Appendix a

1. **The Committee has received evidence about the widespread use of trusts in the operation of ESOPs. The Committee would be interested in receiving information on:**

- **Why trusts are used.**

Response

Trusts aid in the administration of ESOPs, enforce restrictions and forfeiture/performance conditions. Trusts also facilitate progressive share acquisition by on-market purchase at low transactions costs, similar to collective investment trusts operated by leading fund managers.

A detailed account of the characteristics of trusts and their effectiveness as a vehicle for ESOPs is contained in Appendix B. Appendix B also compares trusts with a proposed alternative, the so-called "share trading block".

- **Are trusts the best vehicle to use when establishing an ESOP?**

Response

In most cases, yes. Trusts enable employees to acquire relatively small parcels of shares on a regular basis in a cost effective manner. They enable employers to operate plans cost effectively, to outsource (if required) their administration, and to have any necessary performance, forfeiture, insider trading and other restrictions and plan policies properly enforced and supervised.

- **Is one of the reasons for their use that they provide tax advantages to the employer and employee?**

Response

The tax "advantages" of using a trust are no different from those which occur when an employee acquires shares under a plan directly in his (or her) own name. There might, however, be substantial adverse tax (and other) consequences for the plan trust itself under the Federal Government's proposal to tax trusts as companies. These would be avoided if share plan trusts were quarantined from the new "entity taxation" system.

The adverse consequences of "entity taxation" for share plan trusts are explored in Appendix C.

- **When a share is transferred from a trust to an employee, when is tax payable and at what rate?**

Response

Tax is payable in the year of transfer, on the market value of the shares transferred, at the individual's personal marginal rate.

- **Will you outline the most common trust arrangements, indicating taxing points, rate of taxation and the advantages of the trust structure over other arrangements for ESOPs?**

Response

The most common trust arrangements are where shares are held in the name of a trustee company, under a discretionary trust deed. Shares are not released from the trust to the employee until specific criteria are met. This may be a performance target, a time-based vesting period, the repayment of a loan. Shares are acquired by the trust either by on-market purchase, or by applying for new issues of shares by the employer company.

Tax is payable in the year of transfer, on the market value of the shares transferred, at the individual's personal marginal rate.

2. **At his appearance before the Committee, Mr Jon Kirkwood made reference to "share trading blocks" as vehicles for employee share ownership plans. He said:**

> More recently, the idea of a share trading block, which is a tripartite agreement among the company, the employee and the share registry, has become the go. The Commonwealth Bank is using that. Telstra is using that. A number of companies are using that. It is so much simpler and easier to administer that I am now recommending that companies stay well away from trust arrangements. (EEWR *Transcript of Evidence*, p. 132.)

- **Will you provide the Committee with more detail on the nature of a "share trading block" and the way that such blocks operate?**

Response

A "share trading block" plan involves the shares being registered in the name of the employee participant, but recorded as a separate holding that is not freely tradable. The employee receives information from the registry manager the same, or similar, to that received by other shareholders. The trading block is designed to apply relevant conditions necessary to attract the available tax concessions in Division 13A ITAA. The trading block is capable of enforcing performance criteria and other plan design conditions or restrictions, but not nearly so well as a trust-based plan. The reasons for this are outlined in Appendix B. They key problem is a CGT liability to which the "trading block" plan itself can be exposed in certain routine administrative situations.

- **In your view, what are the merits, if any, of share trading blocks?**

Response

The Share Trading Block (STB) is initially attractive as it does appear "simple". However, it does not suit in many cases. Employees hold shares on different terms to those of other shareholders to attract the tax concessions, or to reflect the fact that they must satisfy conditions before they can access the shares freely. Employees also require supplementary information that share registries do not normally provide, for example tax information to assist in declaring the appropriate share value required by Division 13A.

STBs do not easily facilitate plans that acquire shares by on- market purchase, which are increasingly popular particularly among existing shareholders who want to minimise dilution caused by new issues of shares. STBs would not be an appropriate vehicle for a leveraged ESOP which would be used in an employee buy-out. STBs are also more costly to administer as trusts can aggregate purchases and sales to achieve lower transaction costs.

