- Series A and later venture rounds; and
- growth equity.

55. The age and turnover thresholds limit the proposed IBCC to the early part of this lifecycle. The Law Council considers that this creates a material policy gap.

56. The proposed $50m turnover threshold in particular appears to be based on the existing start-up employee share scheme concession framework in section 83A-33 of the ITAA 1997, which was introduced in 2015.

57. Since 2015, innovative businesses have faced material increases in labour costs, software development costs, professional costs, regulatory costs, premises costs and general business expenses.

58. At a minimum, the threshold should be uplifted to reflect inflation since 2015. The Law Council also recommends that the threshold be indexed or subject to periodic statutory review.

59. The Law Council also notes the raising of the R&DTI refundable tax offset turnover threshold from $20m to $50m and allowing companies to claim the refundable offset for 10 years, as described in the Consultation Paper, which recognises that innovation support may need to extend into the scaling phase. If the $50m boundary is retained without indexation or a taper, it may operate as a hard boundary at the same time as other parts of innovation policy are being recalibrated to support scale-up activity.

The concession may create a funding cliff

60. The proposed age and turnover thresholds create cliff-edge outcomes. A company that issues shares shortly before crossing the threshold may qualify, while an otherwise identical company issuing shares shortly afterwards may not. This is particularly problematic because successful companies often require their largest funding rounds at or shortly after the point at which they exceed early-stage

thresholds. The concession may therefore cease to apply precisely when additional capital is most needed.

61. If the policy objective is to encourage businesses to scale and remain headquartered in Australia, consideration should be given to whether a higher threshold would better support that objective.

62. Specifically, the Law Council recommends that consideration be given to mechanisms that soften these cliff edges (for example, by materially uplifting the $50m threshold, indexing the threshold or providing a partial tapered concession for companies between, for example, 10 and 15 years and $50m and $80m in turnover to extend the tail of the concession).

The 10-year test should include flexibility for genuine long-cycle businesses

63. The Law Council supports consideration of a 15-year age limit for sectors such as biotech, medtech and deep tech.

64. However, the Law Council recommends that the test should not be confined to sector labels alone. The relevant policy question is whether the business has a long development or commercialisation cycle.

65. The Law Council considers that it would more appropriately support the policy objectives of the IBCC if the structure of the age threshold for eligibility was reconsidered for all businesses. If an extended age limit for certain businesses is preferred, that extended age limit should therefore be framed by reference to objective features of the business and its commercialisation pathway, rather than by narrow industry labels.

66. If sector labels are maintained, the Law Council also recommends that Treasury clarify how any relaxation of the listing disqualification would operate for these longer-cycle sectors. By way of example, if a biotech, medtech or deep tech company lists to raise capital needed for clinical, regulatory or technical milestones before it has achieved meaningful commercialisation, automatic loss of IBCC eligibility may undermine the proposed 15-year extension. Any relaxation should be objective and limited to circumstances in which listing is a financing step in a long commercialisation pathway, rather than evidence that the business has ceased to be an early-stage innovative enterprise.

The new equity requirement

Relevant consultation questions: Questions 1 and 2

Secondary transactions are part of normal start-up and scale-up financing

67. The Consultation Paper proposes that only new equity issued by the company qualify for the IBCC. The Law Council considers this eligibility requirement to be unduly rigid, and is concerned that interests in genuinely innovative start-ups which have changed in form as a result of commercial secondary transactions may be arbitrarily excluded.

68. Secondary transactions are a normal feature of private company capital raisings and may occur where:

- founders sell a small proportion of shares to obtain liquidity;
- early employees sell shares to diversify risk;
- early investors recycle capital into new ventures;
- a new investor acquires a position from an existing shareholder;
- a primary capital raise is accompanied by a secondary sell-down;
- an employee share trust acquires shares from existing shareholders; or
- management equity is reallocated as part of a growth transaction.

