Our Ref: 100-AD-0119

The Standing Committee on Tax and Revenue
PO Box 6021
Parliament House
CANBERRA ACT 2600

19 March 2020

Dear Sir or Madam

SUBMISSION TO THE STANDING COMMITTEE ON TAX AND REVENUE IN RESPECT OF THEIR ENQUIRY ON THE TAX TREATMENT OF EMPLOYEE SHARE SCHEME INTERESTS

Fortescue Metals Group Ltd (Fortescue) generally supports the changes that came into effect post 1 July 2015 in respect of the taxation of employee share scheme (ESS) interests. We have briefly set out the costs and benefits of these changes below to the broader community and stakeholders. We take this opportunity to highlight additional opportunities for improvement.

This document outlines the key submission points to the Standing Committee on Tax and Revenue (Standing Committee) addressing the Terms of Reference outlined below:

1. The costs and benefits of these concessional taxation treatments, and deferred taxing points for options, to the broader community;
2. How companies currently structure their employee share scheme (ESS) arrangements and how taxation treatment affects these decisions; and
3. The challenges faced by companies in setting up an ESS arrangement and whether additional improvements should be made.

This document does not address the last item in the Terms of Reference. However, Fortescue is generally in support of the changes made to the ESS rules in respect of 'start-up' companies.

Yours sincerely

FORTESCUE METALS GROUP

[redacted]

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1. THE COSTS AND BENEFITS OF THESE CONCESSIONAL TAXATION TREATMENTS, AND DEFERRED TAXING POINTS FOR OPTIONS, TO THE BROADER COMMUNITY

A. Benefits include the following:

- Overall, the 2015 ESS reforms have increased the attractiveness of providing ESS to employees as an incentive mechanism.
- The deferral of tax for options now matches the point when participants can first realise the benefit of the award (i.e., the point where they are able to sell a portion of the shares, which may be required to satisfy income tax obligations). This was an important change as it was previously a disincentive to provide options to employees due to the mismatch in the taxing point.
- The increased deferral period of up to 15 years (from 7 years) provides participants with increased flexibility. From an employer perspective this assists with encouraging long-term employment.

B. Costs include the following:

- In our view there are no significant costs to the community. In the absence of taxing mechanisms that appropriately align with the value of an award such as an option, that award simply stops being used by employers. However, there are several areas which create additional costs to employers, who are also stakeholders.
- Employers are required to track cessation of employment as a taxing point which increases administration for the employing entity (particularly as additional calculations are required to calculate the market value of the share on the date of cessation, and for the employer to ensure they are correctly reporting the ESS interests for ESS reporting purposes).
- ESS reporting is onerous for employers, and increases the administration required for those preparing the reporting.
- Due to the choice of determining the market value of ESS interests, there could be differences between the reporting and the final taxable amount reported in the participant's personal income tax return.
- We have commented further below on some specific issues which could be the focus of further improvement to reduce costs of compliance and increase the availability of ESS arrangements to employees.

2. HOW COMPANIES CURRENTLY STRUCTURE THEIR ESS ARRANGEMENTS AND HOW TAXATION TREATMENT AFFECTS THESE DECISIONS

- As noted above, the changes to the ESS taxing rules for ESS interests granted post 1 July 2015 have provided employees with fairer outcomes and allowed employers greater flexibility when structuring ESS arrangements. This is largely driven by the changes to the taxation treatment of options.

- The tax treatment of options aligns with most countries internationally and facilitates the use of this arrangement more effectively in cross-border employment scenarios.

3. THE CHALLENGES FACED BY COMPANIES IN SETTING UP AN ESS ARRANGEMENT AND WHETHER ADDITIONAL IMPROVEMENTS SHOULD BE MADE

- The ESS reforms have resulted in a number of challenges for employers and ESS participants alike. We identify some of these below and discuss additional improvements that should be made.

