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Commitee Secretariat
Parliament House
PO Box 6021
CANBERRA ACT 2600

By Email: *TaxRev.reps@aph.gov.au*

Dear Sir/Madam

INQUIRY INTO THE TAX TREATMENT OF EMPLOYEE SHARE SCHEMES

1. Thank you for the opportunity to provide comments to the House of Representatives Committee on Tax and Revenue in respect to their inquiry into the tax treatment of employee share schemes ("**ESS**").

2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service many businesses that would be impacted by any changes to the taxation of an employee share scheme.

3. We refer to our previous submission that was made on 8 May 2019 to the Consumer and Corporations Division of the Treasury. In that submission, we indicated that one the greatest impediments to the middle market in using ESS arrangements was the taxation treatment of such arrangements. We still hold this position and thus have reiterated those key concerns in this submission.

4. Unless such issues are addressed, we do not believe that there will be a significant uptake in the use of ESS arrangements in the middle market. We believe that this would be unfortunate, as ESS arrangements provide the opportunity for employees to have a vested interest in the success of small business and to be rewarded together with the success of the business. Accordingly, there are significant economic benefits that would flow from a fully effective ESS regime.

5. We have included our comments relating to the key questions posed in the Terms of Reference in Appendix A as well as detailed comments with respect to the key tax

considerations for ESSs in Appendix B which highlight many ways in which the tax treatment of ESSs can be improved.

[redacted]

Yours sincerely

A M KOKKINOS
Executive Director

APPENDIX A – COMMENTS REGARDING TERMS OF REFERENCE

6. In response to the Terms of Reference to the inquiry in relation to ESSs for “start-ups”, we note:

   6.1. Our view of the 2015 ESS changes is that they were very effective in increasing the consideration of, and adoption of, ESSs in this sector. These concessions in particular have reduced the administrative and tax-based barriers that previously limited participation in ESSs by these companies.

   6.2. The ESS provisions remain highly relevant to start-up companies and our recommendation is for these concessions to be retained. As noted further in this submission, taxation issues remain a significant barrier to entry for companies that do not qualify for the start-up concessions, and removal of these concessions we anticipate would result in an immediate reversal of the level of interest and enquiry of ESS in this sector.

   6.3. Our experience is that start-up companies primarily adopt option plans, as opposed to share plans. This primarily stems from the fact that:

      6.3.1. Where there is value in the underlying share, it defers the need to consider how employees fund the purchase price of the share (refer to *Treatment of Loans* and *Division 7A* commentary in Appendix B to this submission);

      6.3.2. Share Options are less burdensome to administer. Share schemes have additional complexities to manage on employee exit events such as share buy-back rules (also referred to in Appendix B below);

      6.3.3. Start-ups often do not have a medium-term expectation of paying dividends, diluting the value proposition associated with a share as opposed to an option.

   6.4. The Australian Taxation Office’s (“**ATO**”) template Plan Rules have been effective in reducing the legal costs associated with implementing an ESS. However, this has led to a significant number of companies considering implementing an ESS without obtaining legal advice, which we see as concerning. We recommend:

      6.4.1. The ATO include a strong caveat relating to use of the standard documents, recommending that companies still seek professional advice before adopting an ESS;

      6.4.2. Inclusion of added guidance in the standard documents such as key planning considerations a company should consider before adoption (with a view to lowering the commercial risk associated with adoption of an ESS without specialist advice);

      6.4.3. Simplification of the regulatory relief guidance in the documents. The current commentary in respect to the provisions of the *Corporations Act 2001*, the ASIC Class Order, and other potential relief mechanisms, could be made clearer. This is especially important in view of the limited use of relief under the current ASIC Class Orders. We are concerned that companies relying on the ATO standard documentation (and without seeking legal advice) may not be appreciating the regulatory considerations when making offers to employees.

7. In response to the Terms of Reference to the inquiry more generally, we note:

7.1. Our clients are predominantly unlisted private companies.

7.2. Our view of the 2015 ESS changes is that extension of the deferred taxing point for ESS interests that are options (i.e. to the time of exercise) has seen companies that are not "start-ups" give more considerations to the implementation of ESSs via option arrangements.

7.3. However, our view is that the tax complexities of ESSs remain a significant hurdle to navigate and continue to be the primary barrier for unlisted private companies considering an ESS.

