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The Secretary
Senate Economics Legislation Committee
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Dear Secretary

Submissions regarding review of employee share schemes

On 24 June 2009, the Senate referred to the Economics Reference Committee the operation of employee share schemes in Australia.

The issues that the Economics Reference Committee was specifically asked to consider in the terms of reference included:

- the taxation issues relating to compliance of employers and employees participating in employee share schemes; and
- the recent announcement of proposed changes to the treatment of employee share schemes, the background to these changes, consultation undertaken to develop these change and the anticipated impact of these changes on employees, employers and Australian business generally.

The purpose of this letter is to set out, at a high level, our submission to the Economics Reference Committee regarding these issues.

The issues contained in this submission include issues that we have raised in submissions to Treasury during the consultation process regarding employee share schemes.

We have focused on the more high level policy design issues regarding the taxation of employee share schemes, rather than the detailed operation of the proposed rules.

Very broadly, our key submissions regarding the taxation of employee share schemes are as follows:

- ***restrictions on ability to obtain a refund for forfeited rights should be removed***—we support the proposal to extend the availability of refunds for forfeited awards to shares as well as rights. However, we consider preventing a refund from being obtained where the employee "chooses" to forfeit their entitlements is inappropriate. For example, it unfairly disadvantages employees who hold "out of the money" options. At a practical level, it will change the nature of the equity which is offered to employees;

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- *proposed real risk of forfeiture test is too uncertain* — we consider that the current proposal to test the availability and extent of tax deferral based on whether there is a "real risk of forfeiture" is inappropriate, as it creates uncertainty for employers, and may deter employers from offering employee equity plans with a deferral element;

- *proposed cap on tax deferral for salary sacrifice based plans is arbitrary and too low* —we welcome the decision to allow tax deferral for shares or rights that do not have a "real risk of forfeiture". However, we consider that this relief should be more generally extended as the proposed limitations placed on the availability and extent of tax deferral in this situations may be arbitrary and too restrictive;

- *it is inappropriate for taxing point to occur on cessation of employment in many cases* — we consider that where an employee is entitled to defer taxation on shares or rights on their employee share schemes, it is inappropriate for a deferred taxing point to occur when they cease employment, unless the employee obtains access to their shares or rights at that time;

- *there are obstacles to unlisted companies offering employee equity that should be removed* — the current limitations in the existing tax rules against unlisted companies offering equity to their employees should be addressed. It is crucial that the proposed amendments remove some of the obstacles for unlisted companies to offer equity to their employees. The review by Board of Taxation of "start-up, research and development and speculative-type companies" should extend to the taxation of employee equity granted by unlisted companies more generally;

- *proposed withholding regime is unnecessary and should not be implemented* — we consider that the proposed withholding regime on the grant of shares or rights under employee share schemes to employees that do not quote the TFN is likely to discourage and prevent smaller companies from offering employee equity, due to the compliance costs involved; and

- *availability of rollover relief should be clarified* — confirmation regarding the availability of rollover relief for shares or rights under employee share schemes that are provided under a takeover or restructure should be provided, so that companies that are currently or contemplating undertaking takeovers or restructures have certainty.

Our submissions are outlined in further detail below.

1 Restrictions on ability to obtain refund on forfeiture should be removed

We support the decision to implement amendments to allow an employee who has forfeited shares or rights to obtain a refund of any tax paid on those shares or rights more generally. In the Assistant Treasurer's press release on 1 July 2009 ("**Press Release**"), it is proposed that a refund will not be available if the shares or rights are forfeited as a result of a choice made by the employee.

The basis for refusing a refund where shares or rights are forfeited as a result of a choice made by employee is not correct. In our experience, employees do not intentionally forfeit shares or rights to subsidise commercial losses.

Further, preventing a refund being obtained where employees forfeit "out of the money" options is an inappropriate outcome. Although such employees may technically be regarded as "choosing" to forfeit their options (as they allow them to lapse unexercised), the options do not become "out of the money" as a result of any effective choice or fault of the employee.

A refund should not be denied in this situation. If an employee has, through no fault of their own, lost the benefit of the option or right that they were assessed on (due to a fall in the price of the underlying shares), the employees should, as a matter of principle, be permitted to obtain a refund.

This is particularly unjust if the amount on which the employee is assessed does not take into account the risk that the employee will forfeit their shares.

Preventing employees from obtaining a refund where they lose the benefit of the option or right, even where those options or rights are "out of the money", is likely to create a bias towards granting options or rights with lower exercise prices to ensure the options or rights are never "out of the money". This may be inconsistent with good corporate governance practice.

Recommendation: that an employee should be entitled to obtain a refund of tax paid on shares or rights acquired under an employee share scheme where those shares or rights are forfeited as a result of a choice of the employee (or, at least, where they are out of the money).

2 Determination of deferred taxing point

2.1 Real risk of forfeiture" test for tax deferral should not be adopted

We support the availability of tax deferral for shares or rights provided under employee share schemes. However, we consider that the proposed "real risk of forfeiture" test for the availability of tax deferral should not be adopted.

