Mr John Hawkins
Secretary
Senate Economics Reference Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Our ref 8175655_1

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22 July 2009

Dear Mr Hawkins

Inquiry into Employee Share Schemes: Employee Ownership Group submission

Thank you for the opportunity to provide a submission to the Senate Economics Reference Committee. By way of background, the Employee Ownership Group ("EOG") is a network of companies committed to promoting employee share schemes for all employees. The EOG's objective is to pursue reform so that employee ownership will continue to be widespread in Australian workplaces.

The EOG presents the following submission in relation to the Government's proposed new employee share scheme rules. We have structured our submission in three Appendices:

1 Submission on fundamental policy issues;

2 Submission on technical issues; and

3 Submission on *Corporations Act, 2001* issues.

We will be pleased to discuss these issues in further detail and respond to the Senators' questions at the Committee's hearing on Monday 27 July 2009.

Yours sincerely

Martin Morrow
Chairman
Employee Ownership Group

Appendix One

Fundamental policy issues

Taxation of rights

The Government proposal: Under the proposed legislation, employees will be subject to taxation when there is no longer a real risk of forfeiture and a restriction preventing the exercise or disposal of the rights, 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. It, therefore, follows that employees will generally be taxed at the time the rights vest in the employee.

EOG's concerns: The proposed rules for the taxing point of rights will create significant issues for the employer and the employee. In summary, the problems likely to arise will include:

- Determining what is a "real" risk of forfeiture. This will often be a question of interpretation and lead to confusion among employers and employees, and potentially disputes with the Commissioner of Taxation.

- Determining what is a restriction which prevents sale. This will create similar issues and lead to disputes with the Commissioner of Taxation.

- An employee may be subject to tax at a time before they are able to exercise their rights, or subject to tax on an amount that is not eventually realised by the employee. The Corporations Act and company policy prohibitions mean that many employees are not able to realise their equity for many months after it has vested.

- The calculation of a taxable amount which is considerably higher than the gain, if any, an employee receives upon exercising their rights and selling the underlying share.

- The interaction of the real risk of forfeiture test and disposal restrictions as applicable to options is inconsistent with the operation of the test applicable to shares. In relation to shares, post vest, it is only necessary for disposal restrictions to apply in order for deferral of tax to apply. However, in relation to options, an additional risk of forfeiture requirement following exercise and acquisition of the share must also apply in order for deferral to be available.

The Policy Statement indicates that the deferral past vesting of options is only available if there is a sale restriction and a forfeiture condition in respect of the share obtained on exercise. From discussions with Treasury we understand that it is intended that deferral will be available post-vesting where there is either a sale restriction or a forfeiture condition. This is the correct policy

approach from the EOG's perspective and this issue should be monitored through development of the legislation.

EOG's recommendation: It is our view that the most appropriate time to tax the employee, and which time would avoid disputes and confusion, is the time when the employee exercises their right and acquires the underlying share and is free to dispose of the share without restriction. It is not until that particular time that the employee derives an economic gain which has 'come home' to him/her. However, consideration should also be given to allowing tax to be further deferred (up to the seven year maximum) where post exercise disposal restrictions apply (in line with the position proposed by the Government in relation to shares).

$1,000 tax exemption

The Government proposal: The Government proposes to provide an exemption from tax for certain qualifying employee share schemes. The exemption will be an amount up to $1,000 of discounted employee share or rights income.

EOG's concerns: The $1,000 tax exemption was implemented in 1997. On a CPI-adjusted basis, the exemption amount should be significantly more in 2009 than $1,000.

This exemption is significantly lower than similar tax concessions that are provided in foreign jurisdictions to encourage employee share ownership and mid-term savings arrangements for employees.

It is worth noting that marginal tax rates have moved significantly since 1997 so that the tax benefit to employees would generally be no more than $315 or $395.

On this basis, there is not a significant incentive for employers of low- and middle-income earners to provide the $1,000 tax-exempt plans.

