16th December 1999

Dr Brendan Nelson MP
Chairman
House of Representatives
Standing Committee on Employment
Education and Workplace Relations
Parliament House
CANBERRA ACT 2600

Dear Dr Nelson

RE: INQUIRY INTO EMPLOYEE SHARE OWNERSHIP PLANS

We refer to our earlier submission to the inquiry, and now, as requested, answer the questions raised specifically in your letter to me dated 22 November 1999, in order, as follows:-

Q. 1 Should a person be required to divest shares acquired under an ESOP when they cease employment with that employer? Should benefits be transportable to other ESOP schemes?

A. 1 Currently, participants in qualifying ESOP's are not required to divest shares acquired under ESOP's when they cease employment, however under Qualifying Deferred Benefit Plans tax is levied on the benefit in the year of termination, thereby forcing most participants to sell their shares to pay the tax.

We see no reason why the current 10 year deferral benefit should not be a continuing benefit for terminating employees. This would allow employees to build a portfolio of shares, facilitating lower risk through diversification.

The taxing point (as referred to later) would be when the shares are sold and not when employment is terminated, thereby allowing portability and diversification.

Properly developed portability provisions would accommodate this preferred tax treatment.

Q. 2 Some ESOPs are available to only full-time, permanent employees. Other ESOPs are available to part-time and casual staff. Flexible employment modes are increasingly common. Should qualifying ESOPs be available to all employees, irrespective of the mode of employment?

A. 2 Qualifying Division 13A ESOP's are currently available to all employees. Accordingly, we see no reason to change.

There is a minimum test that must be met for a Plan to achieve qualifying status. That is, the same offer must be made to 75% of all full-time and permanent part-time employees with 3 years prior service. This is a minimum test, but in no way prevents a company from offering shares to any employee. If the minimum test was made more onerous it would be unnecessarily restrictive, make plans harder to administer, and make it difficult for casual employees to build a reasonable shareholding.

Q. 3 What will be the effect of the recommendations of the Ralph Review on the operation and development of ESOPs?

A. 3 The reforms proposed under the Review of Business Taxation ("the Ralph Report") will, if enacted, impact on certain ESOPs adversely.

The proposed reforms which effect ESOPs are under two headings as follows:-

(i) New rules for calculating taxable capital gains ("Capital Gains Tax Changes"); and

(ii) Unified Entity Regime Proposals.

(i) **Capital Gains Tax Changes**

The taxation treatment of benefits received under Division 13A (ITAA) ESOPs varies depending on the nature of the benefit received.

Gains above the threshold on exempt benefit plans are taxed as capital gains. Under deferred benefit plans, the total value of the benefit, including gains are assessable as income.

Under the proposed reforms contained in the Ralph Report, individuals will include half of the nominal net capital gain in assessable income for disposal of assets after 30 September 1999. Indexation credits would be frozen and the averaging of gains is removed with immediate effect.

The impact of these changes on ESOPs is both positive and negative, as illustrated below:-

Type of Plan	Ralph Report Impact
Division 13A (ITAA) Exempt Benefit Plans	**Positive to Neutral**. Gains are taxable at the concessional CGT rate, although indexation and averaging lost.
Division 13A (ITAA) Deferred Benefit Plans	**Negative.** Relative benefit of tax deferral significantly eroded compared to investment outside an Employee Share Plan and when compared to highly leveraged Non-Division 13A loan based plans. Also, difference between Exempt Plan and Deferred Plan further exaggerated.*(Comments: Deferral benefit marginalised and may lead to reduction in usage and/or redirection of investment to less desirable leveraged Employee Share Plan alternatives).*
Qualifying Option Plan	**Negative.** Tax payable on exercise as income. Taxable income is market price less exercise price. Option holders forced to sell shares to pay tax on exercise. Any gains, above market price at date of exercise taxable as a Capital Gain if shares held for investment purposes. *(Comments: Reinforces the pressure on employees to sell shares upon exercise. Long term shareholding is not encouraged by premature selling and higher tax rate applying. May encourage participants to pay tax up front on Division 13A formula to secure Capital Gains cost base. This will create negative funding implications, which may potentially limit use of options to chosen few to the detriment of Australian companies with international competitors. Australia will be unique in being the only country in the world that taxes a ESOP benefit before its received by the participant.*

