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Aligning interests: employee share plans and public policy

Introduction

3.1 The different motivations in the public and private sectors underlying support for employee share plans has led to different outcomes. The current legislative foundation does not promote employee share plans as fully as it could. For the most part current business practices focus on employee share plans as remuneration devices, narrowly focused on executive employees, rather than broadly based plans providing wide benefits to general employees.

3.2 In this chapter, and the next two, recommendations are made that, if implemented, will re-align practice and legislation. It is anticipated that they will lead to a growth in the number and size of employee share plans for general employees as well as amongst, small, medium unlisted, and sunrise enterprises. They are also intended to reduce opportunities for misuse.

3.3 Chapters 4 and 5 are responses to issues raised by witnesses. Issues concerning taxation legislation and employee share plans are considered in Chapter 4. In Chapter 5 regulatory issues and matters of general promotion of employee share plans are examined. In the present chapter those issues surrounding the legislative standing and place of employee share plans in the broader sweep of public policy are considered.

3.4 In this chapter the current legislative foundation for employee share plans is explained. Improvements in the present arrangements are addressed, including their 'user friendliness' and the misuse of employee share plans for aggressive tax planning purposes. Finally, the

place of employee share plans in the broader sweep of public policy is considered.

The current legislative arrangements

3.5 Current legislative arrangements that provide explicitly for employee share ownership programs are contained in Division 13A of the *Income Tax Assessment Act 1936*.[1] This division replaced Section 26AAC of the Act, which provided for employee share plans prior to the enactment of Division 13A. Section 26AAC had been enacted in 1974 to provide for the taxation of benefits that were received from shares or rights to acquire shares under an employee share plan.[2]

3.6 When Division 13A was enacted in 1995 three reasons were given by the then Assistant Treasurer, the Hon George Gear MP:

- to counter arrangements that exploited loopholes in Section 26AAC, so as to create artificial tax minimisation plans;
- to ensure that employee share plan legislation was directed at the creation and promotion of employee share plans; and
- to promote further the availability of employee share plans in the workplace.

3.7 'The Government is making these changes', the then Assistant Treasurer advised the House:

> …to reduce the exploitation of the existing legislation and to ensure that the tax concessions that are available under the new arrangements are directed at share schemes which encourage employees to own shares in the company in which they are employed or a holding company of the employer. The measures will increase the taxation benefits available to employees under these schemes.[3]

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1 Division 13A of the *Income Tax Assessment Act 1936* consists of Sections 139 to 139GH of the Act. Reference will be made to specific sections of the division by referring to the numbering scheme of the ITAA. Note also that s. 26AAC is still in force, as it applies to equities acquired under certain employee share schemes prior to Division 13A coming into force.

2 Taxation Laws Amendment Bill (No. 2) 1995, *Explanatory Memorandum*, paragraph 2.11, pp. 27-28.

3 House of Representatives, *Debates*, 22 June, 1995, p. 2083.

How Division 13A operates

3.8 Division 13A establishes a legislative framework that provides for:

- the taxation of any discount off the market value of any equities acquired by way of an employee share plan; and
- the concessional taxation treatment for certain 'qualifying' equities acquired under an employee share plan after 28 March, 1995.

3.9 The division is constructed in such a way as to reduce the opportunity for exploitation on the one hand, while facilitating on the other the creation of employee share plans for non-executive employees. It attempts to do this by:

- specifying the conditions and qualifications that equities must satisfy in order to be eligible for the concessions in Division 13A;
- specifying which equities will be considered by the division to be subject to the provisions of the division;[4]
- providing for two distinct classes of shares or rights: qualifying or non-qualifying. Qualifying shares or rights are those that meet the provisions of s. 139CD of the *Income Tax Assessment Act 1936*. This has the effect of specifying when the discount on the different classes of shares or rights must be included in a taxpayer's assessable income;
- providing that a plan which is not open to all employees of an employer may be considered as qualifying if it meets the various conditions for a qualifying plan and there is another qualifying plan which is open to or at some time was open to 75 per cent of the employees of that employer.[5] The effect of this is to allow plans of narrow membership, typically more generous executive plans, to 'piggy back' on less generous non-executive employee plans and so obtain the various tax concessions available to employee share plans under Division 13A;
- setting out the conditions that must be satisfied by an employee share plan operated under Division 13A in order for it to be operated on a non-discriminatory basis.[6] These conditions must be satisfied in order for a plan to meet the exemption conditions and the taxpayer to be eligible for taxation

4 Broadly, where a share or right is provided at a discount on the market value. See 139C(3) of the *Income Tax Assessment Act 1936*. If the value of a share or right provided to an eligible person, typically an employee or associate of an employee of the provider of the share or right, is at its market value or above, then the taxpayer is, under Division 13A, held not to have acquired a share or right under and employee share scheme.

5 ITAA, s. 139CD(5).

6 ITAA, s. 139GF.

concessions in respect of shares or rights provided or accepted under a qualifying employee share plan;

- providing for the taxation of shares or rights acquired by an employee or an associate of an employee under an employee share plan (as defined by the Division), and in virtue of an employee's employment with, or because of services rendered to, the provider of the share or right to a share;[7]
- providing that the discount on the market value of a share or a right to acquire a share is to be included in a taxpayers assessable income;[8]
- specifying when such discounts are to be included in a taxpayer's assessable income;[9]
- setting down when taxation liability occurs by specifying certain 'cessation' times;[10]
- separating the taxation of income from capital gains and taxing them separately. The policy basis appears to be that different sorts of benefit should be taxed according to different principles;
- providing incentives to both executives and employers to create employee share plans under division 13A for non-executive employees;[11]
- providing employees with incentives to take up the offer of an employee share plan by way of allowing for a tax exemption on the first $1,000 of the discount on the value of eligible equities;[12]
- specifying when deductions or other concessions apply;
- providing for the taxation of shares or rights held by an associate of the employee;
- specifying the manner by which the value of shares or rights acquired under an employee share plan will be determined and thereby the value of the discount; and

7 ITAA, ss. 139C(1) and 139C(2).

8 ITAA, s. 139B(1).

9 ITAA, ss. 139B(2); 139B(3); 139CA and 139CB.

10 ITAA, ss. 139CA and 139CB.

11 The so called 'piggy back' clause (s. 139CD(5)(b)), which provides that shares or rights may be qualifying under Division 13A but offered to a select number of employees of an enterprise, provided that there was at some time a scheme more widely available to employees; the $1,000 deduction available to employers for providing eligible equities to employees; fringe benefit tax exemption for eligible equities under a Division 13A qualifying scheme; and tax deferral for certain qualifying equities, as provided for in Division 13A.

12 A deduction of up to $1,000 on the value of the discount off the market value of qualifying equities.

- defining a number of key concepts that determine taxation treatment, such as the meaning of 'acquiring a share or right'.

3.10 Under Division 13A of the *Income Tax Assessment Act 1936*,[13] employees may make an election, subject to the equities meeting certain conditions, concerning the time when their taxation liability will be assessed and tax will be payable in respect of the discount they have received on shares or options acquired under an employee share plan.

3.11 There are two sorts of election: a tax exemption election and a tax deferral election. As the legislation presently stands, both concessions cannot be taken in the one year of income. That is to say, a taxpayer must elect to take one concession or the other but may not take both in any one year.[14] An employee may:

- elect to pay tax in the year in which the shares or options are acquired.[15] In this case, so long as the share qualifies[16] under Division 13A and other additional 'exemption' conditions[17] are satisfied,[18] the first $1,000 of the discount off the market value of the shares or options is exempt from income tax. The employee will pay income tax on any amount of discount in excess of $1,000.[19] The employer is entitled to a deduction in respect of the discount provided, up to a maximum of $1,000 for each employee.[20] When the taxpayer disposes of the shares or options (other than by exercising them) capital gains tax is payable on the market value of the share or option at the date of sale, less any consideration paid for acquiring the share or option in the first place. This is the 'tax exemption election'.

Alternatively, the employee may:

- elect to postpone the payment of tax on the discount on the share or option and pay it when a 'cessation' event occurs. Such events typically occur in a later year of income.[21] Division 13A sets out various cessation events which trigger the liability to pay income tax on the discount. These include: when the taxpayer disposes of the shares or options (other than by exercising them), when employment ceases in respect of which the shares or options

13 A flow chart, prepared by the ATO, showing how Division 13A operates and how it relates to employee share schemes that operate outside it, is reproduced in appendix E, figure 9.

14 ITAA, s. 139B(2).

15 ITAA, s. 139B(2).

16 ITAA, s. 139CD.

17 ITAA, s. 139CE.

18 ITAA, ss. 139B and 139BA(2).

19 ITAA, s. 139BA(2).

20 ITAA, s. 139DC.

21 ITAA, s. 139B(3).

were acquired, or ten years after the shares or options were acquired. The discount upon which income tax is payable is the difference between the price paid by the employee for the shares or options and their market value when they become liable to taxation; that is, at a cessation time. This is the 'tax deferral election'.

3.12 Each election provides a different taxation treatment. In the case of a tax exemption election, in return for electing to pay income tax on the discount in the year in which the shares or equities are acquired, the equities are moved immediately into the capital gains tax regime.

3.13 In the case of tax deferral elections, instead of receiving an income tax exemption on the first $1,000 of the discount, the employee receives the benefit of deferring the payment of income tax on the benefit for up to ten years. The value of the discount provided when the employee acquired the shares or options is indexed to their value as it moves in response to the market. This is, in effect, a trade-off for the delay in payment of the employee's income tax liability in respect of the shares or options. After income tax has been paid, the shares or options enter the capital gains tax regime. Any income generated by the subsequent disposal of those equities will be subject to capital gains tax. This is calculated on the amount received by the employee at the time of the subsequent sale, less the market value, at cessation, of the shares or options.

Are the current arrangements effective?

3.14 There are three distinct issues in terms of assessing the effectiveness of Division 13A. First, is Division 13A adequate as it stands? Second, has Division 13A fostered the development of employee share plans? Third, has Division 13A succeeded in reducing aggressive tax planning?

3.15 In broad terms, the Committee received three opinions on the current taxation-law arrangements in respect to employee share plans. Some witnesses advised the Committee that the present arrangements are working well and that no change at all is required.[22] The ATO advised the Committee that:

> From our observations Division 13A with its $1,000 concessional treatment and up to ten years deferral of tax has been successful in achieving its aim of encouraging employee participation in taking up share offers in their employer's share schemes. However, it is acknowledged that in the small to medium

22 ATO, submission no. 24.2, p. 8; Southcorp submission no. 34, pp. 7, 13.

> enterprise segment, which is predominantly privately owned, the take-up has not occurred to the same extent. Employee share schemes in this segment may not be looked favourably upon as they would dilute the 'Controller's' interest in the company.[23]

3.16 Another group of witnesses supported the present arrangements, for the most part, but suggested the clarification of certain issues, the removal of anomalies and minor amendments that would facilitate the development of employee share plans.[24] In this vein, AEOA advised the Committee that it took the 'view that Division 13A provides a sound and secure basis for the implementation of ESOPs in publicly listed companies but is a much less effective instrument where unlisted companies are concerned'.[25] In a later submission the AEOA added to this comment by saying that:

> …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).[26]

3.17 In particular, the AEOA advocated the removal of various barriers that it suggested hindered the development of employee share plans for general employees in the listed sectors. The AEOA also advocated removal of those barriers that restricted the development of employee share plans in the unlisted and small, medium and sunrise enterprise sectors.[27] Removal of the barriers facing this latter group of enterprises would be particularly effective in fostering the development of employee share plans. The reason is that, according to the AEOA, only 13 per cent of employees worked in listed enterprises. The greatest potential for growth in participation is, therefore, in the unlisted, small, medium and sunrise enterprise sectors.[28]

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23 ATO, submission no. 24.2, p. 8.

24 AEOA, submission no. 5.5, p. 6; Lend Lease, submission no. 26.2, p. 2; Mr R Stradwick, submission no. 25, p. 9; Esso, submission no. 21; Macquarie Bank, submission no. 18, p. 5.

25 AEOA, submission no. 5, p. 9.

26 AEOA, submission no. 5.5, p. 6.

27 The barriers identified by the AEOA, and other witnesses are examined in Chapters 4 and 5.

28 AEOA, submission no. 5, p. 5.

3.18 A third group of witnesses advised the committee that significant change to the legislation controlling employee share plans is required. In effect, they advised a substantial rewriting of the legislative arrangements.[29] Accounting firm Ernst & Young suggested to the Committee that:

> … Division 13A be thoroughly reviewed and overhauled, particularly its reflection of the ill-based concept that taxation can arise before realisation. I would be further inclined to focus the benefits for 'appropriate behaviour' on the employers rather than the employees particularly having regard to the fact that qualification for the benefits, under current rules, depends more on the behaviour of the employer than the employee.[30]

3.19 The difficulties that witnesses identified in the current arrangements may explain other information given to the Committee. RPC advised that by its estimation, less than 25 per cent of all public companies have taken advantage of taxation concessions embodied in Division 13A.[31] This is in stark contrast to advice from the ATO, which told the Committee that, 'Although the ATO does not possess details of all ESAS participants, we believe that the Division 13A provisions have been very popular with publicly listed companies.'[32]

3.20 Has Division 13A reduced aggressive tax planning using employee share plans? The evidence from the ATO was that Division 13A had removed various loopholes and that this had caused the promoters of aggressive taxation schemes to shift their attention to other avenues for tax minimisation.[33] ATO advised the Committee that:

> The introduction of Division 13A required tax planners to contemplate other means for maximising the after tax returns of their clients. Their focus swiftly fell on trust structures, which provided adequate potential to avoid the operation of the increasingly restrictive legislation. Promoters developed many trust-based products to mirror the advantages of past employee share schemes – that is, immediate deductions for contributions, avoidance of any kind of tax on the contributions themselves, performance and time criteria, employee / employer control of

29 RPC, submission no. 30, p. 10; BHP, submission no. 31, p. 2; Ernst & Young, submission no. 20.2, p. 10.

30 Ernst & Young, submission no. 20.2, p. 10.

31 RPC, submission no. 30, p. 3.

32 ATO, submission no. 24, p. 12.

33 Mr Jon Kirkwood, Ernst & Young, also agreed that Division 13A had curtailed various forms of tax avoidance: *Transcript of Evidence*, p. 129.

