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Australian Senate Economics Reference Committee
PO Box 6100
PARLIAMENT HOUSE
CANBERRA ACT 2600
Via email to: economics.sen@aph.gov.au

22 July 2009
Our Ref: SM/PB/ar

Re: Submission on inquiry into the operation of employee share schemes in Australia

This submission is made in response to the Senate's inquiry into the operation of Employee Share Scheme (ESSs) in Australia which was referred to the Economics Reference Committee on 23 June 2009.

The Government has proposed substantial reform to the tax rules governing ESSs in Australia (currently included in Division 13A of the Income Tax Assessment Act 1936 (ITAA 1936)). The Policy Statement released by the Assistant Treasurer, Senator Nick Sherry, on 1 July 2009 (Policy Statement) confirmed the Government's final position on the proposed changes to the taxation of ESSs. In this regard, the Government confirmed that it was adopting the changes outlined in the ESS Consultation Paper (Paper) and the preliminary draft bill that were issued on 5 June 2009, subject to several minor modifications.

The proposed changes address a number of the concerns which have been raised by industry since the initial measures were announced in the 2009 Federal Budget. However, in our view some important modifications are still required to the Government's proposals in order to:

- Better achieve the Government's stated objectives of encouraging broader based share plan ownership, ensuring greater tax compliance and protection of the revenue base.
- Balance the economic fairness to employees by providing access to certain tax exemptions where appropriate in light of the terms and conditions attached to the equity awards

We have provided detailed comments on each of the main unresolved issues, as well as other aspects raised by the Government in the Paper and the proposed amending legislation, where appropriate in the attached Appendix. The desire to re-write the proposed new ESS legislation into the 1997 Act also provides an opportunity to address certain aspects of existing law which do not work as intended.

Recommended modifications to the proposals or existing law are outlined in boxes (where applicable).

In summary, the key issues we have addressed in this submission are as follows:

1. The deferred taxing point based on real risk of forfeiture
2. Termination of employment as a deferred taxing point
3. Limits applicable to tax concessional plans
4. Shares and rights awarded in respect of foreign service
5. New annual reporting requirements
6. Refund of income tax for forfeited benefits
7. Adjusting or replacing underwater options
8. Consequential amendments

Deloitte would be please to assist the Economics Reference Committee with providing further background information on the benefits and taxation issues associated with employees participating in an ESS. We have discussed these issues with a number of clients who, along with Deloitte representatives, would be willing to discuss or meet with appropriate personnel from the Economics Reference Committee in relation to these matters.

If you wish to discuss any aspect of our submission, please contact Paul Baillie on (02) 9322 5792 or me on (02) 9322 7511.

Yours sincerely

Sally Morton
Director, Deloitte Touche Tohmatsu Ltd

Issue 1 - Deferred taxing point based on real risk of forfeiture

The most typical taxing point for shares and rights, pursuant to the Policy Statement, is likely to arise when:

In the case of qualifying shares, there is both no longer a real risk of the taxpayer losing the shares and no restriction (present at acquisition) preventing the taxpayer from disposing of the share

In the case of qualifying rights to shares (options), there is both no longer a real risk of the taxpayer losing the right and no restriction (present at acquisition) preventing the taxpayer from either disposing of the right or exercising the right. However, if after exercising the right the underlying share is subject to forfeiture and restrictions preventing the taxpayer from disposing of the underlying share, it is the point at which there is both no longer a real risk of the taxpayer losing the share and no restriction (present at acquisition) preventing the taxpayer from disposing of the share

The above taxing points reflect modification to the changes that were contained in the preliminary draft Bill. The Policy Statement noted that these taxing points are now more closely aligned with the taxing points under existing legislation.

