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Guerdon Associates
Equity and Executive Pay

13 July 2009

Mr. John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100 Parliament House
Canberra ACT 2600

Dear Sir

Re: Inquiry into the reform of the taxation of employee share schemes

Summary of main points

The suggested taxation arrangements for employee share schemes makes traditional share option plans inconceivable. Yet these plans are an essential ingredient for facilitating economic growth.

The taxation of deferred equity payments at termination discourages the use of these instruments as executives and other key employees approach retirement. The unintended consequence is that there are fewer controls to ensure management and key employees of Australia's enterprises manage risk for sustainable long-term returns over time. Given that a significant contributor to the world's economic problems has been the absence of these controls, Guerdon Associates suggests taxation regulation amendments to time taxation of performance contingent employee benefits to coincide with vesting of shares and exercise of options, rather than at termination of employment.

About Guerdon Associates

Guerdon Associates is Australia's largest independent consulting firm specialising in board and executive remuneration matters. Our mission is to provide executive and director remuneration, performance measurement, management and governance advice, and employee equity data and solutions that contribute to improved total shareholder returns.

Clients are mainly board remuneration committees of listed and unlisted Australian companies. These include a significant proportion of Australia's largest ASX-listed companies.

Note that as an independent adviser (i.e. as a board adviser we do not also provide services to management), we do not have a conflict of interest that could influence our recommendations on executive pay matters.

Our website is at http://www.guerdonassociates.com.

Introduction

Guerdon Associates welcomes the government's initiatives to review the taxation of employee share schemes and its rapid response to set up a consultation process on its plans. We share the government's concerns that some recipients of share scheme benefits have evaded tax, and encourage more robust methods of ensuring tax evasion is minimised.

However, we do have concerns with the draft regulation as proposed:

- The regulation will in effect kill off traditional share option plans.
- The absence of appropriate option plans will ensure that start up and high potential growth companies essential for the country's economic growth do not attract local and migrant entrepreneurial and professional skills necessary for success
- The regulation does not support global and APRA initiatives to ensure stable maintenance of the financial system through the facilitation of long term equity holdings by "responsible persons"[1]
- The regulation encourages short-termism and less than optimal corporate governance by insisting that cessation of employment be the trigger for tax, rather than the meeting of long term performance requirements and exercise of options
- The regulation discourages the use of salary- and fee-sacrifice share plans as a means of encouraging the alignment of key management personnel's interests with shareholders
- In relation to the above, non executive director acquisition of company shares via fee sacrifice will be untenable
- "Solutions" to circumvent the restriction of the share scheme tax as proposed will result in poor-performing key management personnel being paid as much as good-performing key management personnel in some situations

These and other issues are detailed below.

We conclude with recommendations that may resolve some of these issues.

Taxing on grant rather than realisation will stunt important sources of economic growth

The draft legislation requires taxation on grant, unless there are genuine forfeiture conditions.

The foundation for much of Australia's wealth, particularly in recent decades, has been the ability to attract local and migrant entrepreneurs, professionals and executives to take on challenging, start up and

[1] "Prudential Practice Guide, PPG 511 – Remuneration", APRA, 28 May 2009

immature company management roles for much lower salaries than they could receive elsewhere.

This has been possible because they in effect exchange the security of high salaries for insecure but potentially high value share options. The US technology sector's success would not have been possible without this method of compensation. Likewise, Australia's success in minerals and energy would not have been possible without this.

Typically these options are not subject to forfeiture provisions, as they are provided in lieu of cash salary that these individuals could secure elsewhere[2]. In addition, given that there are extremely limited opportunities to find buyers for shares in these companies, there is in effect no market to sell shares into even if they exercised their options while the company is still immature. Yet the proposed regulation requires taxation to be levied on grant of these share options, at a time when many of the recipients, given their low salaries, would not have the wherewithal to pay, nor the market to sell shares into if forced to exercise their options to pay the tax.