7.4. The tax complexities include:

7.4.1. Tax based hurdles in respect to helping employees fund the acquisition of shares, or exercise of share options (particularly the limitations posed by Division 7A);

7.4.2. Tax based hurdles associated with the taxation of ESS generally manifesting at a time where there is no liquidity available in the instrument to support the tax payment (whether at grant, vesting or exercise); and

7.4.3. Taxation complexities in managing employee exit events and unwinding of arrangements.

7.5. We attach at Appendix B, our detailed commentary on these issues.

7.6. In respect to the more common arrangements adopted by unlisted private companies, the more common arrangements tend to involve either:

7.6.1. Loan-backed share arrangements (where the company provides a limited recourse loan to fund the acquisition of the share). This is despite the significant planning hurdles of Division 7A and the tax treatment of exit events and off-market share buy-backs.

7.6.1.1. Companies that adopt these plans tend to prefer to manage these complexities rather than manage the risk associated with the ESS provisions creating a taxation event when there is no liquidity, and/or are unaware of the complexities around cancellation of the arrangements on employee termination; or

7.6.2. Share Option plans either taxable under the deferred taxation provisions, or with an issue price at the Share Option's fair market value at the date of grant.

7.6.2.1. Where the plan involves deferred taxation, the schemes endeavour to align the exercise time to a liquidity event, which is not necessarily easy to do.

8. In addition to the taxation hurdles, we note some additional non-tax-based hurdles faced by unlisted private companies from implementing an ESS:

9. **Privacy concerns (employees being aware of other employee offerings) and the high cost of using employee share trusts to alleviate this** – Employee share trusts provide an added advantage of allowing employees to maintain their privacy (e.g. their fellow employees could simply search ASIC to find out the shareholders of the company and the quantum of shares held). However, employee share trusts are complex vehicles to manage and require strong taxation advisory support, in addition to the costs generated by the AFSL requirements. As a consequence, it is difficult for employers to be able to make equity offers to employees and maintain their privacy.

10. **Administration concerns on exit –** Most small and medium businesses do not want to retain departed employees on their equity register, meaning the exit of an employee requires an exit event. We note in Appendix B the taxation complexities associated with this, but this also creates funding issues for the company. This tends to limit the range and quantity of employees that such companies are willing to consider for participation in the ESS. The narrower the employee class (and more senior) the lower the expected turnover of staff who hold shares reducing the obligations on exit as well as tax and reporting considerations. These concerns undermine the potential benefits of broader participation in the ESS.

APPENDIX B – DETAILED COMMENTS REGARDING TAX ISSUES

11. We provide here detailed comments with respect to key tax considerations for ESS that we believe are currently acting as an impediment to the middle market using ESS to reward employees. While we acknowledge that changes to these rules may come at a cost to revenue this is uncertain as, in our experience, we find it rare for small and medium businesses to enter into ESSs which are taxed upfront. Consequently, we believe that changes to the tax treatment of ESSs will primarily result in more businesses in this market entering into such arrangements rather provide a tax saving for those that would enter into such arrangements under the current rules despite the adverse tax outcomes.

12. Our comments in this Appendix relate to:

    12.1. the taxing point for employees;

    12.2. share buy-backs of employee shares;

    12.3. the implications of Division 7A where loans are used to fund ESSs;

    12.4. availability of the capital gains tax ("**CGT**") discount on a disposal of employee shares;

    12.5. dividend imputation in respect of certain employee shares;

    12.6. CGT rules where employee share trusts are used; and

    12.7. valuation requirements.

13. A common theme that arises out of our comments below is that the rules can often result in funding pressures in relation to the ESS that discourage many unlisted businesses from entering into ESSs.

Taxing point for employees

14. The legislative framework in Division 83A of the *Income Tax Assessment Act 1997* ("**ITAA 1997**") broadly results in the taxing point occurring at a time before the employee has cash to fund the tax liability (in addition to the liability to pay a premium or exercise price where applicable). This creates a material and often insurmountable hurdle for companies, especially those not seeking a trade sale or IPO in the medium term. Further, this often encourages the employee to sell the share, defeating a key purpose of implementing the scheme in the first place.

15. For most small and medium businesses which operate through unlisted companies, the sale may be impractical due to there being no liquid market for the shares or otherwise restricted by a shareholders' agreement. Although a share buy-back by the company can provide a means for the employee to liquidate their shares, this cost would need to be funded by the company and may give rise to further tax issues (see below).