69. By way of example, the Law Council is concerned that an investor subscribing for new shares may qualify, while an investor acquiring an economically equivalent stake in the same company as part of the same financing round may not.

70. The Law Council considers that this distinction is not justified where the secondary transaction is genuine, commercial and connected to the growth or employee ownership objectives of the business.

Employee share trust arrangements require specific rules

71. The exclusion of secondary transactions is particularly problematic for employee share trusts.

72. Employee share trusts commonly acquire, hold and allocate shares for the benefit of employees under regulated employee equity plans. In some cases, shares may be acquired from existing shareholders and warehoused for later allocation to employees. If the IBCC only applies to newly issued shares, employees receiving shares from an employee share trust may be disadvantaged even though their economic position is equivalent to an employee receiving newly issued shares.

73. The Law Council recommends that Treasury provide specific rules to maintain the availability of the IBCC for employee share trusts, including rules dealing with:

- acquisition of shares from existing shareholders;
- warehousing of shares;
- later allocation to employees;
- forfeiture and reallocation;

- trustee disposals; and
- beneficiary-level qualification.

Innovation testing and certification

Relevant consultation question: Question 4

Certainty is required at the time equity is issued

74. The Law Council is concerned that the IBCC as currently proposed does not provide for certainty of application for founders, employees and investors at the time equity is issued or acquired.

75. Founders, employees and investors should not be required to determine, many years later at exit, whether the company satisfied subjective innovation criteria at a much earlier point in time. The Law Council also considers that certainty is necessary to support investor behaviour and without clear eligibility, the concession is unlikely to appropriately encourage investment in Australian start-up businesses.

76. The policy objective should be supported by certainty at entry, not dispute at exit.

The ESIC-style principles test is costly and uncertain

77. The Consultation Paper proposes to draw on concepts derived from the early-stage innovation company (**ESIC**) regime.

78. The Law Council accepts that the ESIC regime is a relevant reference point. However, in the experience of the Taxation Committee of the Business Law Section, the ESIC principles-based innovation test is often difficult to apply. It commonly requires:

    - detailed factual analysis;
    - technical or commercial evidence;
    - professional advice;
    - contemporaneous documentation;
    - consideration of market and competitive position;
    - consideration of scalability and addressable market; and
    - in many cases, engagement with the Australian Taxation Office through a private ruling process.

79. For these reasons, the Law Council considers that the ESIC innovation test is not well suited to a concession intended to apply broadly to founders, employees and early investors.

80. To address these concerns, the Law Council recommends that Treasury provide an optional binding certification pathway, for example, registration with, and a legally binding determination from, the Department of Industry, Science and Resources (**DISR**) discussed in further detail below.

The active business test creates additional difficulties

81. The proposed active business requirement also raises difficulties.

82. The 80 per cent active asset test drawn from the small business CGT rules can be difficult to apply over time and is particularly problematic in a start-up context.

83. Following a capital raise, a company may temporarily hold substantial cash. That cash may be intended for product development, employee hiring, regulatory approvals, research, sales expansion or commercialisation.

84. The temporary holding of cash following a genuine capital raise should not put eligibility at risk.

85. The Law Council recommends that the final design include specific rules treating capital raised for business development as an active business asset for a reasonable deployment period.

Founders require a specific safe harbour

86. The Law Council considers that the position of founders is particularly difficult when measured against the proposed eligibility criteria.

87. Founders often subscribe for shares at incorporation, when:

- the company has no trading history;
- the business has not commenced;
- intellectual property may not yet have been created or assigned;
- no employees have been engaged;
- no customers have been signed;
- no revenue has been earned;
- no capital raise has occurred; and
- the company may hold only nominal share capital.

88. At that point, it may be practically difficult to satisfy an innovation or active business test.

89. The Law Council recommends a founder safe harbour. Under such a safe harbour, founder shares acquired at incorporation should qualify if the company satisfies prescribed innovation criteria within a defined period after incorporation. For example, the company could be required to satisfy an objective innovation test within three years after incorporation. Alternatively, founder shares could be deemed to qualify where the company later obtains IBCC certification.