> investments, and minimal (if any) tax paid on ultimate distribution of the money.[34]

3.21 The result, the ATO said, was that:

> The intelligence and compliance data gathered to date on tax aggressive employee share and incentive trust arrangements indicates that contributions peaked in the 1997 and 1998 income years. The pre-lodgment activities undertaken by the ATO last year and the resultant publicity appear to have reduced the attractiveness of these schemes.[35]

3.22 While Division 13A may have closed some loopholes, it does seem clear from an examination of the business press that aggressive tax planning using employee share plans still persists, and that some of these plans use Division 13A. One article reported that using tax effective plans:

> … is a matter of making the most of an executive's legal opportunities and to maximise the extraordinary, yet often unrecognised, openings allowed in the tax legislation for tax planning, including the use of executive / employee share plans. As the remuneration deals struck by [some executives] show the big, big money is now in shares and options.[36]

and that:

> Although executive shares and options are widely used and much is known about their tax advantages, tax planners for the new… managing director… show how creative structures potentially can produce breathtaking and, until now, largely unknown tax breaks.[37]

3.23 The Committee referred a number of plans discussed in the business press to the AEOA and the ATO to determine whether they did comply with Division 13A. In each case, the plans were assessed as complying with the law as it stood.[38]

3.24 Another plan involves arranging a share plan so that it falls under the capital gains tax regime rather than the income tax regime. Mr Ernest Chang was quoted in the *Business Review Weekly* as saying:

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34 ATO, submission no. 24, p. 4.

35 ATO, submission no. 24, p. 16.

36 Gil Levy, quoted in Michael Laurence, 'Gil Levy, tax crusader', *Business Review Weekly*, 21 (1999), February 8, 1999.

37 Michael Laurence, 'Gil Levy, tax crusader', Business Review Weekly, *Business Review Weekly*, 21 (1999), February 8, 1999.

38 AEOA, submission no. 5.5, pp. 4, 8; ATO, sub 24.2, pp. 12-14.

> …one strategy is to forgo the tax-deferral provisions of Division 13A and provide employees with a loan to buy shares. There would be no deferral of income tax and CGT (not income tax) at the lower rate recommended by the Ralph report would be payable upon the eventual sale of the share.
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> …With a loan to buy shares, the employee would not have a tax liability on day one [the date of acquiring shares through a share plan] because of the liability for the loan.[39]

3.25 Mr Chang is reported in the same article as saying that 'many employers will be unwilling to meet the cost of administering loans to thousands of their employees'. This suggests that the benefits of such plans would usually be the preserve of executive employees.[40]

Conclusions on the operation of Division 13A

3.26 The Committee concludes that although Division 13A has had some success in promoting employee share plans, only limited use of the concessions has been made. The Committee agrees with witnesses that considerable scope remains for expanding the incidence of and participation in employee share plans, especially amongst general employees and in unlisted small, medium, and sunrise enterprises. Specific recommendations for fostering plans amongst general employees and in these enterprise sectors are made in Chapters 4 and 5.

3.27 The Committee also concludes that while Division 13A has reduced some aggressive tax planning, attention has shifted, as indicated by the ATO, to other arrangements, some involving employee share plans, involving the exploitation of the existing legislative arrangements. The present legislative arrangements inherited from the Keating

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39 Michael Laurence, 'Taxation: Ralph report leaves share plans out in the cold', *Business Review Weekly*, 5 November, 1999, pp. 74-77, at 75.

40 The reason is that general employees have been reluctant to participate in schemes that involve loans, as they may dislike the risk associated; executives, however, will have the resources to off-set the risk. Southcorp advised the committee that its 1997 scheme achieved only a 75 per cent participation rate because, 'Even though the share plan loan is risk free and non-recourse to the employee, the existence of any kind of loan facility over the shares represented a debt in the minds of many employees which either they, or their spouses, were not willing to commit to.' Submission no. 34, p. 10. This reluctance is demonstrated in the take-up rates to the employee share scheme offered by North Ltd. See submission no. 8, p. 3; see also ANZ, submission no. 39, p. 3. Successful schemes do operate around a loan. For example see the submissions from: Telstra, submission no. 42; Colonial Ltd, submission no. 28, p. 2; Brambles Ltd, submission no. 32, pp. 2 and 4; QBE Insurance, submission no. 33, p. 2; Woodside, submission no. 37, pp. 1-2; National Australia Bank, referred to by the Business Council of Australia, submission no. 36, p. 2.

Government, concerning all types of employee share plans have not eliminated the proliferation of aggressive tax planning employee share schemes.

3.28 Overall then, Division 13A has had limited success in achieving its objectives. Much more remains to be done to foster non-executive employee share plans while at the same time diminishing opportunities for aggressive tax planning.

Focusing employee share plan legislation

3.29 Specific modifications to the current legislative arrangements affecting employee share plans will be discussed in Chapters 4 and 5. In the present section, the broad legislative initiatives are considered that could provide a suitable framework for the specific modifications examined elsewhere.

Stand-alone, consolidated legislation

3.30 At present, legislation affecting employee share plans is scattered across a number of pieces of legislation, each of which is itself very complex. The major pieces of legislation that govern employee share plans are the *Income Tax Assessment Act 1936*, and ancillary legislation, and the Corporations Law. Other laws that affect the operation of employee share plans are the law of trusts and various pieces of employment law.

3.31 Division 13A, for example, attracted considerable comment. It is regarded by some witnesses as a difficult piece of legislation to understand, let alone implement and comply with. Ernst & Young advised the Committee that:

> …following the insertion of Division 13A into the Income Tax Assessment Act (in 1995) and the associated changes to the Capital Gains Tax rules, there has been a great deal of confusion and concern regarding how the law should be interpreted and administered. Many corporations and their advisers have had a number of meetings with Treasury and the ATO regarding these matters of concern but only a handful of changes have been made to the law and it remains the case that without a statement of the Commissioner's opinion it is virtually impossible to

> construct and administer ESAS plans with any certainty of outcome.[41]

3.32 Enterprises contemplating establishing and administering an employee share plan are faced with dealing with a number of different and highly complex pieces of legislation. To do so confidently requires considerable expertise, spread across several distinct branches of legislation.

3.33 This produces two results. First, enterprises may be faced with considerable costs: initially, establishment and maintenance costs to ensure that their plans comply with the different but relevant laws. Second, enterprises may be deterred from establishing an employee share plan or, if one is established, discontinue the plan because of the administrative cost.

3.34 Some idea of the costs that face enterprises when they establish employee share plans was provided by the ATO, which advised the Committee in relation to the fees chargeable for designing employee benefit schemes. The ATO said:

> The arrangers of … schemes are charging around $15,000 for 'modest' contributions of between $100,000 to $600,000. For higher contributions they often work on a percentage basis. The more aggressive marketers we estimate are making up to $4,000,000 on their marketing efforts. On past experience, we would expect this income to be 'washed' through their own EBA. … The fee structure in these [superannuation] arrangements ($60,000 to $4,000,000 and over) appears to be flexible between a 5 to 10 percent range. One promoter has made over $300,000 on just four sales.[42]

3.35 Such barriers may not deter a large listed enterprise. Such enterprises have the resources to obtain the most appropriate advice and manage the employee share plan on an ongoing basis. For small, medium, unlisted and sunrise enterprises, however, such barriers may act as a deterrent. For example, The IT enterprise, CEA Technologies, advised the Committee that:

> Although our scheme is successful, it is not without its problems. The problems generally are attributable to the mire of

41 Ernst & Young, submission no. 20, p. 1. See for example, Esso, submission no. 21, for criticism of the current legislative arrangements. Other submissions, for example from the Macquarie Bank, submission no. 18, p. 7 and Brambles Ltd, submission no. 32, passim, and the AEOA, submission nos. 5, p. 5 and 5.5, p. 4, criticised the corporate law prospectus requirements.

42 ATO, Submission no. 24, p. 16.

> government legislation that one must wade through in setting up and operating such a scheme. No real incentives are provided by the Government for schemes such as ours and it is our belief that in this area of encouraging and facilitating employee share ownership schemes is an important role for Government. Incentive programs such as simplifying legislation structures, access to tax concessions and a more generous approach to capital gains tax for ESOS related transactions are needed to bolster such schemes in Australia.[43]

3.36 A 1998 survey by KPMG revealed that thirteen per cent of respondents said that a slight disadvantage of creating a share plan was the cost of complying with the taxation legislation in order to take advantage of the concessional plans available under Division 13A.[44] The same respondents also said that the cost and time of administration of the plan also presented disadvantages.

3.37 The conclusion is, then, that ambiguities in individual pieces of legislation and regulating legislation being spread across different enactments tends to discourage the spread of employee share plans.

3.38 Compliance and administration costs can be minimised if a plan is designed in an appropriate and straightforward manner, from an administrative point of view. This can be further assisted through the use of appropriate accounting processes and computer technology which can facilitate the process of record keeping and calculating the benefit to be received. Nevertheless, there are areas of cost that are beyond the control of an enterprise. These are:

- the preparation of disclosure documents that meet statutory requirements;
- the cost of clarifying or working around ambiguities in the legislation;
- navigating anomalies in the legislation; and
- designing a plan to suit enterprise needs.

3.39 An initiative that would reduce these costs is to draw the major relevant pieces of legislation together in one Act. Such so called ‘stand-alone’ consolidated legislation would draw together the relevant and major items of legislation in one place, making the process of establishing employee share plans more accessible. The effect of such consolidation would be enhanced if the opportunity was taken to rewrite Division 13A:

43 Submission no. 9.

44 KPMG, exhibit no. 13.

- improving its structure and, at the same time,
- removing the anomalies;
- clarifying those provisions that witnesses found obscure; and
- bundling it with such other relevant sections of the taxation laws and the Corporations Law as to set out the major legislative basis for employee share plans.

3.40 The ATO was asked for advice on the feasibility of stand-alone legislation and advised that there did not seem to be a compelling reason for such legislation in Australia. According to the ATO, stand-alone legislation, such as that proposed in the United Kingdom,[45] was designed for a particular type of tax system, specifically one that was attempting to increase personal savings in the absence of a universal superannuation system:

> The ATO would make the following points:-
>
> (i) The UK does not have Australia's comprehensive superannuation legislation to promote retirement savings; and
>
> (ii) The UK tax legislation is structured on a "schedule" basis much like our current wholesale sales tax structure. [Wholesale sales tax was abolished on 1 July 2000.]
>
> If Division 13A was to be replaced with a broader "stand alone" piece of legislation covering all employee share arrangements we would foresee a number of complications because, unlike the UK and some other jurisdictions, Australia has a "global" personal tax system. That is to say that all the provisions are integrated and inter-connected.
>
> For example the current Division 13A is integrated into the remainder of the Income Tax Assessment Act by references to CGT and FBT legislation which were amended on the introduction of this Division. From a design point of view, if a UK style piece of legislation were implemented, it may be beneficial to make reference to these (CGT & FBT) provisions or even consider the possibility of including these concepts under the 'new' employee share scheme umbrella.

45 For an outline of employee share scheme initiatives in other jurisdictions, see appendix F.

> Without seeing an outline of what may be proposed, our current view would be that a stand alone piece of legislation may in fact add more complexity and compliance costs.[46]

3.41 The issue is whether stand-alone legislation would in fact add administrative complexity to the current arrangements, as the ATO asserts. The Committee does not believe that it would.

3.42 The nature of the legislative arrangements in Australia and the United Kingdom should not add to the administrative complexity. In fact, having the major legislative foundations, especially if they have been simplified and made clearer, would tend to focus enterprises on the purpose of employee share plans and facilitate administration of them by enterprises and government.

3.43 While fully aware of the hesitation of the ATO in respect of stand-alone legislation, the Committee concludes, nevertheless, that stand-alone legislation does not present any insurmountable legislative or public policy hurdle.

3.44 The Committee takes the point that the taxation system in the United Kingdom is structured differently from the system in Australia. However, the proposal is to bring together into the one enactment the major pieces of legislation, including also the corporate law and any other laws that affect the design, introduction and administration of employee share plans. Where a matter is not dealt with in the stand-alone legislation, the Act could specify that the originating legislation should be considered decisive.

3.45 Should such legislation cover only plans that offer equities at a discount or any employee share plan? It is clear from the last chapter and also from the discussion below concerning the use of employee share plans for aggressive tax planning, that there are different types of employee share plans. While many are used for purposes consistent with the intent of public policy, a considerable number are not.

3.46 Moreover, as the evidence from KPMG demonstrates, Division 13A has not attained widespread acceptance across the private sector. If an enterprise does not like the provisions of Division 13A or wishes to establish an arrangement for some other purpose, such as remuneration, but use an employee share plan as the vehicle to do it, then it will move outside Division 13A. Monitoring and control of such plans has proven to be extremely difficult because such information is not routinely collected, as noted already.

46 Submission no. 24.2.

3.47 It is the Committee's view that stand-alone legislation should apply to all employee share plans, whether or not they offer equities at a discount. This would provide a sound legislative basis for the plans, facilitate their creation and facilitate monitoring to ensure that employee share plans attain the public policy purposes that Parliament intends. The Committee also believes that stand-alone legislation, if implemented, will assist in combating abuse.