In sum, STBs does not suit the following situations:

a) where employee shares are purchased on-market at the full price (rather than sourced from new issues, or provided free);

b) where shares are delivered to employees on condition of meeting performance and other criteria and, therefore, can be subject to forfeiture.

c) where the share plan is being used as a vehicle for an employee buy-out; and

d) where the employer is familiar with the internationally accepted practice of using trusts as the structural foundation for an ESOP.

- **Please make such other comments as seem appropriate.**

  Response

  Mr Jon Kirkwood refers to Telstra. Telstra recently utilised a trust structure for its performance-based share plan introduced as part of the T2 offer. It neatly demonstrates the role of a trust. This new Telstra plan allocates shares subject to performance targets being met. It also facilitates on market purchase, as there is obviously a limit on sourcing new shares, due to the limit on the government's holding not falling below 51%. Mr Kirkwood's comment is a serious over-simplification, and overlooks some real practical problems in the operation of plans using the STB approach.

  Trusts aid in the operation of plans for employees of international companies. Clearly there is no local share registry to run a name on register system. Employees can benefit greatly by participating through a local trustee structure. The local trustee can aggregate purchases and sales to minimise transaction costs. Dividends can be translated more cost effectively by the trustee into local currency, then distributed to employees. Often employees would be faced with receiving small $US dividend cheques that cost more to bank than the value they represent. A trustee avoids this situation.

  Finally, it should be noted that the ESOP reforms recently announced by the UK Government are based on trust structures.

3. **The Committee received information that the current legislative arrangements, Division 13A, and the taxation laws in general act as an impediment to Australian businesses establishing ESOPs for foreign-based employees and for foreign-listed employers establishing ESOPs for Australian-based employees.**

- **In your view, does Division 13A and or the taxation laws, create such barriers and if so, how can they be remedied?**

  Response

  The AEOA does not believe such impediments exist. The only restriction that exists is that Australian employees cannot borrow to buy foreign shares, a practice that is not really to be encouraged given the heavy financial risks of such an approach.

  There are many plans operating where Australian employees receive or acquire shares and/or options in their international parent companies. These plans operate very effectively.

4. **The Committee has noted in a business publication the claim that salary sacrifice schemes are widespread. [Michael Laurence, "Ralph report leaves share plans out in the cold", *Business Review Weekly*, 5 November, 1999, p. 74.]**

- **Are such schemes in widespread use?**

  Response

  They are becoming more popular, in particular because the dangers of lending by employers to their employees have become better understood. In contrast to the potential risks of the loan plan, progressive share purchase, funded out of pre-tax salary and bonus payments, offer a comparatively low-risk route to employee share ownership. Nevertheless, the interest free loan plan, and the option plan, are still the most widely used share plans.

- **Are they generally open to all employees or are they usually limited to executives?**

  Response

  They are normally offered to all employees, and employees simply elect to participate as a form of regular saving by contributing from their pre-tax pay, like salary sacrifice to superannuation.

- **The report referred to above claimed that salary sacrifice funds the entire value of the shares. Would such schemes operate under Division 13A?**

  Response

  Yes, they are completely compatible with Division 13A

- **If the salary sacrifice schemes provide shares at a discount, when would the tax on the share or right and the sacrificed salary be payable and at what rate?**

  Response

  Both amounts are taxed upon the earlier of when the shares are withdrawn from the plan, termination of employment, or 10 years after each purchase, as required under Division 13A. The rate is the individual's personal marginal rate.