EOG's recommendation: The exemption amount should be increased to make such employee share schemes more attractive for employers to provide to low- and middle-income earners.

$1,000 tax exemption available up to $180,000

The Government proposal: Employers are able to provide discounted shares and rights under a $1,000 tax-exempt plan to employees with an adjusted taxable income of up to $180,000.

EOG's concerns: It is often not possible for employers to determine which individuals have an adjusted taxable income of less than $180,000 given they do not have access to an employee's income details. Some employees may not even have access to this information themselves until after the tax year is complete, particularly those who earn close to the limit. In these instances, employers cannot accurately apply the $1,000 tax exemption.

The limit of $180,000 will create administrative and communication difficulties for employers that are unwarranted. The $180,000 limit has very little effective purpose.

Employers would also encounter difficulty in determining whether there is a reporting obligation in respect of grants of shares or rights (where the income becomes taxable), or a withholding requirement if the employee has not provided their tax file number to their employer.

EOG's recommendation: It is our view that there is no need for an income cap.

Salary sacrifice $5,000

The Government proposal: Under the proposed legislation, employees will be able to sacrifice up to $5,000 of salary in return for discounted shares and/or rights under an employee share scheme.

EOG's concerns: The EOG appreciates that the Government has recognised salary sacrifice arrangements are an important tool in promoting employee share ownership in Australian companies.

Shareholders and employers want employees to take part in employee share schemes. Employee share ownership is an effective tool in aligning the interests of employees with shareholders. In line with this, employee share plans increase motivation and productivity among employees, and overall performance of the individuals.

However, there are difficulties surrounding the implementation of a $5,000 limit on the amount that may be salary sacrificed. Firstly, the amount represents only a small portion of many employees' salary and wages, which may not provide enough incentive for employees to take part in the schemes.

It can be administratively difficult for employers to keep track of and regulate the plans to ensure employees do not contribute more than the specified amount in a year.

Employees may also encounter problems in understanding the implications of the plans in their circumstances, which could result in further compliance for companies in communicating this to their employees.

Importantly, there is the potential for this legislation in relation to salary sacrifice to deny the benefit of deferred taxation to employee share schemes that have been specifically used by companies to encourage employee share ownership by their middle and lower income earners. Such schemes are typically characterised by the employer giving employees a 'gift' of shares that matches their purchase of shares from after-tax salary. For example, a large international employer enables its employees to purchase shares up to an amount of $3,000 per annum out of after tax salary. At the same time the employer matches that purchase with fully paid shares at

no cost to the employee. The employees' purchased shares are subject to a two-year restriction on sale while the matching shares are subject to a three-year restriction on sale. Neither tranche of shares is subject to forfeiture. It is conceivable from the Policy Statement that the matching shares would be subject to tax at the time of grant and potentially not be eligible for the $1,000 tax exemption.

This employer has indicated to us that they expect there would be less participation by employees in this plan if it is not eligible for deferral as is currently the case.

EOG's recommendation: We propose that there be no limit on the value which can be salary sacrificed. If the Government is concerned about the length of tax deferral it could provide specific restriction provisions for varying fixed terms such as three year, five year and seven year which must be chosen by the employee and adhered to.

Further, such matching schemes as described above should be subject to deferral in the same way as salary sacrifice. These schemes encourage employee share ownership and are not artificial in any sense.

Taxation on termination of employment

The Government proposal: The proposed legislation imposes a taxing point on employee shares and rights at cessation of their employment with the company.

EOG's concerns: As employee share ownership plans are designed to align the long-term interests of employees and shareholders, having cessation of employment as a taxing point is working against this goal. This could have implications where employees are subject to performance hurdles which extend beyond the termination of their employment, and are subsequently not met.

The proposed arrangements will have the effect of causing most employers to release equity at the time of termination of employment. They will do this to enable employees to meet their tax liability.

The proposal has the effect of tax law determining remuneration design, rather than good governance being the basis on which remuneration structures are designed.

