Ernst & Young Submission regarding Employee Share / Option Plans

This submission outlines the fact that the taxation rules and the administration of those rules governing offers of and participation in employee share and option plans are inhibiting the encouragement of that participation. We submit that the Government and the bureaucracy must commit to meaningful discussion, in a spirit of co-operation to get Australia's ESAS rules and administration much closer to the international benchmarks to which we aspire.

In this submission we refer to the subject generally as "ESAS".

ESAS participation is essentially a corporate issue because the subject property is equity or rights to equity in the company offering participation. However, the taxation rules are aimed at the employee participants most of whom would be unlikely to adequately understand the impact or potential impact of those rules and/or the administration of those rules without substantial guidance from the employer. In fact, 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. Unfortunately, whilst there are a number of errors, ambiguities and unintended consequences in the legislation, there are many more issues which, with the benefit of hindsight, reflect a lack of understanding of the issues at the time the policies were developed. As it now stands, only amendments to the law will achieve an appropriate outcome.

Having stated that ESAS is essentially a corporate issue albeit, in relation to the employees, Ernst & Young explains that its focus on these issues has arisen from many years of worldwide experience in ESAS plans and particularly since 1994 when the Australian Tax changes were first flagged. Since then, we have been working with a very large group of Australian and Internationally based public companies regarding their concerns with the new rules. This work included a number of meetings with Treasury and ATO officers following submissions[1]and the discovery of specific issues but we have concluded that the significant barrier to resolution of these issues is a reluctance of the Government to make further amendments having already absorbed a number of sessions of Parliament to achieve the handful of amendments already made.

ESAS plans are a critical factor in achieving profitability and shareholder value. This fact has been proven in the United States and many other countries where the taxation rules have been developed over many years to achieve a stable and reliable basis for the development and operation of appropriate plans[2].

---

[1] Submissions by / on behalf of - the Institute of Chartered Accountants / the Australian Society of CPA's / the Taxation Institute of Australia / the Corporate taxpayers Association.

[2] The recent United Kingdom Budget proposed a new scheme with the potential to deliver flexible widely based employee share ownership.

We wish to emphasise the fact that we are not talking about abusive plans which are of concern to the ATO. This submission discusses only the issues which arise from participation in plans generally covered by Division 13A and usually implemented by listed or about to be listed companies. These could sensibly be described as "plain vanilla" plans based on precedents established over many years in the United States, UK, Canada and other countries and adapted specifically to accord with the taxation rules in Australia. Unfortunately, the existence/discovery of other types of plans has created an aura of suspicion around the very mention of employee share/option plans. This aura has often inhibited rational discussion regarding plans of the type discussed in the submission.

Attached is an outline of "some ESAS issues" demonstrating the existence of errors, ambiguities, unintended consequences and inappropriate policy applicable to ESAS plans. Behind these simple examples is a plethora of convoluted and conflicting rules which did not predict the realities of common transactions arising from participation in the plans.

An example of the difficulties encountered arises when a company is making an original public offering (IPO) ie it is issuing a prospectus with a view to listing. The company will have received advice and settled an issue price about a month before the listing and will use that price as the benchmark for its offer of shares or options to employees (such offer requiring full disclosure in the prospectus). In the majority of cases, for options, there will be no payment for the option and the exercise price will be the IPO price or a premium above the IPO price. More frequently now, the options will not be exercisable for at least three years and only then if the share price has outperformed industry benchmarks.

Unfortunately, offers accepted before the listing (as is inevitably the case in an IPO) are treated by the tax rules as being in respect of unlisted shares which must therefore be valued .This will force the company to incur an unnecessary cost having regard to the fact that it has already carefully chosen an IPO value for public subscription. Worse, the tax rules mandate the valuation to occur at the date the right (option) is created in the employee. This occurs when the offer is accepted which could be different days for different employees as they take up the offers (requiring valuations for each relevant day).