In summary, the relative value of the tax deferral concession embodied in Division 13A which was introduced to encourage broad and deep employee share ownership is diminished when compared to after tax investment in the same share, which can take advantage of the concessional taxation of capital gains proposed. This is an unintended consequence of the changes and should be neutralised.

Accordingly, we have a potential scenario where reforms ie. The Ralph Report recommendations which are designed, in a Macro sense to produce a more equitable and efficient taxation system could operate to diminish Employee Share Plan Participation (Division 13A - Qualifying Deferred Plans) and/or encourage the proliferation of sub-optimal high risk Employee Share Plans (Non-Qualifying Leveraged (Loan) Plans).

Solution

To neutralise the impact of the proposed reforms we would recommend the Committee consider amending Division 13A (ITAA) to tax any gains on shares and options acquired under a Qualifying Division 13A (ITAA) Plan as a Capital Gain. Only discounts from market price should continue to be taxed as income.

This in effect would produce a "level playing field".

(ii) **Unified Entity Regime Proposals**

The Unified Entity Regime Proposals contained in the Ralph Report are complex. The principal supporting the proposals, as we understand it, is to unify the approach to the taxation of entities regardless of their structure.

The aspects of the proposal of most relevance to ESOPs is the proposal to tax trusts as if they were companies with effect from 1 July 2001.

We do note, however, the Ralph Report envisages exceptions (see paragraph 279, page 62).

"Moving to a consistent entity tax regime does not preclude the maintenance of entity - focused tax concessions, for example………….. employee share acquisition scheme arrangements".

It is extremely important this concession be preserved with respect to ESOPs, as a trust based structure is a critical component of effective Employee Share Plan communication, distribution, management and control.

Trusts have been used extensively for the implementation of, and facilitation of ongoing administration of Employee Share Plans. There are many plans in operation today that currently operate via a trust.

There are a range of reasons why companies will utilise a trust structure, with some reasons more applicable than others depending on the plan design.

Employers should be allowed to choose whether they wish to use a trust or simply register the employees on the company share register, for the following reasons:-

1.0 Trusts facilitate the enforcement of forfeiture clauses without adverse CGT consequences for the employee if shares held subject to certain performance criteria or concessional finance arrangements are not met. In the case of Deferred Benefit Plans, Division 13A (ITAA) requires specific restrictions such as forfeiture to apply to shares held under such plans otherwise no tax deferral provisions can be accessed.

Many ESOPs create contingent share entitlements subject to performance targets or to encourage employees not to leave the employer.

In addition, shares are often offered on concessional terms, to encourage participation. Those concessions can often be forfeited if the employee does not know a condition(s) upon which the concessions were offered exists.

The use of a trust enables the efficient enforcement of these conditions, and efficient re-allocation of the shares which may be forfeited in the event the conditions are not satisfied.

2.0 Assists in the management of insider trading issues which can arise for senior employees participating in an ESOP. By having external trustees administering the plan, the decision to buy shares is being made by an external person, not in possession of inside information thus facilitating administration and preventing unnecessary administrative complexity.

3.0 Administration can be streamlined and simplified using a trust in the following ways:

3.1 Share plans, especially the $1,000 tax exempt plans, generally lead to the creation of a large number of relatively small shareholders, as many employees leave employers after only 1 or 2 years participation.

Using the share registry to record employee's holdings means the company can significantly increase its long term share registry expense as small shareholders can be costly to service, but difficult to entice off the register by encouraging them to sell their small holdings, eg. departing employees who leave no forwarding address.

A plan trustee can facilitate and assist small employee shareholders who wish to liquidate their shareholdings upon termination of employment particularly if their holding is below a certain $ value.

