

Our ref: GMB

21 July 2009

Australian Senate
Economic References Committee
P O Box 6100
Parliament House
CANBERRA ACT 2600

Dear Committee Members

Employee Share Plans - SMEs

I refer to your request for submissions in respect to the Senate Committee Inquiry on employee share plans.

While I am Chair of the Law Institute of Victoria's Tax and Revenue Committee and I am also Chair of the Law Council of Australia's Business Law Executive Taxation Committee, I make this submission in my own capacity.

I understand that various organisations and law firms have made submissions to the inquiry. Accordingly, I will not cover all areas that the Committee will investigate, and I wish to draw the Committee's attention to a particular problem that existed under Division 13A of the ITAA 1936 and will continue under the new provisions announced to take effect from 1 July 2009. This problem relates to encouraging wider share ownership by employees of small and medium enterprises (SMEs).

SMEs wish to offer shares to their employees but often find the requirements imposed by tax law too burdensome to encourage such share allotments.

Under Division 13A, an employee needs to know the discount on the value of the shares that he or she has been given. This involves establishing the market value for the shares as the taxable discount on the shares is equal to the market value of the shares less the amount paid for the shares. Unlisted SME shares are illiquid and determining a value for them can be difficult and expensive.

Many SMEs provide in their shareholders agreement or the Constitution of their company for a methodology to be adopted to determine the share value.¹

In practice, Division 13A requires that each time a share is given to an employee (and SME may have more than one allotment in a year), a valuation of the shares must be undertaken.

Under Division 13A, section 139FB(1) provides that the market value of the shares "is the arm's-length value of the share:

- (a) as specified in a written report, in a form agreed by the Commissioner, given to the person from who the taxpayer acquires the share by persons qualified person in relation to valuing the share (see section 139FG);² or
- (b) as calculated in accordance with any other method approved in writing by the Commissioner as a reasonable method of determining the arm's-length value of unlisted shares."

Section 139FB(1)(a) enables an independent company auditor to value the shares. However, this is an expensive process and if there is a number of share issues in a year, the cost becomes excessive for an SME.

As a means of ameliorating this cost to SMEs, section 139FB(1)(b) allows the Commissioner to determine a reasonable method. Indeed it is open to the Commissioner to adopt the methodology in the SME's shareholders agreement or Company Constitution.

Initially, the Commissioner of Taxation did issue rulings and an ATO ID in respect of methodologies for calculating arm's-length value. However, under influence from the Australian Valuation Office, and its views of market value, the Commissioner ceased to issue such rulings.³

There may be a number of methodologies by which an SME's share value can be determined without the need for an expensive valuation by a company auditor. In particular, where the SME are governed by shareholder agreement or Company Constitution either may specify a calculation methodology for entry or exit of shareholders. That methodology will bind all existing and potential shareholders (including employees) and will provide the value at which any arm's-length sale of the shares will occur.

The AVO rejects this approach and would still require an independent valuation of the shares in order to determine their market value even though parties would be bound by the methodology in the shareholder's agreement or Constitution.

¹ For example, the methodology could be based on net assets in the most recent balance sheet or may be involving using a multiple of the average profit for a number of years.

² Section 139FG define a qualified person as a registered company auditor.

³ I am aware of a number of practitioners who have sought rulings from the Commissioner and no rulings were given after the interventions by the AVO.

As no rulings would be given by the Commissioner the cost of undertaking such a valuation often discouraged SMEs from issuing shares to employees.

It defies logic that when the parties may only transfer or allot shares in accordance with the valuation methodology in a shareholder's agreement that the market value of the shares can be anything other than as determined by the formula. However, this view is not accepted by the AVO.

This problem of valuing unlisted SME shares will continue under the rules as proposed to take effect on 1 July 2009.

I have raised with Treasury, the referral to the Board of Taxation of the issue of simpler methodologies for valuing SME shares as part of the Board's activities around the new provisions. I believe the Treasury does not intend to do so, but I believe this would be a valuable exercise.

If the law treated the value produced under a calculation methodology for entry or exit of shareholders in a binding shareholder agreement, or Company Constitution, as the market value of the shares it would encourage SMEs to offer more employees shares.

Yours sincerely

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