The fundamental premise of these modified taxing points for shares and rights is still the "real risk of forfeiture", which is an extremely difficult concept to define. The Policy Statement (consistent with paragraph 61.4 of the Paper) suggests that the test to be applied in determining whether there is a "real risk of forfeiture" will be an objective one. That is, would a reasonable person conclude that there is a real risk that the share or right will not come home to an employee by a particular time and be forfeited. We consider that such a test is subjective rather than objective. The uncertain nature of this concept is likely to lead to significant costs for employers who will be encouraged to obtain class rulings from the Commissioner in order to determine the particular application of this test to the company's share plan(s). This will also result in consumption of significant Australian Taxation Office (ATO) resources which is a concern clearly noted at paragraph 106 of the Paper. Based on discussions with clients, we do not consider the preparation of general explanatory and ATO materials to assist taxpayers in applying this principal (as proposed in the Policy Statement) will alleviate these administrative complexities.

Our greatest concern with the particular taxing point is its application to rights, such as options.

By way of example, it is not particularly clear to us when the taxing point would arise if an option award has "vested" but a particular trading restriction exists at vesting e.g. the employee can exercise the option but has no ability to sell the shares until the trading window is re-opened. Arguably, the taxing point in this situation would arise at "vesting" because there is no longer a real risk of the employee losing the right <u>and</u> no restriction preventing the employee from exercising or disposing of the right. However, if the options are then exercised, the above proposal suggests that the taxing point could be deferred until the sale restrictions are lifted. This would mean that employees who choose to exercise their options immediately would be taxed at a later point than employees who choose not to do so and the taxable amount may be very different. This would create issues for employer reporting as well as lack of equity between employees.

We consider there to be a number of additional concerns associated with a taxing point for options arising before exercise:

1. Taxation at a time other than exercise is inconsistent with international norms developed by the Organisation for Economic Co-operation and Development (OECD) and the tax laws adopted by most (if not all) countries with developed taxation regimes. As most countries consider exercise to be the appropriate taxing event for options, the difference in timing and amount of taxation will lead to a number of double taxation issues (such as timing and amount of foreign tax credits and ability to amend within statutory limitations) for employees working both in and out of Australia during the period between the grant and exercise of options.

2. This treatment is counter-intuitive to the stated policy objective of the Government (and indeed will undermine of the key objectives of employee share plans), being to encourage employees to acquire shares in their employing entity to align employees interest with those of shareholders. A taxing point for options prior to exercise, i.e. prior to the moment when the employee would ordinarily choose to exercise and realise the economic gain on the shares, may force many participants to immediately exercise the options and sell the underlying share in order to fund the tax liability and mitigate any risk associated with holding the shares.

3. The options may be underwater at the moment of taxation (i.e. where the exercise price is more than the underlying share price). In many of these cases the taxable value (per the deemed valuation tables) is likely to be relatively low with the consequence that the overall tax collection is likely to be less than under current law. This is because the subsequent exercise event would not be taxable, such that employees who then hold the shares for 12 months after exercise obtain discount capital gains tax treatment on a large portion of the ultimate gain.

4. On the other hand, if the options remain underwater until expiry of the award, employees would not be able to claim back the taxes paid at the deferred taxing point (refer to issue 6 below)

With respect to 3 above, taxation prior to exercise will place a greater burden on employers to determine the value of options under the option valuation rules. These are the very rules that the Government remains concerned about in that, as expressly stated in the Paper at paragraph 98, they result in a systematic undervaluation and therefore frequent under taxation. Should the valuation tables ultimately be replaced with a more consultative approach to ascertaining market value, as the preferred in principle approach suggested at paragraph 83, many companies would likely seek clarification from the Commissioner on the value of their options or potentially be forced to wear significant costs to obtain an appropriate valuation. This administrative issue may be magnified where multiple vesting dates occur during a year (e.g. where new starters are granted awards at different dates to the main award during the year) and companies may be forced to limit the number of vesting dates. Further, we understand at present that the ATO will not usually provide ruling requests on valuation methods. We propose that retaining an ESS deferred taxing point for options at exercise rather than when there is no longer a real risk of forfeiture and no restrictions (set at acquisition) preventing the disposal or exercise of the right, in alignment with existing law, will alleviate the issues identified above. In consideration of the above, it would appear particularly onerous if this treatment was not at least retained in respect of options which are issued to employees at or above market value, i.e., where the underlying share price at grant is equal to or more than the exercise price payable by the employee. In this regard, exercise is a clearly definable and certain term that is globally well understood. The calculation of the gain at this point is straight forward (no valuation is required) and in most cases the quantum will be greater, thus protecting the revenue base.