An objective pathway should be available

90. The Law Council recommends that taxpayers be able to satisfy the innovation requirement through an objective pathway.

91. That pathway could be based on an adapted version of the ESIC 100-point test.

92. Relevant objective indicators might include:

- eligible research and development expenditure;
- ownership or development of intellectual property;
- patent applications or registered patents;
- commercialisation grants;
- participation in recognised accelerator or incubator programs;
- investment by a registered VCLP or ESVCLP;
- completion of recognised regulatory, clinical or safety pathways;
- recognised university or research institution collaboration;
- verified export or global market expansion activity;
- software, technology, engineering, scientific or product development expenditure; and
- certification by an appropriately qualified government agency.

93. While the ESIC points test is not appropriate without modification, a points-based alternative to the innovation criteria would provide materially greater certainty than a principles-only test.

A binding certification pathway is essential

94. The Law Council recommends that Treasury introduce an optional binding certification pathway.

95. Certification should be available at the company level. It should not be necessary for each founder, employee or investor to separately establish innovation status.

96. A certification framework should have the following features:

- it should be prospective;
- it should be legally binding;
- it should apply for a defined period;
- it should be accessible and affordable;
- it should apply to subsequent equity issues during the certification period;
- it should bind outcomes for founders, employees, investors and trusts;
- it should be capable of renewal; and
- it should be subject to revocation only in cases of fraud, material misstatement or material change in business activities.

97. The Law Council considers that a certification issued by an appropriate government agency should be binding on the Commissioner for the purposes of determining eligibility under the concession. Employee shareholders should be entitled to rely on such certification without assuming the risk that the company's innovative status may subsequently be revisited many years after shares have been issued.

98. The Law Council further considers that certification could be administered by the Department of Industry, Science and Resources, or another agency with expertise in innovation and commercialisation.

Private rulings are not a satisfactory substitute

99. The Law Council does not consider that private rulings are an adequate mechanism for delivering certainty. Private rulings can be costly, slow and unsuitable for early-stage businesses. They also do not provide a scalable framework for a concession intended to apply across the innovation economy.

Transitional status of existing ventures

Relevant consultation questions: Questions 4 and 7

Existing ventures were created under different rules

100. The Law Council is concerned that the proposed transitional arrangements may require existing companies to satisfy innovation and active business criteria that did not exist when the venture was created.

101. Many existing start-ups and venture-backed companies were formed years before the Consultation Paper. Founders, investors and employees made decisions based on the law and could not reasonably have anticipated that future tax outcomes would depend upon demonstrating satisfaction of innovation criteria that had not yet been designed.

Historical evidence may not exist

102. Existing companies may not have retained records directed towards satisfying a future IBCC test.

103. Given the proposed five-year minimum holding period, and the possibility that shares may be retained for substantially longer periods, founders, employees and investors may be required to preserve historical evidence relating to innovation criteria for many years before any CGT outcome arises. Such evidentiary requirements would create a significant compliance burden and increase uncertainty in the operation of the concession.

104. A retrospective test may arbitrarily and unfairly reward businesses that happened to retain suitable records and penalise genuine innovators that did not. The Law Council therefore considers this an inappropriate basis for determining eligibility for a substantial CGT concession.

Retrospective innovation testing creates uncertainty for employees

105. The problem is particularly acute for employees.

106. Employees who accepted shares or options under existing arrangements generally had no control over:

- whether the company documented its innovation activities;
- whether the company obtained an ESIC ruling;
- whether the company maintained active asset calculations;
- whether the company preserved historical records;

- whether the company obtains IBCC certification; or
- whether the company satisfies future legislation.

107. It would be unfair for those employees to lose access to concessional treatment because of later evidentiary or certification failures outside their control.