Recommendation 8

3.48 **The Committee recommends that Parliament enact a single piece of legislation, bringing under one Act all laws governing employee share plans, their structure, taxation treatment, reporting and disclosure requirements. This legislation should apply to those plans presently operating under Division 13A as well as those plans that do not. The advice of relevant regulatory, industry and accounting bodies should be sought in undertaking this significant reform.**

An employee share plan advisory board

3.49 A criticism made by a number of witnesses was the inadequate communication between the ATO and the promoters and operators of employee share plans.[47] The result was that the current legislative arrangements did not fully foster the development of employee share plans. Witnesses called for an overhaul of the policy making process to make it more responsive to the goals of fostering the creation of, and participation in, employee share plans.[48]

3.50 A suggestion raised by a number of witnesses was that a process be developed that involved widespread public consultation. The wisdom of this process was made clear by the Macquarie Bank which advised the Committee that:

> …in changing any relevant legislation (taxation or otherwise) … Parliament should undertake a widespread and early public discussion of the issues at the legislative design stage. Often such discussions raise awareness of unintended consequences or

47 Mr Jon Kirkwood, Ernst & Young, *Transcript of Evidence,* pp. 128, 132 and submission no. 20, p. 1; *Transcript of Evidence,* p. 252;

48 Mr Ian Crichton, *Transcript of Evidence,* p. 33; AEOA, submission no. 5; *Transcript of Evidence,* p. 3.

> practical difficulties of intended changes. Further, Macquarie Bank notes that it is very important to avoid uncertainty in these areas as this can lead to employers becoming effectively paralysed as to the implementation or continuance of schemes, which in turn, leads to frustration for employees. Parliament should recognise the considerable lead time in implementing a new scheme or reconstructing an existing one.[49]

3.51 The Committee agrees that community consultation is an essential element in the development of effective legislation. It encourages participation in the system of Government. Community consultation provides an opportunity for ambiguities and anomalies to be identified and removed before legislation comes into force. It also provides a means whereby problems that emerge as legislation is used can be addressed. Such a process increases the likelihood that legislation will attain the public policy goals set for it. It also provides an opportunity to ensure that legislation is tailored to the aims of public policy. The result is that the practical administration of legislation is improved. This is especially important where there is a large and diverse constituency, as is the case with employee share plans. The Committee notes that an extensive public consultation process was undertaken by the Blair Government in the United Kingdom when developing the new employee share plans for that country.[50]

3.52 Employee share plans have the potential to play a vital role in increasing productivity and national savings. It will be necessary then to ensure that the legislative arrangements remain up to date and foster the development of plans. Importantly, ambiguities, anomalies or barriers that emerge should be dealt with quickly. Ongoing consultation is therefore required to ensure the smooth development of employee share plans.

3.53 A mechanism was suggested by the AEOA and supported by other witnesses[51] that would assist in the development of employee share plans and relevant legislation. The AEOA's suggestion was that an advisory committee '…representing the Federal Government, the AEOA, and ESOP companies and consultants', should be established, whose task it would be 'to advise Government on the design and

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49 Submission no. 18, p. 7.

50 Draft legislation was developed in consultation with the community and published for public comment on 10 November, 1999. Consultation on the proposed legislation closed on 28 January, 2000. See www.inlandrevenue.gov.uk/shareschemes/index.htm.

51 For example, Mr Ian Crichton, RPC, *Transcript of Evidence,* p. 34.

implementation of suitable measures to promote the growth of employee ownership'.[52] The Committee agrees with this suggestion.

3.54 Given the earlier conclusions concerning the areas of the business community that should be the focus of legislative attention, the Committee considers that the focus of the advisory committee's work should be the promotion of employee share plans amongst general employees and in the small, medium, unlisted and sunrise enterprise sectors.

Recommendation 9

3.55 **The Committee recommends that an Employee Share Plan Advisory Board be established:**

- **consisting of all relevant interests, including but not limited to: the Australian Taxation Office, the Australian Securities and Investment Commission and representatives of employers and employees; and**
- **to provide advice on the policies to be implemented in order to foster the widespread development of employee share plans amongst general employees and in sectors where uptake has been poorer, such as in small and medium companies and sunrise enterprises.**

Information requirements

3.56 In the space of a few years, Australia has attained one of the world's highest rates of share ownership. As a result, for many, share ownership is a familiar concept. Nevertheless, in the case of employee share plans, access to information about the nature of particular plans is essential in fostering them.

3.57 There are two constituencies in this respect: employers, who need to be aware of the opportunities for establishing an employee share plan as well as what they must do, and employees, who need to be aware of the provisions of any plan they may be offered so that they can make informed choices.

3.58 Establishing 'best practice' approaches and communicating them is, in the Committee's view, a task in which groups interested in fostering employee share plans should be closely involved. In this regard, the

52 Submission no. 5, p. 3.

Committee notes the work undertaken by the AEOA. It was noted by Ms Hunt, then president of the AEOA, that its activities have been concentrated in advising the larger corporate section of the business community and that she intended to address gaps in the membership of the AEOA, especially in the small and medium sized business sector.[53]

3.59 The ATO advised the Committee that:

> The ATO recently developed a new service aimed at developers of taxation products or arrangements. Under the Product Ruling system, product developers can supply the ATO with the facts surrounding their arrangement and obtain a technical clearance for the income tax consequences relating to those facts. This system provides confidence to taxpayers, particularly, at the small to medium end of the market who cannot afford individually designed arrangements.[54]

3.60 While the initiatives of the ATO in this regard are to be commended, they are by their nature passive. The Committee believes a more pro-active approach should be taken. An example of such an approach is that taken in the United Kingdom by the Inland Revenue. The Inland Revenue provides information to both employers and employees by way of advice and pamphlets.[55] Specifically, the Inland Revenue has an 'Employee Share Schemes Team'. As indicated on the Inland Revenue internet site, the team's responsibility is to:

- give practical advice to companies and their advisers on the operation of approved share plans;
- approve share plans and give advice to companies and their advisers on draft plan documents ;
- monitor the operation of share plans and provide technical support to local Inland Revenue offices; and
- give policy advice and support to Ministers on all aspects of remuneration in shares.[56]

3.61 Such active promotion of employee share plans by the United Kingdom government is an element in a raft of measures specifically designed to increase awareness of employee share plans and their incidence.

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53 *Transcript of Evidence*, pp. 11-12.

54 Submission no. 24.2, p. 1.

55 See www.inlandrevenue.gov.uk/shareschemes/index.htm; downloaded: 11 November, 1999.

56 http://www.inlandrevenue.gov.uk/shareschemes/team.htm; downloaded: 3 May, 2000.

3.62 The Committee believes that more than policy supported in legislation is required. Active promotion of the policy should occur too, as is occurring in the United Kingdom. In this way, policy objectives are more likely to be met.

3.63 It should be noted, however, that public policy in this area has two elements: promotion of the benefits of employee share plans and the regulation of any plans that are implemented. It is essential that the task of promoting employee share plans is administratively distinct from the task of regulating them, and that separate agencies should perform each task. Those whose duty is to supervise and regulate the revenue system should not be placed in a situation where they may be perceived to have a conflict of interest. Conversely, those whose duty is to promote the development of employee share plans should not be responsible for the regulation of the revenue base.

3.64 For this reason, the Committee believes that the Department of Employment, Workplace Relations and Small Business (DEWRSB) is the appropriate agency to promote employee share plans in Australia. A unit should be established within the Department to provide information to enterprises and employees on the relevant legislative requirements and to liaise with other authorities, such as the ATO, the regulatory agency and ASIC to ensure that the information held by those agencies is readily available.

3.65 Specifically, the information provided by the Department should include not only the relevant legislative requirements, and assessments of the likely tax consequences of an employee share plan, but also active promotion, on its internet site and elsewhere, of the benefits of these plans. The Department should, in the Committee's view, not only provide advice on the likely tax consequences of a plan but advice, especially to small, medium, unlisted and sunrise industries, on the design and implementation of plans.

3.66 Later in this chapter, the Committee examines in more detail the most effective way of regulating employee share plans, and the establishment of a regulatory agency within the ATO.

3.67 Such an approach would reduce the compliance costs faced by enterprises because they would be assured that the plan they implemented already met all legislative requirements. Similarly, any regulatory agency could be assured that such plans met legislative requirements, thus enabling it to focus its attention on plans that did not comply with public policy. This approach would in no way prevent an enterprise devising its own plan, but it would ease the implementation

of a plan for those enterprises that are willing to offer a pre-approved plan.

3.68 The information provided to employees is of critical importance. The Corporations Law sets out the mandatory minimum of information that employees are entitled to receive.[57] Enterprises that wish to achieve a high acceptance of an offer of shares often see the process, the Committee was advised, as a Human Resources Management exercise. Such enterprises make significant efforts to meet the requirements of the employees individually and collectively. [58]

3.69 In contrast, smaller companies may experience difficulties in communicating information about the plan. The reason is that they do not have the resources to communicate the plan adequately, especially if they have to respond to a large number of enquires.[59]

3.70 There should be a minimum amount of information set. Ernst & Young advised the Committee that:

> The difficulty in determining what is needed arises from the wide variation in the level of knowledge which is likely to exist among the many "classes" of potential applicants. However, it is almost axiomatic that the more information that is given, the more likely it is that the information may cause some confusion among less "experienced" persons. In many cases it may not be sensible to provide all the information required by some people as it may result in the proper decision making process being subsumed by opinions which may only be relevant for "informed" investors.[60]

3.71 Having said this, the firm went on to say that some form of 'standard information' about the plans should be provided to employees but that any regulation should not be prescriptive:

> …in all circumstances a sensible commentary regarding the likely taxation implications for participants should be provided. Obviously a summary of the rules of the plan would be an essential ingredient of the information provided and should be reviewed by a third-party, suitably qualified person (however, it is often necessary to avoid overly legalistic language in which

57 See Chapter 5.

58 Ernst & Young, submission no. 20.2, p. 4.

59 Ernst & Young, submission no. 20.2, p. 4.

60 Ernst & Young, submission no. 20.2, p. 4.

case the document may require some 'comprehensibility testing' before it is released.[61]

3.72 The Committee agrees with these observations. The task of adequately informing employees would be eased by the development of model plans. In such cases, the plans would include not only the formal legal structure but also an information pack for employees, suitably designed and tested. This would ease the compliance cost to small, medium and unlisted companies, as well as sunrise industries. The Committee also considers that it would not be improper for DEWRSB to provide officers to explain such model plans to employers and employees.

Recommendation 10

3.73 **The Committee recommends that the Department of Employment, Workplace Relations and Small Business establish an Employee Share Plan Promotional Unit. Its purpose would be to actively promote employee share plans, including assistance with design, implementation and the provision of information to both employers and employees.**

Recommendation 11

3.74 **The Committee recommends that the Employee Share Plan Promotional Unit should aim, in cooperation with a proposed Employee Share Plan Regulatory Agency in the Australian Taxation Office, to develop and make available to employers and employees, *model* or off-the-shelf plans. This would reduce costs to smaller businesses while facilitating the uptake of employee share plans already approved by the ATO as being consistent with taxation provisions.**

Recommendation 12

3.75 **The Committee recommends that a minimum information list for employees be developed and specified in legislation for all employee share plans.**

61 Ernst & Young, submission no. 20.2, pp. 4-5.

Reducing misuse

3.76 One of the reasons that Division 13A was enacted was to reduce aggressive tax planning. However, aggressive tax planning continues.

3.77 In order to put the Committee's recommendation in respect of aggressive tax planning into context, it is important to see the extent of tax minimisation schemes. For example, the Australian Taxation Office advised the Committee that it had been reviewing aggressive tax planning practices involving 'employee incentives'. In its submission, dated 10 May, 1999, the ATO said that,:

> The picture that has been built to date is one that indicates that a small but aggressive segment of the legal, financial planning and accounting professions have moved to exploit government initiatives in relation to employee share ownership, incentives to increase productivity in the work place, and provision for retirement through superannuation.[62]

3.78 The ATO reported that, 'The tax aggressive employee share, welfare and incentive trust schemes detected and on which we have ascertained contribution levels, to date, have involved over $400,000,000 in contributions.'[63] The ATO also advised the Committee that it was reviewing the products of over forty promoters involved in the 'employee benefit arrangements' and that it estimated that the total contributions made by the clients of these identified promoters will, on a conservative measure, amount to approximately $1.5 billion.[64]

3.79 According to the ATO, aggressive tax planning in this area occurs predominantly in the small, medium and unlisted business sectors:

> Analysis of share acquisition and incentive arrangements has indicated that these have been sold to the small, medium enterprise end of the market. They have attempted to provide the 'controllers' of private companies with the ability to defer corporate income tax and or transfer income from the company to themselves in a non – taxable or lower taxed form.[65]

3.80 In contrast, the ATO said that it did not have any cause to be particularly concerned about arrangements in larger companies because:

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62 Submission no. 24, p. 12.

63 Submission no. 24, p. 16.

64 Submission no. 24, p. 16.

65 Submission no. 24, pp. 12, 18.

> Higher levels of accountability and public scrutiny suggest that share ownership schemes appear to be working well and on a bona fide level at the publicly listed company end of the market. The issues encountered at this end are usually related to valuation matters or the unique circumstances of the corporate involved. Share option arrangements, however, do have the potential for tax avoidance and are being closely monitored.[66]

3.81 Whilst the ATO holds the view that arrangements in larger companies are of little concern, the Committee reviewed a considerable amount of information which suggested that a number of plans use existing taxation concessions to an extent not anticipated when the legislation was passed by the Parliament.

3.82 It is the Committee's view that such schemes seem to have gone beyond the intent of Division 13A, FBT legislation and successive Parliaments in providing for employee share plans. As a result, some executive share and remuneration packages are out of step with community expectations. The challenge is how to contain the few without penalising legitimate remuneration packages.