In any case, to have to resort to exercise and sale on receipt of share options to pay tax defeats the purpose of taking on these risky opportunities in the first place. That is, these entrepreneurs, professionals and executives take on the roles believing they can create wealth for shareholders, and thus themselves, via the share options they have taken in lieu of salary. In these cases, it makes sense to levy tax when this wealth is realised, i.e. when the options are exercised.

We note that Senator Sherry has referred the matter of option taxes for start up companies to the Australian Tax Board. In our opinion, it would be extremely difficult both practically and legislatively to make exceptions for employees of companies in certain stages of growth for tax collection purposes. At what stage, for example, does a start up, high potential company suddenly transition to a mature company? What if, as in Silicon Valley in California, there are companies that are permanently set up as "ideas factories" that are in a permanent state of "start up", selling off the ideas for the next stages of growth to others.

Performance or service contingent option plans become unworkable

Many share option plans have performance or service contingent requirements, so meet the forfeiture provisions of the draft regulation. However, moving the taxation point to the time of vesting from the time of benefit realisation makes these plans less attractive and less valuable:

- On vesting (after meeting performance or service criteria) the exercise price of the option may exceed the market price of the option. However, the implication under the legislation is that these options will be taxed at fair value on vesting. Because they are

[2] And that a start up or immature company cannot afford to pay in any case because of cash flow constraints

"underwater" the employee will not be in a position to exercise these options and sell the resultant shares to meet the tax obligation. Hence these shares will fail to meet basic prerequisites for plan effectiveness (i.e. for attraction, motivation and retention). In fact, such plans may motivate good performing employees to terminate their employment to avoid their "reward" vesting.

We note that Senator Sherry has referred the issue of determining the "market value" of share scheme benefits to the Board of taxation. While one alternative they could consider is the intrinsic value of options at vesting (i.e. the difference between exercise price and market price at time of vesting), there are still many other complexities to consider. For example, the market value at time of vesting may be more than the exercise price. But many publicly listed companies do not have a liquid market for their stock. So it may take many days, or weeks, to find a buyer, and by that time the market price has changed. Then there is the difficulty of establishing a value for unlisted companies.

- Many small listed companies and most private companies do not have a ready or liquid market for their shares to be traded. Hence an employee who has received a vested option may not be able to generate any cash from sale of the shares to pay the tax (or even to pay the exercise price of the options).

- Other problems are associated with the taxation of options at vesting. For example, what is an equitable way to value options over unlisted shares, typically also covered by a shareholders' agreement on disposal?

Options are a useful and desirable equity payment vehicle that can help to overcome agency costs for alignment with shareholder requirements. They are well suited as a reward vehicle for start up and high growth companies, and as a reward vehicle to be provided with other equity reward vehicles to balance risk and return requirements in more mature companies.

Given the difficulties, we are strongly of the opinion that share scheme tax should be applicable at the time a benefit from the securities is realised and final value can be validly ascertained. For options and share rights this would be at the time of exercise, assuming that the resulting share can be traded without restriction. If the resulting share is subject to restriction, then tax should be levied when that restriction is lifted.

Non-executive directors receiving equity in lieu of fees will no longer be encouraged

Current governance standards (such as those promulgated by the Australian Shareholders' Association) encourage board non-executive directors to receive equity in lieu of fees.

This practice is now typical in Australian listed companies and non-listed companies.

The form of equity is often share options in small start up or immature companies[3] or shares for directors of Australia's larger companies. However, governance standards dictate that these equity grants must not be subject to forfeiture provisions[4]. To do so would have the potential to conflict with a director's independence. The fact that the equity is also part of fixed pay also means it would be unreasonable to make it subject to forfeiture.

The taxing of shares at grant unless there is a genuine forfeiture provision will not encourage directors to take up shares. All else being equal, directors would rather receive cash fees because these are liquid, and can be used for everyday needs. Shares, in contrast, have severe limitations. They typically can only be sold for cash in windows coincident with announcement of results. Even then, they cannot be sold if the director is privy to material and undisclosed inside information. Also, in many small and/or private companies, there is no ready market in which to sell shares. Lastly, and particularly in the larger listed companies, directors are often required to hold shares and not sell them until after they retire.