5. Some witnesses have testified that where the level of risk to the employee is low, there should not be strict disclosure requirements. Witnesses have also suggested that strict disclosure and prospectus requirements, because they are costly, discourage the creation of ESOPs.

i) **The CLERP legislation has been passed by Parliament. Will it help address these issues or is further legislative action required?**

Response

In practice, these measures have not helped. Further legislation will be required.

ii) **Are non-executive employees given sufficient information concerning ESOPs?**

Response

Yes, especially where employers follow Policy Statement 49 issued by the ASIC.

iii) **Should standard information about the ESOP be provided to employees before they agree to participate? What should it contain? Who should prepare it? [For example, the ATO, listing tax liability, total contribution over set number of years; date shares can be cashed in; and other conditions, etc.]**

Response

In these matters, Policy Statement 49 is already sufficiently detailed and exacting - at points, excessively so. For example, only companies which have been listed for 12 months are eligible for a PS 49 prospectus exemption. This discriminates against new, emerging businesess which are among the keenest to promote employee ownership. Such companies are obliged to issue supplementary prospectuses in order to make additional offers of shares to existing employees, or offers to new employees, within a year of listing. If there is to be no further advance on CLERP, then, at the very least, all companies should be eligible for a PS 49 exemption from Day 1 of their public listing.

6. What will be the effect of the recommendations of the Ralph review on the operation and development of ESOPs?

Response

The Ralph proposals on CGT will create an artificial distortion in favour Division 13A Exempt plans at the expense of Division 13A Deferred Plans. This is because any increase in the value of shares acquired under an Exempt plan is subject to Capital Gains Tax while any increase in the value of shares acquired under a Deferred plan is subject to Income Tax. The new, lighter CGT regime proposed by Ralph will, therefore, skew Division 13A in favour of a share plan which, by its very nature, is an 'entry level' structure intended to deliver 'wide' rather than 'deep' employee ownership.

For employees to develop a major stake in their employer's company requires widespread use of well-funded Deferred plans. The Ralph reforms could, therefore, reduce employee ownership to small packets of shares for general employees. In order to pre-empt this possibility, the taxation of the Deferred plan needs to be aligned with that of the Exempt plan.

The Ralph reforms will also encourage share plans which operate *outside of* Division 13A, and attract CGT . The popular, yet very risky, interest free loan plan will be favoured by the CGT changes.

In order to avoid a distortion in favour of the loan-funded, *ex*-Division 13A approach, and to align the taxation of Division 13A Exempt and Deferred plans, any *increase* in the value of employee shares, whether acquired under an Exempt or Deferred plan, should be treated as a capital gain and taxed at the CGT rate.

7. Would removing the present cessation requirements and replacing them with a single requirement, [such] that tax is payable on disposal of the asset, assist the development of ESOPs:

i) **in general?**

Response

Yes, most definitely.

ii) **for non-executive employees?**

Response

Yes, most definitely.

iii) **for unlisted companies?**

Response

Yes, most definitely. There are two problematical cessation points in Division 13A which this proposal would resolve.

The first - and most serious - is the "10 year rule" which obliges employees to sell shares simply in order to pay tax at 10 years. This measure subverts the purpose of an ESOP by forcing employees arbitrarily to sell when the object is to acquire and hold.

Among other things, the "10 year rule" poses a major threat to the viability of worker buy-outs, since employees would be obliged to sell part, or all, of the business at 10 years to pay tax. Why would employees buy-out a company only to have to sell at least half of it again just to comply with an arbitrarily imposed taxing

point? An employee-owned company might well wish, at some point, to dilute employee equity to raise new capital, or to acquire new management skills or technology. These are legitimate commercial decisions. But to be forced into selling out, or into taking on a new (and perhaps uncomfortable) partner, in order to meet the "10 year rule" is anti-commercial and hostile to the long term, viability of worker-owned businesses.

The second cessation problem is the need to pay tax on shares upon separation from the employer from whom the shares were acquired. Taxing shares upon disposal rather than at cessation of employment would greatly enhance the retention of shares by individual employees and facilitate diversification of risk, by enabling employees to build a portfolio of shares gathered from time spent with different employers. Taxation upon disposal, therefore, could only enhance the spread of employee ownership.

8. Do you have any specific suggestions that could further reduce the potential abuse of ESOPs by those who wish to use them to artificially reduce tax?

