INQUIRY INTO EMPLOYEE SHARE OWNERSHIP IN AUSTRALIAN ENTERPRISES

SUBMISSION TO THE HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON EMPLOYMENT, EDUCATION

AND WORKPLACE RELATIONS

TECHNOLOGY TAXATION ALLIANCE

AUSTRALIAN INFORMATION INDUSTRY ASSOCIATION

AUSTRALIAN ELECTRICAL AND ELECTRONIC MANUFACTURERS' ASSOCIATION

AUSTRALIAN TELECOMMUNICATIONS INDUSTRY ASSOCIATION

ASIA-PACIFIC SMART CARD FORUM

AUSTRALIAN INTERACTIVE MULTIMEDIA INDUSTRY ASSOCIATION

INTERNET INDUSTRY ASSOCIATION

INTRODUCTION

This submission has been prepared by the Technology Taxation Alliance (the TTA) as input to the inquiry by the House of Representatives Standing Committee on Employment, Education and Workplace Relations.

The inquiry examines the extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on:

a. workplace relations and productivity in enterprises; and

b. the economy.

The TTA prepared a comprehensive submission covering all aspects of taxation reform as input to the Ralph Review of Business Taxation. That submission also covered the issue of employee share ownership plans, with specific reference to their current tax treatment and the need for urgent reform.

It was the TTA's understanding that the issue of share ownership, particularly as it impacts innovative start-up companies in the high technology area, would be addressed in the Ralph Recommendations.

With the omission of share ownership treatment from the final Recommendations, the TTA has been advised to refer its concerns to the Standing Committee. We welcome this opportunity to present the industry's concerns to the Committee, and are appreciative of the Committee's generosity in allowing a late submission.

THE ALLIANCE

The **Technology Taxation Alliance** comprises six leading Australian industry associations in the areas of computer hardware, software, services, electrical equipment and communications, electronics manufacture, electronic commerce and the internet:

- Australian Information Industry Association (AIIA)

- Australian Electrical and Electronic Manufacturers' Association (AEEMA),

- Australian Telecommunications Industry Association (ATIA)
- Asia-Pacific Smart Card Forum (APSCF)
- Australian Interactive Multimedia Industry Association (AIMIA)
- Internet Industry Association (IIA)

The TTA represents an unprecedented instance of related associations joining together to address a critical issue with a common voice. Together, these associations represent more than 1,100 Australian technology firms with:

- $A 50 billion annual turnover;
- 200,000 Australian employees;
- average 15 % annual growth rate; and
- representing more than 8.2% of Australia’s GDP.

SUMMARY

A 1997 survey of small (under $US 50 million in turnover) US firms indicated that **74 percent** of firms granted share options to all employees. In high-technology companies, employee share option plans are all but mandatory.

They can be the principal form of compensation and an essential tool in recruiting, motivating and retaining valued employees by letting them share in the company’s success. If this were the case in Australia it would have a positive consequent impact on workplace relations. But the tax treatment in Australia of shares and options means this benefit is largely lost to the labour market, at least in the high technology sector.

The US-based National Center for Employee Ownership estimates that employees own, or have options to own, shares worth almost **$US 800 billion**, or about 9% of all the shares in the United States.

Australian law discourages employee ownership by taxing the employee on the difference between share value and option price either at the grant date or at the exercise date (if terms of the scheme place restrictions on the employee’s

ability to dispose of the shares). Employees are also taxed on this paper profit at the marginal rate for ordinary income rather than at a special capital gains rate. As a consequence, employee share option plans are unattractive to employees and are rarely introduced in Australian technology companies.

The TTA believes urgent reform is needed to remove the impediments operating in the current tax treatment which discourage experienced executives with business skills in management, marketing and finance from joining the executive teams of high technology start-up enterprises.

The flow-on impact of this disincentive includes lost economic growth opportunities and the loss of innovation to other more competitive regulatory and tax environments. Options and shares are an important tool in attracting skilled managers as they provide direct participation in the rewards generated by innovative companies. Yet in Australia the current regime impedes their use by taxing gains before they are realised and limits their value by taxing them as ordinary income, rather than capital gain.

A more appropriate treatment of shares and options will:

- encourage the growth of high technology firms with downstream benefits for the economy;
- foster an entrepreneurial business culture; and
- ensure appropriate rewards for entrepreneurs and employees in the industry.

The Internet Business Challenge

Business management skills have been identified by capital markets experts as both a crucial element in the success of high-tech start-ups and the main deficiency which those companies have to address to become investment ready.

While the whole IT & T sector is beset by this problem, the issue is particularly acute with Internet start-ups. Taking an Internet-based business idea to market is a process far more complex than the typical business start-up for two reasons;

- the market for Internet applications is far more dynamic than other markets. The market moves so fast that new applications must be brought to market within months rather than years;

- the Internet is unique among immature markets in that it is a global market. This means that it is not enough to exploit a new Internet application locally. It must be brought to market globally (particularly in the US), or it will not achieve the economies of scale essential to success.

There are many reasons for the success of US Internet businesses, but two of the major ones are a tax system that encourages risk-taking and innovation and a sophisticated capital market. Australia has neither, although recent responses by the Government to the Ralph recommendations are very encouraging.

Without risk and capital, Australia is destined to remain a net importer of technology and it will miss out, at least in part, on the social dividend that will flow from increased employment, wealth and export earnings.

Why Shares and Options are Particularly Important in IT & T Start-ups

We have already noted the importance of adequate business skills in the process of bringing new ideas to market. This importance is not only an intrinsic one: investors will not even look at an investment without the right management team. The investments being made are very high risk, and investors take every step they can to reduce those risks.

