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Thursday, 19 March 2020

Mr. Jason Falinski MP
Chair
House of Representatives Standing Committee on Tax and Revenue
Parliament of Australia
PO Box 6021
Parliament House
Canberra ACT 2600

Also by Email: ***TaxRev.reps@aph.gov.au***

Dear Chair,

The American Chamber of Commerce in Australia (AmCham) is writing in response to the House of Representatives Standing Committee on Tax and Revenue's inquiry into the Tax Treatment of Employee Share Schemes (ESS).

Employee Share Schemes perform a key role in aligning the interests of employers and employees by motivating and driving the productivity of employees. U.S. ESS allows retiring employees to retain the ESS rights or shares (ESS Interest) and defer taxation until they become fully vested and the value can be determined. The law in Australia on the other hand, as presently enacted, may see Australian retirees being taxed unfairly where unvested or not fully vested ESS interest are taxed upon termination of employment. This has the potential to impact both the performance of businesses and the Australian economy. We recommend that the law be amended to remedy this potential injustice.

The American Chamber of Commerce in Australia - better known as AmCham - was founded in 1961 by Australian and American businesses to encourage the two-way flow of trade and investment between Australia and the United States, and to assist its members in furthering business contacts with other nations. In pursuing this goal, AmCham has grown and diversified. It finds itself not only representing the United States' business view, but also speaking increasingly for a broad range of members involved in the Australian business community.

Direct U.S. investment in Australia is worth nearly $900 billion, or 27 percent of all foreign investment in Australia which makes it, by far, the largest single foreign investor in Australia's total FDI stock. Furthermore, the cumulative two-way investment relationship between Australia and the U.S. totals over $1.7 trillion.

The Issue in Detail

Many ESS arrangements contain restrictions on when an employee can exercise or dispose of an ESS interest, and rules that provide a real risk of forfeiture or loss of the ESS interest during the period of restriction. An ESS Interest with such restrictions and/or risk is said to be 'unvested' or 'not fully vested' (that is, the employee cannot realise the 'value' of the ESS interest). The ESS interest is said to be 'fully vested' when the restriction period ends and the employee is no longer at risk of forfeiture or loss of the ESS interest.

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The then Minister for Small Business, Mr Bruce Billson, stated in Parliament in 2015;[1]

> *"An effective employee share scheme can support those hard-working women and men out there having a go.*
>
> *Employee share schemes can drive growth in jobs and growth in productivity—important ingredients in a healthy economy.*
>
> *Employee share schemes offer employees a financial interest in the company they work for—aligning the interests of employees with the interest of their employers. This synchronicity of interests and objectives can drive innovation, entrepreneurship and enterprise success.*
>
> *Both shares and options provide employees with a direct interest in the performance of the firm. They can turn out to be very lucrative for employees of successful companies.*
>
> *These schemes encourage positive working relationships and reduce staff turnover.*
>
> *Employee share schemes benefit employers, too.*
>
> *They are a very valuable tool for employers to attract and retain talented employees."*

The ESS taxation rules help to support hard working Australian women and men by deferring the point of taxation on unvested ESS interests until the interest is fully vested and the employee can realise the benefit and pay the tax properly due. However, if the employee retires before the ESS interest is fully vested, the ESS taxation rules will tax the retiree on the 'value' of unvested ESS interests whether or not the value has been received or may ever be received.

It is inconsistent and unfair to allow the deferral of tax on unvested ESS interests for employees but to tax retirees on such interests, further marginalises older Australians by discouraging their participation in ESS arrangements as they get closer to retirement, or their ability to retire. It is an antithesis of the central premise of an income tax; to tax something that has come in - to instead tax something that is no more than anticipated, and may never come in. The Committee should therefore recommend a change in the law to defer taxation of retirees on unvested ESS interests until such time that the retiree is able to realise the value of the ESS interest.

Taxing Point of Equity from Employee Share Schemes

The ESS taxation arrangements contained in Division 83A of the *Income Tax Assessment Act (Cth) 1997 (ITAA97)* sets out the legislative architecture to tax ESS interests provided to employees in respect of their employment, including timing rules about when these interests will be subject to taxation.