Response

The utilisation of trusts could be encouraged as a means for tracking and monitoring plan operations. A concept similar to "complying funds" in the superannuation environment could be emulated, enabling more effective supervision and enforcement of intended concessions. Plan trustees would need to be registered, and obviously be subject to audit, to ensure compliance and therefore qualification for the intended concessions.

All transactions with beneficiaries of the plan trustee can be checked, and distributions reported under the TFN system. Trustees could even be required to withhold tax in respect of distributions, and remit on behalf of the participants.

More fundamentally, however, the best way to prevent the abuse of ESOPs by people bent on artificially reducing their tax is to make Division 13A sufficiently flexible to accommodate a wide range of legitimate employee ownership conditions and objectives. Share plans have been designed outside Division 13A in order to meet 'live' employee ownership situations which Division 13A cannot accommodate because of

- the "ordinary share" rule;
- the "5 per cent rule";
- "10 year rule".

These limitations and their implications have been treated exhaustively in the evidence taken by the Committee. The problem, however, with going outside Division 13A to address the deficiencies posed by it is that alternative ESOP structures can be designed which could also be used for other than genuine employee ownership purposes. In other words, the very narrowness and inflexibility of Division 13A has contributed, significantly, to the misuse of ESOPs about which the ATO has complained - albeit to excess, with a blind eye to legislative inadequacies, and by pretending that its hostility to *ex*-Division 13A plans is a matter of law rather than of departmental policy.

In contrast, the AEOA has always regarded Division 13A as a basically sound, but inadequately articulated, legislative framework for employee ownership. The AEOA has taken the view, therefore, that work on Division I3A needs to be resumed and completed in order to meet a broad spectrum of authentic employee ownership situations and to target more exactly, and more decisively, the abuse of ESOPs for tax avoidance purposes. This can be achieved by making Division 13A 'inclusive' rather than 'exclusive' and by the ready deployment of the ATO's anti-avoidance powers (enhanced, if necessary).

To sum up, Division 13A ought to be provide the normative path to employee ownership; but it has to be wider in its scope and much more flexible in its possibilities. Outside it, there should be no tax advantages for alternative share plan structures and no tolerance for phony 'ESOPs'.

9. To what extent should an ESOP be permitted to use equities other than ordinary shares or rights to ordinary shares?

Response

There are some interesting employment situations where this would be very useful and justifiable. For example:

a) for employees of property trusts or other entities using stapled securities;

b) for employees of listed companies which have listed, preferred shares or where shares carry a higher dividend but no voting rights; and

c) in small, closely held companies where voting rights and control are major issues and where non- or limited-voting shares would provide an attractive alternative.

10. Should a distinction be made here between unlisted and/or small companies, "sunrise" companies, and listed companies in respect of the use of equities other than ordinary shares or rights to ordinary shares?

Response

Yes. Often the issue of voting is what stops owners of young companies inviting their employees to become co-investors. In this case an equity in the employer's company to which no (or limited) voting rights were attached would encourage implementation of an employee share plan.

11. Should a distinction be made between schemes open to general employees and those open only to executives, in respect of using equities other than ordinary shares, or rights to ordinary shares?

Response

No.

12. To what extent, if any, and on what basis, should a qualified ESOP scheme be permitted to purchase shares or options in companies other than the employer company? Should a distinction be made between unlisted and/or small companies, "sunrise" companies, and listed companies?

Response

This idea is long overdue in Australia, and would greatly assist in helping to ameliorate risk for employees. The United States has set a standard in this regard with its 401(k) model. The greatest obstacle for many employees in electing to participate in a share plan is having too many eggs in the one basket. The 401(k) was established, on the initiative of the US Congress, to meet this problem. By enabling co- investments alongside shares in the employer, the employee can significantly reduce risk by diversification of investment. This issue is as relevant for all types of company.

