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Review of Employee Share Schemes
The Board of Taxation
c/- the Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Sir / Madam

Review into elements of the taxation of employee share scheme arrangements

The Australian Institute of Company Directors (AICD) welcomes the opportunity to comment on the elements covered in the Board of Taxation's Review of Employee Share Schemes.

AICD is the second largest member-based director association worldwide, with over 25,000 individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, and government and semi-government bodies. As the principal professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

This submission concentrates on the application of tax deferral rules to options issued by small and medium sized enterprises (SMEs) under employee schemes. SMEs will be disproportionately affected by the more onerous taxation of options because they rely on them more than other sectors do.

Nature of SMEs

It is clear that SMEs are an important part of Australia's economic backbone. Collectively they make a significant contribution, amongst other things, to employment levels, tax revenue and general economic activity. This in turn helps us, as a society, to continue to enjoy the high standards of living we have come to enjoy and expect. In addition, individual SMEs of today are potentially major Australian companies of the future.

While there are a wide variety of SME businesses, they frequently have certain commonalities. First, SME businesses are often inherently risky, with a material possibility that the venture concerned will not prove successful. Many SMEs are at an early stage of development, with very limited access to external capital. Some do not yet generate revenue and must closely manage their cash "burn rate" (e.g. research and development or mining exploration companies). Typically, the markets for their securities are relatively illiquid.

An SME's approach to remuneration is often key to it attracting, motivating and retaining appropriate senior staff and board members. The use of options (and performance rights) - which are used more frequently as a component of remuneration in SMEs than in larger companies - can serve as an enticement for senior managers and board members, through allowing them to share in the success of the business venture. Options also allow cash starved entities (e.g. start-ups, mining exploration companies, research and development entities, and other SMEs not yet earning revenues) to obtain senior staff at cash salaries or fees which are lower than the market rate.

Options do not often vest immediately, and vesting is usually predicated on the achieving of hurdles, or with time (which serves as an incentive to stay). There are also likely to be circumstances where options have vested but the employee is restricted from exercising for a period (e.g. by agreement, under trading restrictions). Given that a high proportion of SME businesses will not prove successful, there are going to be many instances where options granted end up delivering no or little value to holders.

Effect of Proposals

It is our view that removal of the pre-Budget taxation provisions, which allow deferral of taxation until options are exercised, will have a disproportionate negative impact on SMEs. In particular, changing the taxation point from date of option exercise to date of option vesting (or when options are exercisable) will make it even more difficult for these entities to attract or retain suitable senior managers and board members.

Further, if the holder of the options is unable to recoup tax because the underlying share price remains or falls below the exercise price, this will further erode the attractiveness of SMEs as an employer. In this regard, we note the proposals contained in the *Exposure Draft Tax Laws Amendment (2009 Budget Measures No.2) Bill 2009: Employee Share Schemes and its accompanying explanatory materials* (the Exposure Draft) would result in tax being paid on options that vest notwithstanding they are "underwater" (i.e. the cost of exercise is greater than the underlying share price) at the time of vesting. It may be the case that the options remain underwater until they expire, with the result that the holder is unable to claim a refund of the tax paid.

We believe it is an inequitable outcome that employees may be required to pay tax on options without ever being able to realise value through exercise or sale. To our knowledge there is not any other occasion when Australian income tax is applied to fictional benefits in this manner.

A likely consequence of bringing forward the taxation point for options, and denying tax refunds where value ultimately is not delivered, is that SMEs will need - where it is possible - to increase the cash component of packages (redirecting precious funds from other uses and resulting in faster cash "burn rates") and/or an increase in the amount of securities based remuneration, to compensate for an individual's additional taxation burden.

Summary

In short:

- SMEs play an important economic and societal role;
- remuneration arrangements are key for SMEs in attracting and motivating executives and directors;
- the use of options reflects not only the "cash strapped" nature of many SME businesses, but also the greater risk often inherent in working for these companies; and
- making the vesting of options the taxation point will have a material and disproportionate negative impact on SMEs.

AICD contends that the ability of the holder to defer taxation in respect of options and similar rights should continue on the same basis that existed prior to this year's Federal Budget announcement concerning proposed taxation changes. That is, as a general rule, tax should be payable on exercise rather than on vesting.

We would be happy to discuss any of the points made in this submission should this be considered appropriate.

Yours sincerely

John H C Colvin
Chief Executive Officer

cc Michael Willcock, Revenue Group, The Treasury