16. The taxing point occurring prior to the receipt of cash by the employee is the key barrier limiting the prevalence of traditional ESSs and results in business seeking to

use other arrangement (e.g. loan plans). Alignment of the due date of the tax liability to the cash receipt would, in our view, remove the most significant factor that discourages employees from participating in ESSs.

17. This could be achieved in a manner similar to that which applies to deferred settlements for the sale of CGT assets – see *Taxation Determination TD 94/89*. The gain or assessable amount could be calculated in the exact same way but only becomes certain once a sale occurs. The employee would then have the obligation to amend his or her tax return with an unlimited period to do so.

Share buy-backs

18. Division 16K of the *Income Tax Assessment Act 1936* ("**ITAA 1936**") contains the income tax rules in respect of share buy-backs. One of the features of the rules for off-market share buy-backs is that the shareholder is deemed to have disposed of their shares at their market value where this is greater than the buy-back price – see subsection 159GZZZQ(2).

19. Take the example where the employee originally purchased their shares for full value but funded this with a limited recourse loan from the company on the condition that if they cease employment the company will be able to buy-back the shares as consideration for waiving the employee obligation to repay any remaining loan. Despite otherwise dealing at arm's length, the provisions would deem the employee to have received the full market value if it exceeds the remaining loan balance.

20. This results in a further (unfunded) taxation liability for the employee as well as a further need to value these unlisted shares to determine this.

21. A carveout for employee shares from this deemed market value rule would prevent this adverse outcome on exit which acts a further discouraging factor for employees and employers when considering whether or not to participate in an ESS. Additionally, an exemption from section 45B of the ITAA 1936 for certain employee shares would provide certainty that any exit sourced from the employer company's share capital will not be taken to be a dividend paid to the employee.

Division 7A

Treatment of loans to fund ESS

22. The rules in Division 7A of Part III of ITAA 1936 seek to treat a payment, loan or debt forgiveness provided by a private company to a current or former shareholder (or their associate) as a deemed dividend where the company has profits.

23. Notably, Division 7A does not apply to future shareholders. This creates an arbitrary outcome where a private company can, without any Division 7A consequences, lend to an employee for the purpose of their initial acquisition of shares in the company (i.e. a once-off lending opportunity). Afterwards, the employee becomes a shareholder and Division 7A will apply to any subsequent loans.

24. Any future loans will need to charge interest at a benchmark rate, be for no longer than 7 years and require a repayment of principal and interest every year. This in turn

provides another near insurmountable funding pressure on the ESS arrangement, as unlisted businesses cannot typically sustain dividend flows to allow the employees to meet these annual repayments nor do the employees typically have the personal savings to make these loan repayments. Further, even if the loan repayments are funded by company dividends, the setting off of the dividend against the loan does not result in the employee receiving any cash to pay tax on the dividend that remains fully taxable in his or her hands.

25. An existing Division 7A exception exists for loans used to acquire ESS interests to which certain provision of Division 83-A of ITAA 1997 apply – see section 109NB of ITAA 1936. This means that the terms of the entire loan may not need to comply with Division 7A requirements if it is used to acquire ESS interests at a small (e.g. 1%) discount to their market value but not where the ESS interests are not acquired for any discount (i.e. acquired at their full value). In our experience, this exemption is very limited in application and rarely seen as a viable solution.

26. The inconsistent Division 7A treatment for existing employee shareholders compared to prospective employee shareholders and for shares offered at some discount compared to no discount could be resolved with a broad Division 7A exemption for loans made to an employee to acquire ESS interests in the company.

Debt forgiveness

27. Following on from the example mentioned above in relation to share buy-backs, the market value of the share may have decreased to less than the outstanding loan balance. If the company discharges the loan in full, the excess over the market value of the shares may be considered to be a debt forgiveness.

28. We note that *ATO ID 2003/317* concludes that such a discharge of a loan in these circumstances does not give rise to a debt waiver for Fringe Benefits Tax ("**FBT**") purposes because the transfer of property in full and final satisfaction of a loan is not considered to be a release or waiver. However, a debt forgiveness for income tax purposes can also occur where a debt is extinguished other than by repaying the debt in full – see paragraph 245-35(a) of ITAA 1997.