The default rule is that an employee is taxable on the value of an ESS interest when they receive the interest. However the division will defer the time of taxation for an ESS interest to the earlier of;

1. When the ESS interest is fully vested in the employee (that is, there are no restrictions on the interest) if at the time the employee acquired the interest, there was a genuine restriction on their disposing or exercising the interest and there was a real risk that the employee would forfeit or lose the ESS interest (without disposing or exercising the interest);
2. **The employees employment ends – including on retirement;**
3. Fifteen years after the employee acquired the ESS interest; or
4. If the ESS interest is a right to acquire a share, the employee exercises the right and their interest in the share is fully vested.

The Explanatory Memorandum to the *2015 Amending Bill*[2] stated (at [1.48]);

> *"The deferral period for ESS interests covered under deferred taxation schemes is limited by the ESS deferred taxing points **to ensure fairness**, continue to align the interests of the employer and employee, and preserve the integrity of the tax system by preventing unlimited deferral of tax on employment remuneration." (Emphasis Added)*

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[1] Second Reading Speech in support of the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* (the *2015 Amending Bill*)
[2] *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015*

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Tax can be deferred on an ESS interest of an employee until the interest is fully vested in the employee. The Explanatory Memorandum to the bill that introduced Division 83A[3] stated (at [1.128]):

> *"It is considered appropriate for tax to be deferred on ESS interests that the employee may never in fact receive".*

The Explanatory Memorandum also stated (at [1.43]):

> *"Providing for deferral of tax ..... recognises that the employee may never have a chance to realise the economic value of the ESS interest, and that having employee remuneration 'at risk' in this manner is consistent with the purpose of concessionally taxing employee share schemes, to align the interests of employees and employers."*

It is fair that the ESS taxing rules defer the incidence of taxation on ESS interests until such time as the employee can actually realise the value of the ESS interest (and pay the tax). However, it is not fair that where an employee retires with ESS interests that has not fully vested, she or he is forced to either relinquish that interest, or pay tax on the 'value' of the interest in circumstances when they have not actually received the 'value' and may never receive the 'value'.

The 2009 Productivity Commission report into Executive Remuneration In Australia (PC Report)[4] examined deferral under the ESS rules and stated (at page [334]) that a:

> *"general principle of income taxation is that it should apply in the year that income is derived. A conceptually neutral income tax system would tax taxpayers on the value they receive, irrespective of the form in which that value is provided"*

The PC Report went on to state (at page [341]):

> *"The requirement that employees must pay income tax on equity at termination of employment creates a disincentive to defer equity beyond retirement for executives and is thus contrary to best practice governance promoted in Australia by the prudential regulator and overseas. Further, it maintains an inconsistency in the Government's approach where taxation on performance-contingent, unlisted rights can be deferred until vesting where the employee continues employment, but not in circumstances where this employment ceases. In circumstances* ***where deferral is deemed appropriate during employment it is not clear why it is no longer appropriate after termination.****" (Emphasis Added)*

The Productivity Commission thus recommended (Recommendation 13) to Government that:

> *"The Australian Government should make legislative changes to remove the cessation of employment trigger for taxation of equity or rights that qualify for tax deferral and are subject to risk of forfeiture. These equity-based payments should be taxed at the earliest of: the point at which ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares."*

The then Government did not support this recommendation. However, AmCham submits that given the manifest unfairness of taxing retirees on 'value' that they have not received, the disincentive created by this taxation rule and the inconsistency with how employees are taxed, the Committee should review the recommendation and support it.

Thank you for your consideration, and for this opportunity to submit AmCham's views to this inquiry. We welcome any queries you have regarding our submission and any opportunities to further engage in the consultation process.

Kind Regards,

April Palmerlee
Chief Executive Officer

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[3] *Tax Laws Amendment (2009 Budget Measures No. 2) Act 2009*
[4] Productivity Commissioner Inquiry Report No. 49, 19 December 2009, Executive Remuneration in Australia