Existing ventures should have simplified transitional pathways

108. The Law Council recommends that existing ventures have access to simplified transitional pathways.

109. Possible approaches include:

- deemed qualification for shares and options issued under existing start-up ESS arrangements;
- deemed qualification where the company was previously treated as an ESIC;
- objective transitional criteria based on research and development expenditure, registered intellectual property, venture capital investment or grants;
- certification based on current activities rather than historical reconstruction;
- a safe harbour for companies that satisfy the proposed test within a defined period after commencement; and
- grandfathering of existing employee interests without requiring the company to prove historical innovation status.

110. The transitional arrangements should also allow the investor to choose to test the turnover of the start-up in 2025–26, or at the time that the equity was issued or acquired, for the purpose of the turnover eligibility requirement.

111. The Law Council's preferred approach is that existing employee share scheme interests be expressly preserved.

Interaction between employee share scheme rules, the new CGT regime and the IBCC

Relevant consultation questions: Questions 1, 2, 4 and 7

The start-up ESS concession is essential innovation infrastructure

112. The start-up employee share scheme concession in section 83A-33 of the ITAA 1997 is one of the most important tax settings supporting Australia's innovation economy. It recognises that early-stage companies often lack the cash flow to compete for talent on salary alone. It allows such companies to use equity as a recruitment and retention tool.

113. The economic value of the concession depends upon the combination of:

- deferral of the taxing point;
- capital account treatment;
- the ability to hold equity over time;

- access to the 50 per cent CGT discount where relevant holding periods are satisfied; and
- the specific acquisition date and cost base rules that apply to employee share scheme interests.

114. If the ultimate gain is taxed under the new indexation and minimum tax regime without preservation of the CGT discount, the concession is reduced to a timing mechanism. That is not a meaningful incentive for employees who accept illiquid, high-risk equity in lieu of cash salary.

Employee equity is not passive investment

115. Start-up employees are not passive investors seeking concessional treatment for investment returns.

116. They often accept:

- below-market remuneration;
- employment risk;
- business failure risk;
- illiquidity;
- uncertainty as to exit timing;
- dilution risk; and
- limited ability to sell or diversify.

117. The tax system has historically recognised this bargain through employee share scheme concessions and CGT treatment. The broader CGT reforms should not inadvertently undermine that policy.

No equivalent carve-out is provided for ESS interests

118. The broader CGT reforms provide targeted treatment for some assets and arrangements. However, no equivalent exclusion or preservation rule has been provided for employee share scheme interests.

119. The Law Council considers this omission significant.

120. Employee share schemes are a distinct statutory regime. They are not the target of reforms directed at leveraged investment in passive assets. They are productive arrangements through which employees acquire equity exposure in the businesses for which they work.

The ESS rules have a multi-event architecture

121. The interaction problem arises because Division 83A and Subdivision 130-D of the ITAA 1997 do not determine all relevant CGT inputs at the same time.

122. Depending on the type of interest, the following may occur at different times:

- grant of a right or option;
- vesting;
- exercise;
- acquisition of shares;
- cessation of employment;
- lifting of disposal restrictions;
- the deferred taxing point;
- determination of the ESS assessable amount;
- determination of cost base;
- application of CGT acquisition date rules; and
- disposal of the share.

123. The proposed CGT transition rules appear to assume that a taxpayer holds a CGT asset at 1 July 2027 being an eligible share, that the cost base of that eligible share is known, and that a deemed disposal and reacquisition can be calculated at that time.

124. That assumption does not hold for many employee share scheme interests.

Tax-deferred shares may not have a known cost base at 1 July 2027

125. For tax-deferred shares, the cost base may depend on the ESS deferred taxing point. If the deferred taxing point has not occurred by 1 July 2027, the amount to be included in assessable income may not yet be known.

126. Division 83A and Subdivision 130-D of the ITAA 1997 may affect the timing, CGT treatment and cost base consequences for employee share scheme interests.

