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17 July 2009

The Secretary
Senate Economics References Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir / Madam,

Inquiry into Employee Share Schemes: Ernst & Young submission

Ernst & Young are pleased to provide this submission to the Senate Economics References Committee (the **Committee**) in relation to its inquiry into employee share schemes.

We note that the Committee's Terms of Reference includes a number of matters, including taxation issues relating to compliance of employers and employees participating in employee share schemes and the recently announced proposed changes to the tax treatment of such schemes. Our submission will focus on the issue of the taxation of employees share schemes in Australia, in particular the key taxation issues that remain unresolved under the proposals contained in the Policy Statement released by Government on 1 July 2009 (the **Policy Statement**).

We note that many of our comments in this submission were made as part of our 12 June 2009 submission to Treasury in response to its earlier Consultation Paper (issued on 5 June 2009) (the **initial Consultation Paper**). In addition, our comments are based on the announcements to date made by the Government and our understanding of how the rules proposed in the Policy Statement will operate. We expect further clarification on the rules when the Exposure Draft and Explanatory Memorandum for the legislation is released, at which time some of our comments in this letter may be updated.

Summary

Overall, in our view, the proposals contained in the Policy Statement represent a significant improvement compared to the position immediately following the federal budget announcement on 12 May 2009. However, we believe there are still material aspects of the proposals that require clarification and/or modification to ensure:

- Participants in employee share schemes are only subject to tax on their equity awards at a time when they are able to realise a benefit from the awards;
- In addition to ensuring the taxing point only occurs when employees can realise a benefit from their equity awards, appropriate and relevant concessions are available to encourage broad-based employee share ownership; and
- Anomalies in the tax rules that apply to employee share schemes are removed.

This letter sets out our key comments on the following issues:

1. **Income cap for $1,000 tax exemption**: We recommend removal of the cap as it introduces unnecessary complexity for employers and employees.

2. **Increase $1,000 tax exemption:** In addition, we suggest that the $1,000 exemption be increased so that the concession provides a more material incentive to increase broad employee share ownership;

3. **$5,000 limit on salary sacrifice arrangements**: We recommend removal of, or at least a significant increase to, the proposed $5,000 limit on salary sacrifice schemes. Such a limit will make the operation of such schemes administratively complex and may not provide sufficient incentive for employers to offer salary sacrifice plans;

4. **Taxing point for share options and rights**: We recommend imposing the taxing point for share options, and other rights to acquire shares, at the time they are exercised, rather than at vesting (which may be the taxing point under the proposed rules set out in the Policy Statement);

5. **Removal of cessation of employment as a taxing point**: We submit that retaining cessation of employment as a taxing point for employee equity awards is inconsistent with the commercial objectives of many schemes, as well as with moves to encourage long-term share ownership by executives, and will ensure that Australia continues to be out of step with its international competitors. In any event, taxing equity awards on cessation of employment will not, in our view, assist with meeting the Government's stated objective of addressing tax integrity concerns (in our view, the introduction of a reporting requirement for employers regarding employee equity awards is sufficient to meet this objective);

6. **Amendment to rules on tax refunds for forfeited equity awards:** We recommend modification of the proposed refund provisions so that they apply to tax paid on options (and other rights to acquire shares) that are forfeited (or simply expire), regardless of the reason for the options / rights lapsing.

In summary, we believe that the introduction of an appropriate employer reporting requirement will meet the Government's stated tax integrity objectives, whilst ensuring appropriately structured employee equity schemes continue to play an important role for companies in aligning the interests of employees to those of shareholders.

Detailed comments

1. Income cap for $1,000 tax exemption

Under the current proposals, means testing for the $1,000 tax exemption applies such that only employees with adjusted taxable income of less than $180,000 will qualify.

By introducing the income cap, the exempt plan will be beneficial for some employees, whilst triggering an immediate tax charge for others (for those participants who exceed the cap, an immediate tax charge will arise at the time of grant, with no ability to sell the underlying shares for up to 3 years).

The income cap will introduce complexities for both employers operating tax-exempt schemes and participating employees:

- Employers are still required to include employees earning more than the cap when making offers under a tax-exempt plan. This is as a result of the tax-exemption conditions that require tax-exempt plan offers to be made to at least 75% of "permanent employees" (for this purpose, permanent employees are, broadly, full-time and permanent part-time staff with at least 36 months service – directors and overseas employees are excluded).