A. Removal of taxation on cessation of employment

- Currently, ESS interests that are subject to the tax rules set out in Division 83A become subject to tax at the time the employee ceases employment (if the ESS award is not forfeited and has not already been subject to taxation).
- The taxing point on cessation of employment is inconsistent with encouraging the long-term ownership of shares and the premise that employees should only be taxed on equity awards when they are able to realise a benefit.
- Similarly, it is also inconsistent with the taxation treatment of equivalent cash-based incentive awards, which are generally only taxed when the participant receives the cash ‘pay-out’, rather than at termination of employment.
- Imposing a taxing point when participants cease employment conflicts with the commercial objectives of many schemes, forces terminated employees to fund a tax liability in relation to interests which are unable to be disposed of. In some cases, it is determined several years later that performance conditions have not been satisfied. While a refund of tax should then be available, this can leave an employee out of pocket for years.
- Taxation on cessation of employment also does not align with the Payroll Tax taxing point causing additional administration to employers in having to perform additional tracking and calculation for the two taxes.

B. Participant election to be taxed up-front

- The former Division 13A (pre-2009) enabled taxpayers to elect to pay tax up-front on their ESS interests. This provided certainty of the taxable value. Employees are sometimes reluctant to accept awards when it is unclear what the future tax consequences will be. Upfront tax eliminates this uncertainty. While it would not be appropriate for upfront tax to apply in all circumstances, for employees who would prefer to have certainty, it would be helpful to include this opportunity.
- Upfront taxation (at the employees’ choice) also reduces administration as there is no ongoing need to track the exercise of rights (which can occur at many different times) or the removal of disposal restrictions.

C. Double taxation of dividend equivalent payments (DEPs)

- According to Tax Determination 2017/26 Income tax: employee share schemes - when a dividend equivalent payment is assessable to an employee as remuneration (TD 2017/26), after-tax dividends distributed from a trust to employees should be taxable to the employee as remuneration. This is on the basis the distribution is made to the employee as a result of satisfying the conditions which have a sufficient connection with the employee's employment.

- TD 2017/26 clarifies that until the employee owns or has beneficial interest in the share, a DEP would likely constitute remuneration. The TD suggests that in arrangements where the employee holds vested rights (instead of vested shares), a DEP would also constitute remuneration. That is, where the employee technically does not have beneficial interest in the share but in substance the employee has received the right to exercise the vested rights into a determined number of shares, DEPs would be taxed as income.

- This approach results in the dividend being taxable in the hands of the trustee and the after-tax DEP being taxable to the participant. That is, the dividend income is taxed twice.

- It is a well-established principle that double tax should not apply unless the intention of the law in doing so is clear beyond doubt. The Commissioner's approach results in the dividend income being taxed at a rate of 71.9% (for employees at the highest marginal tax rate of 47%).

- Double taxation undermines the value employers are intending on delivering to their employees through shareholding. This punitive tax on the payment of DEPs has resulted in the removal of payments of this nature and as such limits the benefit of the incentive received by participants at a point at which they have done everything they need to do to earn the share.

- The changes to the historical approach caused significant concern for many companies that operate their ESS arrangements using trusts and generated additional administration for these companies. The tax treatment of after-tax DEP should revert to historical practice as outlined in CR 2013/15 where a post-tax DEP is not taxable to the recipient.

D. Increase $1,000 tax-free limit

- The income tax exemption (reduction in taxable value) available to employees where certain conditions are met is limited to awards valued at no more than $1,000.

- The tax-free limit should be increased as this amount has not been adjusted since 1997. It is now too small a value to represent a meaningful incentive to most employees.

- In some cases, the costs of administering a tax-free ESS plan for the purposes of delivering value to employees and aligning their interests with their employer would be disproportionate to the benefit and discourages many employers from offering such plans.