Noting that the employee is required to pay at least the current market value to acquire the share it is surprising that the tax rules ignore that fact and force taxpayers to use valuation tables in Division 13A to value the options. The starting point is the valuation of the shares referred to above and the other significant components are the exercise price and the full period of the option. The outcome of the application of the tables is always an assessable amount partly because the tables adopt methods of valuing exchange-traded options (which these are not) and partly because no regard is had to any payment to acquire the option (as mentioned above this does not occur in the majority of cases but when it does the oversight is significant) nor is there any regard paid to the fact that the option cannot be transferred or sold (and would therefore be considered valueless or incapable of valuation) nor to the fact, as is increasingly the case, that the option cannot be exercised until specified price "hurdles" are exceeded (rendering even more uncertain the possibility of the option ever being exercised) and the option cannot be exercised for (typically) at least three years and will be forfeited if the employee leaves the company.

It is trite to point to the fact that options usually “qualify” for “deferral” because participants may wish to hold the shares obtained from exercise but if deferral is selected, the participation will be taxed at the date the option is exercised notwithstanding the fact that there will be no revenue at that time (on the contrary, the exercise price will have reduced the available revenue at that time to meet the tax bill which will then be based on the market value of the share at the date of exercise).This is why many employees (assuming they understand the very complex rules) will decide to be assessed “up-front” at which time the Div13A valuation rules referred to above apply. These and many other related issues are horrific circumstances for employees to face in relation what is essentially a very simple transaction which should only be taxed on realisation ie: when the shares are sold (the options are never voluntarily sold).

On behalf of the many corporations and employees affected by the inadequacies referred above, Ernst & Young submits that the Government should commit to meaningful consultation in a spirit of cooperation, to get Australia’s ESAS rules and administration much closer to the international benchmarks to which we aspire.

Should you have any inquiries regarding this submission, please call Mr Jon Kirkwood of this office (02-9248-4717).

List of ESAS Issues

1. How can there be any certainty about the value of a share (or right) where an offer is made based on the then current price of a listed share but the price changes through the acceptance period. Uncertainty is a huge issue for shop-floor/blue collar employees. The date of acceptance should be the date of acquisition and the market value at the date of offer should be the value for ESAS purposes. Shares that have not been traded or are only traded on the particular day should be clearly drawn within the rules (eg the IPO price should be accepted as market value).

2. The width of the "no forfeiture" provision in Section 139CE (the exemption provision) operates too harshly and should not apply where the reason for the forfeiture is a bona fide allegation of fraud/dishonesty or misconduct.

3 Many plans are now subject to amendment / replacement / termination as a consequence of a take-over or merger forcing acquisition of shares / options from employees. The resultant "disposition", whether or not replaced by shares in the acquiring group,appears to give rise to a CGT liability and a "cessation" event under Div13A. Surely this was not intended? Worse, where it is an "exemption"plan, the requirement that the shares / options be held for three years is breached and the exemption claimed is jeopardised. Surely this was not intended?

4. ESAS trusts have a primary purpose of preventing transfer of shares/options before conditions are met. For example, no transfer is permitted before a loan is repaid or a specified period of service is completed or a price hurdle is reached, etc. Accordingly, the establishment of the trust, transfers to the trust and from the trust to or for the benefit of the employee, should not be taxable transactions. This should be made clear by a special exception provision for both Section 26AAC and Division 13A (and **now in the rewrite -** 130-90 "PAYE earner").

5. The valuation tables are very unfair and inappropriate where the share or right cannot be transferred or realised. In addition, the tables do not recognise an amount paid for an option, nor do they recognise a restricted open period for exercise and/or price hurdles for exercise (often the hurdle is substantially above the exercise price). Where the share or option cannot be traded, the value should be determined as the simple difference between the market value of the share and determined in accordance with Section 139FA or FB, less the amounts which must be paid to obtain the share (including amounts for and the exercise of an option where relevant). There are also problems where the exercise price is variable but cannot be determined until it is paid. Section 139C(3) refers only to consideration for the right and ignores the exercise price (whereas it is rare for payment to be made for the option and common for there to be an exercise price!(this provision leads to an unintended outcome in relation to Section 139FE see #10 below).

6. Given that the employee is always the person taxable under Division 13A, qualification for the shares or rights should be available under Section 139CD even

where an associate is the participant.(an associate is **a** taxpayer but is not **the** taxpayer.- an example of the same term being used for different purposes) In addition it is a very harsh result that there is no amendment available where the right is lost if an associate is the participant.

7. Why is cessation of employment a cessation time? Is this intended to catch retirees? What if the participant retires and the option lapses? S139DD(3)does not permit an amendment because there is no longer any employment! Why is the exemption forfeited because the participant retires? Why is a participant taxed because they have retired but have not exercised options? Why does Section 139DD apply only to options (not shares)?

