CORPORATE TAX ASSOCIATION
of Australia Incorporated

Submission to

Senate Economics References Committee

Employee Share Plans

Corporate Tax Association of Australia Inc.

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INTRODUCTION

The Corporate Tax Association (CTA) was formed in 1989 to represent the taxation interests of Australia's largest companies. Our current membership is about 125 companies across all sectors of the economy.

Many of our member companies have employee share plans in place and regard such arrangements as an important and effective way of aligning the interests of employees with those of company shareholders. The unexpected changes announced in the May 2009 Budget created unprecedented levels of concern among those companies and initially resulted in many plans being suspended pending further clarification from the Government.

Following a brief consultation period the Government's released a final Policy Statement on 1 July 2009, which largely restores the position that obtained before the Budget announcement, save for the bringing forward of the taxing time in certain circumstances and a reporting system that is intended to improve voluntary compliance. The CTA regards the Government's Policy Statement as a positive signal of its continuing support for through the tax system of employee participation in broad based equity plans and we look forward to providing further input on the draft legislation once it is released.

A copy of the joint submission form the Business Council of Australia and the CTA dated 17 June is attached for the Committee's information. As can be seen, the "capacity to pay" principle put forward in our joint submission is broadly reflected in the prohibition on selling condition which is proposed to operate in tandem with the real risk of forfeiture test, thereby addressing our principal concern.

WHAT WAS WRONG WITH THE EXISTING RULES?

By way of context, we suggest the Committee should look at where we came from and ask what were the shortcomings of the existing system for taxing employee share benefits. The existing rules have been in place since 1995, and were subject to an exhaustive Parliamentary examination (the Nelson Review) relatively recently without revealing the kind of "excessive concessionality" that was thought at the time of the Budget to warrant making radical changes to the tax timing rules for employee share benefits.

Frankly, we struggle to understand what it is about the existing rules that was thought to be excessively concessional – particularly having regard to the relatively minor timing changes that are now being proposed.

In the CTA's submission both the existing rules and the final Policy Statement broadly impose tax on employee share benefits at the right time and the Committee needs to appreciate that these timing rules are not in any way concessional. They do no more than reflect the general principle of good tax design of not imposing a tax until the subject of the tax is in a position to pay it. If the rules were otherwise, such as the original Budget proposal to tax shares and rights at the grant time, the tax system would be taxing employee share benefits more harshly than other benefits, which is precisely why most share plans were suspended almost immediately the Budget announcement was made.

Without being unduly pedantic, we have a problem with the whole notion of a "deferral", which implies there is some earlier benchmark time when the benefit should properly be taxed and compared to which taxpayers are given concessional treatment. That is quite the wrong way to look at things. The grant time should in no way be regarded as the benchmark since imposing a tax at that point would be to tax a "benefit" to which the employee may never become entitled. We do use the term "deferral" in places in this submission, but only for the sake of (hopefully) avoiding unnecessary confusion.

Given the apparent levels of non-compliance in the community as revealed by compliance work undertaken by the Australian Taxation Office (ATO), the CTA does support the proposed reporting requirements. Indeed, we believe that is the most important part of the package, and should account for most of the projected revenue gains.

Rather than just placing an ambulance at the bottom of the cliff however (by enabling the ATO to detect non-compliance through data matching), we think it would be sensible for the ATO to also look at the design of the personal income tax return form to better assist taxpayers with voluntary compliance under self assessment.

SOME RESIDUAL CONCERNS

While we are happy that the Government has addressed our main concerns as to timing, there are some aspects of the proposed new rules that, in our submission, could be further improved.

Cessation of employment

One of the more serious flaws in the existing rules that has not been addressed in the final Policy Statement relates to the tax treatment of unvested shares and rights on termination of employment (for whatever reason, but particularly in the case of retrenchments, as well as death or disability).

As we understand it, the policy basis for making termination of employment the taxing time stems from the misguided belief by policy makers that the existing and proposed tax timing rules for employee share benefits are highly concessional and should therefore be withdrawn immediately the employment relationship comes to an end. As we have indicated, the current and proposed timing rules are entirely appropriate, and without them very few share plans would in fact survive.

There are no compelling reasons for continuing this inequitable and inconsistent treatment – terminating employees are taxed on a benefit they may never receive while remaining employees are not taxed until vesting (when the risk of forfeiture falls away) or even later (where there is a prohibition on selling).

More broadly, we note there is pressure on corporate law and governance rules to ensure that company executives remain "at risk" in respect of their equity based remuneration even (and especially) after they leave the company. While it been suggested that sufficient unvested shares could be released to help meet the tax liability in such cases (presumably across the board and not just for senior executives), that would in our view see the tax tail wagging the governance dog. We don't support that idea, and consider that the tax rules should follow the governance principles. Our preferred policy outcome would therefore extend the deferral to former employees in all cases where the shares are unvested (due to performance hurdles) or there is a prohibition on selling.

Rights to acquire shares

The tax timing rules for rights to acquire shares as proposed in the final Policy Paper are illogical and inconsistent with the timing rules for shares.

For shares, the proposed taxing time would normally be when the real risk of forfeiture falls away, unless there is a subsequent prohibition on selling in which case the taxing time is when the prohibition ends or seven years, whichever is the earliest.

However, for rights to acquire shares, where an employee is able to exercise the right to acquire the shares but there is a subsequent prohibition on selling the shares, there is no further deferral unless the underlying shares after exercise are themselves subject to a real risk of forfeiture.

This creates a kind of double jeopardy which is difficult to understand or justify. Typically, the rights themselves will have been subject to real performance hurdles before the employee reaches the stage of being able to exercise them. Where there is a subsequent prohibition on selling the shares acquired pursuant to the rights it seems unreasonable and unrealistic to expect companies to then impose an additional real risk of forfeiture on the shares.

There are no employee share plans that we are aware of that operate in this manner and while companies could modify their plans to accommodate this proposed rule (by avoiding the prohibition on selling) it seems more sensible just to change the rule so that the deferral continues while the shares are subject to a prohibition on selling. That would put shares that are acquired under rights that were previously subject to a real risk of forfeiture on the same footing as shares that were initially granted subject to performance hurdles and where in both cases they are subject to subsequent disposal restrictions.

THE CONSULTATION PROCESS

In spite of some improvements in the consultation process following the Reform of Self Assessment Report, recommendations from the Board of Taxation and the Tax Design Panel, we nevertheless continue to experience poorly designed tax policy announcements that have suffered from a lack of consultation. It is inconceivable that a tax practitioner specialising in remuneration planning would not have warned the Government of the risks to existing share plans created by the Budget proposals.

It has been suggested that since the employee share plan changes were integrity measures it is not generally desirable to consult on those. We would like to challenge that idea. Is it being seriously suggested that large public companies would have put in place dubious employee share plans before tighter rules were put in place? Given the shareholder approvals that are required that must be unlikely.

But even where a proposed tax measure is highly sensitive and confidentiality is considered essential, there is no reason why consultation could not take place on a confidential and restricted basis – perhaps from the panel of experts Treasury is currently putting in place. This happens currently in a number of other countries and it is high time Australia embraced the notion of confidential consultation on proposed policy measures.

If the Committee would like further clarification on any matter raised in this submission we would be only too happy to oblige.

Yours Faithfully,

Frank Drenth

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