13. The following is an excerpt from the *Business Review Weekly* 8 Feb, 1999:

> Whenever Anderson meets staged short and long-term performance benchmarks, the trust will acquire BHP shares. However, Anderson could choose not to exercise his performance rights for up to 10 years and thus defer tax on the accumulated value acquired by the trust during this period. Meanwhile, he receives all dividends.
>
> If he had taken the conventional course of immediately taking the rights in his own name, he would have had no access to the dividends before the rights were exercised. He receives the double benefit of tax deferral and a large income. Anderson will pay nothing for either the rights or, provided the performance goals are met, the shares themselves.
>
> BHP can claim tax deductions for the cost of providing shares and, under a clause in the FBT Act, employee shares and options held in trust are not subject to fringe benefits tax, provided the securities are in the employer's company. Anderson's "performance rights" are options by another name.

- **Can you explain in detail how this scheme works, indicating the taxing points and the rates of taxation.**

Response

This plan actually operates within Division 13A.

Shares are acquired by the plan trustee, using tax deductible funds received from the employer. Such funds would represent deductible remuneration other wise payable to the employee.

The trustee holds the shares for the benefit of the employee participant, subject to restrictions. The restrictions attract the tax deferral concessions in Division 13A.

The tax deferral period lasts for up to 10 years, unless the shares are withdrawn earlier, or the employee leave s the employer.

Tax is payable at the participant's personal marginal rate on the entire value of the shares in the year in which the tax deferral period ends, again as provided under Division 13A.

14. Do ESOP schemes generally contain provisions that require an employee to dispose of shares or rights obtained under an ESOP upon ceasing to be an employee of the provider of an ESOP?

Response

Yes, as this is what Division 13A effectively requires. Therefore many employees are forced to sell their shares upon termination of employment.

15. The cessation rules provide that taxation is assessable when an employee ceases the employment in respect of which the share or right was acquired under an ESOP. This effectively reduces the portability of shares and rights between jobs or the retention of shares and rights when a person ceases employment for family reasons. Should consideration be given to facilitating the portability and retention of ESOP shares and rights?

Response

Absolutely. Again, this would encourage a portfolio approach to investment by employees, and enable them to become long term investors. Again, a trustee structure would facilitate this process greatly, as the shares can be more effectively supervised, and help the employee to keep track of his (or her) accumulated interests.

16. What would be the effect of replacing the present taxation arrangements with a single rate, payable at disposal of the share or option, at:

i) **the marginal income tax rate?**

Response

This is actually the present situation right now for Deferred plans and it creates a distortion in favour of plans which are taxed only on their capital gains, such as Exempt plans and Loan plans.

ii) **the capital gains tax rate suggested in the Ralph report?**

Response

It is our view that all gains in value of shares, and any gains arising from share options, should be treated as capital gains, and taxed at the CGT rate.

However in the case of discounts, or other shares acquired by way of salary sacrifice, the discount, or the cost of the shares bought by way of salary sacrifice, should be treated as income, assessable at normal personal marginal rates.

Appendix b

The Role of Trusts in the Design, Implementation, and Management of Employee Share Ownership Plans.

Introduction

The AEOA wishes to submit to the House of Representatives Standing Committee on Employment Education and Workplace Relations some considerations for its inquiry into employee share plans on the place of trusts in the design, implementation, and management of Employee Share Ownership Plans (ESOPs).

The AEOA has been prompted to offer this further advice by two main factors: first, by the Federal Government not having moved clearly to exempt employee share plans from the proposed new "entity taxation system" under which trusts will be taxed in the same way as companies; and, secondly, by evidence about the alleged redundancy of trust structures for ESOP purposes given to the Committee on 14 July 1999 by Mr Jon Kirkwood, a Partner in Ernst and Young.

In his evidence Mr Kirkwood said:

> "More recently, the idea of a share trading block, which is a tripartite agreement among the company, the employee and the share registry, has become the go...It is so much simpler and easier to administer that I am now recommending that companies stay well away from trust arrangements. In any event they are threatened by the Ralph review." (*Hansard*, 14 July 1999, p. 132)

Off-the-cuff, partial, and overly simplistic judgments of this kind, when combined with an apparent indifference to the fate of ESOP trusts on the part of the Federal Government, represent a potential threat to the ordered and healthy development of employee ownership. To deprive ESOPs of the trust, would be to deprive them of the most flexible, and internationally normative mechanism for holding and managing employee equity.