- Employees are required to satisfy an income test under the current ESS provisions and the test ensures the concession is targeting employees on salaries below the top marginal rate i.e. the broader employee population as opposed to management and executives. As such limiting the tax-free component to $1,000 disadvantages the segment of the employee population who could most reasonably benefit from a higher level of incentive.

- We consider it would be reasonable to increase the limit to $5,000, in line with the concessions available to employees who opt to acquire ESS interests under salary sacrifice arrangements.

E. Simplify option valuation rules

- The ESS legislation prescribes the way the taxable value of a right is calculated. The taxable value of the right at exercise is the higher of the market value of the underlying share (less the exercise price, if any) or the value determined in accordance with the ESS regulations.
- Where the deferred taxing point is the date of exercise, the prescribed methodology technically still requires a comparison of the value under the regulations and the share price less exercise price (based on the remaining exercise period of 0 to 3 months). It would reduce costs of compliance if it was prescribed that for options taxed at exercise, the taxable value was always based on share price minus exercise price.

F. Greater clarity on indeterminate rights

- Indeterminate rights are considered rights under the ESS legislation from the time the indeterminate rights were acquired, but this classification is applied retrospectively when it later becomes clear that the right will result in the receipt of a definite number of shares.
- The grant of rights which are subject to shareholder approval is common due to Corporations Act requirements. However, such grants create additional complexity, as highlighted by the decisions in Davies v FCT [2015] FCA 773 and the guidance in Taxation Determination TD 2016/17.
- The legislation should clarify whether the grant of a right which is subject to shareholder approval is considered an indeterminate right or whether the right is considered to be granted upon approval by shareholders. The difference in the timing between the two events could not only impact the market value at grant, but also the financial year in which reporting and taxation occurs.
- It would be helpful for the legislation to include a deeming provision to clarify this issue, to enable greater clarity in valuing and reporting the award.

G. ESS reporting

- ESS reporting, though necessary, has undoubtedly increased compliance costs for employers. As such, where possible, reporting requirements should be simplified.
- Some ideas have already been suggested in the preceding points.
- Further simplification could include the removal of the 30-day rule for employer reporting purposes as this increases the complexity and requirement to perform additional calculations for the employer.
- The ATO could also simplify the way it receives the ESS annual report. Currently to lodge, a software compatible with ATO systems must be used and for 50 employees or less, reporting can be completed through online forms. The online forms are cumbersome to complete and require manual entry of data, which increases the chance of error and is impractical for large

employee populations. The historical option of being able to lodge in a spreadsheet format would be the most cost effective as it does not require employers to acquire a specific software only for the purposes of lodgement.

H. Application of the “sole activities” test

- An “employee share trust” (EST), for an ESS, is defined in subsection 130-85(4) of the ITAA 1997. Additionally, the ATO recently finalised the Taxation Determination 2019/13 Income tax: what is an “employee share trust” (TD 2019/13).
- We understand the ATO’s current view is that the “sole activities” test must be construed narrowly, as it acts as an integrity measure in respect of the EST tax concessions. TD 2019/13 sets out activities which the ATO considers can be properly characterised as “merely incidental” for paragraph (c) of the test, as well as activities which the ATO considers not “merely incidental” for paragraph (c) of the test which may adversely impact an ‘employee share trust’ status.
- While recognising integrity measures are appropriate to ensure EST activities align with the intended use of an EST, it should also be recognised that it is easy for simple errors to create disproportionate consequences and significantly increase costs. This is not desirable.
- We consider the interpretation of the “sole activities” test for the purposes of an EST is overly rigid and onerous for companies that utilise an EST structure to implement an ESS plan.
- The rules regarding the operation of an EST could be clarified to allow increased flexibility. For example, the ATO stance is that if a trustee of an EST instructs an activity that is “not merely incidental to the sole activities of the EST”, it permanently fails the “sole activities” test and will forever be excluded from the tax concessions available to ESTs. The current approach overly penalises companies that operate an EST.
- It would be more appropriate for the sole activities test to be applied on an annual basis.