Deferring tax until the benefit is received[5] would overcome these constraints on director share holdings.

Performance-testing Long Term Incentive (LTI) plans after cessation of employment

In the wake of the global financial crisis, governments and governance agencies globally are supporting LTI plans that performance test rewards after cessation of employment. These feature as an important part of the risk-control measures within the APRA guidelines and have also been advocated by the Financial Stability Forum (now the Financial Stability Board) and endorsed by the G20. They also feature in remuneration guidelines published by the Australian Institute of Company Directors (AICD), and have been promoted by US pension funds to counter the excessive outcomes of US executive compensation plans. The draft legislation's requirement that cessation of employment trigger tax negates these initiatives and is inconsistent with the concession provided in respect of other equity that is subject to genuine forfeiture due to long term performance requirements during the term of employment.

The consultation paper notes (refer paras. 67-69) that APRA's proposed use of post-retirement performance-tested LTI plans could be accommodated by allowing enough shares/rights to be vested at cessation of employment to allow the employee to pay tax at that time. Such an approach will not work. The ATO will require tax to be paid in relation to all of the unvested shares/rights, although there is no guarantee that the

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[3] That does not in any case have cash flow to support fees that would otherwise be due to proficient and expert directors.

[4] For example, to make non executive director shares subject to a performance condition will conflict with the director's role to judge the performance and set the performance conditions of executives.

[5] That is, when an option or share right is exercised to acquire a share.

performance conditions will be satisfied. This means that for senior executives nearly half of the unvested shares will have to be vested to pay the tax even if the performance conditions are ultimately not met.

Few companies will be prepared to operate "performance based" plans on this basis because release of shares to fund the tax represents a reward that has no performance basis.

More disconcerting, however, is that vesting equity (or providing cash in lieu) to pay the tax prior to the end of the performance period has a net result that equally rewards both good performers and poor performers. That is, all else being equal, the good-performing employee will receive after tax value at the end of the performance period equal to half of the original equity (being the component that is vested), while the poor- or non-performing employee at the end of the performance period will receive back from the tax office the overpaid tax, also equal to half the equity provided[6].

Share plan benefits and termination payments

The share scheme tax consultation paper suggests that incentive plan rewards be vested early to pay tax on unvested shares that remain contingent on performance requirements at cessation of employment. Under the government's proposed termination payments rules, any vesting of otherwise unvested share plan benefits on cessation of employment to pay tax (or cash in lieu) will be counted against the one-times average base salary cap for termination payments not requiring shareholder approval. (But any employee share plan benefit vesting after termination would not be counted against the termination payments limit). Any vesting of share plan rewards on cessation of employment would therefore be caught up in the calculation of termination benefits. In many cases, this will mean the termination payment will exceed the average annual salary limit and will require shareholder approval.

Catching overseas absconders

The only reason provided for taxing equity up front or on cessation of employment is to ensure those that choose to live overseas after receiving share scheme benefits pay tax.

Some recipients may remain in employment and be transferred overseas. In these instances the employer has (in the great majority of cases) TFN information and address details. The tax can be recovered via a withholding requirement on the employer.

Other recipients (providing there are other changes in the regulation) may leave employment, but have share scheme benefits subject to continuing LTI performance requirements. Again the employer will have TFN and

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[6] Assumes for illustrative purposes that there is no change in share price over this period.

address details for the release of any benefit, so withholding requirements can be levied on the employer.

For recipients who receive vested benefits and leave both employment and the country during the tax year, we acknowledge that tax recovery can be problematic. But these same problems apply to recovery of all taxes owed by these individuals (e.g. gains on investment properties for example). We suggest that these are systemic issues best tackled on a system wide basis via cooperative efforts with tax agencies offshore.