The costs to an employer of servicing an individual shareholder, even if holding only 1 share can be up to $30p.a. This is fine for the registry manager, but very inefficient and costly for the employer company.

3.2 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 sold at institutional brokerage rates that plan trustees can negotiate due to their bulk capacity and therefore negotiating strength.

3.3 Employees of international employers face these issues raised in paragraph 3.1 and 3.2 even more acutely.

International companies often have very high unit share prices, compared to Australian companies. It is not unusual for U.S. companies to trade at between A$100 and A$200 per share.

There is also the need to convert currencies. This again is an extra administrative step that a plan trustee can streamline and reduce the cost for participant employees.

The costs to employee participants of liquidating on-register share benefits in these circumstances can be prohibitive, and would be a major disincentive for subsidiaries of listed overseas companies to set up plans, and for employees to participate.

3.4 Similarly, international companies paying lower dividend yields can send dividend cheques in foreign currency four times a year that cost individual employees more to encash than they are actually worth. This can be the source of significant frustration for employees.

Plan trustees can receive the foreign currency dividend on behalf of all participants, and convert it once only into $Australian at wholesale rates, and then distribute the A$ dividend to participants cost effectively by direct credit to their bank accounts.

4.0 Plan Trustees are required by the 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

There are countless other examples of where a trust based structure is the most cost efficient for participants.

Q. 4 What will be the effect of the CLERP legislation on the operation and development of ESOPs

The CLERP changes impact on ESOPs in a number of ways, including:-.

1. The new Clause 6D fundraising provisions affect the prospectus disclosure requirements. Generally the new requirements are more flexible.

   The impact on ESOPs is hard to assess. At present many ESOPs can rely on prospectus relief under PS49, which is quite comprehensive and relatively easy to comply with. One exception is for companies about to list, or have not been listed for 12 months. Where this relief is not available the new provisions should be easier to satisfy and therefore conducive to ESOPs.

   However, the prospectus requirements really represent a constraint for private company ESOPs. The new provisions do not seem to provide any real relief in this regard and any ASIC modification of PS49 in the light of the new rules will determine whether private company ESOPs are facilitated under the new provisions.

2. New accounting standards will be introduced under Pt12. Again the impact on ESOPs is unclear and the details have not been developed. However, inappropriate disclosure or accounting treatment for ESOPs in financial statements could be detrimental to ESOP development.

We strongly support a uniform code of disclosure. We are strongly against a prescriptive financial statement treatment as promulgated by the various accounting firms.

Q. 5 Would removing the present cessation requirements and replacing them with a single requirement, that tax is payable on disposal of the asset, assist the development of ESOPs:

i. In general?
ii. For non-executive employees?
iii. For unlisted companies?

A. 5 Unambiguously, yes for all categories. It has always seemed anomalous to me, to tax a participant in an ESOP at a time when they can least afford it (eg. retirement, retrenchment, termination for ill health, etc) or when they have achieved a significant milestone ie. 10 years of continuous ownership and participation. Long term employee shareholders should be rewarded, not penalised by the tax system.

A single taxing point is totally consistent with normal CGT principles of applying tax upon disposal, is fair and equitable and easy to understand for all.

Q. 6 Should standard information about the ESOP be provided to employees before they agree to participate in an ESOP? 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].

A. 6 Standardisation limits design flexibility and therefore may have adverse consequences. All participants in an ESOP should receive, at least, the following information.

- A detailed offer letter, advising the precise terms and conditions of the offer;
- An employee handbook summarising the essential terms of the relevant Plan;
- Access to a full copy of the Plan Rules, if required;
- A comprehensive holding statement of all shares held in the Plan;
- A detailed tax statement for participants on receipt of dividends and on withdrawal.

The company and/or a duly appointed qualified share plan administrator should be responsible for providing all this information.

ASIC's PS49 largely covers these requirements already, except for identifying standards to be met by a plan manager/administrator.