EOG's recommendation: It is our view that termination of employment should not be a taxing point. The employee should be taxed at the end of the performance period and in line with the final taxing rules. The taxation law should operate on a basis consistent with good corporate governance principles.

New legislation exclusion

EOG's concerns: Employee share ownership plans exist in both listed and unlisted companies. Under the current laws, unlisted and private companies encounter obstacles and rules preventing them from implementing employee share schemes in their companies.

These private companies are also continually faced with issues such as retiring owners, and one solution to this problem is the employees buying out their employer (e.g. purchasing more than 50% of the company's voting shares).

EOG's recommendation: We therefore propose that there be a carve out in the new legislation for employees purchasing a controlling interest in a company (for instance, under business restructures and as part of succession planning), so that they are not subject to the employee share scheme rules.

Unit trusts

EOG's concerns: Businesses (particularly property trusts) that operate solely through a unit trust (rather than a 'stapled entity' of a trust and a company) are unable to access the benefits of the employee share provisions. Rather the unit trust would pay FBT on the value of any benefit provided to an employee. This is incongruous given that many of their competitors operate through stapled entities and are able to access the benefits of the employee share provisions.

EOG's recommendation: The employee share provisions be extended to employees of unit trusts as well as companies and stapled entities.

Appendix Two

Technical issues

Shares or rights?

Under the current legislation, there is often uncertainty as to whether an employee has acquired a share, or simply the right to a share. For example, this lack of distinction can occur under a matching share scheme. Issues therefore arise in determining the taxing point for the equity.

It is our view that the new rules should provide further clarity in determining whether a share or right is being provided, either in the legislation or via explanatory memorandum.

Broader definition of equity

The equity of unlisted entities which are taxed as companies, including corporate limited partnerships, limited liability companies and trusts taxed as companies, are often not classed as 'shares'. As a result, there are no rules specified for determining the taxation treatment of such interests.

An unlisted employer should be able to offer its employees interests which entitle the holder to dividends and an entitlement to capital, similar to equity provided to employees of listed companies. Therefore, we believe that the new legislation should provide clarity in respect of the tax treatment of the instruments of unlisted entities.

Replication of section 139DB

Under the proposed legislation in Division 83A, section 139DB has not been replicated. This section operates to allow a tax deduction but not before the time when an employee first acquires shares or rights under an employee share scheme.

Greater clarity is required around the application of section 139DB of the 1936 Act (i.e. when it applies, and if so, how). Practically speaking, the underlying intent in our view should be that a company is entitled to a deduction for contributions made to a third party to acquire rights or shares under an employee share scheme, provided the employees concerned have "acquired" a right or share either at, or prior to, the time of the contribution as determined under Division 83A.

If no such acquisition has occurred, then the tax deduction is deferred until there is such an acquisition. In this way, the tax deduction is aligned with the acquisition point under Division 83A. This is a practical outcome for companies as this is the time when companies can show that the remuneration taxing provision, i.e. proposed Division 83A, first has application. While this view seems to be the one followed in practice, section 139DB needs to be re-written to make this position clear.

Capital gains tax implications

Capital gains tax ("CGT") provisions that are not directly impacted by the proposed reforms create unintended implications in respect of employee share schemes which could negatively impact the desired outcomes from the taxation reforms.

Employee share trusts are widely used by Australian organisations and are recognised as a practical way of achieving sale restrictions and forfeiture conditions during performance periods, enabling plans to be established in a way that motivates, provides incentives and retains employees during the performance period.

Typical examples of such an arrangement follow:

- An employee share scheme is established under which employees are granted shares that vest (i.e. become transferable) in them subject to certain performance hurdles.
- Upon grant, an employee share trust holds shares for the beneficial interest of the employee shareholder.
- Upon satisfaction of the performance hurdles, the trustee of the employee share trust is bound by the share plan rules to transfer legal ownership of the shares to the employee, who is then free to sell.
- If the performance hurdles are not achieved, employees will forfeit their interest in the shares for minimal consideration.
- The trustee of the employee share trust will retain the forfeited shares to be granted to other employees in accordance with the scheme rules.