- As a result, companies will need to provide detailed taxation information to all employees, setting out the consequences of participating in the tax-exempt plan; in particular, highlighting the adverse tax implications for those individuals whose income exceeds the cap. For those employees participating in a tax-exempt plan who exceed the cap, an immediate tax charge will arise at the time of grant, with no ability to sell the underlying shares for up to 3 years. Employees will need to understand the potential tax implications of participating when deciding whether to take up the tax-exempt plan offer. Accordingly, the tax information that employers will need to provide will increase in complexity compared to the position prior to introduction of the cap.

  Even where employees understand the implications of participating in the plan and exceeding the cap, employees close to the cap will have difficulty determining, at the time the tax-exempt share offer is made, whether they will exceed the cap or not, as some of the information needed to calculate their 'adjusted taxable income' will not be available until after the end of the tax year (for example, the extent of any investment losses through negative gearing).

- The introduction of a cap will also cause problems regarding the new reporting and withholding obligation for employers. Employers will not have the information available to determine which employees exceed the income cap and, so, will not be able to provide details under the annual reporting requirement of those employees who have received shares that are exempt from tax and those which are subject to immediate tax at the time of grant. This issue is also relevant for those employees where the company is required to withhold tax (which applies for those employees who have not provided their Tax File Number to their employer).

The current proposal for an income cap introduces a number of complexities whilst only a small part of the employee population (i.e., those with adjusted income of $180,000 and above) will be excluded from obtaining the relatively minor $1,000 tax exemption. Accordingly, in our view, the income cap on tax exempt plans should be removed.

If the Government believes such an income cap is required, we suggest that the taxing point for shares granted to employees under such plans who do not qualify for the exemption should be deferred until the relevant shares are released from the plan and can be sold (to meet the exemption conditions in the legislation, shares cannot be sold for at least 3 years, unless the employee leaves the company). In this way, the potentially adverse tax implications of a tax charge being triggered up to 3 years before the shares can be sold would be removed, allowing employers to offer the tax-exempt plan without potentially causing unfavourable tax consequences for some employees.

2. Increase the $1,000 tax exemption

The tax exemption concession was originally conceived to help align the interests of companies and employees as a whole. An income tax exemption of $500 was set at the time the concession was introduced, which was increased to $1,000 in 1997. This is now more than a decade ago and the exemption level not been increased since that time. In both absolute terms, and when compared to concessions for similar broad-based employee equity plans offered in other jurisdictions, the exemption provides a very limited tax benefit.

For example, under the Share Incentive Plan – an 'approved' employee share scheme in the United Kingdom – companies can provide employees (at no cost to participants) with up to GBP3,000 of shares each year, free of tax and national insurance provided the relevant conditions are satisfied. Where employees contribute to the cost of shares through pre-tax salary sacrifice, the annual limit on shares provided by the employer doubles to GBP6,000 (approximately A$12,500), not including the shares paid for by employees.

We therefore believe that for the tax-exempt plan to remain relevant as a scheme to encourage broad share ownership by employees, the $1,000 tax exemption should be increased.

3. $5,000 limit on salary sacrifice schemes

The concept of salary sacrifice is a recognised and accepted remuneration tool across the entire workforce. Accordingly, we welcome the special dispensation outlined in the Policy Statement for salary sacrifice plans; i.e., schemes that allow employees to contribute pre-tax remuneration to acquire shares in their employer. Since employees contribute to the cost of the shares, such schemes do not typically apply 'vesting' conditions under which employees could potentially forfeit their shares. The Government's proposals provide a special dispensation for salary sacrifice schemes in that shares acquired by employees under such schemes do not need to be subject to a "real" risk of forfeiture for tax deferral to be available (a condition which applies to other schemes, other than the $1,000 tax-exempt plan).

We note however that salary sacrifice schemes will be subject to a limit of $5,000 (we understand the limit is to apply annually to the value of shares acquired under such schemes). In our view, the introduction of a limit will make the operation of schemes administratively complex (in that employers will need to 'police' whether the limit has been reached) and may not provide sufficient incentive for employers to offer salary sacrifice plans.

In addition, corporate governance guidelines encourage the payment of a portion of non-executive director (**NED**) fees in the form of company shares. Based on information published by ASX 200 companies[1], 36% of such companies operate plans under which NEDs may sacrifice fees to acquire shares. Such schemes typically require NED participants to retain shares acquired under the plan whilst they remain on the company's board of directors. The proposed $5,000 limit on pre-tax sacrifice schemes means that such NED share acquisition plans will no longer be workable in relation to a

[1] Market data has been sourced from the Ernst & Young Board & Executive Remuneration Database. The database includes the remuneration quantum and practice information for S&P/ASX 200 companies with year ends between 1 November 2007 and 31 October 2008. The S&P/ASX 200 is defined as at 31 October 2008. The database excludes trusts and funds that did not disclose sufficient remuneration data for analysis and companies that were not listed for a full financial year.

material level of NED fees, likely resulting in a reduction in the overall level of share ownership amongst NEDs of ASX-listed companies.

