Australian Venture Capital Association Limited
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September 17, 1999

ESOP's

Attached as discussed is advice from Deloitte Touche Tohmatsu about the impediments to venture capital growth in Australia created by existing tax treatment of employee share options.

We would be most appreciative of an opportunity to address your committee on the importance of this matter.

Yours sincerely,

ANDREW GREEN
Executive Director

DeloitteTouche Tohmatsu

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7 September 1999

Mr Andrew Green
Executive Director
Australian Venture Capital Association Limited
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SYDNEY NSW 2000

Dear Andrew

DEFICIENCIES IN THE AUSTRALIAN TAXATION SYSTEM IN RELATION TO EMPLOYEE SHARE OPTION PLANS

As we have discussed, Australia is behind the pace in encouraging high level employees to work for venture capital backed companies.

Taxed up front on the value of options

The current system is biased in favour of listed companies in that it is often difficult for a venture capital or some other private companies to meet the stringent requirement so as to enable them to establish a "qualifying" employee share option plan for their employees.

The penalty suffered by the employees who take employee share options under a non-qualifying scheme is that they will be taxed at the time of receipt of the options on the value of those options received. There are two aspects to calculating the amount on which these employees are taxed. The first aspect relates to any discount to the market value of the shares provided to the employees. The second aspect relates to the time value of money which is included in the value of the options. In this regard, if for instance the option is for a five year period. then the value of the option will include 13.2 % of the market value as at day one. In other words, for every $100 of value of shares available for purchase pursuant to the options, the employee will be assessed on $ 13.20 at the time of receipt of the options.

This is an absolutely ridiculous situation as the employee is in no position to sell those options or realise any gain relating to those options.

I note if the employee is issued options which are considered to be "qualifying" for the purposes of our tax law then he does have the ability to defer the tax liability until such time as he exercises those options. But upon acquiring the shares, he must immediately sell them to finance his tax liability, which arises by virtue of acquiring the shares.

For venture capital companies, it may in fact be quite difficult to be able to issue options pursuant to a "qualifying" scheme as one requirement is for each employee to be in a position to own no more than 5% of the shares in the company.

The bottom line is that any employee share option scheme should not result in an employee being subject to tax at the time of issue of those options - assuming of course that those options are issued at what the company directors consider is the market value of the shares on the day of issue. Further, there should continue to be a deferral of any taxation until the employee has the relevant cash in hand from selling the shares acquired pursuant to the exercise of those options ie. the acquisition of the shares should not trigger a tax liability.

The US experience

An employee of a venture capital backed USA company is in a much superior position to his counterpart in Australia for two reasons, namely:

the US employee is not taxed until he disposes of his shares; and the typical tax rate applying to the US employee is a rate less than 20% (because the gain is considered to be a capital gain).

Conclusion

Clearly, an Australian employee is disadvantaged under our system when it is considered that:

- he will normally be taxed at a rate of 48.5 % on any gain he makes in relation to his employee shares; and
- he is required to pay tax earlier than his counterparts overseas, namely either at the time of issue of options or at the time he exercises his options (and before the time he sells his shares).

If you have any questions, please do not hesitate to contact me.
Yours sincerely
DELOITTE TOUCHE TOHMATSU

Rick Taylor
Partner - Deloitte Tax Services