29. Some further clarity around this issue as well as whether subsection 109F(4) of ITAA 1936 applies as an exception for Division 7A purposes would provide further certainty to taxpayers who have entered into ESS loan plans. Subsection 109F(4) states that an amount of debt is not forgiven where it is discharged by a payment consisting of a transfer of property (e.g. shares).

CGT discount and 12-month holding rule

30. The 50% CGT discount rules include a special rule in Item 9A of the table in subsection 115-30(1) of ITAA 1997. This rule deems employee shares that were acquired as a result of the exercise of a right or option to have been acquired at the time the right or option was acquired only if the acquisition of the right or option was eligible for the concession applicable to "start-up" companies.

31. For companies that weren't start-ups, the employee would be required to hold the shares for 12 months after exercise to be eligible for the CGT discount. This can be

problematic where the proceeds from the sale of the share are needed to fund the tax liability under the ESS rules.

32. Given that the economic gain is made for the period between obtaining the right or option and the ultimate sale of the share, expanding this deemed acquisition time treatment for all employee shares acquired through the exercise of a right or option will provide a further incentive for employees to participate in ESSs.

Employee shares and the 45-day rule

33. Employees who received franked dividends on their employee shares must be a qualified person to obtain the relevant imputation benefits – see paragraph 207-145(1)(a) of IAA 1997. This may require the employee to hold the shares "at risk" for 45 days in the relevant qualification period in accordance with Division 1A of former Part IIIAA of ITAA 1936.

34. The "at risk" requirement is determined by considering the "positions" held by the shareholder and whether these result in the shareholder having a delta of +0.3 or above – former subsection 160APHM(2). The definition of a "position" in former subsection 160APHJ(2) disregards the conditions attached to employee share scheme securities that prevent the holder from disposing of the share. Employee share scheme security is defined in former section 160APHD by reference to Division 13A of Part III of ITAA 1936 (i.e. the predecessor to Division 83A of ITAA 1997) which ceased to have effect from 1 July 2009.

35. This outdated legislative reference should be updated as it otherwise leaves employees in some doubt about their eligibility for imputation benefits in relation to dividends received on their employee shares.

36. Further, we note that a non-recourse loan made to acquire the share can be considered to be a position under former paragraph 160APHJ(2)(f). Paragraph 4.54 of the explanatory memorandum to the *Taxation Laws Amendment Bill (No. 2) 1999* notes that a non-recourse loan repayable up to the value of the shares effectively contains a put option (i.e. a short position).

37. Further to the examples mentioned above, many loan plans for the acquisition of employee shares are funded by such non-recourse loans. Where franked dividends are paid on these shares while such loans remain on foot, there is uncertainty and complexity for employee shareholders in calculating their net position in relation to the shares.

38. An exception to non-recourse loans being considered a position in the case of employee shares, similar to that which intends to disregard the restriction on disposal, would significantly reduce complexity and uncertainty for those participating in ESSs.

Exemptions from CGT events E5 and E7 where employee share trusts used for loan schemes – unlisted companies

39. The rules in Division 83A of ITAA 1997 are meant to be the primary taxing rules for ESS interests. Subdivision 130-D of ITAA 1997 was introduced under the same amending legislation to help clarify the interactions between the main ESS rules and the general

CGT regime to give primacy to Division 83-A during the period of deferred taxation – see section 130-75.

40. The CGT amendments in sections 130-80 to 130-90 also included rules where the ESS interests are held by employee share trusts. In particular, these deem the employee beneficiary of the trust to be absolutely entitled to the underlying share or right held by the trust when they acquire the ESS interest (under subsection 130-85(2)). The beneficiary is provided with a CGT exemption (e.g. from CGT event E5) in relation to this deemed absolute entitlement under section 130-80. Further, the employee share trust and the employee beneficiary are provided with exemptions under from CGT events E5 and E7 under section 130-90 in certain circumstances (e.g. vesting of rights or transfer of shares from the trust to the employee).

41. It is important to note that these rules only apply where the ESS interest is one to which Subdivision 83A-B or 83A-C apply. Sections 83A-20 and 83A-105 set out when these respective Subdivisions apply to ESS interests and a requirement common to both is that the interest was acquired at a discount.

42. Similar to our comments in relation to Division 7A, these rules will therefore not apply to loan funded schemes where full value is provided for the ESS interests but would apply if the interests were acquired at a small (e.g. 1% discount).

