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Dear Dr Nelson

Thank you for your letter of 22 October 1999 concerning recommendations put forward to the inquiry into employee share ownership plans in Australia by the House of Representatives Standing Committee on Employment, Education and Workplace Relations. I apologise for the delay in responding to you.

The Government strongly supports the development of employee ownership schemes within Australia. These schemes are consistent with Government policy of allowing employees and employers greater flexibility and choice in their working arrangements.

I have considered Mr Kirkwood's recommendations for changes to the taxation treatment of employee share ownership schemes. In a number of cases, the suggestions are likely to result in increased complexity in the taxation provisions. Other recommendations would significantly increase the generosity of the scheme beyond the original policy intent without providing evidence of the benefits, if any, beyond those that currently exist. I enclose a preliminary response to the issues raised.

Mr Kirkwood has made some recommendations concerning issues that are being addressed as part of the Government's response to *A Tax System Redefined*, the final report of the Review of Business Taxation, such as taxing trusts like companies and dividend franking rules. These will be factored into the consultation process which is currently taking place.

I trust this information will be of assistance to the Committee.

Yours sincerely

PETER COSTELLO

1. The prospectus issues and corporate law requirements.

This suggestion is already addressed by existing ASIC policy for listed companies and will be addressed further by the commencement of the CLERP reforms. Currently, employee share ownership plans (ES0Ps) may be subject to the fundraising provisions of the Corporations Law. Typically this would require the preparation of a prospectus where shares, or options over shares, are offered to employees.

ASIC has a policy of providing relief from the fundraising provisions where ES0Ps meet certain conditions. The relief is targeted to small-scale offers of shares where the primary aim of the offer is not capital raising, but to foster the relationship between the company and its employees. To ensure that employees receive appropriate disclosure, the relief is currently only available to listed companies.

The *Corporate Law Economic Reform Program Act 1998* contains reforms to the fundraising provisions of the Corporations Law. The major reforms contained in the Act are due to commence on 13 March 2000. The reforms are designed to minimise the costs of fundraising while improving investor protection. In framing the Act, it was considered that specific exemptions for ES0Ps were not appropriate because of the large variation in the types of ES0Ps currently being used.

Instead, the Act will facilitate ES0Ps as follows:

- A range of reforms are designed to facilitate fundraising by small to medium sized entities. It is anticipated that these reforms will provide an avenue for smaller entities to offer shares under ES0Ps. In particular, smaller entities will be able to raise up to $2 million each year from up to 20 investors without preparing a prospectus. Smaller entities will also be able to raise up to $5 million based on an offer information statement. It is anticipated that preparing an offer information statement will be less costly than preparing a prospectus.

- ASIC will continue to have the power to exempt companies from the fundraising provisions where appropriate. It is envisaged that ASIC's current relief for ES0Ps will continue under this power.

The cost of ES0Ps will also be reduced by the implementation of the other fundraising reforms. These include facilitating the use of short-form prospectuses and shorter profile statements, and rationalising the current liability rules.

2. The no forfeiture requirements regarding exemption plans.

Division 13 aims to provide incentives to encourage employee share ownership among a wide range of employees. It does this by providing a tax exemption on up to $ 1000 of benefits per employee and also provides a matching tax deduction for the employer, where a uniform level of benefits is offered and other specified conditions are met. Allowing the tax concession to be tied to forfeiture provisions may work against encouraging broad employee participation in such arrangements.

3. The inappropriateness of the valuation rules in division 13A.

A The issue here is that any solution must take into account that the value of a share discount should be determined as close as possible to the date the share is acquired by the employee. The longer the period of time between when the share is valued and the day on which the share is actually acquired by an employee, the greater the risk that the assessable discount will not reflect the actual discount (this could favour either the employee or the revenue).

The date of acceptance is not the date of acquisition. Further, shares that have not been traded or are only traded on the particular day do not fall outside the rules. Where employee share schemes are offered in association with an initial public offer of shares prior to trading of shares, the market value is already determined in accordance with public offer price in these situations by virtue of section 139FB of the ITAA 1936.

B Under the old employee share scheme provisions (section 26AAC), rights were valued as the current price of the share less the exercise price (to be paid some time in the future). However, a share right can have a significant market value at the time it is acquired, even where the exercise price is greater than or equal to the current market value of the underlying share: this reflects the probability of future share price movements. This means that, under the old valuation method, a package of rights with a significant market value could be assessed as having no taxable value.

Therefore, when the new Division 13A was drafted, it included valuation tables designed to provide a more accurate valuation of rights. The tables are based on the Black-Scholes methodology, a widely accepted methodology for valuing traded share rights.

