Shareworks
by Morgan Stanley

19 March 2020

The Standing Committee on Tax and Revenue

Inquiry into the Tax Treatment of Employee Share Schemes

Dear Members of the Committee,

Shareworks by Morgan Stanley is pleased to provide the enclosed submission addressing the outlined Terms of Reference. We believe that the comments and observations made in this submission will assist the Committee in assessing the effectiveness of the 2015 Employee Share Scheme (**ESS**) changes. This submission will also serve to provide considerations on potential changes aimed at improving the taxation treatment and administrative arrangements for ESS.

If you would like to discuss the submission, please feel free to contact me on the details below.

Yours sincerely.

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Executive Summary

Inquiry into the Tax Treatment of Employee Share Schemes

Shareworks by Morgan Stanley welcome the opportunity to submit a response on the Inquiry into the Treatment of Individual Share Schemes; set forth by the Treasurer, The Hon Josh Frydenberg and the Standing Committee on Tax and Revenue.

This submission will detail our observations in relation to the certain points of the Terms of Reference and the effectiveness of the 2015 Employee Share Scheme (**ESS**) changes.

We are of the view that the 2015 changes introduced clear positives across both corporate and start-up landscape. The start-up concessions were an important first step in expanding the reach of ESS. We have, however, observed several hurdles that currently prevent organisations and their employees from reaping full benefit of ESS, including:

- **PRESENCE OF THE CESSATION OF EMPLOYMENT AS A DEFERRED TAXING POINT**
- **ABSENCE OF TAX WITHHOLDING OBLIGATIONS ON ESS**
- **RESTRICTIVE LIMITS IMPOSED ON TAX EXEMPT AND DEFERRED SALARY SACRIFICE PLANS**

Our key observations point to ways to potentially streamline and simplify the current tax regime to better align it with global standards and practices around taxing points and tax withholding obligations. Reduced complexity and enhanced attractiveness of ESS can further the benefits offered to employees in both listed organisations and start-ups. This in turn would have positive externalities for the broader community by fostering employee ownership and promoting economic growth in Australia.

We would welcome an opportunity to discuss any questions you may have regarding our submission.

Overview of effectiveness of the 2015 Employee Share Scheme (ESS) changes

We have documented our observations of the recent trends in ESS plan design and administration to highlight the impact the current tax regime has on structure and rollout of ESS arrangements.

Presence of the Cessation of Employment as a Deferred Taxing Point

In Australia, where deferred remuneration is delivered in equity, termination of employment triggers a tax event under Division 83A of the Income Tax Assessment Act 1936. This occurs even where vesting is deferred beyond termination of employment and the individual does not have control of the equity. This puts the individual in an adverse cash-flow position where an individual is required to pay tax in the year of cessation of employment even though they cannot sell equity to fund the tax liability. To burden individuals with a tax obligation on ESS award that may never vest and be realised can be seen as a detriment to the value it is meant to deliver. An online survey conducted at the Global Equity Organisation Regional Event in Melbourne in 2018 determined that majority of attendees recognised removing the taxing point at termination of employment as their top priority. Further, academic research by Stephen Graw suggests that changes to the cessation of employment taxing point could help promote fairness for the employees[1].

ALTERNATIVE APPROACH AND ITS BENEFITS

A change we anticipate the organisation and the industry would welcome would be to move the taxing point on the actual realisation of value, if and when that occurs. The benefits of moving the taxing point are summarised below:

1. Individuals do not need to fund their tax liability through other means of income as the potential gains and value from their ESS is realised at the crystallisation date of their equity which may fall in a tax year different to date of their cessation.
2. Individuals have a further benefit of their ESS plan, and their faith in their plan is not undermined by knowing a potentially substantial tax liability is due immediately should they leave their organisation.
3. Organisational plan design and requirements are streamlined as it removes the need for separate termination clauses in ESS Plan Rules, as well as heavy reliance on indeterminate rights and cash settlement provisions.
4. Tax reporting and lodgement to the Australian Tax Office becomes more seamless for organisations and/or equity providers; reducing the risk of misreporting.

The presence of cessation of employment taxing point may have led to potentially unintended consequence of the rise of indeterminate rights plans with a cash settlement provision in the plan rules. The indeterminate right provides the Board discretion to settle awards in cash in lieu of equity – a common practice at vesting for departing employees who retain the equity at termination. The use of cash settlement provision ultimately undermines the initial goal of ESS – delivering equity to the employees to foster a long-term alignment with the interest of shareholders.

