

# IT Industry Innovation Council

## Submission to the Board of Taxation

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**To: The Board of Taxation**

**From: IT Industry Innovation Council**

**Submission regarding: Employee Share Scheme / Employee Share Options**

**Date: 1<sup>st</sup> December 2009**

### BACKGROUND

The Information Technology (IT) Industry Innovation Council (the Council) was announced on 5 May 2009 in recognition of the leading role that IT plays across all sectors of our economy and its potential to enable innovation which can transform existing industries, create new ones, enhance Australia's competitiveness, assist with solutions to environmental problems and enhance social inclusion.

The Council acts as an advisory body to the Minister for Innovation, Industry, Science and Research, Senator the Hon Kim Carr both in regard to innovation within the sector and IT's potential to foster innovation across the economy. Members of the Council have been drawn from across the IT spectrum and include representatives of industry, suppliers, users, education, research, government and unions.

The Council plays an advocacy role promoting the sector in its own right and as an enabler of innovation, productivity and sustainable development for the economy as a whole.

The Council is aware that the legislation to reform the taxation of employee share schemes was introduced on 21 October 2009. The Council is also aware that the government has commissioned a comprehensive Board of Taxation review on two further substantive issues, to report to the Assistant Treasurer by 28 February 2010. These issues are:

1. How to best determine the market value of employee share scheme benefits; and
2. Whether shares and rights under an employee share scheme at a start-up, R&D or speculative focused company should have separate tax deferral arrangements, despite not being subject to a real risk of forfeiture.

Item 2 above is of the most direct and practical relevance to the IT Industry and therefore to the IT Industry Innovation Council.

We have been informed by the Department that your Board would be willing to accept a late submission from the Council in relation to the employee share scheme review, provided our submission is delivered by close of business, Wednesday 2nd of December to allow the Working Group sufficient time to review our submission prior to the scheduled December Board of Taxation meeting.

This extremely tight deadline does not allow the Council to prepare the comprehensive and detailed submission we had intended. However, the matter is so important to the development of a vibrant and innovative IT Industry that we seize this opportunity to speak on its behalf. Based on the large number of IT SMEs that the Council members are involved or have contact with, opinions are nearly uniform on this subject.

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### IT INDUSTRY INNOVATION COUCL SUBMISSION REGARDING EMPLOYEE SHARE SCHEME / EMPLOYEE OPTIONS

We would like to highlight the following points:

- A cash tax on a non-cash benefit that may never eventuate flies in the face of natural justice
- It is a principle of Australia's tax system that income is taxed in the year that it is earned. Taxing unrealised benefits is not consistent with this principle. While the legislation introduced on October 21 (pursuant to responses to the Consultation Process) improves upon the original Budget proposals, there remains a general strategy to tax the discount upfront (except for real risk of forfeiture), with limited deferral arrangements being considered. Unless there is clear guidance as to the meaning of the term, application by taxpayers of the concept of real risk of forfeiture may prove too problematic, thus discouraging organisations from offering share schemes after July 1 2009
- The ICT sector is characterised by small, innovative and entrepreneurial organisations that struggle at all times let alone in current economic conditions to motivate and retain good staff. Tying employee commitment and performance to the overall performance of their company is one way to ensure engagement and alignment with corporate aims, enabling workers to share in wealth creation longer term. But share schemes are not limited to smaller organisations; many multinational companies offer share option schemes to employees at all levels
- In the context of the tax compliance debate it is critical to understand that share options are not limited to executives and very senior employees
- Employees who sacrifice immediate income for a longer-term hypothetical benefit directly enhance the nation's productivity, contribute to the development of the innovative companies that will ultimately produce competitive export products and help create the future employment growth in the new industries. They do that by sharing a level of risk taking inherent in creating the future wealth and competitiveness of Australia. This kind of risk-sharing employee deserves encouragement, appreciation and support rather than punishment and discouragement through taxation of a merely hypothetical advantage
- The overwhelming majority of employees have no objection to being fairly taxed if and when employee shares or options are sold for cash
- Australia is not operating in isolation. It competes with countries internationally, many of which offer very favourable treatment of employee shares and options. It is therefore both dangerous and counter-productive to impair Australia's competitiveness in this area. Australia should instead study and adopt 'world best practice' as part of the evidence based decisions and legislation that the government proclaims to follow. The ITIIC would have identified and presented such 'best practice' examples to the Board of Taxation, had we had a longer time frame for our submission.
- The changes do not justify why Australia should pursue a scheme radically different from the US and the UK. Australia cannot afford to be out of step with the rest of developed world especially since business and industry is now a global phenomenon and labour mobility is a given. The Council is particularly concerned about retaining existing talent we have invested in both as companies and as a nation and attracting senior talent from overseas if Australia is out of step with the US and the UK. This is not only a concern of larger companies; even more significantly start-ups need to be able to retain or lure high quality labour from other jurisdictions with the incentives of lifestyle, concessions and potential sharing in company growth.

As a concrete example of how other jurisdictions deal with employee share options, the following is provided:

*Employees in complying companies in the US and the UK can only sell their shares or exercise their options through a nominated broker. The broker withholds the tax at the rate determined by the Government and the employer is obligated to pay that over to the relevant tax authority. It is*

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*analogous to the way employers withhold and pay PAYG. There is no way for an employee to override the withholding, unless it is allowed by the relevant tax authority. Further, organisations only issue shares/options rights in the name of the employee, not to an entity such as a trust or super fund. Exercised rights are thus reported as ordinary income against the employee's tax ID, which makes evasion virtually impossible.*

- Efforts to address alleged abuses of the share scheme, particularly in the wake of recent audit data released by the ATO, which appeared to indicate widespread rorting of share schemes by executives, are welcomed. However the Government should address tax evasion and avoidance through the traditional compliance and enforcement measures available to the ATO (or supplemented by additional measures) rather than by broad based legislation that compromises policy objectives that promote the align corporate and employee performance.
- The government's assumption that evidence of avoidance indicates the employee share scheme as originally established 'is not achieving its policy objective', is misplaced. On the contrary, evidence of tax avoidance is merely evidence of tax avoidance, and clearly shows that enforcement and compliance measures must be tightened to deal with certain individuals. It does not prove that the policy objective behind share option schemes has failed. It is disappointing that the most recently announced changes do not take up the opportunity to provide the ATO with targeted anti-avoidance measures relating to share schemes, or introduce withholding into the scheme. Employers are just as able to withhold tax upon shares vesting and options exercising at an agreed rate and remit to the government as they are to do so for PAYG as currently administered. There is no ability to "defer the taxation point", which eliminates the potential for abuse. The failure to adopt this option is a lost opportunity to align Australian policy and practice with that of other jurisdictions such as the US.
- Australia is one of the few countries in which our international members operate that does not require withholding; here it is up to the employees to declare the income and pay any taxes due. It would be relatively straightforward for large and small organisations to withhold taxes if required. It would not be much more work than administering the already onerous employee PAYG and superannuation payments.

It is the sincere hope of Council that the above points of concern and advice will be duly taken into consideration by your Board. We will be pleased to elaborate on the views presented and to interact constructively with your Board in your endeavours to produce an optimal outcome in the interest of our nation.



John Grant  
Chair  
Information Technology Industry Innovation Council