It is recognised that a table of this kind cannot take into account all the possible characteristics of each type of right: hence the table is not designed to provide a tailored valuation for each possible share right. Therefore, to minimise the chance of an excessive taxable value, the parameters used to construct the table had the objective of generally providing a concessional value compared to the market value of traded rights (but less concessional than the valuation method under section 26AAC).

It is suggested that where a share or right cannot be transferred or realised there is something wrong with the valuation tables. The issue appears to relate to the non-inclusion of the amount paid for a share or right, or the non-recognition of restrictions, in the valuation of the share or right.

In regard to the non-inclusion of the amount paid for the share or right, the amount paid does not necessarily have any relationship to the market value of the right. The amount paid is important, however, in determining what benefit may have been received by a taxpayer ie. market value less amount paid.

Regarding the non-recognition of restrictions, it would be extremely difficult to take various restrictions into account when determining the appropriate value of benefits. Indeed, to do so may open an opportunity for employers to create restrictions (that they were in fact willing to waive) in order to minimise taxable values.

It is suggested that there are valuation problems where the exercise price of an option is variable. This issue was considered in developing the legislation. The problem is that an option's exercise price is needed in order to calculate any reasonable valuation of the option, and no alternative has been suggested which is better than that currently in the legislation. It appears likely that, in designing an employee share scheme which qualifies for the concessions in Division 13A, an employer will ensure that an exercise price will be stated in order to minimise the amount of taxable discount.

4. The $1,000 exemption is too low.

The Government doubled the concession from $500 to $ 1,000 in 1996. This increase represents a substantial commitment by the Government to encourage share ownership amongst employees.

Indexing the concession available under the employee share ownership scheme would be inconsistent with current policy. Personal income tax scales and the income tax-free threshold are not indexed. The Government's 1996 increase in the threshold is much more generous than had the $500 threshold been indexed since that time.

5. The 5 per cent limit on individual participation in the company is too low, especially for small companies.

The aim of the employee share ownership scheme is to encourage widespread employees ownership of shares in the company in which they are employed. The scheme encourages this ownership broadly amongst many employees through conditions such as the requirement that at least 75 per cent of the permanent employees are entitled to acquire. However, the scheme is not intended to provide concessions to substantial shareholders, hence the 5 per cent limit on individual participation. The number of employees in the company does not alter the need for a limit such as this to ensure that the concessions available under the scheme are spread widely among employees.

Mr Kirkwood also raised concerns in relation to this 5 per cent limit and proxy voting. This need not be a concern, as officers who hold proxy votes at a general meeting only have that power at that time. Subsection 139CD(7) is only triggered where the officer holds more than 5 per cent of the votes immediately after the acquisition of a share or right.

6. The cessation time rules and the fact that retirement and death are a cessation time, the time when you are taxed under the rules.

Cessation of employment

One of the events that can trigger a cessation time (and therefore, payment of deferred tax) is the taxpayer ceasing to be employed with the employer company. This is appropriate given that, after termination of employment, continued tax deferral cannot be justified in terms of encouraging the employer-employee relationship. A taxpayer is not unfairly treated in these circumstances. Rather, the taxpayer has already had the benefit of deferring tax for some period of time.

Section 139DD application to options but not shares

Section 139DD refers to a situation where an employee loses the right to acquire a share before ever having obtained the share. In this instance because the share has never been acquired no tax concession has been acquired. This is clearly in contrast to where a share has been obtained.

Takeover or Merger

When a takeover or merger occurs the previous employer-employee relationship no longer exists. In this circumstance continued tax deferral cannot be justified in terms of encouraging the employer-employee relationship. We do not consider that a taxpayer is poorly treated in these circumstances. Rather, the taxpayer has already had the benefit of deferring tax for some period of time.

Mr Kirkwood's also raises concerns that where a merger or a takeover has occurred an employee may breach the requirement that the share be held for three years. Section 139CE states that the scheme must not allow the employee to dispose of a share or a right before the earlier of.5

(a) 3 years after the time of acquisition of the scheme share or right; **or** (b) the time when the taxpayer ceased to be employed by the employer (bold added).

7. An election to be taxed up front to obtain the exemption also captures all planned participation in that year.

Under the existing provisions, a taxpayer may claim the exemption concession or the tax deferral concession, but cannot claim the exemption concession for some benefits and the deferral concession for other benefits in the same year. We consider this appropriate. An employee who has benefited from the $1,000 concession should not also be allowed to benefit from tax deferral in that year. Allowing access to both would involve a significant increase in the generosity of the employee share ownership provisions.