3.83 The ATO's observation would appear to be supported by evidence collected by the Committee. For example, the business press has reported the following:

> It is a matter of making the most of an executive's legal opportunities and to maximise the extraordinary, yet often unrecognised, openings allowed in the tax legislation for tax planning, including the use of executive / employee share plans. As the remuneration deals struck by [some executives] show, the big, big money is now in shares and options.[67]

and:

> The trick will be to set up share plans which use company loans to buy shares, so that any gains are taxed at CGT rates, not income tax rates. A share plan can be moved outside the income tax system if it uses loans. In a loan plan, the employee borrows money interest-free from the employer to buy shares, and any rise in the share price is then taxed at the much lower capital gains rate, which will be half the employee's marginal income

66 ATO, submission no. 24, p. 18. See also, *Transcript of Evidence*, p. 339.

67 Michael Laurence, 'Gil Levy, tax crusader', *Business Review Weekly*, February 8, 1999, Vol. 21, No. 4.

> tax rate. Essentially this is a form of gearing, and will work only if the share price rises….[68]

3.84 In other evidence provided to the Committee, it appears that less than 25 per cent of all public companies have taken advantage of the concessions provided for employee share plans in Division 13A.[69] Witnesses also testified that the incidence of employee share plans is highest amongst listed enterprises and lowest amongst unlisted, small and medium companies.[70]

3.85 Taking this information together it appears that, according to the ATO:

- misuse of employee share plans occurs mostly in the small, medium and unlisted market;
- discovery of misuse in either listed or unlisted, small and medium enterprises is difficult;
- exploitative behaviour occurs more often in plans that do not use the concessions in Division 13A, and when it does, involves trading on ambiguities in the law and over the ambit of the law, especially in relation to the operation of FBT;[71]
- some plans have relied upon rulings from the Australian Taxation Office;
- given the small number of employee share plans that operate in the small, medium and unlisted sector the rate of misuse may be quite high.

3.86 The Committee was advised by the ATO of the Commissioner's strategy against the aggressive tax planning in respect of employee benefit arrangements. These include:

- speeches to advise taxpayers and advisers of the 'ATO view' concerning these plans;
- a draft ruling issued by the Commissioner to clarify the ATO's view on the meaning and application of the term 'associate' for FBT purposes in response to the aggressive marketing of a number of plans;
- the progressive withdrawal of previous opinions in this area; and
- centralised control on the issuing of rulings and opinions concerning employee benefit arrangements. This involves the development of a

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68 Hans van Leeuwen, 'Boost for Company Share Plans', *The Australian Financial Review*, 23 September, 1999, p. 7.

69 RPC, submission no. 30, p. 3.

70 RPC, submission no. 30, p. 13.

71 *Transcript of Evidence*, p. 353; ATO submission no. 24.2, p. 4.

comprehensive 'ATO view' on the tax implications of employee benefit arrangements.[72]

3.87 The ATO advised the Committee that it believed that aggressive tax planning in respect of employee benefit arrangements, 'could be regulated under existing laws, including the anti-avoidance provisions'.[73] The Committee sought more detail from the ATO concerning this assessment. The ATO reiterated its earlier advice.[74]

3.88 A number of recent events, as well as evidence provided to this inquiry, indicate to the Committee that the powers of the ATO in respect of meeting the challenge created by aggressive tax planning could be enhanced.

3.89 The Committee notes the announcement on 30 June, 2000, by the Assistant Treasurer, Senator the Hon Rod Kemp, that the Government will be introducing amendments to address aggressively marketed employee benefit arrangements. The amendments will be targeted at abusive superannuation schemes.

3.90 The Committee also notes that on 6 September 2000 it was advised by Mr Michael D'Ascenzo, Second Commissioner of Taxation, that the ATO was:

> …continuing to monitor employee benefit arrangements, including those that rely on Division 13A. We are coming across variations to these types of arrangements, including Division 13A arrangements, and are examining whether they come within the policy intent as expressed in the law.[75]

3.91 The ATO described to the Committee the way in which it was pursuing the $1.5 billion (or more) in employee benefit arrangements that it believed may have been channelled through aggressive taxation planning arrangements.[76] The ATO testified that after its interpretation of the law, usually by way of a ruling, was published, it instituted a 'safe harbour' arrangement. Under this arrangement, taxpayers involved in aggressive tax minimisation schemes were invited to come forward voluntarily and settle matters with the ATO. About one third of taxpayers involved in such schemes, the ATO said, used the safe

72 ATO, submission no. 24, pp. 14-15.

73 ATO, submission no. 24, p. 18.

74 ATO, submission no. 24.2, pp. 4-5.

75 Letter to the Committee Chair, 6 September, 2000.

76 *Transcript of Evidence,* pp. 355-363.

harbour arrangements.[77] For taxpayers who refused to use safe harbour arrangements, the ATO would then use investigations and audits. The ATO said that it 'would be surprised if the number that are settled does not increase fairly dramatically…' as a result of this process.[78] For those taxpayers who disputed the ATO's interpretation of the law, the ATO would pursue them through the courts until settlement. If the courts ruled against the ATO, then advice would be provided to the Government recommending legislation, including the possibility of retrospective legislation.[79]

3.92 This approach could be even more laborious in the case of schemes that had been mass marketed. The ATO advised the Committee that in such schemes:

> The problem … is that if you are not in there early in the piece, the application of an anti-avoidance provision requires you to go through the facts of each individual investor, and it does become resource intensive in doing that. On the other hand, if the arrangement is blatant, artificial and contrived, and designed to give a purpose other than the purpose intended by parliament, it is hard for parliament to have anticipated that when they legislate.[80]

3.93 In the Committee's view this process is complex and consumes significant resources. Clearer powers for the Commissioner of Taxation would result in the ATO having to rely less on such a protracted and uncertain process. The results of the process are all the more uncertain because, as the ATO cautioned the Committee, even if recovery action against a participant in these schemes is successful, recovery of the taxation due is subject to the taxpayer's capacity to pay.[81] There is no guarantee that the full amount owed will be recovered.

3.94 Additionally, the process described by the ATO is one that seeks to remedy a mischief, rather than to prevent it occurring. While the existence of adequate recovery powers is essential, the Committee also believes that the Commissioner having clearer powers, combined with consolidated, unambiguous legislation would work to deter aggressive tax planning in this area.

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77 *Transcript of Evidence,* p. 360.

78 *Transcript of Evidence,* p. 360.

79 *Transcript of Evidence,* p. 355-356.

80 *Transcript of Evidence,* p. 355.

81 *Transcript of Evidence,* p. 361.

3.95 Moreover, the Committee, while noting the ATO's assessment that aggressive tax planning in respect of employee share plans is confined largely to the unlisted, small and medium sector, using novel or unusual share plans, also noted information collected from business publications referred to throughout this report. These suggest that aggressive tax planning also exists within sections of the listed business sector. These are more likely to involve salary sacrifice schemes, trust arrangements and low or no interest loans. The beneficiaries of such schemes are, almost entirely, executives. The schemes themselves fall under Division 13A. The following examples, drawn from the press, indicate that the opportunities and strategies available within Division 13A to shift large amounts of income from the income tax system or to minimise the amount of income tax paid, go beyond that intended by Parliament.

3.96 Case 1 (from *Business Review Weekly*, 21 (1999), 5 November, 1999):

> [Using salary sacrifice]… employees [can] direct unlimited portions of pre-tax salary each year to fund the entire value of the shares (the initial amount invested each year plus gains are subject to income tax yet the impost is deferred for up to 10 years). Income tax on tax-deferred plans must be paid after 10 years or earlier if the shares are sold or employment is terminated.
>
> From a practical perspective, the tax-deferred plans enable a top taxpayer, for example, to acquire almost twice as many shares as would be possible with after-tax income. This provides excellent compounding if the shares rise in value. And although the shares are held in trust, employees receive dividends twice a year.[82]

3.97 Case 2 (from *The Bulletin*, 29 February, 2000):

> …the obvious approach for an executive receiving discounted shares or stock options in a company for which he or she works is to consider electing to pay tax on any initial gain immediately. As noted, once that has been done any future gain should benefit from the 50% gains tax concession.
>
> An example would be an executive who received shares for no cost when their market value was $2. At present most elect to defer tax, which means the eventual gain is caught under the income tax regime. In this case, if the shares were subsequently

82 Michael Laurence, 'Taxation: Ralph report leaves share plans out in the cold', *Business Review Weekly*, 21 (1999), 5 November, 1999.

> sold for $10, tax would be payable on the whole amount, thus resulting in a tax bill of almost $5 a share. The alternative would be to pay tax on $2 at the time the shares are issued, resulting in an initial tax bill of $1. When the shares are later sold for $10, half of the net $8 gain is taxable, resulting in tax at that time of almost $2. When the initial $1 in tax is added in the total tax bill is just on $3 - 40 % less than if all tax had been deferred.
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> …
>
> Probably the most obvious drawback with this whole approach is that the executive has to part with money to pay the initial tax bill. One alternative which overcomes this … involves the executive actually paying the market price for the shares, but doing so by using an interest-free, non-recourse loan from the company that issues the shares. Once this has been done, any future realised gain will be taxed under the gains tax system and so will benefit from the 50% rule.
>
> Although the loan is interest-free, no fringe benefits tax has to be paid. This is because if a standard loan had been used to invest in the shares, the interest payable on this loan would have been tax deductable.[83]

3.98 The Committee concludes that aspects of the present arrangements are open to exploitation. The opportunities surround the operation of FBT, the use of salary sacrifice and interest free or low interest loans,[84] and the capacity to defer taxation on unlimited amounts of equity. These – as the business press suggests – provide opportunities for aggressive tax planning. For the following reasons, the Committee concludes that consideration be given to their closure:

- Since Division 13A allows deferral of tax on unlimited amounts of equities[85] it invites the use of novel financing arrangements in order to access this concession;

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83 P Freeman, 'Executive tax relief', *The Bulletin*, 29 February, 2000, p. 71. This is confirmed by the ATO, submission no. 24.2. The ATO advised the Committee: 'Company loans, of this type, to employees being used to purchase any type of income producing asset, have the benefit of not incurring FBT. The rationale for this being the 'otherwise deductible rule' provided for in the law. If the taxpayer had borrowed the money, at interest, in order to derive a dividend stream, then that interest would have been deductible. Thus the 'otherwise deductible rule' means no tax benefit has been derived from the interest free loan from the employer'.

84 For an example of a generous interest-free loan provided to executives to fund equity purchases in the enterprise, see Glenda Price, 'Spotless directors lift stake with $10m interest-free loan', *The Weekend Australian*, March 4-5, 2000, p. 33.

85 The effective limit is set by the employer.

- Division 13A allows, via the use of the tax exemption election, access to the lower CGT rate if tax is paid in the year in which the equity or option to purchase it is acquired. Again, this concession allows the use of novel financing arrangements. Considerable amounts of income can be moved into the CGT system using this method. This approach converts income to capital and minimises income tax;[86]
- These provisions allow Division 13A to be diverted from the purpose intended by Parliament: to foster employee involvement in the operation of their employers. They have at times assumed the characteristics of remuneration schemes. Division 13A provides, in effect, a vehicle for subsidising executive salary packaging by companies assisted by concessional taxation arrangements;
- Owing to the lack of full disclosure,[87] these concessions and the financing arrangements which underpin them have the potential to diminish the completeness of annual reports, and lead to an incomplete picture of the financial position of businesses;
- The provisions embodied in Division 13A may be seen as unfair to the 80 per cent of employees who, by virtue of the industries in which they work, will never have access to employee share plans. These provisions have the capacity to diminish public confidence in the integrity of the revenue system.

3.99 The Committee believes that these schemes, though lawful, fall outside the public policy rationale underlying employee share plans. They are also out of step with community expectations.

Recommendation 13

3.100 **The Committee recommends that the Australian Taxation Office receive an additional, specific appropriation to fund investigation of the promoters of aggressive tax schemes. Further consideration should be given to appropriations in support of ATO-initiated legal action should this be supported by the outcome of systematic inquiry.**

86 See paragraph 3.95 and appendix G.

87 See Chapter 5.

Recommendation 14

3.101 **The Committee recommends that the Government consider that a cap be applied to salary sacrifice arrangements when foregone salary is contributed to an employee share plan qualifying under Division 13A. Further concessional arrangements should apply to sunrise industries, small and medium businesses where the Share Plan Regulatory Agency recommended elsewhere in this report is satisfied that the employee share plan is a bona fide employee buyout. This arrangement would apply for a defined period of time to be negotiated between the Government, the regulatory agency and relevant industry bodies.**

The Committee further recommends that the Government give consideration to requiring all sacrificed salary in executive-only or non-13A plans be assessable in the income tax year in which the sacrificed salary was earnt, having conducted first an analysis of its impact on corporations, especially their ability to attract and retain key personnel.

Any substantial changes to the taxation treatment of executive remuneration packages should be phased in and prospective.

3.102 The Committee notes that in the announcement referred to in paragraph 3.89, the Assistant Treasurer, Senator Kemp, said that he had asked the ATO to review the interaction of the income tax and fringe benefits laws to ensure that employee benefit trusts and employee share plans were taxed appropriately. The Committee welcomes this review and urges also an examination of the taxation treatment of salary sacrifice and interest free or low interest company loans.

3.103 The Committee suggests, however, that attention be given to the special needs of sunrise enterprises. In their early stages, such enterprises may require access to concessional taxation treatment in order to attract and retain key employees. If, as a result of the proposed review, a tightening of the FBT legislation and the taxation treatment of salary sacrifice and company provided loans is recommended, the Committee would advise that higher taxation exemption thresholds be provided to sunrise industries.