Limiting eligibility for the $1,000 tax exemption to employees with adjusted taxable incomes of $180,000 or less

Using adjusted taxable income to determine eligibility means many employees will not know whether they will be eligible for the $1,000 exemption at the time they acquire shares. An employer who wishes to limit participation to employees who will not have to pay tax on a grant of shares worth up to $1,000 will certainly not know who is eligible. Even if an employer can make a reasonable guess at eligibility based on their own arrangements with the employee, many employees have income from other sources of which the employer can have no knowledge. This uncertainty will discourage employers from offering employee share schemes and discourage many employees from participating in such schemes, which will prevent the new provisions from achieving their stated objective.

Some "high value added" companies may have a significant part of their workforce earning in excess of the $180,000. But these companies may still wish to enhance shareholder alignment through provision of exemption share schemes to employees. With many of their workforce not able to effectively take part in the general scheme because of the income threshold, these employers may be reluctant to offer them because they are unfair to large sections of their workforce, or may be unable to comply with the 75% requirement as it is now defined, so even employees with adjusted taxable incomes below $180,000 would be excluded from the $1,000 exemption.

Lastly, the limit of $180,000 is unnecessarily discriminatory. It increases administrative costs for what end? Being a flat $1,000 is progressive in that the % of income that is tax exempt decreases with income level. For reasons mentioned above, employers would typically prefer employees to be treated equally, and so offer participation to all. They would also prefer to encourage all employees to become better aligned with shareholders through share ownership.

Salary sacrifice to $5,000

Salary sacrifice share plans are applied by employers to encourage alignment between shareholders and employees. They assist with attraction and retention in competitive labour markets that, for many occupations, are now global. Most large employers offer such plans to all employees on a non-discriminatory basis.

The typical salary sacrifice plan provides for delivery of shares, whereby the employee can elect to acquire shares in exchange for the equivalent value of pre-tax salary (or bonus). The shares are subject to trading restrictions and risk of forfeiture in the event of fraud, defalcation or misconduct, for up to ten years. On the earliest of release of the restrictions, cessation of employment, or the expiration of ten years, the employee paid the full marginal rate of income tax on the value of the shares at that time. Deferral of the taxing point is the only tax benefit provided under these arrangements; there is no further concession, such as a reduced capital gains tax rate, as the full value of the shares initially acquired, plus any increase in their value, is subject to income tax.

Non-executive directors are encouraged by most major stakeholder governance guidelines to acquire shares in lieu of cash fees, being obligated to hold these shares until retirement.

Limiting the amount salary sacrificed is an unnecessary administrative complication that also limits Australian companies' ability to attract and retain employees, conserve cash flow, and engender employee identification with shareholders. It could also be seen as unnecessarily paternalistic to restrict employee choice.

Removal of the $5,000 limit would allow freedom for employees to choose according to their economic circumstances, encourage employers to consider plans that offer shareholder alignment, provide greater opportunity for companies to conserve cash flow and hence use this cash to grow and invest in more employment, assist Australian companies to be more competitive in attracting and retaining employees, and allow non executive directors to convert their cash fees into equity to better meet preferred governance guidelines.

Deferral using a minimum term of employment

Where deferral is achieved by requiring employees to complete a minimum term of employment before shares vest, an exception will be required to allow shares to vest where the failure to complete the specified period of service is the result of circumstances such as a 'no fault' termination of employment by the employer, redundancy, retrenchment, total and permanent disablement or death, or certain "good leaver" situations, such as maternity reasons. The government appears to have acknowledged this in an example regarding the "real risk of forfeiture test" provided with its Policy Statement release on 1/7/09. It will need to be embodied in the final legislation.

Recommendations

1. Allow deferral until a benefit is realised
2. Within this allow salary or fee sacrifice for equity
3. Remove cessation of employment as a taxing point for those in receipt of continuing share scheme benefits subject to genuine forfeiture conditions
4. Include tax withholding requirements for employees who receive benefits and relocate offshore during a tax year

Yours sincerely

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