In summary, therefore, introducing a $5,000 limit on salary sacrifice plans would appear to be counter intuitive to the desires of both employers and shareholders that the level of broad employee and NED share ownership should generally be increased and, accordingly, we recommend that the cap be removed, or at least substantially increased.

4. Taxing point for share options

The Government's introduction of the concept of a "real" risk of forfeiture is aimed at reducing the "excessive concessionality" which is perceived to exist under the prior, pre-1 July 2009 tax rules. Such "concessionality" is, in many cases, simply triggering the tax liability at a time when the employee can realise a benefit from the underlying equity award. In our view, this should not be considered "concessional" but rather the application of a basic principle of fair and sensible tax rules.

The proposal to introduce the new concept of "real" risk of forfeiture means that a clear understanding of what constitutes a "real" risk of forfeiture will be required by all stakeholders, including the Australian Tax Office (ATO), employers and practitioners. The Policy Statement suggests that explanatory materials will be developed by the ATO to assist taxpayers apply the principle of "real" risk of forfeiture. In our view, the definition of what constitutes a "real" risk of forfeiture for the purpose of the new tax rules should not be left to the ATO to develop but should be set out in the legislation so that there is limited opportunity for uncertainty and ambiguity to arise.

In relation to options and other rights to acquire shares, the proposals outlined in the Policy Statement could result in options and rights being subject to tax at the time of vesting, rather than at the time of exercise (which was the established tax treatment under the pre-1 July tax rules and is consistent with the tax treatment of options in virtually all other developed economies). In particular, the interaction of the "real" risk of forfeiture concept with the application of disposal restrictions to equity awards is unclear and introduces unnecessary complexity to the tax treatment of options and rights.

If the legislation to effect the proposals does not address such uncertainty as to when tax may be triggered, there will be potentially significant implications for the tax treatment of options and rights; specifically, where the vesting point may occur some time before the participant is able to exercise the options / rights and sell the underlying shares:

- **The taxing point may arise some time before the employee is able to exercise the option and realise any gain.** For example, due to share trading restrictions that apply (in particular to senior employees who for large portions of a financial year will typically be subject to Corporations Law and ASX trading restrictions, such as insider trading rules, and company policies that prevent them from dealing in shares), it may not be possible for an employee to exercise the option for some time after the vesting point. As a result, the employee may only be able to exercise the option and sell the underlying shares to fund the tax liability at a time when the share price may have moved significantly compared to the share price on which the tax liability is based. Therefore, if the share price has fallen since the option vested, the employee will have been taxed on an amount of income which has not been received, with no ability (under the rules outlined in the Government's Policy Statement) to claim a refund for the tax overpaid.

In addition, imposing a taxing point at vesting forces employees who **can** exercise the options (and sell their shares) to immediately dispose of sufficient shares to fund the related tax liability. This is inconsistent with the move to encourage long-term share retention by employees.

- **The existing valuation rules will give rise to a taxation liability for employees, even where the option is not (and may never be) "in the money"**. Under the current valuation rules (which we note are to be reviewed), taxable values are imputed for options based on an option's exercise price and time to expiry, and the company's prevailing share price. Under the proposals, the valuation rules could, at the time an option vests, impute a taxable value for the option which is significantly higher than the gain an employee could ultimately realise by exercising the option and immediately selling the underlying shares.

  For example, an option with an exercise price of $1.00 per share and time to expiry when the option vests of 5 years, would have a taxable value of $0.049 per share under option if the company's share price was $0.90 at the time of vesting; i.e., tax would be payable at the time of vesting even though share price is lower than the option's exercise price at the time of vesting (the option is "out of the money"). The option in this case would still have a taxable value even where share price is, say, 30% lower than the company's share price at the time the option vests (i.e., where the option is significantly out of the money).

- **Depending on share price performance after the option vests, the employee may never realise any gain from the option** – in these circumstances, based on the proposed rules, the employee would be liable to tax when the option vests but would **not** be entitled to a refund when the option later expires without being exercised.

- **Australia would be significantly out of step with its international competitors.** Options (and other rights to acquire shares) should not be taxed until exercise – to do so would put Australia out of step with virtually every other developed economy. The initial Consultation Paper sites international comparisons with the US and UK. In this context, we note that the earliest taxing point for options in both of these jurisdictions (even for non-statutory options in the US as identified in the initial Consultation Paper) is at exercise.