This Appendix deals with the role trusts play in ESOPs and provides a comparison of trusts with the so-called "share trading block". Appendix C outlines the potential pitfalls for ESOP trusts if such trusts are not exempted from the entity taxation system.

Background

There are three ways of providing a structure to deliver equity to employees:

1. Contract (the most common form being the employee share option contract);

2. The Employee Share Trust (under which the trustee is legal owner and which extends beneficial and legal rights to participating rights employees); and

3. The so-called "share trading block" structure which uses, within a company's general share register, a separate employee share sub-register in which employee shares are recorded.

It would involve a radical narrowing of perspective, and require an artificially prescriptive orientation, to insist that trusts for employee share plans should be avoided and that the "share trading block" model should be the preferred employee share plan structure.

Trusts and Share Trading Blocks

Employee share plan trusts are the established, normative vehicles for providing employees with shares in those advanced Western economies (particularly the USA and UK) in which employee share ownership is a significant phenomenon.

The trust offers a greater range of design possibilities for ESOPs than any other available alternative. This makes the trust the most effective structure on which to implement ESOPs in the widest range of company circumstances - whether small or large, whether privately or publicly owned, whether listed or not. Furthermore, companies which are worker-owned, or in which employees own a large minority stake, would need trust-based ESOPs to hold and to manage the employees' equity. Finally, ESOPs designed around a trust would be required in order to execute an employee buy-out.

In comparison, the uses of a "share trading block" plan are narrow. The Share Trading Block (STB) provides a simple and effective way for a big listed company to deliver a small number of free, or new issue, shares to a large group of employees where the objective of the plan is not to create a deeply rooted "culture of ownership", or a significant worker stake in the company, but rather to deliver a wide incidence of low-level share ownership as part of a limited, savings-related remuneration strategy. While these modest objectives are certainly worthy, the structure used to deliver them is unsuited to other, higher-order, share plan purposes such as enabling employees progressively to acquire, under performance criteria, substantial equity in a business, or as an employee buy-in, or buy-out, vehicle. Moreover, the STB is not attractive to Australian subsidiaries of foreign companies, especially with US or UK parent companies, because those companies traditionally use trust-based share plans as the preferred vehicles for providing ordinary equity in the company to their employees. Indeed, the fundamental role which trusts play internationally in ESOP design has just been illustrated by the UK Government whose proposed employee ownership reforms are based around trusts.

To sum up, the STB does not suit the following situations:

- where employee shares are purchased on-market at the full price (rather than sourced from new issues, or provided free);

- where shares are delivered to employees on condition of meeting performance and other criteria;

- where the share plan is being used as a vehicle for an employee buy-out;

- where shares are acquired overseas in foreign parent companies, using foreign currency, and involving relatively high transaction costs; and

- where the employer is familiar with the internationally accepted practice of using trusts as the structural foundation for an ESOP.

Which structure to use

Just as Governments and legislation should not be prescriptive about the kind of share plan companies should implement - option plan, loan plan, remuneration-funded plan, etc. - nor should they be prescriptive about the kinds of structures used to implement a share plan. Plan structures are determined by a combination of factors: by the kind of equity to be delivered; by the particular character of a company and its workforce; and by the objectives of a particular share plan (to deliver performance-based remuneration; to turn employees into owners; or to promote 'cultural change' in the workplace). The choice of structure should be guided freely by these kinds of practical considerations which vary from case to case rather than by artificial notions of what is 'ideal' ESOP design.

Flexibility of Trusts

The chief reason why trusts are most commonly chosen as the preferred ESOP structure is their flexibility. Trusts have the following characteristics:

- Trusts allow for bulk purchases of shares.

- Trusts provide a 'warehouse' and a market for shares. The latter is especially important in unlisted companies whose shares are not traded on a stock exchange and where trading in employee shares would need to be funded by the employer.

