



**AUSTRALIAN BANKERS' ASSOCIATION INC.**

---

David Bell  
Chief Executive Officer

Level 3, 56 Pitt Street  
Sydney NSW 2000  
Telephone: (02) 8298 0417  
Facsimile: (02) 8298 0402

---

24 July 2009

Mr John Hawkins  
The Secretary  
Senate Economics Legislation Committee  
P O Box 6100  
Parliament House  
CANBERRA ACT 2600  
[economics.sen@aph.gov.au](mailto:economics.sen@aph.gov.au)

Dear Mr Hawkins,

**Economics References Committee Inquiry into employee share schemes**

The Australian Banker's Association (ABA) welcomes the opportunity to make a submission to this inquiry. Our submission makes three recommendations regarding the taxation rules applying to employee share schemes and one recommendation regarding the coordination of legislative changes.

Our tax recommendations are:

- Termination should be removed as a taxing point for shares, options and share rights (i.e. nil-priced options);
- The taxing point for shares and share rights should be at vesting, that is when service restrictions, disposal restrictions and any performance hurdles are satisfied, and within 7 years of grant; and
- The taxing point for market priced options, which require an exercise price to be paid, should be at the point the option is exercised (within 7 years from the date of grant).

These adjustments to the proposals will allow vesting periods that run their full course, supporting long-term decision making of executives even beyond their employment period.

**Termination should be removed as a taxing point**

Termination should be removed as a taxing point for employee shares, options and share rights. This will support longer term holding and shareholder alignment, and will provide a fairer outcome for employees themselves. Any concerns over tax avoidance can be readily addressed through appropriate disclosure and reporting obligations.

Economics Reference Committee Inquiry into employee share schemes

Under the current rules, when an employee leaves an organisation, their employee shares/options/rights are subject to taxation in that same financial year. This is the case, even if the ex-employee is prevented from selling these securities by selling restrictions imposed when the shares were granted.

The current tax rules create negative outcomes for:

- employees, who must come up with the funds to pay tax on a security that may never realise any value (for example for underwater options), unless an employer allows premature vesting to cover the tax liability;
- shareholders, because it promotes vesting periods that end when employment ends which supports short-term executive decision making behaviour<sup>1</sup>; and
- businesses, who may feel compelled to allow the vesting of a portion of shares/options to cover an employee's tax liability, but where the underlying shares do not eventually vest. (In this case employees could receive a windfall if they request a refund of the tax paid, with the effect that they realise value from shares/options that did not in fact ever vest.)

### **The taxing point for shares and share rights at vesting**

Shares and share rights do not require the payment of an exercise price to vest.

The ABA recommends that to mitigate the negative effects of tax when an employee terminates, that the taxation point for shares and share rights should be at the time that all service restrictions, disposal restrictions and any performance hurdles are satisfied, even if this is after an employee's termination.

Genuine restrictions, which allow for a deferral of the taxing point, should be defined as restrictions which serve the commercial objectives of the employer. Forfeiture restrictions such as gross misconduct or fraudulent behaviour are real restrictions designed to influence employee behaviour.

Whilst forfeiture in these circumstances may be unlikely, they can be distinguished from sham scheme arrangements (e.g. "if the sun does not rise tomorrow") which are clearly not aligned with commercial objectives. Whilst the ABA supports moves against sham arrangements, this should not be at the expense of genuine commercial arrangements.

### **Taxing point for market priced options should be at exercise**

However, due to the requirement to pay an exercise price, the taxing point for options should be at the time the option is exercised, and not at the time the option vests.

An option is the right to acquire a share at a point in the future, at a price set at the time the option is struck ('exercise price'). For the employee, the value of an option is the difference between the underlying share price and the exercise price. For example, if Bank X's share price is \$30 and the exercise price is \$20, the intrinsic value of the option is \$10.

---

<sup>1</sup> The ABA notes APRA's proposed prudential practice guidance (PPG 511) on remuneration (paragraph 53) states: "*Particular attention should be given to the length of the deferral periods of equity-related remuneration components to ensure executives maintain a long-term view, even when approaching the end of their employment contracts.*" (APRA's proposed 'PPG 511 – Remuneration' is available at [www.apra.gov.au](http://www.apra.gov.au)).

However, if Bank X's share drops below \$20, then the intrinsic value of the option will be Nil, i.e. the option is 'under water'.

Under the current proposals, taxation on options is triggered once selling restrictions are lifted - even if the option is 'under water'. While the option is under water, the employee cannot realise any value from the option, yet the tax office will apply a formula to estimate its present value and levy the tax on that estimated value. (The idea behind this being that in time positive value will accrue to the option).

The ABA recommends that the appropriate fix to this problem is to shift the taxation point for market priced options to the point the option is exercised, and value can be realised from the underlying share.

### **Coordination between inquiries**

The ABA's final concern relates to the coordination of inquiries and legislation regarding remuneration. Currently, APRA is undertaking a review of remuneration principles to be included in the prudential framework; the Productivity Commission is undertaking a comprehensive review into executive and director remuneration.

Yet, the Government has pre-empted these reviews by initiating legislation {(a) employee share schemes, and (b) termination pay limits} that significantly impacts incentives in remuneration setting. The risk is that we end up with legislation that runs counter to the recommendation of the Productivity Commission and runs inconsistently with APRA's guidelines.

In one sense it would be better to delay the employee share scheme legislation until the Productivity Commission and APRA have finalised their reviews. But the problem is that the banks want certainty as soon as possible over their employee share scheme arrangements, so ABA's preference is for legislation to proceed quickly, albeit with the changes outlined above.

Yours sincerely,

---

**David Bell**