127. The result is that the grandfathered gain required to be calculated at 1 July 2027 may be incapable of calculation because a statutory input is determined only later.

128. This is not merely an administrative issue. It means the transition mechanism may not operate coherently.

Options and rights create even greater difficulties

129. Options and rights create further difficulty because the asset originally acquired may not be the asset ultimately disposed of.

130. For example, an employee may hold an option at 1 July 2027 but later exercise it and dispose of the resulting share. The grandfathering rule may apply to the option, but the eventual CGT event may occur in relation to the share. Unless continuity rules are enacted, pre-1 July 2027 economic growth may fail to be preserved.

131. This is especially problematic for start-up options, where existing rules may treat the resulting share as having an acquisition date referable to the original option acquisition time.

132. That existing statutory design should not be displaced by the transitional rule based solely on the legal form of the asset held at 1 July 2027.

Out-of-the-money options illustrate the problem

133. Out-of-the-money options may have little or no value when granted. They may later become valuable because of business growth.

134. If such options are held before 1 July 2027 but exercised after that date, the economic appreciation may have accrued substantially before commencement of the new regime.

135. However, if the grandfathering mechanism attaches only to the option and not to the resulting share, the pre-commencement growth may be taxed entirely under the new regime. That is not an appropriate transitional outcome.

136. A coherent rule should preserve pre-1 July 2027 economic appreciation where an employee share scheme interest was acquired before that date, even if the legal form of the relevant asset later changes.

Testing time for options must be specified

137. The Law Council considers that the IBCC should clearly specify when eligibility is tested for options, rights and similar instruments.

138. Possible testing times include:

- grant;
- vesting;
- exercise;
- acquisition of the underlying share;
- the ESS deferred taxing point; or
- disposal.

139. The Law Council recommends that eligibility should generally be tested at grant for employee options and rights. By way of example, we consider that a company may satisfy the proposed age, turnover and innovation tests at grant but fail them at exercise because it has successfully scaled. That is the time when the employee makes the relevant economic decision and accepts the risk. Testing at this time would also support certainty of outcome upon which investors could make investment decisions, which is consistent with the policy objectives of the IBCC.

140. It would be anomalous and antithetical to the policy objectives of the IBCC for employees to lose concessionary treatment because the company succeeded.

Existing ESS interests should be grandfathered or deemed to qualify

141. The Law Council recommends that employee share scheme interests issued before commencement should either:

    - remain subject to current CGT treatment;
    - be carved out from the new regime; or
    - be deemed to satisfy the IBCC innovation requirements.

142. At a minimum, existing start-up concession options and shares should be protected.

143. Employees who accepted equity under the existing rules should not be retrospectively exposed to new eligibility requirements.

Holding period

Relevant consultation question: Question 5

A five-year holding period is too rigid

144. The Law Council accepts that a minimum holding period can be an integrity measure.

145. However, a rigid five-year holding period will create harsh outcomes in genuine commercial circumstances. Innovative businesses frequently experience:

    - acquisitions;
    - mergers;
    - scrip transactions;
    - restructures;
    - venture capital exits;
    - founder leaver events;
    - employee cessation events;
    - secondary liquidity events; and
    - fund lifecycle events.

146. These events may be outside the control of founders, employees and investors. For example, an employee may contribute significantly to the growth and success of a business but fail to qualify for the concession solely because a disposal occurs before the five-year holding period has elapsed. In such circumstances, the policy outcome appears disconnected from the employee's contribution to value creation. The Law Council suggests consideration should be given to appropriate relief where disposal occurs involuntarily or as part of a company-driven liquidity event.