Recommendation 15

3.104 **The Committee recommends that the Government establish an independent inquiry to examine:**

- **the extent to which FBT exemptions are being used to develop and underwrite executive salary packaging, the cost to revenue and the economic benefits, including the attraction and retention of key personnel;**
- **the merit of plans, open to executives only, which operate on a salary sacrifice basis or on low or no interest loans, or which use various FBT exemptions, to continue to operate as they stand;**
- **whether limits should be placed on the amount of salary that may be sacrificed, the size of a low or no interest loan that may be accepted, or the amount of FBT exemption that may be allowable, without the value of the benefit being treated in the same way as cash income; and**
- **whether sunrise enterprises should be given access to concessional taxation treatment in respect of the FBT liability or the taxation treatment of salary sacrifice and company provided loans.**

3.105 It is the Committee's view that the recommendations made should only be adopted if appropriate safeguards are implemented in order to prevent the exploitation of the taxation laws through the use of employee share plans. This general approach is supported by the AEOA, which advised the Committee that:

> 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).[88]

3.106 The remainder of this section deals with specific issues concerning aggressive tax planning, and makes recommendations to address problems identified.

88 AEOA, submission no. 5.5, p. 6.

Power to collect information

3.107 Aggressive taxation arrangements can be removed only if the ATO is aware of them. This in turn rests upon two elements:

- information about employee share plans being collected by the ATO; and
- the capacity of the ATO to collect additional relevant information.

3.108 This report has noted[89] that information about employee share plans is not systematically collected by the ATO, and has recommended that it should be.

3.109 The problem that the ATO faces in terms of collecting additional information is that individuals within certain professional groups may deliberately attempt to thwart its information gathering activities. Such information is necessary in order to verify claims made by taxpayers concerning their taxation liabilities. It is also required to identify abusive schemes so that remedial action can be taken. As the ATO advised the Committee:

> The intelligence sought by the ATO is usually marketing material and client lists. The ATO is meeting determined resistance to the provision of client lists and has had to resort to formal information gathering powers. These formal powers have also been resisted and ATO has been and currently is involved in Federal Court proceedings to obtain lists of clients involved in taxation arrangements.
>
> The ATO predicted and is now seeing evidence that professionals would seek to avoid direct contact with their clients and would instead use 'agents' to market their products to their clients. This has been particularly evident in relation to off shore superannuation arrangements.[90]

3.110 The Commissioner's discovery powers have recently been the subject of actions in the Courts. Mr Michael D'Ascenzo, Second Commissioner of the ATO, advised the Committee that:

> We can work out who marketed that arrangement and then we go through the promoter. That is why you have all these challenges to our request—'We want to find out who marketed them,' and they say, 'We're not telling you.' We say, 'Look, under the law we have asked formally for you to give us this

89 In Chapter 2: Section 'Nature and Extent'.

90 ATO, submission no. 24, pp. 16-17.

> information and the powers of access are there.' They say, 'We don't think you should have it. We're going to claim legal professional privilege.' We are in three court cases at the moment.
>
> …
>
> We have had successful cases in the context of accountants, but we have lost in the case of lawyers. We are challenging these arrangements and we are hopeful that the lawyers on the bench will come to a different conclusion. It is basically a question of legal professional privilege.[91]

3.111 Two cases involving legal professional privilege were decided in 1999. In the first case, the Federal Court initially ruled against an order by the ATO to obtain the names of a lawyer's clients who had been involved in employee share acquisition plans. The reason was that this information was protected by legal professional privilege.[92] This decision was subsequently reversed.[93] In the subsequent judgement it was held that legal professional privilege did not attach to this information. Consequently, the lawyer in question was legally obliged to furnish the information that was the subject of the order from the Commissioner of Taxation.

3.112 In another case, the High Court ruled that the test to be used for determining whether legal professional privilege applied in relation to discovery and inspection of confidential written communications between lawyer and client was a 'dominant purpose test' rather than a 'sole purpose test'.[94]The dominant purpose test allows a far greater range of documents to be concealed than via the 'sole purpose test;.[95]

3.113 The full effect of these judgements on the capacity of the ATO to undertake adequate investigations of aggressive tax planning schemes is unclear. The effect of the latter judgement would appear to be to limit further the Commissioner's powers and hamper the ATO in its continuing efforts to reduce abuses of the tax system, and misuse of

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91 EEWR, *Transcript of Evidence*, p. 26.

92 *The Commissioner of Taxation of the Commonwealth of Australia v David Coombes*, [1998] FCA, 160 ALR 456. Leon Gettler, 'Court rejects ATO request for names', *The Sydney Morning Herald*, Thursday, 24 December, 1998, p. 21.

93 *The Commissioner of Taxation of the Commonwealth of Australia v David Coombes*, [1999] FCA 842; 164 ALR 131.

94 *Esso Australia Resources Ltd v The Commissioner of Taxation of the Commonwealth of Australia* [1999] HCA 67.

95 Evan Whitton, 'Secret lawyers' business – it's a privilege', *The Australian*, 6 January, 2000, p. 26.

share plans in particular. The powers of the Commissioner may not be as clear as is desirable.

3.114 Moreover, as noted in a commentary on the *Esso* judgement, the privilege of confidentiality of communications between lawyer and client has an obvious advantage to certain legal practitioners.

3.115 It hardly needs to be said that discouraging, detecting and dissolving aggressive tax planning schemes is a matter of considerable public importance. Without tax, the services of Government cannot be provided to the community; it is unfair to taxpayers who do honour their community obligations by paying their fair share of tax.

3.116 The Committee concludes that there is evidence to support the view that the present extent of the Commissioner's power could be further clarified in respect of discovering and examining information held by legal practitioners. It would be prudent, then, to remove any uncertainty in this area.

3.117 Nevertheless, the Committee is mindful of the fundamental importance to our system of justice of the confidentiality that attaches to communications between client and legal adviser. The Committee does not advocate a dismissive rejection of this ancient principle but believes that the Government should examine in detail the issues which surround it in relation to tax law. Apart from clarifying the powers of the Commissioner, in this narrowly focused area, discovery of information about share plans and monitoring of share plans can also be facilitated through other, less invasive, means. For example, registration of share plans and a regulatory authority.

Recommendation 16

3.118

The Committee recommends that the Attorney General prepare a discussion paper for public consideration, on the issues surrounding the clarification of the powers of the Commissioner for Taxation in relation to the discovery of information concerning aggressive tax planning schemes. This would include information held by legal practitioners. Particular consideration should be given to ensuring that information collected is used only for the detection and prevention of aggressive tax planning.

Defining the purpose of plans

3.119 At the present time the concessions contained in Division 13A can be obtained by any plan that meets the requirements set down in the legislation. It is possible to design employee share plans that operate under Division 13A but which provide concessions to executive employees that go beyond the original intent of the law. One reason is that the intent underlying Division 13A is not clearly articulated in the legislation itself.

3.120 One way of dealing with this ambiguity was suggested by RPC. In response to a question from the Committee concerning specific measures that could be implemented to reduce the use of employee share plans for aggressive tax planning, RPC said:

> 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.[96]

3.121 The Committee accepts this suggestion. It believes that the intent of any legislation providing for employee share plans should be clearly stated in a preamble to the legislation. Such a statement would provide guidance to users and administrators alike regarding the intent of Parliament. It would be another element in a system that establishes clearly the sorts of plans that should be allowed and those that fall outside the intent of the legislation.

3.122 The public policy motivation that should, in the Committee's view, underlie employee share plans was specified in Chapter 2. It is the Committees view that this motivation should form the foundation of any preamble.

3.123 The wisdom of this suggestion is reinforced by considering the implications of drawing together into one enactment the various pieces of legislation that underpin the operation of employee share plans. Such an innovation will assist those who wish to establish such plans. It will also enable the ATO and ASIC to specify what plan arrangements are considered within the Act and the tax and accounting consequences of each. Employers, employees and investors in employer companies will then know where they stand. This approach would also assist the

96 RPC, submission no. 30.3, p. 8.

collection of data about those plans, with a consequent effect on the administration of, and compliance with, tax laws and other statutory obligations. A preamble is an element in this comprehensive approach to fostering employee share plans while reducing abuse of the plans.

Recommendation 17

3.124 **The Committee recommends that any legislation providing for employee share plans contain a preamble that clearly articulates the public policy goals intended by Parliament.**

The Committee recommends that the Commissioner for Taxation and any other regulatory authority be required to take notice of, and give effect to, this preamble in their rulings in respect of employee share plans legislation.

An employee share plan regulatory agency

3.125 As noted in Chapter 2, government agencies possess surprisingly little information about employee share plans. As a result, it is more difficult to frame appropriate public policy; and the policy that does exist is not monitored either for compliance or effectiveness. To remedy this, the Committee has recommended that the ATO undertake the systematic collection of information about employee share plans in order to assess the effect of the current legislative arrangements and the impact of proposed changes to it. This initiative alone will provide a sound foundation for facilitating the creation of employee share plans. The Committee has also recommended the enactment of a single focused piece of legislation and additional powers for the Commissioner for Taxation. These changes will make the creation and operation of employee share plans more accessible for enterprises, while strengthening the integrity of the tax base. The question arises: would the creation and administration of employee share plans be facilitated by the creation of an employee share plan regulatory authority?

3.126 The ASIC did not support the creation of such an agency. It was claimed that the creation of such an agency would be contrary to the general trend of regulation and the underlying policy approach. The ASIC advised:

As a result of the recommendations of the Wallis Financial System Inquiry, the number of financial regulators has been rationalised… It would appear inconsistent with the general direction of these reforms to establish another regulator to separately and exclusively protect the rights of employees and regulate employee share schemes.

Moreover, unless there is to be a fundamental shift in regulatory philosophy applicable to employee share schemes, it would be unnecessary and inefficient to do so. The regulatory approach taken in Australia in relation to offers of securities is based on disclosure and not an assessment of the merit of the product. … The role of the regulator is to ensure that these risks are disclosed in the offer document so that the employee can make an informed decision about whether or not to invest. ASIC is well positioned to play this role.

….

Having a separate regulator protecting the interests of one group of investors or one class of investments could also lead to market distortions. … A split in the regulation of the interests of these investors could result in administrative difficulties and be confusing to employees, consumers, investors and the market more generally. It would be difficult to justify an outcome that involved different classes of investors in a company having different remedies in the event of difficulties.

While having a separate regulator for employee share schemes may be a means of visibly increasing the intensity of regulation of those schemes, at the end of the day, it must be recognised that there are risks associated with investment in shares that no amount of regulation can remove. … Risks of this kind are best regulated through proper disclosure (a regulatory approach which ASIC is already well positioned to provide).

Finally, while we see benefits in obtaining accurate sources of information relating to employee share schemes, this needs to be assessed in light of other considerations including: the costs of setting up another regulator, duplication of information and whether there are other existing non-regulatory bodies which could perform this task, for example, the Australian Bureau of Statistics and the Australian Taxation Office.

In the final analysis, we must balance the regulatory benefits against the costs of imposing an additional regulator, always

> being mindful of the risks that over-regulation could drive investors out of the market altogether.[97]

3.127 The Committee does not lightly dismiss the ASIC view of regulation. The purpose of an employee share plan regulator is to ensure compliance with relevant tax and corporations law, and other law as appropriate. To do this, information must be collected. The purpose of the regulatory agency would be, amongst other duties, to collect and analyse such information and ensure plans comply. As noted, such information is not now systematically collected. As such, it is more difficult to know with certainty the degree of compliance with existing laws.

3.128 Moreover, as employee share plans grow in number and size, larger amounts will be invested. The Committee recommends in Chapter 2 that one purpose of employee share plans be to increase national savings so as to encourage people to better provide for their retirement. Reliable supervision of such funds provides a further public policy reason for ensuring that employee share plans operate effectively and efficiently. It is also this reason that removes employee-investors from the general class of investor.

3.129 Employee share plans, as they stand, hold considerable amounts of revenue. Knowing the extent of those likely revenue flows is essential to effective and responsible public administration. The Committee therefore considers that such significant sums require closer monitoring.

3.130 In addition, liquidation of large amounts of equities can have an effect upon the operation of the stock market, as indicated in Chapter 5. It is entirely proper for Government to collect and evaluate information about possible movements in capital so that appropriate economic policy settings can be maintained.

3.131 The Committee believes the cost of operating a regulator to be overstated. First, given that billions of dollars are invested, the cost of a regulator is likely to be relatively small. The cost could be recouped by a levy upon employee share plan participants and providers. The annual per employee levy need not exceed $2.00 per investor in order to ensure that the regulatory agency is self-funding.

3.132 Second, it is unlikely that the existence of a regulatory authority would reduce the enthusiasm of businesses for bona fide employee share plans. Any increase in the number of employee share plans can only improve

97 ASIC, submission no. 16.3, p. 12.

the operation of the business sector overall. This should provide an incentive to businesses as a whole.[98]

3.133 Moreover, a regulatory agency would, over time, amass a large amount of information concerning the successful operation of employee share plans. This information could then be passed on as advice to employee share plan operators and participants and to enterprises wishing to establish a plan. Such an agency would provide an institutional foundation for an information service, such as recommended elsewhere in this report. Hence, it would be part of the 'stream lining' of legislation that witnesses advised the Committee was needed if plans were to flourish.

3.134 Support for an employee share plan regulatory and monitoring agency was provided by RPC, which has considerable experience in designing and implementing employee share plans. RPC advised the committee:

> 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.[99]

3.135 The AEOA was asked what suggestions it had for reducing abusive practices. While suggesting that trusts should be encouraged as part of a regulatory framework, the AEOA was nevertheless strongly supportive of the creation of a regulatory body:

> 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

98 As is indicated by the submissions from the Australian Chamber of Commerce and Industry (submission no. 4), and the Business Council of Australia (submission no. 36).