8. Div 13A gives rise to ordinary income but if no amendment or a loss arises there is only a capital loss! Should be an ordinary loss! The Div 13A view on MV is entirely speculation and there is no certainty of income or gain! Alternatively, a revenue deduction in the year of lapse/loss should be introduced.

9. What is the ATO view on the application of 26AAC and Div 13A to non residents where:
   (i) No service connection with Australia/shares in foreign company/never become resident?
   (ii) No service connection with Australia/shares in Australian company/never become resident?
   (iii) Service connection with Australia/shares in foreign company/never become resident?
   (iv) Service connection with Australia/shares in Australian company/never become resident?
   (v) Same as (i) but become resident before shares are sold?
   (vi) Same as (i) but become resident before rights are exercised?
   (vii) Same as (ii) and (v)?
   (viii) Same as (ii) and (vi)?
   (ix) Same as (iii) and (v)?
   (x) Same as (iii) and (vi)?
   (xi) Same as (iv) and (v)?
   (xii) Same as (iv) and (vi)?

10. How is S139C(3) [and (4)] intended to operate? Why is the exercise price for an option excluded from "consideration" for a right? What if there is consideration for the right equal to or greater than the Div 13A discount? What happens to cost base calculations if no amount is included in assessable income under Div 13A? (include rewrite)
    Is it intended that "no discount" participation cannot be included in 139CD(5) umbrella? What if the consideration for the option exceeds the "discount"? Surely this is the policy preferred type of participation and should be encouraged?
    Why can't the umbrella rules look back to all participation before Div 13A and/or have a 3 year rolling test period?

11. The third qualification condition (in S139CD (1)) requires all the relevant shares to be "ordinary shares". Whilst this requirement is understandable where the relevant shares represent only a small percentage of issued shares or are not widely held or easily tradeable or listed, the requirement is onerous, unduly restrictive and not sensible where there is a ready market for the securities (eg. listed preference shares or preferred ordinary shares), or the shares/securities represent a fair percentage of all issued shares. Perhaps the requirement should simply be "ordinary shares or widely held or listed" shares or similar securities (listing usually requires widely held).

12. The cost base rules in the 1936 and 1997 Acts do not work as intended. For example, the amount included in assessable income under Div13A should form part of the cost base but faults in the law prevent this from happening. This artificially inflates the capital gain

13. What does "right" mean? A right to anything? What if a new or "escalating" employee acquires (or is granted) a right to (additional) remuneration. S139C(1) appears to apply. But clearly, 139CD cannot apply therefore 139B(1), (2) applies → 139CC(2) → 139FC → 139FE; but there is no share.

14. Where shares or options are offered to employees with less than 3 years' service (not permanent employees) the company should be able to elect to include all employees in the denominator and all offerees in the numerator. This is a big problem for companies with very few permanent employees, most of whom are not intended to be covered by the "egalitarian" plan. 139CD(5)/CE/GB/GF

15. The tests for employment in 139CD(3) and DD(3) should **only** apply at the time of acquisition, otherwise a takeover will trigger a failure. **Also** the tests should cover employment in joint ventures, partnerships and trusts where the shares are in a company which has say 25% or greater interest in the venture/ partnership/ trust. **Further**, proxy votes should be disregarded for 139CD(7) **and** 139CD(6) is unworkable if it requires a prediction of the position at any future time. There are also difficulties in determining the "permanent employee" status of a person who moves employment from one group company to another before 3 years are attained.

16. What is a **restriction** (s139CA and CB) "preventing the employee from disposing of the share"? A trading block which will only be removed when:
3 years employment is attained?
A particular employment status is attained?
The price of the share reaches $x?
A loan is paid off?
The employee retires?
A call option over the share?

17. Why should the FIF rules apply to unvested interests in shares or rights under ESAS?

18. The Commissioner should quickly promulgate "reasonable methods" of valuation of unlisted shares (otherwise small private company ESAS arrangements will be inhibited).

19. Why should S139E apply to all qualifying participation by the employee in that year instead of selected participation?

20 How is Section 139G intended to operate? Is it the earliest of the events or the most relevant of the events that counts? What if a beneficial interest arises before the transfer / issue / allotment occurs and how does the outcome align with the valuation rules re a "particular day"?