Q. 7 Do you have any specific suggestions that could further reduce the abuse of ESOPs by those who wish to use them to artificially reduce tax?

A. 7 Existing powers to eradicate or minimise abuse are substantial, far reaching and effective. Eg. Part IVA, Spotless, other recent cases, and the current ATO campaign directed at private company Employee Incentive Trusts all demonstrate the fact that current law is already well on the side of revenue protection when threats of abuse arise.

It may be appropriate to consider a preamble to Division 13A (ITAA) that reinforces the existing requirements that the sole dominant purpose of ESOPs are to provide bona fide remuneration benefits to employees to assist in the attraction, retention and motivation of employees; to facilitate succession planning in Australian enterprises, to promote Australian savings, and spread the capital ownership base in Australia.

Q. 8 What, in your view, 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?
(ii) the capital gains tax rate suggested in the Ralph Report?

Please provide reasons for your answer.

A. 8 We believe that all benefits received under ESOPs should be deferred until the benefit is encashed and that any gain in value from the date of share acquisition be taxed as a Capital Gain.

The reasons include:

- Tax is paid upon realisation of the gain, when the participant then has the cash to pay for it;
- Tax is levied on a consistent basis for investments in or outside ESOPs;
- Any growth in value is capital in nature and therefore should be taxed accordingly;
- Gains are easily distinguishable from discounts, which should remain to be taxed as income.

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

A. 9 Different classes of share are usually designed to limit either:

(a) Access to dividends or changed entitlement to dividends; or

(b) Limits on voting rights.

Neither of these restrictions are necessarily disadvantageous to employee participants in ESOPs.

For example, a company may wish to preserve cash flow and only pay share benefits on a growth only basis to ESOP participants. We have no philosophical opposition to this style of benefit if it is preferred by the employer.

In many situations, employees may not be employed by the listed, publicly traded entity: e.g. NRMA Roadside Mutual; employees of managers of listed property trusts. Alternatively, a company may have a control issue to consider. Dilution of voting control may be disadvantageous to a particular shareholder, whereas economic dilution is of less consequence. This is a very common aspect of private company ESOPs.

The answer then, is why restrict the flexibility of employee equity participation, where to do so may deter a company from offering any equity participation at all?

Q. 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?

A. 10 While the preference to utilise other than ordinary shares may be greater in small unlisted companies there are no logical reasons to limit the choice to this group only. For example, listed unit trusts, News Corporation preferred stock, Rural Press preferred stock et al would represent genuine ESOP opportunities, if permitted.

However, the greatest obstacle for unlisted companies is liquidity. A plan could "provide" for employee payments by being able to invest in other publicly traded securities.

Q. 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?

A. 11 No. Usually a company's preference to use securities other than ordinary shares for employee participation has little, if any, relevance to the seniority of those employees. The arguments explained in answers 9 and 10 apply equally to all employee participants.

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

A. 12 Diversification or spread of risk should be (and based on practice, is) of major importance for all ESOP participants. In particular, qualifying ESOP's should be permitted to purchase shares or options in companies other than the employer company in all cases, but particularly in the following circumstances:

- Where the employer company is not listed; (liquidity issue)
- Where the employer company's shares are thinly traded; (volatility / liquidity).
- Where the employer companies shares are unusually volatile as measured by the stocks "beta"(volatility): e.g. resource companies.

In an ideal world some level of diversification of investments should be permitted, for all ESOP's but limited to say, no more than 50% of the total investment value held on behalf of a participating employee.

The US Model, being the S401K plans is a very useful example to follow.

Q. 13 Should certain types of scheme receive preferential taxation treatment?

A. 13 Contribution or subscription (Exempt/Deferred) style ESOPs should receive preferential tax treatment when compared to leveraged (loan/option) style plans, as they represent a much lower risk approach for <u>both</u> employees <u>and</u> employers (including other shareholders). For example, the 100% loan, funded interest free to employees, plan are still the most prevalent in Australian companies, particularly in the Resource sector. Many employees and the employers (shareholders) have lost significant amounts of money under these plans over the last 4-5 years during what has been a very bruising period for the sector: e.g. BHP, MIM, Normandy, WMC, North, Woodside. They all have copied each others plans, and mistakes. Even employees of Woolworths who use the same plan have lost money in recent times.