Absence of Tax Withholding Obligations on ESS

Individuals who are Australian residents receiving ESS incentives, are, in our view, at an administrative disadvantage when it comes to reporting their ESS income tax. Australia does not follow a globally recognised standard in capturing the withholding tax on employee equity at the time the equity instrument becomes vested (or exercised) and consequently, Australia is misaligned with the rest of the world in this regard. Not only is the inability to withhold taxes on ESS a barrier for Australian and non-Australian organisations offering Australian employees' equity; but it can pose a significant administrative disadvantage for individuals when it comes time to declaring their income.

Countries outside of Australia have different ways of dealing with employee withholding tax obligations. For instance, the United States capture Federal and State tax utilising year to date income to determine individual tax obligations at the point of exercise or conversion of rights into shares. New Zealand allowed employers to make an election to withhold tax. In both these scenarios the organisation controls the relevant withholding obligations for their employees participating in ESS and thus are the responsible party for submitting this obligation to the relevant jurisdictional authorities.

ORGANISATIONAL CHANGES AND BENEFITS

Currently, some organisations offering Australian employees' equity as part of an ESS may deem it not a worthwhile task, as they do not have the appropriate tools in place to facilitate arrangements like the sale of shares to cover taxes. In light of this we are presenting a view; introducing a withholding tax at the time of exercise, providing an opportunity for the individual to sell off specific quantity of shares to immediately satisfy their personal tax liability obligations. The resulting funds from this transaction are directed to the individuals' employer to lodge and submit to the relevant tax authority. The introduction of tax withholding obligations not only streamlines the process for organisations, but also provides the tax authorities with comfort that any tax obligations are met at the time of the taxing point and expedites the timeframe with which the authorities in these countries receive their tax money.

INDIVIDUAL BENEFITS FROM A WITHHOLDING TAX INTRODUCTION

Individuals who are participating in ESS could potentially devalue share awards due to the administrative burden of being required to take care of their own taxes when colleagues in other countries participating in the same plan have this obligation taken care of by their employer. With the introduction of a tax withholding obligation on the exercise of options or rights, or vesting of shares, facilitated by an individuals' employer, may lead to an increased perceived value of participating in an ESS.

Restrictive Limits Imposed on Tax Exempt and Deferred Salary Sacrifice Plans

Currently in Australia, individuals participating in a salary sacrifice style ESS are limited with the amount of earnings they can contribute to purchase shares in the organisation they are working for. We would seek that this cap be increased to further foster employee ownership and thus drive plan participation. The limit on the tax exempt plans, and deferred salary sacrifice plans, has remained set at $1,000 and $5,000 respectively since 1997, limiting the attractiveness and putting downward pressure on take up rates of salary sacrifice plans amongst employees.

The tax-exempt plan allows individuals to acquire $1,000 worth of shares in their organisation, not subject to income tax, provided they satisfy a restriction period of three years (unless they cease employment) and are under $180,000 income threshold. It has been a consistent offering for organisations since its inception; however, the $1,000 limit does not strike true with regards to perceived value for individuals anymore. Currently, the UK employs a similar style tax-exempt plan with the value at 3,600GBP; having a significantly higher benefit for individuals fostering a culture of ownership within their respective organisations.

The current limits imposed on tax deferred salary sacrifice plans has led to a decreased popularity of these plans over the years, with only a small number of Australian companies offering this arrangement to their employees. Increasing the $5,000 limit, in our opinion, may increase the popularity of the plan and make them significantly more attractive to employees.

We have observed organisations opting to roll out alternative salary sacrifice arrangements that do not take advantage of the tax concessions available in Australia. These arrangements include plans incorporating post-tax salary sacrifice contributions from employees with matching shares or share rights granted to employees. These plans have generally led to higher take-up rates than tax deferred salary sacrifice schemes, suggesting that the current $5,000 limit may no longer be relevant or attractive.

ORGANISATIONAL AND EMPLOYEE AND BENEFITS

We can foresee an increase in participation and increased employee ownership in Australia as a result of increases to the tax exempt and tax deferred salary sacrifice limits. However, we are not in possession of quantitative evidence to highlight the size of the increase to the limits that would lead to a meaningful increase in participation rates, and the subsequent flow on positive impacts.

[1]Graw, Stephen (2016) *Taxing employee share schemes.* In: [Presented at the 28th Australasian Tax Teachers Association Conference]. From: ATTA 2016: Australasian Tax Teachers Association Conference 2016, 20-22 January 2016, Sydney, NSW, Australia.