In Class Ruling 2009/20, the Australian Taxation Office has stated that where an employee forfeits their shares in the circumstances described above, they could be taxed on the market value of the shares at the time that they are forfeited (even though the employee only receives minimal consideration) through the application of the CGT provisions in Division 116 of the *Income Tax Assessment Act, 1997* (the market value substitution rule).

If the CGT legislation is not changed, employee share trusts will not represent a viable way to effect the sale restrictions and forfeiture conditions that will need to be included in employee share plans under the proposed governance and taxation reforms.

To ensure that organisations can utilise employee share trusts, we recommend Division 83A contains clarification that the market value substitution rule will not apply to a CGT event C2 happening as a result of forfeiture of an employee's shares or rights that are held by an employee share trust.

Commencement time for the changes

The stated reason of the Government for permitting the new rules to apply from 1 July 2009 rather than 7.30pm on 12 May 2009 is to allow for the new rules to be clarified and developed in conjunction with interested parties so that affected parties can apply the new rules with certainty.

However, for the reasons stated below, the start date for the new rules should be postponed and applied only to shares and rights acquired after a future date, such as on or after 1 July 2010:

- The new rules will not be certain until they have been legislated, which we understand will not occur until the Spring 2009 sitting of Parliament at the earliest. In addition, substantial changes could arise through the Parliamentary process; and

- To apply the new rules with a fixed start date of 1 July 2009 will result in a number of anomalies. In particular, a number of different types of schemes will be unjustly affected as follows:

  - Option schemes where offers have already been made to employees pre-1 July 2009 (and in many cases before the Budget announcement on 12 May 2009), but have not been accepted by employees due to uncertainty in the new rules;

  - Option schemes where the options have been granted and accepted by the employees pre-1 July 2009 but where those grants are subject to shareholder approval. As per ATO ID 2007/66, in that circumstance acquisition would not happen until shareholders have given their approval. In the case of publicly listed companies, the approval would normally occur only at a company's AGM, which typically occurs more than three months after the company's financial year-end. For 30 June year-end companies, this can therefore be as late as November each year. In this case, unless changes are made, the new rules will apply to such options even though they were offered to, and accepted by, employees pre-1 July 2009; and

  - Tax-exempt ($1,000) schemes and deferred share schemes where employees have already elected to participate in the scheme for the 2009/10 financial year through a salary sacrifice programme, however the related shares will only be acquired through the course of the year. In this event, the shares will be acquired only when the employee obtains a legal or beneficial interest in the shares after 1 July 2009, when the new rules will apply. This is an unfair result since at the time the election to participate in this type of scheme was made, the existing rules were in force.

Appendix Three

Corporations Act, 2001 issues

The EOG has identified several Corporations Act obstacles to the implementation and efficient operation of employee share schemes in Australia, and makes the following submissions in this regard.

Exempt employee share schemes from the Corporations Act Prospectus/Disclosure Document Requirements

The existing prospectus/disclosure document requirements of the Corporations Act are a significant impediment to many companies wanting to implement employee share schemes in Australia, especially in the unlisted company context.

The EOG submits that employee share schemes should generally be exempt from the prospectus/disclosure document requirements of the Corporations Act. The necessary investor protection can be achieved by developing a minimum prescribed disclosure regime appropriate for schemes.