It is worth noting that in the United States, discounted options or nil priced options such as restricted share units (where the exercise price is less than the market value of the underlying shares on the date of grant) may be considered nonqualified deferred compensation and therefore subject to taxation at the moment of vesting rather than at exercise.

Deloitte recommended approach

That the deferred taxing point for options and other rights to acquire shares be no earlier than the time of exercise (subject to the 7 year deferral limit) OR

At the very least, that the deferred taxing point for options issued at market value (or above) be no earlier than the time of exercise (subject to the 7 year deferral limit)

Issue 2 – termination of employment as a "deferred taxing point"

Proposed section @83A-110 retains termination of employment as an ESS deferred taxing point. This unique taxing event, which we are not aware creates a taxable event in any other country, has resulted in significant tax liabilities to employees on benefits that they are not able to realise for some time. Indeed, the employee may never be able to realise the full "taxable value" of the benefit (in line with the issue identified in point 1 above where the share price subsequently falls).

It is also a strong point of conjecture with Australian Prudential Regulation Authority and the Productivity Commission who have been tasked with reviewing risk in executive pay. Early indications were that an extension of vesting beyond cessation of employment was desirable in order to align executive reward with the risk of business and investment decisions. This is consistent with developing practice in the United States and other markets that are reviewing pay risk practices.

At paragraph 68 it is stated that considerable tax integrity issues would arise if it is removed as a taxing point because, amongst other things, employees may move overseas after ceasing employment making it difficult for the ATO to collect any tax. In our experience, the number of individuals that would retain equity awards where the new employment overseas is not within the same corporate group (thus triggering a deferred taxing point on termination) is extremely limited. In any case, with a stringent reporting system in place, as proposed, we consider that the fear of losing revenue if this taxing point were removed would prove baseless. Nevertheless, in acknowledgment of the Government's comment, we consider that any potential collection of tax concerns would be entirely alleviated if tax withholding was introduced in these limited circumstances (similar to the proposals to introduce tax withholding in the limited circumstances where an employee fails to provide their employer with a TFN or ABN)

Deloitte recommended approach

1. That the proposed "deferred taxing point" be amended to exclude termination of employment AND

2. That income tax withholding be introduced in the limited circumstances where an employee retains equity awards following termination of employment with the corporate group

Issue 3 – Limits applicable to tax concessional plans

$1,000 Tax Exemption Plan

The Government has proposed to introduce a means test for access to the $1,000 tax exemption such that only employees with an adjusted taxable income of $180,000 (top marginal tax rate) can qualify.

The introduction of a threshold creates considerable uncertainty for employees as well as a compliance burden for companies. At the time an employee chooses to participate in a tax exempt plan, it will not always be clear as to whether or not the employee will qualify for the A$1,000 tax exemption. Failure to qualify for the tax exemption will mean that the employee will necessarily be taxed on the discount on the grant date even though the shares cannot be sold for a further 3 years (one of the key conditions that must be imposed in order for the tax exempt plan to work). This uncertainty will also mean that the employing entity will not be clear on its specific reporting obligations under the proposed new reporting rules in terms of disclosure of the appropriate taxable amount to the ATO and each employee.

Salary sacrifice plans

The Government has proposed to introduce a $5,000 per annum threshold in respect of the maximum amount of salary sacrifice shares, purchased through pre-tax salary income, which can qualify for tax deferral. Under existing law, there are no thresholds as such and many of our clients offer their employees, particularly at the management and executive level, access to share ownership through the use of salary sacrifice arrangements. We are not aware of any clients, or non-clients for that matter, who have not suspended the operation of their salary sacrifice plans since the Budget announcement on 12 May, 2009.

We have discussed the above issues with a number of clients, strong advocates of the tax exempt plan and/or salary sacrifice arrangements as an effective tool for rewarding and incentivizing their broad based employee population.