While employees can lose money also under a subscription style plan, their loss is not exaggerated by the effects of loan funded gearing . Employees can "dollar cost average" their purchases by buying regularly through salary sacrifice payroll deductions. It is simply a more prudent funding approach to investment.

Q.14 Some witnesses asserted that the present legislative arrangements present difficulties to overseas employers attempting to establish ESOPs for their Australian employees and that under the same legislation Australian companies wishing to establish ESOP for their foreign employees face difficulties too.

i. What particular difficulties do you see?

ii. How can they be remedied?

A. 14 We have designed a number of ESOPs under the present legislation for overseas companies with Australian employees. They have been no more difficult (in fact in come respect's less so) than implementing ESOPs for Australian companies.

We do note however, many foreign companies are unfamiliar with the unique Australian legislation and are unwilling to understand the differences between Australian ESOP and their domicile county ESOPs. This however is not an Australian legislative problem.

Australian companies willing to establish ESOPs for foreign tax resident employees need to comply with the taxation issues relevant in the country the foreign employees are domiciled. There is nothing we can do in Australia to change that - and nor should we.

Q. 15 Should ESOPs be preferred to superannuation, be permitted in lieu of superannuation or be regarded as augmenting superannuation?

A. 15 No. ESOPs should never be reviewed as an alternative to superannuation. In certain circumstances ESOPs can be applied as a medium and long-term supplement to superannuation, which is entirely appropriate.

ESOPs can be positioned as playing an excellent role in enabling employees to save effectively to help meet their financial needs arising <u>during</u> their working lives, as opposed to super which is designed to provide for retirement.

Q. 16 Should ESOPs be considered incentives, income and savings? Should this affect the rate and time of taxation?

A. 16 ESOP's should be viewed as a continuum. At one end they are a short term saving mechanism. At the other end they can be used as powerful long term incentive vehicles. Both are desirable uses with time being the major determinant of the benefit received. Differentiation of tax treatment is unnecessary, and would simply add to complexity, and cost of administration.

Q. 17 Should employees be permitted to trade participation in ESOPS against salary increases or changes in conditions or superannuation?

A. 17 Yes. Even if it is unstated, participation in all ESOPs is a benefit conferred by the organisation - whether it is "free" or in-lieu of salary, in the expectation of the organisation benefiting as a whole.

ESOPs are about collective investment and collective benefit. They are not about "feeling good" or altruism. ESOPs should in no way replace superannuation, but may often represent a material supplement. People (employees) appreciate being able to make an informed, conscious choice.

Q. 18 Would there be a public policy benefit in:

i. a public registry of ESOPS or
ii. an ESOP regulatory agency to register ESOPs, protect ESOP members and other shareholders and ensure that ESOPs are not abused?

A. 18 Possibly, however, ESOPs are already heavily regulated under existing but overloading laws. A specialist agency, with experienced representatives could achieve streamlined supervision. It is a multi-disciplinary area, similar to the super industry.

In the interests of improving the macro economic impact of ESOPs it would be highly desirable for companies or Employee Share Plan trustees to provide summary information as part of the ABS program. Again, share plan trustees could be monitored as responsible entities, and provide efficient monitoring and auditing to prevent taxation abuse, and facilitate employee protection. This would also protect privacy issues. We have made recommendations along these lines to the Reserve Bank of Australia too.

Once again, thank you for the opportunity to participate in your Committees work. If any of our responses are unclear or if you require further elaboration of any comment, please do not hesitate to contact me direct.

Best wishes to you and your staff for Christmas and Y2K!

Yours sincerely

Ian Crichton
Director - Executive Remuneration & Share Plans