43. This creates further risk and uncertainty for employees participating in loan-backed ESSs involving an employee share trust as the ordinary CGT rules would apply. The risk of these CGT events applying could result in the crystallisation of a tax liability for the employee before any cash is received for the disposal of any shares. See our discussion above in relation to the deferred taxing point and treatment of share buy-backs for the issues this raises.

44. Further, where the rules in Subdivision 130-D do not apply there would also be a need to conduct a costly analysis of complex concepts such as absolute entitlement to determine if and when an employee becomes absolutely entitled to the ESS interest against the trustee. The ATO's draft ruling on absolute entitlement (*Taxation Ruling TR 2004/D25*) is yet to be finalised nearly 15 years after its publication due to the uncertainty of this concept.

45. We would support a broader application of the rules in Subdivision 130-D to all ESS interests (whether acquired at a discount or not) where they are held through an employee share trust where the company is an **unlisted company**. This would ensure that loan-backed arrangements are covered for shareholders who do not have a readily available market to liquidate their interests are not taxed on unrealised gains before they have the means to fund the tax liability.

Scope of definition of "employee share trust"

46. We also note that from our experience, the ATO has taken a very narrow definition of the meaning of employee share trust contained in subsection 130-85(4) of ITAA 1997. To meet the definition, the trust's sole activities may only be those listed in the paragraphs of that subsection. In particular, paragraph (c) permits the trust's activities to include those that are merely incidental to those in paragraphs (a) and (b). The ATO has consistently ruled that where the trust lends to the employees to enable

them to acquire an ESS interest that this activity goes beyond one that is merely incidental.

47. We note that the ATO has recently issued Taxation Determination TD 2019/13 which adopts a fairly restrictive view of when an entity can quality as an 'employee share trust' with a single breach resulting in the trust forever being disqualified from obtaining this status.

48. This view results in the CGT exemptions in Subdivision 130-D not applying to the trust or any of its beneficiaries with the resultant complexities outlined above. A relaxation of this overly narrow view will further assist small and medium businesses in implementing and funding ESSs.

Valuation requirements

Valuation of shares

49. Unlisted companies have no liquid secondary market for their shares and therefore do not have a simple means to determine their market value at any point in time. In order to determine the tax consequences of issuing ESS interests, a costly valuation needs to be obtained every time these are issued in order to properly comply with the tax regime (e.g. to quantify what discount, if any, the ESS interests are issued at). Furthermore, there is a significant risk that the assumptions used in such a valuation could be challenged by the ATO, due to the complexity involved in valuing such entities.

50. While recent capital raising or share sale transactions may be used as a proxy, these do not provide certainty that the Australian Taxation will agree with these proxies as being the true market values.

51. Although the ATO has, by way of legislative instrument ESS 2015/1, approved two safe harbour valuation methodologies (the Net Tangible Asset and CFO Valuation methods), these are limited in scope. They can only be used by "start-ups" and not existing mature (albeit small or medium) businesses. Further, various other restrictions contained in Division 83A of ITAA 1997 need to be satisfied before a company can be considered a "start-up" and access the ability to rely on these safe harbour methodologies.

52. The expansion of these safe harbour methodologies to all small and medium businesses (regardless of how long the company has existed) and all kinds of ESS interests would remove a key impediment to the take-up of ESSs. This could be expanded to any company that has an aggregated turnover of less than $50m in the most recent year, consistent with the current requirement in subsection 83A-33(5) of ITAA 1997.

Valuation of options

53. We note that while Division 83A of the *Income Tax Assessment Regulations 1997*, provides useful concessionary valuation tables in respect of ESS interests that are unlisted options and rights, these rules still require the company and its underlying shares to be valued (see regulation 83A.315.02(1)(a)).

54. Further, these concessionary tables only apply for the purposes of Division 83A of ITAA 1997 and not for other purposes. For example, if an employee acquires options using the concessionary values contained in the regulations, these may still be considered to be acquired at below market value of the purposes of Fringe Benefits Tax ("**FBT**") creating a residual tax exposure for the employer.

55. Broadening the scope of safe harbour valuation methodologies and aligning the income tax and FBT treatment of ESS interests will simplify the valuation requirements and remove some of the significant barriers to companies implementing ESSs or expanding their current ESSs.