With respect to the tax exempt plan, many have commented that due to the relatively modest concession of $1,000 per employee per year (which has not been increased since the original employee share scheme rules were first enacted in 1995) and in consideration of the above it is becoming cost prohibitive to continue to operate a tax exempt plan. As such, we consider there will be a significant reduction in the number of companies operating a tax exempt plan if the proposed changes are enacted without further amendment.

With respect to salary sacrifice arrangements, clients have also commented that the introduction of a threshold at $5,000 per annum will, in practice, be considered, too low for many of the employees that typically participate in these plans. This being the case, we are also of the view that the introduction of this relatively low threshold will be cost prohibitive to employers and lead to many companies not reinstating salary sacrifice share arrangements that had previously been suspended.

Deloitte recommended approach

$1,000 tax exempt plan

1. That there be no income test attached to the $1,000 tax exemption AND

2. That the tax exempt amount be increased to $5,000 per employee per year

Salary sacrifice arrangements

That a $15,000 per annum threshold be introduced in respect of the maximum amount of salary sacrifice shares that will be eligible for tax deferral

Issue 4 - Shares and rights awarded in respect of foreign service

Under the existing law, where shares or rights are awarded to an individual while residing outside Australia and that individual subsequently arrives in Australia still holding the shares or rights, the part of the discount on acquisition that relates to the taxpayer's engagement in foreign service while a non-resident is exempt from Australian tax: section 139B(1A) of the ITAA 1936.

The draft legislation does not include any similar provision. Proposed section @83A-325 suggests that the law will apply equally to non-residents and thus presumably the only relief will be a foreign tax credit to the extent that the discount is considered foreign source in accordance with section @83A-15.

This approach is inconsistent with the stated aim of the amendments to the legislation introduced in 2005 to more closely align the taxation of shares or rights acquired under an employee share scheme with international norms developed by the OECD. The explanatory memorandum to the 2005 changes noted "providing a more internationally consistent treatment of employee shares or rights will ensure a fairer and more certain outcome for relevant individuals. It will also assist Australian businesses in attracting skilled workers."

The particular anomaly of the proposed rules applying equally to non-residents is best illustrated by way of example. Assume a non-resident individual was granted an award of shares in the employing entity on 1 July, 2009. The shares vest (i.e. no longer a genuine risk of forfeiture) on 1 July 2011, the day before the commencement of a 3 year Australian assignment. Under the proposed new rules, there is no taxable discount in Australia in relation to the share awards because the individual remained a non-resident during the entire period between grant and vesting. If on the other hand the assignment commenced 2 days earlier (i.e. on 30 June 2011), the entire discount would be taxable in Australia (subject to foreign tax credit relief) as the deferred taxing point arises on 1 July 2011, when the individual is a resident.

In light of the above, if the draft legislation is enacted in its current format, without similar relief to the changes incorporated in the ESS provisions in 2005, this will significantly impact employees arriving in or returning to Australia with pre-existing awards and may reduce Australia's attractiveness as an employment destination for senior executives.

Deloitte recommended approach

The draft legislation should include a specific exemption for the portion of the ESS discount which relates to a period of foreign service while non-resident as contained in the existing law of Division 13A

Issue 5 - Reporting requirements

The cornerstone of improving tax compliance is employer reporting and we strongly support the introduction of these measures. However, the proposals appear to provide for an excessive amount of reporting, with the provision of some irrelevant data to the Commissioner. The Government originally proposed pursuant to section 392-5 of the draft legislation, that an employer would need to report an estimate of the market value of a share or right in the grant year even where the share or right is not subject to taxation until the deferred taxing point. The Policy Statement released on 1 July 2009 subsequently modified the Governments proposals to only require such an estimate at the relevant taxing point, but still requiring the employer to report the number of shares and rights an employee has obtained at both grant and at the taxing point. We propose that the provision of such data should be confined to the year in which the taxing event takes place, be it at grant or in the year the deferred taxing point arises. In this manner, it would be relatively straight forward and therefore an efficient process for the Commissioner to cross reference the number of awards and the employer estimate of the share plan income to the taxable gain disclosed in the participant's tax return.