99 Submission no. 30.3, p. 12.

> 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.[100]

Taking all these considerations together, the Committee believes that the weight of evidence supports the establishment of a regulatory agency. The purpose and functions of the agency would be:

- to examine proposed share plans and monitor existing share plans to ensure that they comply with the relevant legislation;
- to register plans and maintain records on the taxation and other revenue implications of their operation;
- to provide timely advice to executive government and Parliament on the effective operation of plans;
- to provide advice on the likely taxation consequences of a particular plan; and
- to develop, in consultation with stakeholders, a number of model plans. Use of, and compliance with such plans would ease the regulatory burden on enterprises and the monitoring cost for the agency, thereby enabling it to focus its attention on plans that do not comply with public policy.

3.136 In what administrative department should such an agency be located? While a portion of the work that this agency would undertake would involve matters of corporate law, the larger portion of its work would involve applying the taxation laws and advising enterprises on the most appropriate employee share plan arrangements. In addition, the records that the agency would need to collect, maintain and use most frequently, are more likely to be taxation records than corporate law records. It is more efficient to place the agency closest to the materials that will form the basis of its activities.

3.137 Moreover, the ASIC advised the Committee that it must, amongst other things, strive to:

> (a) maintain, facilitate and improve the performance of the financial system ... in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and

100 AEOA, submission no. 5.5, p. 6.

(b) promote the confident and informed participation of investors and consumers in the financial system.[101]

3.138 If this role was diluted to involve taxation regulation, there may well develop a confusion of purpose. It is far easier for the regulatory agency to be located in the ATO, but have on its staff liaison officers from the ASIC. For these reasons, the Committee considers that the regulatory agency should be located under the aegis of the ATO.

Recommendation 18

3.139 **The Committee recommends that:**

- **an Employee Share Plan Regulatory Agency be established, by legislation and operate under the aegis of the Australian Taxation Office;**
- **the agency should be established as an element of any consolidated employee share plan legislation; and**
- **the agency's responsibilities should be to:**
    1. **administer any employee share plan legislation;**
    2. **monitor the operation of employee share plans;**
    3. **advise appropriate regulatory authorities so that the intent of the legislation can be attained;**
    4. **advise government of improvements to legislation that would facilitate the creation of employee share plans while at the same time reducing opportunities for their use other than for purposes intended by Parliament. This would include, but not be limited to, defining small, medium and sunrise enterprises and establishing criteria for determining what constitutes an aggressive tax planning scheme; and**
    5. **develop, in consultation with stakeholders, a number of model plans with known taxation consequences, and provide these to the Employee Share Plan Promotional Unit in the Department of Employment Workplace Relations and Small Business, recommended elsewhere in this report.**

101 See paragraphs 1(2)(a) and (b) of the *Australian Securities and Investments Commission Act 1989*; quoted in submission no. 16.3, p. 12.

Registering employee share plans

3.140 An employee share plan regulatory agency would only be as good as the information it collected. At the present time, as noted a number of times, information about employee share plans is not collected in a systematic manner. This is a deficiency in the current arrangements, as it does not provide the groundwork for the promotion of employee share plans.

3.141 The challenge is how to collect the necessary information in an efficient manner. Clearly, employers or the vehicles through which they offer an employee share plan, will have records of all employees who accept an offer of equities under an employee share plan. It would be a simple matter to provide this information, in a standardised form, to the regulatory agency.

3.142 Information could easily be collected from taxpayers through their annual tax returns. The ATO attested to the feasibility of this:

> Details concerning deductions claimed or income returned from these arrangements are recorded by taxpayers at "general" income or deduction labels in the return forms and cannot be separately identified from other income or deductions returned at these labels. For the detailed information you require it would be necessary to include specific label fields into the return forms and to provide explanatory information in the 'Tax Pack'. This would have impacts on cost of compliance issues with regard to tax return preparation.[102]

3.143 The Committee acknowledges that there would be costs associated with the addition of a further question to the tax return form. However, it is a relatively minor addition.[103] Furthermore, the widespread use of computer technology means that keeping track of individual employee share plans should be neither labour intensive nor expensive.

3.144 The Committee is aware that some operators of employee share plans may be reluctant to disclose information about their plans. The Committee cannot see a sound policy basis for such reluctance, provided a plan is operated for bona fide reasons. In fact, throughout this inquiry the Committee has received considerable assistance not only from the AEOA, which has considerable experience in the design

102 ATO, submission no. 24.2, p. 1.

103 For example, 'Did you acquire equities of any sort in the past financial year through an employee share scheme? If so, state the scheme's registration number, the value and number of equities.'

of employee share plans, but also from enterprises who have been exceedingly willing to share the details of their plans and their experiences.

3.145 The Committee believes that the benefits of collecting information about employee share plans outweigh any costs. The Committee also concludes that the promotion and administration of employee share plans would be enhanced if all employee share plans were registered.

Recommendation 19

3.146 **The Committee recommends that:**

- **all employee share plans operating in Australia be registered with the regulatory agency and be given a unique identifying number, whether or not they operate under Division 13A or some other arrangement;**
- **registration of employee share plans involve providing to the regulatory authority the following information:**
  - ⇒ **the names of participants;**
  - ⇒ **the type, number and value of equities provided;**
  - ⇒ **the method of valuing equities;**
  - ⇒ **the rules of the plan and how it operates and is administered;**
  - ⇒ **the duration of the plan;**
  - ⇒ **any concessions provided to the plan; and**
  - ⇒ **the number of times equities have been issued under the plan;**
- **taxpayers be required to disclose on their tax returns their participation in employee share plans; and**
- **data be collected, on an annual basis, as to the number and types of membership, size of employee share plan and other operational details.**

Focusing employee share plans

3.147 The recommendations made so far will do much to ensure that employee share plans operate according to their public policy rationale. A final power that the regulatory agency requires is that of dealing

definitively with plans operated for purposes not intended by the Parliament, whether those plans are within Division 13A or outside it. The ATO must be empowered to place such plans on a firm taxation footing. For this reason, the Committee believes that the regulatory agency should have the power to declare that a plan is being operated for aggressive tax planning purposes and forewarn operators and participants that the equities may be liable to income tax.

3.148 The importance of this power can be seen in the limitations faced by the ATO in using the existing anti-avoidance provisions in the face of aggressive taxation minimisation schemes that have been widely marketed. Mr Michael D'Ascenzo, second commissioner of the ATO, advised the Committee:

> The problem with mass marketed arrangements is that if you are not in there early in the piece, the application of an anti-avoidance provision requires you to go through the facts of each individual investor, and it does become resource intensive in doing that. On the other hand, if the arrangement is blatant, artificial and contrived, and designed to give a purpose other than the purpose intended by parliament, it is hard for parliament to have anticipated that when they legislate.[104]

3.149 The provision recommended will greatly enhance the power of the ATO to deal expediently with such schemes. The mere existence of this power will also act as a powerful deterrent.

3.150 The Committee also believes that the deterrent power of this proposal will be enhanced if proof of the lawfulness of a plan rests with the taxpayer, rather than the ATO having to prove that the plan is unlawful. Such a standard of proof would require the operator of a plan to provide evidence, amounting to full disclosure, in order to establish their claim.

Recommendation 20

3.151 **The Committee recommends that the regulatory agency be empowered to declare that a certain share plan has a primary purpose beyond that intended by Parliament. The agency should be empowered to make an assessment in respect of the income and/or equities in the plan.**

104 *Transcript of Evidence,* p. 355.

Private binding rulings

3.152 From the mid-1980s the Australian Taxation System underwent considerable modification in order to remove perceived complexity, inefficiency, uncertainty, and unfairness. Elements in this process included continuing the move towards self-assessment begun in 1986, and providing further certainty in the administration and application of the taxation laws.

3.153 In 1992 the Keating Government undertook a major overhaul of self-assessment arrangements. One initiative to emerge from this process was to permit the Commissioner of Taxation to issue Private Binding Rulings (PBR) on certain matters and under certain circumstances. PBRs were introduced via the Taxation Laws Amendment (Self Assessment) Bill 1992.[105]

3.154 The ATO advised the Committee that:

> Under the move to a self assessment environment the Australian Parliament provided taxpayers with a legislative framework that enables them to obtain binding and reviewable technical advice from the ATO in the form of Private Binding Rulings (PBRs).[106]
>
> …
>
> When we moved to a self-assessment system people said, 'Look, in the areas of genuine uncertainty we want this capacity to get some understanding of what our position will be, and we also want more than that: we want to have an understanding of what our position will be in relation to arrangements that we want to enter into. We want the comfort of knowing up-front what our position will be.' That is the private ruling system.[107]

3.155 The Commissioner for Taxation is empowered to give private binding rulings, which first came into force on 1 July, 1992.[108] A PBR is an expression of the ATO's view on how a particular provision of the

105 Australian Master Tax Guide 2000, p. 12. They are provided for by Act No. 101 of 1992, which added to the *Taxation Administration Act 1953* (TAA) Part IVAA – Private rulings (ss. 14ZAA-14ZAZC).

106 ATO, submission no. 24.2, p. 1.

107 *Transcript of Evidence*, p. 23.

108 Australian Master Tax Guide 2000, p. 12. PBRs are provided for by Act No. 101 of 1992, which added to the *Taxation Administration Act 1953* Part IVAA – Private rulings (ss. 14ZAA-14ZAZC).

taxation law should be interpreted or administered. A ruling usually has a continuing application; that is, both a past and a future application.[109]

3.156 Taxpayers (or their advisers, for example their accountants and legal advisers) or tax planners who market plans, can approach the ATO for a private ruling.[110] A private ruling is, as the name suggests, private, rather than public. The content of the ruling is normally available only to the ATO and the person who sought the ruling and their advisers.

3.157 A private ruling provided by the ATO is a ruling as to:

- the way in which a discretion of the Commissioner would be exercised;[111] or
- the way in which, in the Commissioner's opinion, a tax law or laws would apply to a taxpayer in respect of a specified year and in relation to a taxation arrangement.[112]

3.158 Private rulings are normally binding on the Commissioner provided they are favourable to the taxpayer.[113] They have a life of one year,[114] and no fees are charged for issuing the rulings although the Review of Business Taxation did contain a proposal to consider charging a fee.[115] The term does not appear in the glossary of terms available on the Australian Taxation Office internet site.[116]

3.159 In response to a question taken on notice[117] the ATO also advised the Committee that:

> (1) Taxpayers are not required to seek approval or to notify the Australian Taxation Office (ATO) about proposed ESOP arrangements;
>
> (2) The ATO is not able to collect this information from current tax returns. However, the ATO records details on the Private Binding Rulings issued, at the request of

109 TR 92/20. At: http://law.ato.gov.au/atolaw/view.htm?locid='TXR/TR9220/NAT/ATO

110 Australian Master Tax Guide 2000, pp. 12-13.

111 TAA, s. 14ZAE.

112 TAA, ss. 14AF-14AI.

113 ITAA, ss. 170BB, 170BE and 170BF.

114 *Transcript of Evidence*, p. 340.

115 *Transcript of Evidence*, p. 341.

116 http://www.ato.gov.au/content.asp?doc=/content/corporate/glossary.htm.

117 Mr Barresi asked: 'Would you have a list somewhere in your files of those companies who have entered into employee share ownership schemes? I am not interested in the actual names of these companies, more in the type of industry that they represent and in the size of the industry. Can you give us a breakdown through your records? ……. According to industry type and the number of companies out there, and perhaps the number of employees that would be covered by those schemes.' EEWR, *Transcript of Evidence*, p. 28.

> taxpayers. Taxpayers are not obliged to carry out the arrangement that the tax ruling covers ie the fact that a ruling was obtained concerning an ESOP is not evidence that the ESOP was ever implemented or implemented as described in the ruling.
>
> Such details for advanced opinions are not available.[118]

3.160 The Committee was interested in how widespread the use of private binding rulings was in other developed economies. The ATO advised the Committee that New Zealand had introduced a system based on the system operating in Australia and charged fees for the service. In Sweden a taxpayer could obtain a ruling through a tribunal process, but only a small number of rulings are issued. The United States and Canada provide advice, but the advice provided does not offer the degree of protection to the taxpayer or the level of reviewability that the Australian system does.

3.161 The ATO said that each year it issues over 3000 private rulings.[119] The volume of rulings would suggest that the ATO has invested considerable resources in the private binding ruling system.

3.162 The ATO also advised the Committee that between 1997 and 1999 seventy-nine private binding rulings had been issued in respect of employee share plans,[120] and less than ten rulings appeared to be involved in aggressive taxation arrangements.[121] The ATO told the Committee that some of the promoters of aggressive tax minimisation schemes based the promotion of their plans on rulings and advance opinions obtained from the ATO.[122] Other participants in aggressive taxation minimisation arrangements did not use private binding rulings, but relied upon advice from learned counsel and 'other sources'.[123]

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118 ATO, submission no. 24.1, p. 2.

119 *Transcript of Evidence*, p. 347.

120 Submission no. 24.1.

121 *Transcript of Evidence*, p. 347.

122 *Transcript of Evidence*, p. 340. Prior to the introduction of the PBR system, taxpayers or their agents could request an advance opinion concerning the income taxation consequences of a proposed transaction. Unlike PBRs, advance opinions are not legally binding on the Commissioner, but are treated as administratively binding provided that certain conditions are satisfied, including: 1) An advance opinion applies only to the taxpayer for whom it is given and cannot be taken as a precedent for other cases; 2) It will have application only in relation to the factual situation presented by the taxpayer and only in respect of the transaction specified in the advance opinion; and 3) It will operate unless it is later decided that the opinion was incorrect (IT2500). Private rulings substantially replace advance opinions. However, there may be circumstances where a taxpayer is unable to request a private ruling and may instead request an advance opinion (TR 93/1).

123 *Transcript of Evidence*, p. 348.