147. The proposed framework may also favour founders and early employees over employees who join a business during later stages of growth. An employee who acquires equity in the early years of a business is more likely to satisfy the minimum holding period, whereas an employee who joins shortly before a period of significant expansion may make a substantial contribution to enterprise value but be unable to satisfy the five-year requirement before an eventual exit event

148. In such circumstances, relief should be available where disposal occurs involuntarily or as part of a company-driven liquidity event. Unlike founders and external investors, employee shareholders often have limited control over the timing of disposals, which may occur because of acquisitions, drag-along rights, compulsory sales under employee share plan rules, restructures or other corporate transactions. Denying access to the concession solely because the five-year holding period has not been satisfied may produce outcomes that are inconsistent with the policy objective of encouraging employee participation in innovative businesses.

A three-year holding period should be considered

149. The Law Council recommends consideration of a three-year holding period, consistent with the minimum holding period in section 83A-45 of the ITAA 1997 that applies for the start-up employee share scheme concession. At a minimum, the legislation should provide exceptions or continuity rules for:

- whole-of-company sales;
- scrip-for-scrip rollovers;
- Division 615 top-hat restructures;
- employee cessation;
- compulsory acquisitions;
- IPO-related sell-downs;
- secondary sales permitted under plan rules;
- venture capital fund exits; and
- corporate reorganisations that do not involve cashing out.

Rollovers and continuity

Relevant consultation questions: Questions 1 and 5

Division 615 and Subdivision 124-M must be addressed

150. The Consultation Paper does not adequately address whether IBCC status continues where shares are exchanged under division 615 restructures or subdivision 124-M scrip-for-scrip rollovers.

151. The Law Council considers this to be a material gap in the proposed concession as it is set out in the Consultation Paper.

152. Start-ups and scale-ups commonly undertake top-hat restructures before capital raisings, IPO preparation, international expansion or acquisition.

153. If IBCC status is lost because of a commercially necessary restructure, the concession will distort ordinary corporate activity. The Law Council expects that this would not be the desired position and notes that outcome could further discourage investment in genuine start-up businesses.

154. The legislation should provide continuity rules so that equivalent replacement interests retain the relevant IBCC status.

Venture capital, funds and carried interest

Relevant consultation questions: Questions 1 and 6

Tracing through funds will be complex

155. The Law Council welcomes the proposal that carried interest of general partners of eligible venture capital limited partnerships may qualify for the concession where it relates to early-stage investment in qualifying start-ups.

156. However, the practical operation of the concession through fund structures remains unclear.

157. Funds may hold mixed portfolios, including:

- IBCC-qualifying investments;
- non-qualifying venture investments;
- follow-on investments;
- secondary acquisitions;
- offshore investments;
- trust interests; and
- convertible instruments.

158. The legislation must explain how eligibility is traced, calculated and reported.

Whole-of-fund waterfalls create arbitrary outcomes

159. Many Australian venture capital and private equity funds operate on a whole-of-fund or European waterfall. Carried interest may not be distributed until investors have received return of capital and preferred returns across the fund. If early IBCC-qualifying investments are sold before carry is payable, later carry distributions may be economically attributable to the success of the whole fund, not easily traceable to a particular investment. A strict investment-by-investment tracing rule may therefore produce arbitrary outcomes depending on the timing of exits.

160. The Law Council recommends that Treasury consult specifically with venture capital and private capital fund advisers on this issue.

The $10m cap

Relevant consultation question: Question 6

The cap may be too low for genuine breakout success

161. The Law Council understands the policy rationale for a cap. However, innovation ecosystems depend on a small number of exceptional successes. A cap of $10m may be reached quickly by founders or early employees in genuine high-growth companies. Once the cap is exceeded, near-nil-cost-base equity will be taxed under the broader regime, with indexation providing little practical benefit. That means the concession may provide meaningful support for modest outcomes but limited support for the very outcomes that drive the venture capital model.

The application of the $10m cap is unclear

162. The Consultation Paper does not make clear at which level the $10m lifetime cap applies.

163. The Consultation Paper describes the $10m cap as a lifetime cap for each individual, calculated by reference to the total capital gain before the discount is applied. The Law Council recommends that Treasury should instead consider a cap that applies in respect of an investor's interest in a particular company (a per-company cap) which would be more appropriate and consistent with the policy objectives of the IBCC. A per-company cap would support serial entrepreneurship and repeat investment in innovative businesses, and removes complexity associated with tracking the cap on a per investor basis.