- Trusts provide the most efficient mechanism for enforcing conditions (productivity, longevity of service, etc.) under which shares can be offered and for re-allocating shares which might be forfeited in the event that such conditions are not satisfied.

- Trusts allow for the forfeiture, and reallocation, of shares *without* taxing the trustee on an unrealised capital gain.

- Trusts which use trustees who are 'foreign' to the employer's company assist in regulating insider trading problems which can sometimes be a problem among senior employee participants in a share plan. With external ESOP trustees the acquisition of shares is conducted by 'outsiders' not normally aprised of the sort of 'inside' information which might tempt a senior employee to improper trading activities.

- Trusts allow for the provisions of "fractions of shares" to participating employees. This is an important issue for subsidiaries of companies listed on the New York Stock Exchange where shares can be valued at hundreds of dollars.

- Trusts provide an economical way of handling large numbers of small share-holdings.

- Trusts provide an efficient means of handling the currency conversions and high transaction costs involved in ESOPs holding foreign company shares and distributing foreign-sourced dividends.

- Trusts quarantine the risks to employees associated with the use of debt by an ESOP in a leveraged employee buy-out.

- Plan Trustees are required by ASIC to treat employee participants as if they are actual shareholders, as a condition of prospectus relief for employee share plans. Therefore employees do not lose any shareholder rights if the employer chooses to use a trust. In other words, ESOP trusts operate under Australian conditions to preserve the rights of employees in such a way that there is no practical difference for an employee between holding the shares directly and having them held in a trust.

- Share trusts are an internationally favoured ESOP structure and, as such, are very acceptable to the overseas parents of Australian subsidiary companies.

Limitations of the Share Trading Block

The STB is useful in the case of certain Division 13A Exempt share plans (which cannot have any forfeiture conditions) implemented in a listed company which intends to issue free or new shares to the employees.

However, the STB is not suited to the situation where shares are to be purchased on-market at the full price. The STB would also be unsuited to a Division 13A Deferred share plan with forfeiture provisions which is typically used to deliver larger numbers of shares to employees and usually on condition of meeting certain performance, or other, criteria. The STB would also be unsuited for the unlisted company.

The key limitations of the STB are:

- Because it provides employees with both legal and beneficial ownership of the shares, there can be unwanted CGT ramifications for the plan itself if the shares are forfeited and re-issued (which can happen in a Division 13A Deferred share plan).

- The STB does not enable quarantining of debt risk from employees in the case of a leveraged employee buy-out.

- The STB is inappropriate for unlisted share situations where a warehouse for employee shares and a market for employee share sales must be provided.

- STB cannot handle the ‘fractional share’ issue which can arise for Australian employees of foreign-listed parent companies.

- The STB tends to dissipate and to scatter employee share ownership into a myriad of individual employee shareholders. This might be inappropriate where there are minimum trading requirements. It would also be unsuited to the case where a company and its employees choose to ‘bundle together’ all employee shares as part of a strategy to emphasise the employee stake in the business and (or) to mobilise the total voting power of the employee owners.

Share Plan Administration Issues

Trusts provide solutions to important problems posed by share plan administration.

Administration costs: *employer considerations*

A major issue for companies implementing a share plan is the cost of administering the plan.

Some share plans, especially Division 13A Exempt plans, can create a large number of relatively small shareholders a good number of whom separate from their employer after 1 or 2 years. Using a share registry to record these employee holdings means the company can

significantly increase its long-term share registry expense as small shareholders can be costly to service. The costs of servicing a single shareholder, even if holding only one share, can be up to $30 p.a. This is not cost efficient for the employer company.

Administration costs: *employee considerations*

Small shareholdings are more expensive to sell, relative to larger ones. Therefore it can be in the interests of the small employee shareholder to have their shares bought and sold at the institutional rates which plan trustees can negotiate.

Employees of international companies face the same problems only more acutely. Many international companies often have very high share prices, compared to Australian companies. It is not unusual for U.S. companies to trade at hundreds of dollars. So share-holdings are smaller, harder to sell in separate parcels, and consequently attract higher brokerage fees. The problem can be solved through a trust which has the capacity to combine the small share-holdings and trade their shares in larger parcels.