3.163 The ATO told the Committee that the problems encountered by the private binding ruling system have been focused on employee share plans rather than a systemic problem across the system of private binding rulings.[124] The ATO said that:

> In some instances promoters of these arrangements sought opinions or rulings from the ATO. We provided comfort to some of these arrangements on the basis of our understanding at that time as to the application of the law, and the features of the arrangements. However, when investigations are made into how the arrangements were implemented, the ATO has found that the arrangements were often not in accordance with the legal opinion and memorandum of explanation provided to the ATO. In some circumstances the arrangements appear to be no more than shams.[125]

3.164 Problems discovered in the use of private binding rulings led the ATO to introduce centralised control on the issue of private binding rulings and advance opinions on employee benefit plans, as well as the progressive withdrawal of opinions.[126] This will also ensure consistency of treatment and correctness of the advice given to taxpayers.[127] However, in evidence given in hearings in response to questions about the private binding ruling system, the ATO said that any person who operated 'outside the system' would be difficult to detect.[128]

3.165 While the number of private binding rulings being used in aggressive tax minimisation schemes was under ten, the ruling may be used as the basis of a generic scheme which is then sold to a large number of clients. This appears to be the practice in this area of aggressive tax planning.[129] The ATO advised the Committee that at a conservative estimate, $1.5 billion in contributions to all types of employee benefit arrangements was the subject of recovery action by the ATO.[130] Of that, about one quarter, or $375 million, was contributed by employee share plans.[131] The taxation revenue exposed had been channelled through schemes marketed by just 40 promoters.

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124 *Transcript of Evidence*, p. 344.
125 ATO, submission no. 24, p. 12.
126 ATO, submission no. 24, pp. 14-15.
127 ATO, submission no. 24.1, p. 8.
128 *Transcript of Evidence*, p. 341.
129 *Transcript of Evidence*, p. 360.
130 ATO, submission no. 24, p. 16.
131 *Transcript of Evidence*, p. 360.

3.166 A number of witnesses criticised the practice of private binding rulings. Cadbury Schweppes, advised the Committee that Division 13A operated in such a way that employers and employees had to seek from the ATO a private binding ruling to ensure that the share plan met the specific requirements of the relevant legislation. This, the company noted, 'is always difficult to obtain and is an expensive exercise for the company'.[132] A clear example of the problems facing enterprises in this area was provided by Qantas. The example demonstrates the two concerns: the necessity to protect the revenue, on the one hand, and the importance of certainty in respect of the taxation laws:

> There are a number of anti-avoidance provisions in the *Income Tax Assessment Act 1936* which are designed to prevent streaming of distributions (either as dividends or capital) to certain shareholders in such a manner as to give rise to a tax advantage. The provisions are Sections 45, 45A, 45B and 160AQCBA.
>
> Although the provisions are not intended to cover normal employee share acquisition schemes, they could potentially apply in circumstances where a company issues shares to employee shareholders only and not to other non-employee shareholders.
>
> Qantas sought confirmation in the form of a binding private ruling from the Australian Taxation Office that these anti-avoidance provisions would not apply to QSSPII under certain commonly used procedures contained in the *Taxation Administration Act 1953*.
>
> The ATO indicated that as a matter of policy it would not provide a binding private ruling to taxpayers including Qantas on these matters without an analysis of the taxation position of the individual employees receiving the shares (ie. approximately 30,000 employees) and its non-employee shareholders.
>
> It is clearly impossible for Qantas to undertake an analysis of the tax position of each of its employees and its non-employee shareholders.
>
> In recognition of this, the ATO provided a non-binding letter of comfort which indicated that "it is not envisaged that the

132 Cadbury Schweppes, submission no. 47, p. 2.

> Commissioner would make determinations that these sections would apply, provided the circumstances do not change".
>
> However, this outcome is not satisfactory. The Government should remove the ambiguity in the widely drafted anti-avoidance provisions to facilitate the implementation of employee share ownership schemes.[133]

3.167 The clarification and consolidation of the laws relating to employee share plans, along with the creation of a regulatory agency, and model plans, would do much to remove the necessity for private binding rulings in cases such as this.

3.168 Ernst & Young advised the Committee that some of the rulings appeared to be misconceived:

> It should also be recognised that some of the rulings issued by the ATO would appear to be wrongly conceived but resulted in a proliferation of some plans which may be described as abusive.[134]

3.169 Witnesses would appear to be saying that not only do the present legislative arrangements invite the use of private binding rulings, but that the practice itself may at times invite misuse.

3.170 Mr Edward Wright of Equity Strategies Pty Ltd criticised the practice of private binding rulings, for a quite different reason: that the public is entitled to know what the ATO believes the law to be:

> There are people selling products around the town and we are told a product has tax rulings on it. This makes it 'a proprietary product'. I talk to top tax advisers and those tax advisers say, 'Look, there is a conflict here between this and this and those people say they have a tax ruling, but we would not encourage anybody to try to utilise this plan or this arrangement without a tax ruling.' If the tax situation is such that these arrangements are within the tax law, I believe that should be made public. I am not saying that the details of particular products should be made public, but I do not understand why people should be put to the expense of getting a tax ruling on something where there is a bit of doubt, when it has already been decided by the tax people that there is not a problem. There seems to be a conflict but they are taking a certain view.[135]

133 Qantas, submission no. 35, p. 14.

134 Ernst & Young, submission no. 20.2, p. 10.

135 *Transcript of Evidence,* p. 152.

3.171 The Committee notes that the Tax Commissioner has appointed Mr Tom Sherman AO QC to review certain aspect of PBRs. It is anticipated that this review will examine the present arrangements and the improvements, if any, that are required to ensure the integrity of the PBR system.

3.172 It may be that the preferred remedy in this area of public administration is public disclosure. Rulings themselves already exist in electronic form. It would be a simple matter to post them on the ATO internet site and to provide an annual or even more frequent compendium in electronic form.

3.173 The Committee is concerned that much of the attack on aggressive taxation arrangements takes the form of actions arising in response to movements in tax minimisation. This approach will, of necessity, have to remain an option, and the Commissioner's powers in this regard should be as clear as possible. However, court actions take time and the clearer the legislation the more certain the outcome. This was a view put to the Committee by the ATO:

> …good systemic policy … is the best way of dealing with things. I also hope that in these arrangements which we [the ATO] think are blatant, artificial and contrived, that ultimately when it gets to the courts the courts will see it that way and people will look at the substance of the arrangements and not be overly narrow in focus in terms of formalism or other features of judicial interpretation that have perhaps been a blight on our system in the late 1970s.
>
> …
>
> Good legislation which provides the policy intent is always the best vehicle to have a good tax system. The problem is that you may have a very good policy platform and yet people will make these contrived, artificial arrangements. You do not want to get to a provision in the law which starts to have some good policy and 15,000 specific anti-general avoidance provisions. Once you start to get to the specific end, people will find ways of saying, 'Ha, they missed this point.' What I am suggesting is that a good platform of policies is the best option. We argued, in terms of the business tax reform, that we needed to maintain a general anti-avoidance provision to cover things that are built on to that policy in a way that was never intended.[136]

136 Mr Michael D'Ascenzo, ATO, *Transcript of Evidence*, pp. 359-360.

3.174 Like the ATO, the Committee prefers a systemic approach combined with sufficient clear powers to permit timely action in the case of schemes designed to work outside the intent of legislation as determined by Parliament.

Recommendation 21

3.175 **The Committee recommends that:**

- **the Government re-examine the underlying policy of private binding rulings, and consider options for increasing the transparency of such rulings; and**
- **the feasibility of posting rulings issued in respect of employee share plans on the Australian Taxation Office internet site should be examined, provided that no taxpayer identifying information is provided.**

Employee share plans and broader policy considerations

3.176 In the course of the inquiry a number of broader policy considerations emerged. While some of these were not raised by witnesses, they nevertheless need to be examined by executive government, and policy decisions made.

Employment eligibility tests and evolving company structures

3.177 As Division 13A stands at present, a share or right will be qualifying only if the company that issues the equity is the employer or a holding company of the employer of the taxpayer.[137] Witnesses advised the Committee that there are employees who work in company arrangements which do not permit equities offered as part of an employee share plan to qualify for the concessional taxation treatment under Division 13A. As a consequence, employees in such plans are excluded from obtaining the concessions provided by Division 13A. For example, at present many contractors are ineligible to participate in Division 13A plans because they may not satisfy the definition of 'employee' provided in Division 13A. This affects in particular many

137 ITAA, ss. 139CD(3) and 139 DD(3).

small, medium and sunrise industries, which may have a higher proportion of their workforce on contract than other, listed, industries. Mr Edward Wright of Equity Strategies Pty Ltd advised the Committee:

> I would like to see the tax benefits under the regime, which restricts the benefits of deferral to employees of the company or the holding company, extended to contractors. In the IT industry, many of the people involved are contractors. They want to be contractors. They pay their own tax and they want to be able to move sideways and backwards and forwards, and they cannot participate in these plans. I would also like to see the tax benefit extended to employees of joint ventures. If you have a 50-50 joint venture that is managed here in Australia, the Australian company cannot give shares in that company because the employee is not employed by a subsidiary. Increasingly, particularly in the IT area, we are seeing joint ventures and so-called 'virtual corporations'.[138]

3.178 The submission from KPMG reinforced the points made by Mr Wright:

> Employees of joint venture vehicles such as special purpose companies may be offered shares in the employee share schemes of a venturer. However those shares may not attract concessions under Division 13A of the 1936 Act because the vehicle is not a group company of any of the venturers. Division 13A of the 1936 Act should be amended to allow employees in this situation to be deemed as employees of a venturer, not the special purpose vehicle.[139]

3.179 The restrictions referred to by these witnesses diminish the development of worthwhile, long-term equity holdings and the benefits to the employer and the employee. The Committee agrees that contractors, employees of joint venture companies and other special purpose companies should not be excluded from enjoying the concessions offered by Division 13A. Therefore, in so far as such restrictions have retarded the development of employee share plans, the Committee agrees that they should be removed.

3.180 However, the Committee is concerned, as noted already, that the benefits of any changes to Division 13A flow for the most part to general employees, without creating the opportunity for aggressive tax planning. Consequently, it recommends that exemptions be granted to

138 *Transcript of Evidence,* p. 152.

139 Submission no. 13.

joint venture companies and contract employees in respect of satisfying conditions 139CD(3) and 139 DD(3) only on condition that general employees enjoy the exemption.[140]

Recommendation 22

3.181 **The Committee recommends that the Employee Share Plan Regulatory Agency, or failing the creation of such an agency, the Commissioner for Taxation, be provided with a discretionary power to waive sections 139CD(3) and 139 DD(3) of the *Income Tax Assessment Act 1936,* provided that:**

- **the plan in question would otherwise satisfy Division 13A;**
- **the Commissioner is satisfied that the plan is not being used and will not be used for aggressive tax planning; and**
- **there is another plan operating under Division 13A, but open to 75 per cent of employees, with an uptake rate of more than 50 per cent and no disincentive conditions, that is offered at the same time and in respect of which the same exemption is sought.**

Structuring employee share plans

3.182 The Committee was told that there are three structures that employee share plans use to provide equity to employees:

- Contract (the most common form being the employee share option contract);
- The Employee Share Trust (under which the trustee is legal owner and which extends beneficial and legal rights to participating rights employees); and
- 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.[141]

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140 Section 139CD(3) states that: 'The second condition is that the company is the employer of the taxpayer or a holding company of the employer of the taxpayer.' Section 139DD(3) states that: 'The second requirement is that the company is the employer of the taxpayer or a holding company of the employer of the taxpayer.'

141 Submission no. 5.5.

3.183 Under present legislative arrangements no particular way of structuring employee share plans is explicitly mandated. Consequently, the particular structure that a plan has will be a matter for the enterprise offering the employee share plan.

3.184 This is in contrast to the proposed New All-Employee Share Plan in the United Kingdom. That plan will operate using a trust structure. The main reasons are that other structures may involve added complexity for employees, companies are familiar with trust structures, and many operate trusts at present.[142]

3.185 The Australian Employee Ownership Association advised the Committee about many advantages that trusts provided for the operators and the participants in employee share plans.[143] In contrast, Mr Jon Kirkwood of Ernst & Young stated that,

> 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.[144]

3.186 While the same sorts of advantages may attach to trust structures in this country as do in the United Kingdom, it is not clear that there would be any public policy benefit in mandating, through legislation, that employee share plans use a trust structure, or any other structure for that matter. In this respect, the Committee endorses the view put to it by the AEOA:

> …legislation should not 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.[145]

142 The New All-Employee Share Plan explanatory documentation, paragraph 6.6.

143 AEOA, submission no. 5.5.

144 EEWR, *Transcript of Evidence*, p. 132.

145 Submission no. 5.5.

3.187 Although the Committee sees a number of benefits in the use of trusts to operate employee share plans, it agrees with the AEOA that no particular structure should be mandated by legislation. Enterprises should be permitted to retain flexibility in this regard.

Employee share plans and workplace relations

3.188 The *Workplace Relations Act 1996* provides that in order for an enterprise association to be registered under the Act, it must be:

> free from control by, or improper influence from:
> (i) any employer, whether at the enterprise in question or otherwise, or
> (ii) any person or body with an interest in that enterprise.[146]

3.189 As Vice President MacIntyre of the Industrial Relations Commission notes, 'The purpose of the provision is to ensure the independence of the enterprise association'[147] 'so that it is not controlled by the very enterprise the employees of which it can represent.'[148]

3.190 Vice President McIntyre held that a shareholder has an interest in the company in which he or she holds a share or shares irrespective of the size of the shareholding. In the case of an enterprise association, in which its members or management committee hold shares in an employer, those people have an interest in the enterprise. In virtue of that, the enterprise association cannot be held to be free from control by any person or body with an interest in that enterprise. Therefore, such an association fails to satisfy the provisions of s 189(4)(b) of the Act. In effect, Vice-President McIntyre held that the criteria specified in s. 189 (4)(b) of the *Workplace Relations Act 1996* operate to prevent the registration of any enterprise association, the members, or at least the members of the committee of management, of which hold shares in their employer or in a person or body with an interest in the enterprise in which they work.[149]

3.191 This decision has not been tested on appeal. As it stands, however, the decision means that the establishment of an employee share plan and

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146 *Workplace Relations Act 1996*, ss. 189(4)(b)(i), (ii).