8. The 10-year limit should be extended until the shares are sold.

The Government considers that the 10-year deferral of this tax is already generous. The effect of removing the 10-year cessation period would be to allow tax deferral indefinitely, resulting in a significant increase in the generosity of the scheme.

Under deferral, the tax is applied to the discount (ie the difference between the value of the share and any contribution paid by the employee) not to the proceeds of the sale of the share. The ten year limit imposes no need to sell the share at that time and so extending the deferral period need not impact on the length of time for which the shares are held.

The implications for the revenue of any change to the deferral period is not known, as it would depend on taxpayer behaviour and when the shares were traded.

9. Trusts.

A In relation to Mr Kirkwood's comments about the unified entity regime and the consequences for employee share acquisition schemes, paragraph 279 of the Overview to the final report of the Review of Business Taxation, A Tax System Redesigned, noted that moving to a consistent entity tax regime does not preclude the maintenance of entity focussed tax concessions, including employee share acquisition scheme arrangements.

In implementing a consistent entity regime, consideration will be given as to whether to exclude trusts from that regime, or to formally include them but with some modifications to maintain the necessary features of their current treatment. The latter course, for example, was followed for collective investment vehicles in draft legislation prepared by the Review that accompanied its report.

These issues are being considered as part of the consultation process on business tax reforms.

B Under Division 13A, where an employee share scheme provides discounted shares or rights to employees through a trust, the transfers to and from the trust will not (as long as the trust's only purpose is to provide shares or rights under the employee share scheme) be taxable transactions. Where the shares are not discounted or the trust has other purposes, there is no reason to confer a concessional tax treatment on the trust. In regards to section 26AAC, there is no reason to change the rules which have been in place since 1974.

C As stated above, where the shares are not discounted or the trust has other purposes, there is no reason to confer a concessional tax treatment on the trust. A "predominant activity test" would be too broad and uncertain.

10. Ordinary Shares.

The intent of employee share schemes is to encourage widespread ownership by employees. A key argument often put forward in support of establishing employee share ownership arrangements in Australia is the prospect of improved productivity stemming from a closer alignment of the employer, employee and shareholders interests. Many factors can influence productivity in company performance. One example that is cited to help explain improved company performance is the level of employee participation in decision making in a firm, with greater employee participation leading to improvements in performance. This points to the importance of employees having some voting rights as part of employee share ownership schemes. Removal of voting rights may detract from the positive benefits that such schemes can generate.

11. Financing Share Purchases.

A fringe benefit exemption for the forgiveness of an employee's ESOS debt by an employer would create an inequity compared to a situation where an employee had borrowed money from an external lending institution to purchase their ESOS shares. Therefore, the Government believes that it is appropriate that any forgiveness of debt by an employer be subject to fringe benefits tax.

12. Employee buyouts.

An employee buyout may not constitute an employee share scheme because the invitation to participate does not come from the employer. This requirement emphasises the intent of the scheme - to encourage employee participation in the ownership of their employer company to bring about positive benefits to the employee-employer relationship.

13. Franking Credits.

Mr Kirkwood illustrates how currently the crediting of the share capital account for the cost of issuing shares under employee share acquisition schemes (ESAS) results in the tainting of the share capital account. However, companies can avoid the operation of the rule by not transferring profits into that account. As Mr Kirkwood points out, companies are free to choose whether to credit their share capital account with the non-share capital amounts or not.

Under the New *Business* Tax System, the share capital account will not be used for tax purposes. Instead all entities taxed under the uniform entity regime will be required to keep a contributed capital account for tax purposes. Using this approach the contributed capital account will only be credited to the extent that tax legislation allows it.

This issue will be considered in the drafting of the details of this legislation.

Complexity of the taxation rules.

A The existing provisions ensure that, if shares or rights are provided in respect of employment, but are provided direct to an associate of the employee, the employee is subject to tax and does not benefit from tax concessions. This is appropriate, given that there do not appear to be grounds for providing tax concessions where the share benefits are not provided to the employee but to an associate of the employee (eg a company controlled by the employee), possibly in order to minimise tax liabilities. The objective of the concessional tax treatment is to benefit employees of enterprises rather than their associates.

B The existing provisions are based on the value of the shares or rights (less any amount paid by the employee) being subject to income tax when specified events occur (this is called the cessation time, because it represents the end of the tax deferral period). Tax is based on the initial discount and any subsequent gain in value. After this point, subsequent gains or losses on the shares or rights are subject to the normal capital gains tax provisions: including that capital losses can only be offset against capital gains.

C For Division 13A purposes, the factors needed to be taken into account are:

(a) Div 13A taxes at the time of acquisition (even though the payment of the tax may be deferred to another year).

