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

9 July 2009

Our ref: 08P020

Dear Mr Hawkins

Subject: PwC Submission to the Economics References Committee in relation to the Inquiry into Employee Share Schemes

Further to your letter of 3 July 2009, we welcome the opportunity to make this submission to the Economics References Committee (the Committee) in relation to the inquiry into employee share schemes.

This firm made one of the 64 submissions that were received by the Treasury in response to the Consultation Paper released on 5 June 2009 (Consultation Paper). In the interests of avoiding replication of our views set out in our submission to the Consultation Paper, the comments in this submission are restricted to matters we feel are of primary concern and which are not adequately addressed by the Policy Statement (Policy Statement) announcement on 1 July 2009.

1. Salary sacrifice schemes

In our submission to the Treasury of 12 June 2009 in response to the Consultation Paper, we drew attention to the adverse tax consequences for salary and bonus sacrifice schemes if the proposals envisaged in the Consultation Paper were implemented.

For ease of reference, we set out below the relevant excerpt from our submission.

One of the most common ways for companies to encourage broad share ownership is to offer employees the ability to voluntarily sacrifice salary on a pre-tax basis to acquire a similar value of shares on which tax is deferred.

These schemes can also operate on a matching basis where companies may provide free matching shares to employees for every share purchased by the employee through this type of sacrifice.

Many companies have also designed schemes whereby employees must mandatorily take a portion of their bonus in the form of shares, which must be held for a period of time before those shares can be sold.

These scheme designs reflect the draft Australian Prudential Regulation Authority (**APRA**) prudential standards on remuneration and accord with best practice views on the alignment of employees' interests with shareholders.

The tax deferral under such schemes is achieved either due to the use of a disposal restriction or a forfeiture condition (typically structured as "if the employee is dismissed for cause, gross misconduct, malfeasance etc" then the employee will forfeit the shares). Under the proposed rules, a disposal restriction of this type would no longer achieve any tax deferral, and as a result, those scheme designs which rely on such a feature would no longer be viable.

It is unclear as to whether the use of such a general forfeiture condition as described above would meet the test of "genuine risk of forfeiture" as required under the new rules. Therefore, such uncertainty will, unless it can be quickly resolved, also result in schemes using this form of forfeiture being withdrawn by companies. *[note – the Policy Statement provided additional detail on this test]*

Based on feedback received from our clients, and in discussions with the major independent share scheme administration providers, it is thought that the withdrawal of such salary and bonus sacrifice schemes would directly impact up to 250,000 employees, with most of these employees occupying low to middle management positions.

In our view the new rules will directly lead to a material reduction in the use of broad based share schemes, with significant numbers of employees no longer likely to receive any form of equity benefit. In addition, this may lead to reduced private savings by employees who may presently save via their employee equity interests which (at least initially) cannot be spent immediately as cash.

Further, the new rules may lead to the perverse outcome whereby executive share schemes, which will typically have a genuine risk of forfeiture due to the use of performance hurdles and thereby still definitely achieve some form of tax deferral, will become the predominant scheme operated by companies, with general/broad based schemes becoming a comparative rarity.

To exclude such broad based schemes from within the tax deferral regime will again put Australia out of alignment with the rest of the world in designing a tax system which is disadvantageous to broad based employee share scheme participants. Indeed, as many of these plans are international, this will lead to a decrease in levels of employee participation in such plans and this is contrary to the Government's stated intention of increasing employee share ownership.

We note that the Government has made special provision in the Policy Statement for salary sacrifice schemes. However, following discussions with clients who operate these schemes we believe that the proposed cap of $5,000 per annum (we assume this is an annual limit although the Policy Statement does not make this clear) is too low and will not provide sufficient incentive for companies to continue using salary or bonus sacrifice schemes after 1 July 2009. Further, the presence of any threshold will make administration of the scheme complex and burdensome. The special deferral concession may therefore in practice be redundant.

For these reasons, we submit that the proposed cap of $5,000 should be removed. Further, such schemes should attract tax deferral based on disposal restrictions alone. Tax deferral should not be subject to forfeiture conditions. To tax salary or bonus sacrifice schemes otherwise will ensure their rapid demise as a widespread form of equity

participation.

If the Committee concludes however that a cap is required, we urge the Committee to consult with APRA, the Productivity Commission and the Henry Review panel to ensure the cap is set at a level which is commensurate with the findings of those bodies.

We should also appreciate greater clarification where amounts have been sacrificed by taxpayers prior to 1 July 2009 but the matching shares or rights were not acquired under the scheme prior to 1 July 2009. In these scenarios it would seem inequitable that the taxpayer should be treated as having acquired the shares or rights under the new regime commencing 1 July 2009.

2. Ceasing employment as a deferred taxing point

In our view, having ceasing employment as a taxing point is counter-intuitive and creates (not solves) an integrity issue as it is not readily understandable to holders of shares or rights that are subject to tax deferral. No other major jurisdiction has, or has ever had, the ceasing employment as a taxing point under employee share scheme taxation legislation. Further, keeping ceasing employment as a deferred taxing point is likely to be divergent with the APRA discussion paper on sound executive remuneration practices which require Boards to defer payment of performance based remuneration.

Despite this, we note that the Government remains of the view that the absence of cessation of employment as a taxing point represents an unacceptable integrity risk. The Policy Statement suggests that it is open for companies to operate “partial vesting” arrangements to allow employee participants to sell a portion of their entitlement in order to cover any tax liabilities in the event they cease employment with the employer. We do not believe this should be a factor for employers and employees to consider when negotiating employment contracts which integrate commercial performance-based conditions.

We believe that the new employer reporting requirements will reduce the feared non-compliance by the tiny minority of taxpayers who may currently defer a taxing point until they have ceased to be resident in Australia.

We therefore submit that ceasing employment is removed as a taxing point for shares or rights which are subject to tax deferral.

3. Interaction between risk of forfeiture and disposal restrictions

We welcome the extension of the deferred taxing point in cases where shares or rights are subject to a real risk of forfeiture and disposal restrictions.

However, at the time of writing we have some concerns about how the interaction between these conditions will work in practice. We will reserve comment until we have had an opportunity to review the Exposure Draft and Explanatory Memorandum, which we understand is expected to be released this month.

4. Other matters

In our view there are many issues of concern in the existing law (Division 13A of the Income Tax Assessment Act 1936) which do not appear to have been addressed in the new provisions. These include:

- Classes of shares to which these provisions apply. Many traded securities may not meet the very limited criteria of "ordinary share" yet may be the instruments of ownership in a foreign jurisdiction, leading these securities to be excluded from the application of Division 13A.

- The current law includes a concept of a right to acquire a share and this concept is to be carried over into the new provisions. Much confusion has arisen in relation to what exactly is a "right" for these purposes and we strongly urge the Government and the Treasury to give this due attention.

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We would welcome the opportunity to discuss these matters before the Committee and look forward to hearing from you.

Yours sincerely

John Fauvet
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Tax Services