Start-ups themselves do not generate a large pool of executive talent, so the executives must comes from larger, established enterprises, where they generally enjoy more security of tenure, as well a defined career path. Start-ups must lure these executives from the relative security of their current work environment to a new one where the future is unknown and the risks of failure are high.

Today’s start-up CEO can be unemployed tomorrow. Worse still the remuneration package available may well be less than the executive concerned can currently command in a

more orthodox role, and the fringe benefits are likely to be fewer.

The mantra of the venture capitalists is high risk: high reward. So it is for the executives: without the high reward that accompanies a successful float or IPO, the risk is as inherently unattractive as it would be to a venture capitalist.

Shares and options are the obvious way of providing that reward, and it is *essential* that the tax system cease to impede the process by seeking to tax these shares and options as ordinary income either at issue or well prior to the realisation of the gain.

THE TAX TREATMENT OF SHARES AND OPTIONS

Employee share option plans have long been a key factor in the success of technology based organisations in the US, specifically in the IT&T and biotech sectors. They also enable start-up enterprises to attract experienced executives with the superior management skills necessary to ensure the continued growth and viability of the new business. They are frequently used in the US as additional compensation, and sometimes in lieu of salaries.

US law provides that the employee will have no tax liability on exercise of the option, on the difference between the option price and the current market value of the shares. When sold, the shares are subject to maximum tax of 20% as opposed to income tax of up to 39.6% so long as the sale takes place more than one year after the exercise date.

Australian law discourages employee ownership by taxing the employee on the difference between the share value and the option price either at the grant date or the exercise date. Employees are taxed on this paper profit or unrealised gain at the marginal ordinary income tax rate, not the capital gains rate.

Current Tax Treatment of Options and Shares

The relevant legislative provisions may be found in Division 13A of Part III of the Income Tax Assessment Act 1936, a division inserted into the Act in the mid-nineties, and subsequently amended by the Coalition Government.

(a) Options

Division 13A sought to tax unlisted options in a special way to address a perceived tax avoidance technique which entailed the issue of unlisted options at no consideration to executives in listed companies, with an exercise price equal to the value of the shares at the time of issue of the options. These options were generally "long" ie; the window in which they could be exercised commenced some years later. The former provision, section 26AAC, was not thought to be effective in bringing these instruments within the tax net in an appropriate way.

Division 13A taxes these options by providing a basis on which time can be factored into the value of a "long" option, in order to arrive at a current market value, the assumption being that the share value will rise with the effluxion of time. Under Division 13A, one calculates the notional value of the shares the subject of the option, and tax the difference between that notional value and the issue price of the shares (plus any consideration paid for the option itself, generally nil).

While this approach may have some merit in the case of options in established listed companies, the Technology Tax Alliance takes the view that this approach is inappropriate for start-ups. To ascribe a notional future value to shares in a high risk start-up and then tax it places the executive in double tax jeopardy:

- First, he pays tax on an unrealised gain, and has to fund the tax liability (or the company will).
- Second, the gain will prove to be illusory in nine cases out of ten, as the company will either fail or not realise its potential.

Section 139FC of the ITAA 1936 provides that the market value of an unlisted right is the greater of –

- The market value of the shares to which the option relates at the time of issue of the option; or
- An amount calculated by reference to sections 139FJ to 139FN (inclusive) (or by a valuer if the option can be exercised more than 10 years after its issue (unusual)).

These sections contain a series of complex formulae that have the effect of inflating the value of the share over time so that the longer the option the greater the presumed value, and the larger the difference between the presumed value and the exercise price, which difference falls to be taxed.

(b) Shares

The position with shares issued to executives is not as egregious, as the time/inflation factor does not come into play, but under current law the executives will still pay tax on the difference between the price paid for the shares, and their present value, thus taxing an unrealised gain, and diverting precious and scarce tax resources.

(c) Qualifying and Non-Qualifying Shares and Options

There are two types of shares and options and they are taxed differently under Division 13A: qualifying and non-qualifying shares and options. The remarks above all assume the shares and options are non-qualifying, because it is unlikely that shares or options issued to executives of start-ups would ever be qualifying.

The recipient of qualifying shares and options has a choice. He can:

- elect to pay tax in the year of income in which the securities are issued (as the holder of non-qualifying securities must),

- elect to pay at the "cessation time", which is generally the earlier of the sale of the option other than by exercise;

- elect to pay at the exercise of the option (if there are no restrictions on the sale of the shares),

- elect to pay at the cessation of employment, or ten years.

This tax deferral, while far from perfect, makes it more likely that the taxpayer employee will be able to fund the ensuing tax liability.

Qualifying securities are issued under traditional employee share plans established by listed companies for their staff and must conform to strict conditions:

- 75% of all employees of the company are or were entitled to acquire shares under the scheme; and
- after the acquisition of the shares or the options, the employee does not control more than 5% of the shares or the voting power in the company.

In a start-up, neither of these conditions is likely to be satisfied. Only key executives will be issued or will want options or shares, and the 75% test will not be satisfied. Secondly, given the level of risk and the size of the business, allocations of equity in excess of 5% of the share capital are common, particularly in the case of sweat equity issued to the founders.

Conclusion

The TTA believes that unless reform is introduced to remove these anomalies in the employee share arena, the continued development and growth of innovative start-up companies will be impeded. We urge you to ensure appropriate reforms are included or at least recommended for referral in the Committee's inquiry, based on the following principles:

- tax the gain when it is realised, not before;

- tax the gain at rates applicable to capital gains and not to income under ordinary concepts.