164. The Law Council recommends that Treasury, in addition to adopting a per-company cap, reconsider the level and structure of the cap, including whether a higher cap (with a partially tapered concession), an indexed cap, or a differently structured cap (for example, one that preserves a meaningful concession for near-nil-cost-base equity above the cap) would better achieve the policy objective.

The cap should be reconsidered

165. The Law Council recommends that Treasury consider:

- a higher cap;
- an indexed cap;
- a per-company cap rather than an investor-level lifetime cap;
- tapering relief above the cap;
- separate caps for founders and employees;
- separate treatment for carried interest; or
- preservation of a partial discount above the cap for nil-cost-base or low-cost-base founder and employee equity.

166. The design should ensure that the concession remains meaningful for globally mobile founders and early employees. The Law Council considers that the imposition of a cap on discounts may discourage that innovation from occurring in Australia.

Conclusion

167. The Law Council supports the policy objective of encouraging innovation, entrepreneurship, employee ownership and long-term productive investment.

168. However, the proposed IBCC does not yet achieve that objective in a sufficiently coherent, certain or comprehensive manner.

169. The Law Council considers that the concession is too narrow. It does not adequately support the full innovation funding lifecycle. It excludes important secondary transactions. It creates unresolved issues for venture capital funds and carried interest. It imposes uncertain innovation testing. It does not adequately protect existing ventures. Most importantly, it does not adequately address the interaction between the new CGT regime and Australia's existing employee share scheme framework.

170. The Law Council considers that the start-up employee share scheme concession is essential infrastructure for Australia's innovation economy. The IBCC, considered within the context of the broader CGT reform, does not coherently maintain the concessional treatment for start-up employee share scheme interests.

171. If the 50 per cent CGT discount is removed for post-1 July 2027 gains, the legislation must include specific and workable rules to preserve the economic value of employee equity arrangements, accommodate the multi-event architecture of Division 83A and Subdivision 130-D of the ITAA 1997, and protect employees who acquired equity under existing law.

172. The Law Council recommends that Treasury undertake further targeted consultation and revise the proposed design before legislation is introduced.

173. A successful regime should provide certainty at the time equity is issued, preserve existing employee and founder expectations, support both financial capital and human capital, and ensure that Australia remains an attractive jurisdiction in which to create, fund, scale and retain innovative businesses.

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The Law Council of Australia represents the legal profession at the national level; speaks on behalf of its constituent bodies on federal, national, and international issues; promotes and defends the rule of law; and promotes the administration of justice, access to justice, and general improvement of the law.

The Law Council advises governments, courts, and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world. The Law Council was established in 1933, and represents its constituent bodies:

- the Australian Capital Territory Bar Association;
- the Law Society of the Australian Capital Territory;
- the New South Wales Bar Association;
- the Law Society of New South Wales;
- the Northern Territory Bar Association;
- the Law Society Northern Territory;
- the Bar Association of Queensland;
- the Queensland Law Society
- the South Australian Bar Association;
- the Law Society of South Australia;
- the Tasmanian Bar;
- the Law Society of Tasmania;
- the Victorian Bar Incorporated;
- the Law Institute of Victoria;
- the Western Australian Bar Association;
- the Law Society of Western Australia; and
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Through these bodies, the Law Council represents more than 110,000 Australian lawyers.

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- Ms Elizabeth Shearer, President-elect
- Mr Lachlan Molesworth, Treasurer
- Ms Jennifer Ball, Executive Member
- Mr Justin Stewart-Rattray, Executive Member
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The Chief Executive Officer of the Law Council is Dr James Popple.

The Law Council's Secretariat is based in Canberra. Its website is www.lawcouncil.au.