147 *SMQ Enterprise Union*, Australian Industrial Relations Commission, D No. 30007 of 1998, at paragraph 118.

148 *SMQ Enterprise Union*, Australian Industrial Relations Commission, D No. 30007 of 1998, at paragraph 138.

149 Per Vice President McIntyre, *SMQ Enterprise Union*, Australian Industrial Relations Commission, D No. 30007 of 1998, at paragraphs 144-145 and 158.

membership in it by employees is sufficient to prevent registration of an industrial association.

3.192 A result of this decision is that existing members of enterprise associations, or those considering forming them, may find that if they take up employee share plan membership, their enterprise association may then be deregistered or not be eligible for registration. This may induce some employees to decline the offer of employee share plan membership. Consequently, the *Workplace Relations Act 1996* would be working so as to thwart what is a bipartisan policy: the creation of, and membership in, employee share plans.

3.193 The Committee is of the view that it was not the intention of Parliament when the *Workplace Relations Act 1996* was enacted to prevent the registration of enterprise associations in those workplaces that also operated employee share plans. Employees should be free to be members of both employee share plans and enterprise associations.

3.194 The Committee notes that the exposure draft of the Registered Organisations Bill 2000 contains a provision that, if enacted, would permit an enterprise association to qualify for registration even though its members are also participants in an employee share plan offered by their employer.[150] If enacted, this provision would therefore remove the impediment in the *Workplace Relations Act 1996.*

3.195 The Committee note that the Minister for Employment, Workplace Relations and Small Business, the Hon Peter Reith MP, announced in an address to the AEOA in June 2000, that the Government will proceed with the amendment foreshadowed in the exposure draft of the Registered Organisations Bill 2000 that will permit members of an enterprise union also to hold shares in their employer's business'.[151]

3.196 The Committee believes that the impediment in the *Workplace Relations Act 1996* should be removed as soon as possible and that the most effective way to do this is by enacting clear and unequivocal legislation. The Committee therefore supports Minister Reith's proposal.

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150 Section 20, which reads: '…a person or body is taken not to have the capacity to control or improperly influence the association merely because the person or body is the holder of a share, debenture or interest in the relevant enterprise.'

151 The Hon Peter Reith MP, 'Share ownership rules on enterprise unions need to be relaxed', *Press Release,* 29 June, 2000. Available at: http://www.dewrsb.gov.au/ministers/reith/mediarelease/2000/pr101_00.htm; K Murphy, 'Lib push for enterprise unions', *The Australian Financial Review*, 30 June, 2000, p. 4.

3.197 The Committee is, however, sensitive to the fact that membership of an enterprise association and participation in an employee share plan may be seen to produce a conflict of interest and perhaps even an opportunity for manipulation of employees. The Committee believes that legislation providing for membership of enterprise associations and participation in employee share plans should be drafted in such a way that the freedom of choice of employees to participate in employee share plans and enterprise associations is protected.

Recommendation 23

3.198 **The Committee commends the draft Registered Organisations Bill 2000 to Parliament and recommends that any legislation dealing with employee associations, provide explicitly:**

- **for membership of employee share plans;**
- **that when the members of a plan are also members of an employee association, the eligibility for registration of that association; and**
- **for the protection of the freedom of choice of employees who participate in enterprise associations and also participate in an employee share plan.**

Recommendation 24

3.199 **The Committee recommends that the Government refer to the Employee Share Plan Advisory Board the question of whether taxation concessions available to employers for establishing qualifying employee share plans be conditional upon there being a non-interference clause inserted in the qualifying conditions in Division 13A. The intention would be to provide explicit guarantees for the freedom of choice and association of employers and employees.**

Employee share plans and workplace agreements

3.200 The number of employee share plans in workplace agreements is very low. The Department of Employment, Workplace Relations and Small Business advised the Committee that from October 1991 to June 1999, only 42 agreements out of a total of around 25,000 agreements made

under the Commonwealth industrial relations laws, and certified by the Australian Industrial Relations Commission made allowance for employee share ownership plans.[152] Thirty of these agreements are currently in operation. The Department estimated that they cover 85,000[153] (or approximately 6 per cent) of the 1,331,100 employees currently covered by federal workplace agreements (as at 31 March 1999) [update]. The Department further advised the Committee that the highest concentration of current federal agreements with employee share plan clauses was in the finance and insurance sector. There are 14 agreements in this sector and it is estimated that 82 per cent of employees are covered by current federal certified agreements with employee share plan clauses. Three of the four major banks have workplace agreements which provide for employee share plans. Nine agreements that allow for employee share plans operate in the transport and storage industry. This represents some 30 per cent of agreements struck that make provision for employee share plans and 17 per cent of employees are estimated to be covered.[154]

3.201 The Department also advised that it is not only collective agreements that are being used to provide employees with shares. Of the 1,500 employers for whom AWAs had been approved, as at the end of May 1999, ten employers had negotiated AWAs that contained provisions for employee share plans.[155] These AWAs are in the mining industry, manufacturing, retail, construction, health and community services, and cultural and recreational services industries.[156]

3.202 These figures reveal that although many employees covered by workplace agreements have access to employee share plans as part of

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152 In its submission, the Department of Employment, Workplace Relations and Small Business advised the Committee: 'It should be noted that this total includes a number of replacement agreements which cover the same organisations'; submission no. 38, p. 12.

153 The Department also advised: 'The employee coverage numbers refer to the number of employees covered by agreements which contain an ESOP provision and do not necessarily reflect the number of employees either eligible for or participating in ESOPs'; submission no. 38, p. 12.

154 Department of Employment, Workplace Relations and Small Business, submission no. 38, pp. 12-13.

155 The Department also advised that: 'It should be noted that the OEA database comprises a sample of one approved AWA per employer and, as a result, is indicative only of the types of arrangements an employer is making with its employees. It is not possible to say how many employees at such workplaces are eligible to participate in the ESOP. Also as the OEA data refers to employers rather than workplace, it is possible that ESOP provisions apply at more than one workplace owned by a particular employer'; submission no. 38, p. 13.

156 Department of Employment, Workplace Relations and Small Business, submission no. 38, p. 13.

those agreements, the total number of agreements that make provision for employee share plans is very small.

3.203 This is consistent with evidence from the ACCI. The Committee was advised by the ACCI that that a small number of agreements made under the *Workplace Relations Act 1996* provide for employee share plans.[157] The ACCI also advised that no consistent model is used and, as a result, that a variety of plans are offered and conditions of participation vary. Some agreements tie participation and number of equities to the performance of the enterprise, while others use length of employee service or employment status to allocate a specified number of equities. Equities may be offered gratis to the employee, or at a discounted price or at full market value.[158] This indicates that the motivations for the plans vary widely between enterprises.

3.204 Evidence provided to the Committee indicated that most employers regarded participation in an employee share plan as a separate matter from enterprise bargaining. Southcorp advised the Committee that their employee share plan provided 'a mechanism whereby employees can share in the financial rewards of superior Company performance, without the need to deal with this issue in the bargaining environment of an Enterprise Agreement'.[159]

3.205 Information provided to the Committee by other witnesses indicates that some employers are clearly linking remuneration offered to rank and file employees to employee share plan participation. Qantas, for example, advised the Committee that, 'Over the past two EBAs, Qantas has been able to negotiate wage increases lower than the prevailing EBA wage outcomes for the industry through the inclusion of the Qantas employee share ownership plan.'[160] Other employers are linking salary to company performance, specifically company share price.[161]

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157 ACCI, submission no. 4, p. 4.

158 ACCI, submission no. 4, p. 4.

159 Southcorp, submission no. 34, p. 8.

160 Qantas, submission no. 35, p. 9. CSL also advised the Committee that, 'In 1997, as part of an Enterprise Agreement outcome, employees had the opportunity of exchanging the benefits of a 2 per cent bonus for discounted shares. Approximately 70 per cent of all eligible employees took up the opportunity to be involved in that particular share plan'. Submission no. 6, p. 1.

161 G Elliott, 'Telstra eyes net floats' *The Australian*, 10 February, 2000, p. 1. In this article it was reported that: 'Dr Switkowski flagged a radical change in the salary structure among some of Telstra's 50,000-strong workforce, suggesting a new options-based pay system that linked an employee's salary to Telstra's share price.'

3.206 The Committee asked RPC whether employees should be permitted to trade participation in employee share plans against salary increases or changes in conditions or superannuation. RPC told the Committee that,

> 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.[162]

3.207 Other witnesses rejected the inclusion of employee share plan participation in employment negotiations. The Finance Sector Union advised the Committee that when given a choice between participation in employee share plans and increases in wages, superannuation, or more flexible working conditions, employees did not select participation in employee share plans:

> As previously stated, the FSU accepts the financial benefits that may be derived by employees through a free allocation of shares, however this should not occur in lieu of proper wage outcomes.[163]
>
> Shares constitute forced savings often at a level beyond our members. Despite the benefits of contributing to improved savings outcomes, employees look for real wages growth, in a manner that reflects their increased contribution to the success of an employer organisation. In the course of recent enterprise bargaining negotiations, an FSU member concisely articulated that 'shares are good, but they won't pay for those groceries my family needs today at Woollies'. Consistent with this sentiment, FSU reiterates that employee share outcomes should not be regarded as an alternative to proper wage outcomes.[164]

These sentiments were echoed by other witnesses.[165]

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162 RPC, submission no. 30.3, p. 12.

163 Mr B J Hirt, Finance Sector Union of Australia, submission no. 29.

164 Mr B J Hirt, Finance Sector Union of Australia, submission no. 29.

165 The Australian Manufacturing Workers' Union, submission no. 12; Australian Council of Trade Unions, submission no. 27.

3.208 Allowing the unrestricted trading of employment conditions and wages against participation in employee share plans for general employees is contrary to the intent of employee share plans.

3.209 Remunerating employees with equities rather than traditional forms of income, may expose both employers and the general economy to greater pressure for wage increases when the value of the equities falls. This has been noted in relation to the recent downturn in the share market and in relation to the so called 'new economy ' stocks: high technology and IT equities. The chief economist of AMP asset management, Mr Shane Oliver, was reported to have said that:

> …continued falls in the share prices could lead employees to demand higher cash-based packages instead of stock options, putting pressure on wages. '…if employees are less keen to accept options plans because they might not be as rewarding, it could put upward pressure on wages growth'.[166]

3.210 The Committee believes that such concerns apply not only to the high technology sector and employees who are remunerated in part through options allocated to them under an employee share plan, but to any employee who has converted any of their remuneration from salary to equities. The risk to the economy of a wages blowout, should there be a share market downturn, could be increased if a significant number of general employees traded salary for equities. Moreover, the effect on the economy could be exacerbated.

3.211 General employees on modest incomes will be reluctant to place at risk their income. This would result in fewer employees participating in plans. It may also destabilise employment bargaining. This is less often the case for executive employees who can afford to place at risk large portions of their salaries.

3.212 The Committee concludes that it is appropriate that executive employees be free to choose to place a portion of their remuneration 'at risk'. The Committee also concludes that under certain circumstances general employees should also be free to choose to trade remuneration for participation in a bona fide employee share plan. The Committee is fully aware that the downside risk for general employees is considerably greater than for executive employees because executives generally have the resources to weather any downturn in the equity

166 B Clegg and A Hepworth, 'High-tech employees rethink pay', *The Australian Financial Review*, 16 May, 2000, pp. 1, 26.

market. General employees, however, tend to rely upon their regular salary to meet their day to day living expenses.

3.213 The Committee is aware of circumstances where allowing an exchange of some salary for participation in an employee share plan can provide desirable outcomes. For example, a company may be facing a business crisis and need to restructure and reduce costs. One strategy used in Australia has been to negotiate salary reductions and foregoing salary increases in return for shares in the company. This can enable a company to survive and the strategy provides a tangible benefit to employees, employers and communities. The Committee would consider these arrangements to be exceptional.

3.214 In 1998 the Australian Industrial Relations Commission approved an agreement between Greyhound Pioneer and its employees and held that although the agreement provided a reduction in terms and conditions in comparison with the relevant awards, it could be approved because 'it was part of a reasonable strategy to deal with a business crisis and was not contrary to the public interest'.[167]

3.215 The Committee considers that this should be the minimum test. In addition, agreements to engage in trading of conditions should only occur in the light of full disclosure involving an independent assessment of the likelihood that the strategy will be successful. Any agreement struck should be approved by an independent arbiter. The Committee believes that the Australian Industrial Relations Commission and the Office of the Employment Advocate are well positioned to act in this capacity.

3.216 The Committee does not believe that it should be permissible to trade superannuation for participation in an employee share plan, as the risks of doing so outweigh any advantage to be gained.

167 Submission no. 38, p. 7.

Recommendation 25

3.217 **The Committee recommends that employees and employers be permitted to reach an agreement to trade wages and conditions (but not superannuation entitlements) for participation in an employee share plan so long as the following conditions are met:**

1. **the agreement is part of a reasonable strategy to deal with a business crisis;**
2. **the agreement is not contrary to the public interest;**
3. **the agreement involves full disclosure of the company's situation and risks that can reasonably be known;**
4. **the negotiations leading to the agreement involve an independent assessment that the strategy is soundly based;**
5. **the participants negotiate free of duress; and**
6. **any agreement struck should be ratified by an independent arbiter, such as the Australian Industrial Relations Commission or the Office of the Employment Advocate.**