Deloitte recommended approach

That the draft legislation be amended to only require the employer to report the number of shares and rights an employee has obtained at the relevant taxing point (be it at grant or the year in which the deferred taxing point arises)

Issue 6 - Refund of income tax for forfeited benefits

We support the Governments proposals to amend the existing rules of Division 13A to extend the ability to recoup taxes paid at grant for shares that are subsequently forfeited or do not vest. However, we are concerned with certain aspects of the proposed changes that would apply to rights (such as options). We understand from the Governments Paper (at paragraph 111) that if an option is never "in the money" through until expiry of the award (i.e. the company's share price never exceeds the option exercise price the employee has to pay to acquire the share) an employees would not be able to claim back any taxes paid at the deferred taxing point (assuming this moment arises before exercise). This is because it would be the employee's choice in these circumstances not to exercise the options. In our view, it would not be appropriate for a tax liability to arise in this situation because the employee derives no benefit from the right.

In addition, we note that paragraph 110.2 of the Paper states that there should be no time limit for amending an assessment to claim a refund of income tax for forfeited benefits, which would align with the existing law under Section 139DD(4) of the ITAA36. However, there is no similar provision in the draft legislation. This should be addressed prior to the issue of the Bill.

Deloitte recommended approach

1. That no change be made to the existing law of Division 13A with respect to a refund of income tax for forfeited rights AND

2. That the draft legislation be amended to ensure there is no time limit for claiming a refund of income tax for forfeited shares and rights

Issue 7 – Adjusting or replacing underwater options

It is fairly common in a down turn economy for multinational companies to consider adjusting or replacing employee options which are significantly under water. This is because the options are never likely to be in the money prior to the expiry of the awards and therefore they are of little incentive or economic value to employees.

Under the existing law of Division 13A, such a transaction is likely to be regarded as a "disposal" of the original option and result in a "cessation time" taxing event to participants. The taxable amount in this situation pursuant to Section 139CC(3) of the ITAA 1936 would typically be based on the value of the new option interest being the consideration received for the "disposal". We consider this tax treatment to be fair and equitable in these circumstances (notwithstanding that in many countries such a transaction does not trigger an income tax event to participating employees).

The problem is that the replacement option award may also be taxable under Division 13A resulting in double taxation on a portion of the "discount". This is due to the following:

- The replacement option interest falls within Division 13A where the consideration received for the option (being the original option 'disposed of") is less than the market value of the replacement option

- In this regard, it is necessary to compare the market value of the replacement option (at grant) to the market value of the original option "disposed of"

- The value of the original option is likely to be nil (hence the reason for the exchange) whereas there is likely to be a value to the replacement option under the valuation rules in Division 13A

- To the extent the market value of the replacement option exceeds the market value of the original option, the excess (or discount) will be taxable.

Technically, this will result in double taxation on the discount, as the total value of the replacement option (which would necessarily include the discount element) was already taxed on "disposal" of the original option.

Notably, this double taxation issue can also arise in circumstances where a replacement award is made as a result of a restructure or merger and the particular transaction does not satisfy all of the conditions for roll-over relief (e.g. the replacement options do not match the value of the options surrendered) as set out in Section 139DQ of the ITAA 1936.

Deloitte recommended approach

That the draft legislation be amended to remove the potential for double taxation where replacement option interests are provided to employees that do not qualify for roll over relief

Issue 8 - Consequential amendments

The ESS rules interact with many other legislative provisions such that a number of consequential amendments to Federal and state tax legislation will be required if the proposed modifications to the ESS rules are implemented. These include:

- the capital gains tax rules
- the temporary resident rules
- fringe benefits tax legislation
- the rules governing employee termination payments
- state payroll tax legislation: which was only recently harmonised across all the states to ensure it applied consistently with Division 13A of the ITAA36 to allow for the employer to choose the point at which state payroll tax is imposed on ESS income.