There is also the need to convert currencies. This is an extra administrative function which a plan trustee can simplify and where he can reduce transaction costs.

Similarly, international companies paying lower dividend yields can send dividend cheques in foreign currency several times each year. These small dividends cheques can cost employees more to cash than they are worth. This can be a source of frustration and disappointment for employees. Plan trustees, however, can receive foreign currency dividends on behalf of all participants in

a share plan, convert them once into Australian dollars, then distribute them, cost effectively, to employees.

Conclusion

It would be very adverse to the employee ownership interest were the Committee, and subsequently the Federal Government, to accept the view that the so-called Share Trading Block should be the preferred, or ideal, model for all employee share plan structures.

The fact is that there are a number of employee share plan structures operating in the market place. Their different characteristics make them more, or less suitable, according to the circumstances in which they are called upon to operate. These vary from company to company, from workforce to workforce, and according to different kinds of ESOP objectives which different employers, and different bodies of employees, wish to meet. The structure that is ‘ideal’ in one case can be less than ideal, or even completely inappropriate, in another.

Having said that, the fact remains that trusts, because of their inherent flexibility, can handle a wide range of different company circumstances, provide a platform for many different ESOP types, and solve a diverse range of ESOP administrative problems. In contrast, the STB, while being well suited to certain kinds of simple and unambitious ESOP projects, lacks the adaptability of the trust-based ESOP for most other purposes.

The Committee, consequently, should oppose any proposal to favour one model over another, or, especially, to limit the use of ESOP trusts. The Committee should espouse the principle that companies should be free to choose the structure best adapted to their circumstances.

Appendix c

Taxation of ESOP trusts as companies: implications for employee ownership

The Australian Employee Ownership Association (AEOA) is concerned with the Government's proposal to treat trusts, for taxation purposes, as if they were companies and its failure, so far, clearly to exempt ESOP trusts from the new, so-called “entity taxation” system. We believe that employee share trusts require specific and separate treatment for the reasons stated below.

The key differences of trust structure over the corporate structure, in terms of general law and taxation law are:

- Beneficiaries have interests or rights in the property held by the trust whereas shareholders in a company have no interest in, or right to, the property of the company.

- Income or property received by the trustee retains its character under the so-called "conduit principle" - whereas, any distribution by a company, generally speaking, experiences a change of character (e.g. income of the company distributed to shareholders becomes dividends).

- Trusts and their beneficiaries, like partners in a partnership, are taxed under an "integration system" (which prevents double taxation of trust income) rather than the "imputation system" which applies to companies (which prevents the double taxation of dividends).

Given the above, the major potential problems which occur in respect of this proposal are as follows:

1. Shares presently held for the benefit of employees in an ESOP trust would need to be treated as the legal and beneficial property of the company. Employees, therefore, would lose their legal interest in, or rights to, shares which, morally and legally, should be held for their benefit.

2. Distributions by ESOP trustees to employees could represent a capital disposal subject to capital gains tax and payable by the trustees.

3. To accommodate dividends received by an ESOP trust would require the establishment of separate dividend imputation and franking credit accounts for each of its employees. This would be expensive and burdensome on the trustee, and the sponsoring company, and would be certain to discourage the implementation of ESOPs.

4. Shares distributed to employees would be treated as ordinary dividends in the hands of the employees. This causes a number of contradictions to exist in employee share plan taxation provisions including:

    (a) tax exempt employee shares would now be treated as fully taxable dividends;

    (b) shares held prior to 1996 to be distributed as eligible termination payments would now be taxed directly as dividends (this goes against direct assurances provided by the ATO to several of our members);

    (c) dividend withholding tax credits cannot be passed on to employees under the corporate tax system;

(d) bonus shares and rights issues received and passed on to employees would be fully taxable as dividends (i.e. these are not usually taxable under the current regime);

(e) loans to employees by the trustee could be considered taxable dividends under the newly implemented provisions of Division 7A.