In addition, the interaction of a "real" risk of forfeiture and disposal restrictions as they apply to shares acquired under an option / rights plan differs to the rules as they apply to grants under a share plan. In particular, from the proposals set out in the Policy Statement, the tax rules regarding the conditions to defer income tax beyond the point of vesting for a grant of shares (i.e., when a "real" risk of forfeiture ceases to apply) are relatively straightforward and very similar to the pre-1 July 2009 rules. In the case of options / rights, however, additional requirements appear to apply to defer tax beyond the time when shares are acquired (specifically, the proposals suggest it is necessary to have – initially at least – a further post-acquisition "real" risk of forfeiture apply to the shares following exercise of the options / rights. It is unclear why the rules should be different for options / rights compared to grants of shares and this will only add to the complexity of applying the new rules.

In summary, therefore, in our view the taxing point for options, and other rights to acquire shares, should be no earlier than the time the options / rights are exercised and should be able to be further deferred (up to the 7-year maximum) if the shares obtained upon exercise of the options / rights remain subject to disposal restrictions. We also recommend that the definition of what constitutes a "real" risk of forfeiture should be incorporated in the legislation, rather than through the development of separate explanatory materials.

5. Removal of cessation of employment as a taxing point

We note that the retention of the taxing point on cessation of employment is also inconsistent with encouraging the long-term ownership of shares and the premise that employees should only be taxed on equity awards when they are able to realise a benefit.

In some executive long-term incentive plans, for example, companies require participants to retain awards where they cease employment in certain circumstances (such as retirement) until corporate performance hurdles have been achieved (this is consistent with developments in the regulatory and governance framework for executive remuneration that support arrangements which align executives with a company's long-term performance; i.e., cessation of employment should not necessarily trigger vesting of an executive's incentives). If such performance hurdles are not achieved, the equity award is forfeited. Imposing a taxing point when participants cease employment conflicts with the commercial objectives of many schemes and is out of step with the tax rules operated by most other countries.

In the initial Consultation Paper it is suggested that such a tax trigger point is necessary to address the "considerable tax integrity issues" that can arise if an employee moves overseas. In our view, the potential tax collection issue is overstated and is not a valid reason for maintaining the cessation-of-employment taxing point, since:

- Employees can move overseas without ceasing employment; and
- A move overseas can be effected after ceasing employment but before the individual is required to submit the relevant tax return or make the corresponding tax payment.

The concerns raised in the initial Consultation Paper regarding individuals moving overseas is a broader tax collection issue that is not related solely to employee share plans. In addition, the introduction of employer reporting requirements should be sufficient to address the Government's general tax integrity concerns.

6. Amendment to rules on tax refunds for forfeited equity awards

As noted earlier in relation to the taxable value of options, the existing valuation rules that apply to equity awards would trigger a tax charge when an option vests, even where the option has zero intrinsic gain (i.e., the exercise price is not lower than the prevailing share price).

Under the proposed refund provisions described in the Policy Statement, a taxpayer cannot obtain a refund of tax paid on an option when it lapses if the loss of the option is as a result of a choice made by the individual. In other words, if the taxpayer decides not to exercise the option because the company's share price remains at a level which is no greater than the option's exercise price (i.e., the option is never "in the money"), the refund provision would not apply. As a result, an employee could be taxed on the vesting of an option which is never in-the-money and no refund would be available.

In our view, where the taxing point of options is when the options vest (rather than when they are exercised), the refund provision should allow taxpayers to obtain a refund of any tax paid on vesting of the options where the options later lapse without being exercised (regardless of the reason for the options lapsing). We believe that the refund rules should apply to allow a repayment of tax paid on any equity award which is later forfeited without the employee having realised a benefit from the award.

Other considerations – anomalies in the tax rules relating to employee share schemes

During the process of rewriting the employee share scheme tax legislation, we strongly recommend that the opportunity is taken to improve the interaction between the income tax rules and the capital gains tax (**CGT**) provisions that relate to employee share schemes. We would be pleased to discuss in further detail the issues that currently exist in relation to the interaction of Division 13A of the Income Tax Assessment Act 1936 and the CGT provisions. There are numerous further examples of where the rules can be improved to eliminate existing anomalies and we look forward to participating in the consultation process outlined in the Policy Statement.

If there are any areas of this submission that you would like us to expand upon further, we would be pleased to discuss these with you (my direct telephone number is 02 8295 6250). In addition, we would welcome the opportunity to appear before the Committee to discuss our submission and any other points related to the Committee's inquiry.

Yours faithfully

Paul Ellis
Partner – Human Capital