The employee share scheme Disclosure Regime proposed by the EOG is as follows:

- All companies implementing Division 83A share or option plans be exempt from providing a prospectus/disclosure document when they are making an offer to fewer than 100 employees in any 12-month period and when the value of shares offered in that same period does not exceed $2 million.
- All unlisted and private companies be permitted to issue a streamlined "evergreen" disclosure booklet where the offer does not exceed $5 million in a 12-month period. The EOG envisages a disclosure booklet that includes the following information (along with appropriate disclaimers, warnings and undertakings):
  - Identify the company and the nature of the securities to be acquired by employees under the share plan;
  - Explain how the plan works and is managed and administered;
  - Give details of all amounts payable in respect of the securities to be acquired by employees;
  - Identify the tax implications for employees of participating in the share plan;
  - Include a copy of a financial report for a 12-month period and have a balance date that occurs within the last 6 months before the securities were first offered to employees - or,

where a company has not been registered for more than 12 months, a financial report for the period since registration;

- When the offer is being made by a "small proprietary company" (as defined in the Corporations Act) the financial report is unaudited, otherwise it is audited.

- Listed companies continue to be able to rely upon the existing Australian Securities and Investments Commission Class Order relief from the prospectus/disclosure document requirements of the Corporations Act that is generally available for ASX listed companies.

Offers that come within this proposed employee share scheme Disclosure Regime should also be exempt from the advertising, hawking and Australian financial services licensing provisions of the Corporations Act.

Introduce a mechanism for cancelling shares issued or held under an employee share scheme without the need to implement a share buy-back

Companies that have issued shares to employees under an employee share scheme will often want or need to cancel those shares where the holder is no longer entitled to them (e.g. if the shares have been forfeited) or where the shares are surplus to the requirements of the plan.

Under the Corporations Act, shares held under an employee share scheme can only be cancelled pursuant to a buy-back or capital reduction in accordance with Part 2J.1 of the Corporations Act.

However, there are certain practical problems associated with even the simplest of these methods, 'employee share scheme buy-backs'. For example, the need to get an employee's agreement to the cancellation of their forfeited shares can be problematic.

The EOG therefore submits that there should be introduced a procedure for cancelling shares issued under an employee share plan that avoids the need for a buy-back agreement and which thereby gives more certainty to, and simplifies, the cancellation procedure.

Such a procedure could be introduced through an amendment to section 258D of the Corporations Act to allow cancellation of shares the ownership of which has been forfeited, or which are liable to be cancelled, under and in accordance with the terms of an employee share scheme, provided the cancellation does not materially prejudice the company's ability to pay its creditors.

Introduce an employee share scheme exemption from the prohibition on self-acquisition and control of shares

Listed and unlisted companies, for legitimate and compelling commercial reasons, often want to use a plan company or trustee to hold shares for the purposes of their employee share plans (e.g. to hold shares for, or to transfer to, participants or to acquire shares the ownership of which has been forfeited).

However, the current prohibitions on self-acquisition and control of shares in Part 2J.2 of the Corporations Act can cause technical problems in this regard.

In particular, generally it is not currently possible for the plan company or trustee to be a subsidiary or other controlled entity of the issuing company (which often means that an external plan company or trustee must be used as the plan company (which is expensive and may be a deterrent, especially in the unlisted company context)).

The EOG therefore submits that an amendment to section 259C of the Corporations Act should be made to allow the issue or transfer of shares to a controlled entity where the issue or transfer is to, and the shares are held by, the controlled entity solely for the purposes of an employee share scheme.

Introduce an appropriate employee share scheme exception to the prohibition on insider trading

There are several insider-trading issues that can arise in relation to employee share schemes, such as employees possessing inside information at the time:

- of invitation to participate in the plan; or
- when shares are acquired under the plan.

The EOG considers that there should be an appropriate exemption from the insider trading prohibition for the acquisition of securities under employee share schemes.

In this regard, the EOG endorses Recommendation 16 of the November 2003 "*Insider Trading Report of the Treasury Corporations and Markets Advisory Committee*" which formulated an exemption from the insider trading provisions for non-discretionary employee share plans. This Recommendation was subsequently accepted in the Treasury's March 2007 "*Insider Trading Position and Consultation Paper*".

The EOG submits that an appropriate exemption should be implemented.

Conclusion

In the EOG's view, the adoption of the submissions made above is necessary to assist the efficient operation of employee share schemes in Australia and will help promote the expansion of employee share ownership in Australia.