Applying a "real risk of forfeiture" test requires employers and employees to assess the "quality" of any forfeiture, performance or service conditions that attach to their shares and rights, and make a determination regarding whether there is a "real risk" of such conditions being satisfied. This is inherently uncertain and depends not only on the content of the relevant condition, but the circumstances of the relevant company and employee. It may, depending on the nature of the plan, also place companies under an ongoing monitoring obligation.

The uncertainty regarding "risk of forfeiture" based tests is evident from the US experience, where a "substantial risk of forfeiture" based test is used.

If, as proposed, a "real risk of forfeiture" test is to be adopted, then legislative guidance regarding how the test will operate should be provided. The guidance should not be provided in the explanatory materials for the amending legislation and ATO rulings.

Including such legislative guidance will be essential to ensure that the adverse consequences associated with the uncertainty of the "real risk of forfeiture" test are managed. It should also reduce the need to obtain an ATO ruling whenever a plan with a deferral element is offered to employees.

Recommendation: that the deferred taxing point be based on whether there is a forfeiture condition, and not where there is a "real risk of forfeiture". If, as a matter of policy, a "real risk of forfeiture" test is adopted, then legislative guidance regarding the meaning of "real risk of forfeiture" must be provided.

2.2 Restriction on salary sacrifice based plans

It is proposed that tax deferral should be permitted for offers of shares or rights that do not have a "real risk of forfeiture" if they involve "salary sacrifice" of an amount of up to $5,000.

We agree that tax deferral should be extended to plans that do not carry a "real risk of forfeiture". However, we have some reservations regarding the appropriateness of the restrictions placed on the proposed concession.

In the first place, the $5,000 limit appears arbitrary and too low.

We do not think that the availability of tax deferral should be restricted to "salary sacrifice" based plans. "Salary sacrifice" has a very limited meaning under the existing tax law.

If the concession is not available to plans more generally, then this will greatly restrict the ability of companies to offer short term incentive based offers to their employees, as well as the more broad-based plans offered to employees more generally do not contain a "real risk of forfeiture".

Recommendation: that the cap for "salary sacrifice" based deferral be removed, and that the types of plans it may apply to not be restricted to only "salary sacrifice" based offers.

2.3 No taxing point should arise on cessation of employment

Essentially, the policy intention for allowing tax deferral on the grant of employee share and options should be to allow employees to be taxed on such benefits when they are received, but only when the employees are able to get the benefit of the shares or rights they obtain.

Both the current and proposed rules relating to tax deferral do not accord with this intention. Specifically, these rules provides that a taxing point will occur when an employee ceases the employment in respect of which the shares or options are granted. This means that if an employee ceases to be employed at a time earlier than when their taxing point would ordinarily occur (being when disposal restrictions and the forfeiture conditions cease to operate), an employee will be taxed at the time they cease relevant employment.

An employee who is taxed at the time they cease relevant employment requires cash to pay the tax arising on their shares or rights at that time. However, they may not yet have

received the benefit of their shares or rights in such a way that would enable to employee to sell the shares or rights to fund the tax liability (for example, disposal restrictions or forfeiture conditions may still apply to the shares or rights).

In this situation, the employee is "out of pocket" from a cash perspective as a result of having to pay tax at the time they cease relevant employment.

This outcome is unfair for those employees who do not resign and who cease employment through no "fault" of their own. For example, they cease employment as a result of retirement, being made redundant or even death. In this situation, the triggering of the taxing point effectively results in a tax penalty for those employees who participate in these schemes but subsequently cease employment.

Recommendation: That where tax deferral is available in respect of shares or rights, a taxing point should not occur where the employee ceases employment, at least where the cessation of employment was involuntary.

3 Restrictions on unlisted companies offering employees equity

The Australian tax rules pose a number of extremely difficult and often insurmountable obstacles to Australian unlisted companies introducing employee equity plans for their employees. These obstacles impose significant barriers to unlisted companies providing equity incentives to employees.

The law should be amended to ensure that unlisted companies are not inappropriately excluded from offering employee equity programs to employees.

Recently, relief from some of the Corporations Act requirements for offering employee equity was extended to unlisted companies. However, we have not observed there to be a significant increase in the levels of employee equity being offered by unlisted companies, as a result of the continuing restrictions on those companies offering employee equity from a tax perspective.

3.1 Valuation rules

The key obstacle for unlisted companies that seek to offer shares or rights under employee share schemes are the rules relating to the determination of the "market value" of those shares or rights, which must be provided to employees in order for employees to determine the amount on which they pay tax. The Australian employee share scheme rules are drafted in a way which means that the application of these rules and the calculation of the relevant assessable amount is dependent on the deemed tax market value of shares in the relevant company at a particular time.

Where shares in a company are not listed, it is necessary to obtain a market valuation of shares in the company at each time the deemed tax market value of shares in the company needs to be determined under the rules (in the absence of any exception being allowed by the Commissioner).

This creates a very significant and costly administrative burden to any unlisted company that wishes to offer an employee equity program to its employees.

