Wednesday, March 08, 2000

FOR ATTENTION MR PAUL McMAHON, Secretary, EEWR / Employee Share

Ownership in Australia Committee

Dear Mr McMahon,

I called Dr Andrew Brien to discuss the recent amendments to Division 13A (ITAA) and he suggested I write to you regarding that and some other matters we discussed. I shall be pleased if you will pass these comments on to the Committee.

TLAB (No5) 2000

On 17 February 2000, the Government introduced Taxation Laws Amendment Bill (No.5) 2000 to the HoR for debate. This Bill included (in Schedule 2) amendments to Div 13A essentially new Section 139FAA which will make it simpler to determine the value of shares acquired at or about the time of a Public Offering (not being the Initial Public Offering). In effect, the PO price will be the market value of the shares. This overcomes the difficulty which arises when shares are not quoted for a period around the PO (in many cases, the shares are suspended from listing because the announcement of the PO poses market pricing problems which the ASX may not tolerate).

Frankly, I find it strange that this amendment has been made in isolation to any consideration of other changes which would appear to be equally pressing. However, of far greater concern is the fact that the Explanatory Memorandum at pages 10 and 11 makes the comment:-

> para 2.9 - "No change to the law is necessary for ESS's offered in association with an initial public offering of shares. This is because market value is determined in accordance with public offer price via section 139FB of the ITAA 1936"

I consider this to be a potentially misleading statement. I have on many occasions sought this confirmation from the ATO and have not achieved any such outcome. In one case that comes to mind, the ATO considered the book building price applicable to institutions sets the price notwithstanding the fact that the public offer price was lower. The ATO has also shown an inclination to apply the market prices quoted at the time the shares are allotted under an IPO notwithstanding the fact that the employee was offered those shares at the IPO price.

It is quite clear that section 139FB leaves an unfettered discretion with the Commissioner to accept any reasonable method of determining the market value without any assistance or guidance in that regard and without reference to the IPO price. In addition, the price set (agreed?) under S139FB must be confirmed in writing by the ATO and this results in a situation where the offer or must approach the ATO without any certainty of outcome having in many cases already committed themselves to the IPO.

Is the ATO or Treasury now confirming unconditionally that the IPO price is the market value of shares acquired under the IPO? This would be a very sensible outcome and if it is the case then the ATO should issue a ruling to that effect. If it is not the case, then they should provide further and better particulars to Parliament to explain what they mean by the statement at para 2.9 (above).

I note that the amendment requires the company to have been listed for at least 6 months prior to the offer (S 139FAA (1)(d)). This is why the amendment cannot apply to an IPO (see above) and it is also why the amendment cannot apply to any offer by an unlisted company (there is also a requirement that the offer be to at least 1,000 Australian residents other than employees and the outcome raises at least $1,000,000 - these requirements would exclude small companies). It is not

clear why unlisted companies are excluded as it is feasable for such companies to make an offer to the public (subject to onerous prospectus requirements). This aspect of the amendments appears to send a clear message to employers that small and unlisted companies are not considered suitable offers in relation to ESOPS. If this is the message, then it may be at odds with some of the aims of your Committee.

FBT on ESOP participation

In my response (Email of 9 February) to question 6 of your letter of 22 November 1999, I commented under a heading "No FBT if it is an "employee share scheme"). I have been told that my comments were somewhat brief and may not have been clear.

The message I was trying to convey is that if a benefit arising from employment is not exempt under the FBT rules, then arguments can arise as to how the benefit should be valued. Unfortunately, the exemption under the FBT rules for ESOP participation applies only if the share or right gives rise to a taxable discount (this is the effect of Section 139C (3)). Accordingly, if the employee is required to pay the market value of the share at the time participation is offered (subject to the concerns expressed re IPO's above) there is no discount and consequently the FBT rules can apply to the participation. This is a very common situation. Whilst it may appear there is no benefit to the employee, arguments could arise around the fact that no brokerage is payable or the employee may be included in a "preferred" allocation of shares or given some other advantage that has no tradeable value but may be difficult to rebut in the context of the FBT rules. In the spirit of giving some clarity and certainty to ESOP participants, the FBT rules should exclude all participation captured under paragraphs

(1)and (2) of Section 139C This will leave Section 139C (3) to play a role only under Div 13A (note there are also a number of references back to 139C(3) in section 139CD and some of these should also be amended to apply only to participation captured by S139C (1) and (2)). I had also made a submission regarding "possible debt forgiveness" which may arise when loans are only partially collected as a consequence of a fall in the value of the shares. It seems very unfair that the FBT rules can be applied in this situation where the outcome is that the employee has not received a benefit when the realisable value of the shares is taken into account. This problem will be exemplified if the current bubble in market pricing of high tech stocks bursts. Good employers will not be inclined to sue for the outstanding loan amounts and will limit their recoveries to the diminished value of the shares. As it currently stands, FBT will almost certainly be applied to the shortfall.

Please let me know if you require any further information regarding the (additional?) matters raised above.

Yours sincerely

Jon Kirkwood