(b) A resident is taxed on all shares or rights acquired under an employee share scheme.

(c) A non-resident is only taxed on shares or rights acquired under an employee share scheme where the shares or rights are being acquired in respect of employment sourced in Australia.

(d) A share which has been acquired through the exercise of a right has the same source as the right.

Section 26AAC is similar to Div 13A, although the time of acquisition is deferred to the time the tax is paid.

D Section 139(3) is a threshold provision. The Division 13A regime only applies where the employer of an employee provides to the employee shares or right to shares at a value less than market value. Section 139C(4) avoids double taxation where the employee acquires a share as a result of exercising a right that the taxpayer acquired under an employee share scheme.

The exercise price for an option is excluded from consideration for a right as it only forms part of the consideration for a share.

If the consideration for the right exceeds the market value of the right, Division 13A will not apply (subsection 139C(3)). However, the consideration for the right can never be equal to or greater that the Division 13A discount as that discount is calculated by subtracting the consideration from the market value of the right.

Where Division 13A does not apply, normal CGT provisions apply.

E "No discount' participation is not included in subsection 139CD(5). However, "discount" employee share schemes dealt with under section 26AAC can be included in subsection 139CD(5).

F The aim of the 75 per cent test is to ensure that each scheme encourages ownership widely amongst many employees. A 3 year rolling test period (where participation is averaged out) may result in a particular scheme which is not offered widely to employees being eligible for the taxation concession provided. Each scheme must individually satisfy the 75% participation test.

G The rights contained in an ordinary share give an employee some basic guarantees as to what is being given by the employer. In particular, an ordinary share means that the employee has a right to vote in the affairs of the employer. One of the primary purposes of Division 13A is to strengthen employee participation in Australia business (in particular, their own employer), hopefully leading to higher productivity. If the shares' voting rights are removed or reduced, or other share rights are removed, then the share becomes little more than a salary sacrifice pay rise. The generous concessions contained in Division 13A were not intended to subsidise the cost of employers' wages.

H Section 130-80 of the *Income Tax Assessment Act 1997* includes the market value of the share or right in the CGT cost base. In this way, the discount (ie. market value less amount paid) is included in the cost base.

I In Division 13A, clearly "right" can only have the meaning of "right to acquire a share". Its meaning does not extend to rights to other property. This is demonstrated by the example in the question.

J This would defeat the purpose of the provision to ensure that 75% of the permanent employees were part of the offer.

K The tests for employment in subsections 139CD(3) and DD(3) do only apply at the time of acquisition. Nor is a takeover likely to trigger a cessation time under subsection 139CA(2) because of the provisions in 139CA(3).

In regards to the tests covering employees of non-companies, to extend the employee share scheme concessions to other types of shares or entities, such as trusts, would run the risk of opening major loopholes.

In regards to proxy votes, officers who hold proxy votes at general meetings only have that power at that time. Subsection 139CD(7) is triggered only where the officer holds that power immediately after the acquisition of the share or right.

There is no difficulty in determining that a person who changes employment between subsidiaries with a group within 3 years is not a permanent employee. For most employers, this would be an advantage.

L A restriction for the purposes of Division 13A is considered to mean a circumstance which prevents the employee from selling or otherwise dealing with the share or right. The ATO considers that an employee's obligation to discharge the debt owing to the employer in relation to a Share or right is not a restriction preventing the taxpayer from disposing of that share or right. At any time, subject to the employee's individual circumstances, the employee can choose to have such a limitation removed.

All the other things mentioned in the question are not wholly within the control of the employee.

M When Division 13A was introduced, a provision was introduced to exclude the value of tax deferred amounts under Division 13A from the FIF provisions.

N The ATO will consider any proposed method. However, the ATO would not be endorsing any single method as reasonable in all cases as each method must be considered in the light of the particular facts. Under these circumstances, it is not appropriate for the ATO to issue a ruling.

0 Under the existing provisions, a taxpayer may claim the exemption concession (subject to the $1000 limit) or may claim the tax deferral concession, but cannot claim the exemption concession for some benefits and the deferral concession for other benefits in the same year. This appears appropriate, as there do not appear to be grounds for allowing the $1000 exemption for employees who may also be benefiting from significant levels of tax deferral in that year.

P Under section 139G the time of acquisition is the time when the employee gets any legal or beneficial interest in the shares or rights (ie. the earliest of the events). The valuation rules apply on the day of acquisition (section 139CC). Section 139DA provides that where a taxpayer has included an amount in his or her assessable income arising from the acquisition of the beneficial interest in the share or right, he or she is not required to include an amount pursuant to section 139B where the legal interest is subsequently acquired.