

Background – About AIIA

The Australian Information Industry Association (AIIA) is Australia's peak information and communications technology industry body. AIIA's role is to lead and represent the ICT industry in Australia to maximise the potential of the Australian economy and society. AIIA's membership encompasses all sectors of the ICT sector including hardware, software, services and telecommunications. It has almost 500 member companies, from individual consultants, small to medium enterprises to the world's leading multinational corporations. AIIA member companies employ over 100,000 Australians, generate combined annual revenues of more than \$40 billion (approximately 5% of GDP) and export more than \$2 billion in goods and services each year.

AIIA members welcome the review by the Senate Economics References Committee into the treatment of employee share option schemes, particularly given the widespread business concern expressed following the Budget announcement of major changes to the former tax treatment of share schemes.

Benefits of Employee Share Schemes

Many of our large and small ICT members have operated employee share ownership schemes as staff incentives for many years. They have done this to match their employees' performance to longer-term objectives, especially when salary rises and other cash benefits are restrained in these dire financial times.

The ICT sector is characterised by small, innovative and entrepreneurial organisations struggling in current economic conditions to motivate and retain good staff. Tying employee 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.

Taxation Issues relating to Compliance

AIIA supports Government 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. However, as a statement of first principle AIIA reiterates that 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 compromising viable policy objectives of promoting the alignment of corporate performance and employee performance.

AIIA does not agree with the government's assumption that evidence of avoidance indicates the employee share scheme as originally established 'is not achieving its policy objective'. 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. In this regard AIIA is disappointed 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.

Income Threshold

The proposed new threshold, although improved, is the not an appropriate mechanism to deal with tax evasion. In any case it is still too low for senior professional workers in the ICT industry; a staff software engineer or senior engineering manager routinely makes more than \$180,000. If the purpose of the threshold is to prevent abuse, then setting it to a salary level above \$250,000 would be more appropriate. That said, the threshold model would be unnecessary if taxation is deferred until the employee realises the value of the shares or rights.

Withholding

Compliance and revenue integrity is clearly an issue, and AIIA does not support or condone evasion of tax obligations. However, compromising an otherwise sound policy objective in order to address tax evasion is a poor policy response. Compliance issues are always best addressed through the employer, as they are for PAYG and superannuation. 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 in the most recently announced changes of July 1 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.

Recent announcements of changes, consultation undertaken and anticipated impact on business

The Government is to be congratulated for acting so promptly on the business concerns expressed after the initial Budget announcement, and for releasing for comment alternative solutions to those widespread concerns. The decision to continue application of the existing law to all shares and rights acquired before July 1 2009 is welcome as providing some degree of certainty.

However, notwithstanding the subsequent changes to the Budget announcements, AIIA remains concerned that the proposed new scheme will still have the unintended consequence of closing down many legitimate, compliant and non-evading employee share schemes in organisations of all sizes. In fact, several of our members have closed down their employee share schemes and do not intend re-establishing them notwithstanding the outcomes of the new legislation before Parliament. Following a survey of AIIA members, it was discovered that larger companies have discontinued broadly based share schemes to all employees because they cannot justify them under the new rules. Some members had immediately suspended executive schemes after the first announcement (the budget) because it would have resulted in tax being paid 3 years before it was known if the shares would meet the performance criteria or not. Some members are still waiting for the legislation to be confirmed before they re-activate the scheme.

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 amendments announced on July 1 (pursuant to responses to the June Consultation Paper) improve upon the 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. AIIA welcomes the decision by the government to review extended deferral arrangements for start-ups and speculative-type companies.

Other Jurisdictions

The recently announced changes still 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. AIIA members are particularly concerned about 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; start-ups frequently 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 of one of our members in the US and the UK can only sell their shares or exercise their options through Smith Barney (the organisation's globally nominated broker). Smith Barney 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 analogous to the way that 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.