In the Press Release, it was indicated that the issue of how best to determine the "market value" of employee share scheme benefits, and whether different tax deferral rules should apply for "start-up, research and development and speculative-type companies" had been referred to the Board of Taxation.

It is crucial that the rules for determining the "market value" of shares or rights for unlisted companies are simplified and do not require a full complying market valuation of the company to be undertaken.

In this respect, the Board of Taxation's review in respect of "start-up, research and development and speculative-type companies" should not be limited to those companies. It should extend to unlisted companies more generally.

Recommendation: That the rules relating to "market value" be amended to provide that unlisted companies are not required to undertake a market valuation whenever they offer shares or rights under employee share schemes.

3.2 Off-market share buybacks

There is often no liquid market for shares in unlisted companies. This is a serious impediment to the offer of employee equity unlisted companies and, in many cases, results in the schemes not proceeding.

We consider that it is necessary for some buyback or cancellation mechanism to be offered in order for employees who receive shares or rights in unlisted companies under employee equity plans to realise or dispose of their interests. This can be particularly important, for example, where employees who receive awards must dispose of their interests on the cessation of employment with the relevant employer.

This is already recognised in the share buyback provisions of the Corporations Act, which specifically enable companies to buyback shares held by or for employees under employee share plans (part 2J.1, division 2).

However, under both the current and proposed rules relating to reductions of share capital, such as the off market share buyback rules and the integrity rules in sections 45A and 45B, paragraph 177EA(5)(b) and section 204-30, part of the amount paid on the buyback or cancellation of shares can be deemed to be a dividend for Australian tax purposes.

The operation of these provisions can be administratively difficult and, in certain cases, uncertain. In practice, the complexity of the provision effectively prevents unlisted companies from ever undertaking buyback is in connection with employee share schemes. If there is no alternative market in which the relevant shares or interest can be realised, this can prevent employee equity from being offered by such companies more generally.

The proposed amendments to the off-market share buyback rules signal a recognition that the off-market share buyback rules are too complicated as a general proposition.

We consider that to facilitate the creation of a market in unlisted companies to allow unlisted companies to offer and buy back employee equity, these rules should be further simplified to the extent they apply to unlisted companies in an employee share scheme context.

We consider that a similar exemption should apply in the context of the tax rules, to facilitate the offering of such plans by unlisted companies. In particular, the efficacy of the Corporations Act exemption has largely been defeated as companies are still subject to the onerous tax obligations associated with buybacks of this kind.

Recommendation: The off-market share buyback rules and sections 45A and 45B, paragraph 177EA(5)(b) and section 204-30 be amended to provide an exemption for buybacks and share capital reductions that occur in the context of an employee share scheme, such that the tax treatment of such buybacks and share capital reductions are determined under the capital gains tax rules, consistent with how the employee would have been taxed if the shares were disposed of on-market.

4 Proposed withholding regime should not be introduced

In the Press Release, it is proposed that a withholding regime to apply to shares or rights acquired under an employee share scheme where the relevant employee has not provided their tax file number ("**TFN**") to the company providing the shares or rights.

This proposed withholding regime should not be introduced. A withholding regime may be difficult and costly to comply with, and may discourage or prevent certain companies from offering employee equity.

Although the number of employees who such a withholding regime will apply to is, as has been suggested, minimal, the number of employees subject to a withholding regime has a minimal impact on the compliance costs of the regime. Rather, the compliance costs arise because of the need to develop, construct and implement a system that ensures that a company complies with any relevant withholding obligations.

Only the largest companies will have sufficient resources to develop and operate a system that would be able to ensure compliance with the company's TFN withholding obligations under a withholding regime. Introducing the proposed withholding regime would therefore preclude all but the largest companies from offering equity to their employees.

Recommendation: that the proposed withholding regime not be introduced.

5 Rollover relief should be provided for takeovers and restructures

The existing rules contain provisions for an effective "rollover" to be provided where employees receive replacement shares or rights under a takeover or restructure that "match" shares or rights they held prior to the takeover of restructure.

It is uncertain whether replacement shares or rights received under a takeover or restructure that replace existing shares or rights that were taxed under the existing employee share scheme rules will receive "grandfathered tax treatment". That is, whether they will be taxed in the same way as their existing shares or rights. It is also uncertain, more generally, whether a rollover will be available under the new rules at all, and how any rollover will operate.

It is vital to provide certainty to companies currently undertaking takeover or restructure transactions, and their employees regarding whether a rollover will be available and, if so, how it will operate.

This issue should be pursued as a matter of priority to ensure that companies currently undertaking or considering undertaking takeovers or restructures are provided with certainty regarding the tax position of their employees.

Recommendation: confirmation should be provided that a rollover will be available under the new rules for employee shares or rights received under a takeover or restructure.

We would be pleased to provide you with further information and explanation regarding our key submissions and any other issues if you would like us to do so.

We would also be pleased to participate in any hearings regarding this enquiry if you would like us to do so.

Please do not hesitate to contact me if you have any questions, or if there is anything else you would like to discuss.

Yours sincerely

Andrew Clements
Partner