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Ms Lexia Bain
The Secretary
House of Representatives Standing Committee on
Employment, Education and Workplace Relations
R1 116
Parliament House
Canberra ACT 2600

Our ref APShareScheme99-ParlInqyRespMC260

Contact Alec Highnam – (03) 9288-6742

30 April 1999

Dear Ms Bain

Inquiry into employee share ownership in Australian enterprises

I enclose for the Inquiry a submission on the current operation and use of share schemes. In connection with this, a copy of the results of a survey conducted by KPMG this year is enclosed.

KPMG surveyed over 750 Australian companies ranging from small private companies to large multinationals. The responses to the survey will be of interest and relevance to the Inquiry.

The results of the survey show that companies implementing share or share option schemes receive a significant benefit from the increased performance of their employees. Employees welcome the opportunity to take a stake in their employer and view share schemes positively.

KPMG would like to make the following submissions to the Inquiry relating to Division 13A of the *Income Tax Assessment Act 1936*.

Generally, Division 13A has been welcomed by our clients. In the main, it deals fairly with benefits provided under employee share and right schemes. However, since its introduction certain problems have emerged as regards its operation which we believe could be corrected without compromising the policy underlying Division 13A and without leading to any greater compliance costs.

Indeed, in our view, there would be no material revenue effect if these corrections were made (apart from the increase in the tax-free exempt amount). These corrections would allow a

smoother interaction of taxation and this area of employment and industrial relations. Our concerns follow:

Disposal

The current provisions within Division 13A do not contain a definition of 'disposal'. Certain problems have emerged with regard to share scheme rights. It is unclear whether rights that are cancelled or lapse, for whatever reason, are 'disposed' of by the employee. If this is a disposal, the provisions require a decision as to whether this is a disposal in an arm's length or non-arm's length transaction, which is a time consuming and often difficult analysis. In addition, it could be argued that cancelled rights give rise to a taxation benefit even though no benefit may have been received by the taxpayer.

The provisions do contain a mechanism to reverse any tax assessed on rights 'lost' before they are exercised. However, in our opinion, Division 13A would be improved by the insertion of a section stating categorically that if the rights are 'lost' before exercise, no consideration is received for the disposal, and, the employee has not elected to be taxed up-front, then no amount is required to be included in assessable income.

Taxation Elections

a) Section 139E states that where taxpayers are issued qualifying shares or rights, taxpayers may make an election to be taxed in the year the shares or rights are issued. The legislation states that the election covers each qualifying share or right acquired in that year.

   We consider that the legislation is too narrow as taxpayers should be able to make an election in respect of each and every qualifying share and/or right.

b) Taxation Determination TD97/23 states that an election made under Section 139E applies to all qualifying shares or rights acquired during the same year of income by the taxpayer.

   We consider that the legislation is not clear on whether different elections can be made in relation to shares issued under different plans. In the event that the amendments noted at a) above are not implemented , we consider that the legislation should be amended to make it clear that different elections can be made for different plans.

Qualifying Shares

a) De-grouping

Sub-section 139CD(3) provides that shares or rights are only qualifying where they are provided in a company which is the employer of the taxpayer or a holding company if the employer of the taxpayer. It does not address the situation where there is a sale of part of a group (i.e. the employer and the holding company in which shares are issued are no longer part of the same group).

The legislation is unclear on what occurs in the above circumstances, however, where de-grouping occurs, employees should not be penalised by a loss of qualifying status of their shares or rights.

b) 75% Requirement

In order to be a qualifying share, s. 139CD(5) requires shares be issued to 75% of the permanent employees of the employer.

We recommend that s.139CD(5) be amended so that the 75% requirement can be met in additional circumstances to those that currently exist.

This could be achieved by amending s. 139CD(5) so that the 75% requirement could be achieved by inviting at least 75% of the permanent employees of the employer or 75% of the permanent employees of the group, of which the employer was a member, to participate in the scheme.

Calculation of Discount

Where an employer company proposes to provide employees with shares at a discount, the current regime requires the employee to calculate the discount at the time he or she acquires the share, assuming the employee elects to be taxed up-front.

This may lead to differing calculations of the discount as amongst employees, depending on the time the shares are acquired, notwithstanding the fact that all the employees may have been offered the shares at the same time.

If the scheme operates on a small discount being made available to employees as against the market price of the share, some employees may acquire shares for a market value greater than that of the shares at the time the offer was made. Those employees would not come within the concessions at all. In all cases, it is very frustrating for an employer company to not be able to

state that shares will be offered to employees at a certain price and that a certain amount will be included in assessable income.

The fact that an employee may fall outside Division 13A (because of a movement in share prices after the offer was made) will have repercussions in the fringe benefits and capital gains implications of the scheme. This leads to uncertainty and unwarranted complexity in the administration of the scheme and is inimical to the creation of a positive industrial relations environment.

We recommend that Division 13A be amended to allow employers to stipulate a value of the share or right offered to employees. This could be an average of the previous five days market price of the share or right prior to the making of the offer. This value could serve as the market value of the share or right at the time of acquisition by the employee, provided acceptance of the offer occurs within a certain period.

Valuation of Rights

The market value tables provided in Subdivision F of Division 13A can provide anomalous results and are unnecessarily difficult to apply.

It is possible for an application of the rules in the tables to result in a taxable amount of a right, that when added to the exercise price, results in an amount that is greater than the market value of the shares to which the right relates.

The tables are difficult for taxpayers to use to calculate the market value of the rights. The valuation tables should only be used when a threshold number of rights are issued, e.g. 100,000.

For rights issued below this threshold, the taxable discount should be based on a simple comparison between the market value of the shares covered by the right at the date of issue/cessation compared to the issue/exercise price of the right.

Death

The taxing point for qualifying shares or rights is generally the cessation time (s. 139B).

In the event of an employee's death, the cessation of employment triggers the taxing point of the shares or rights. This is a harsh result as the employee has no control of the event.

As under the CGT provisions, a concession should be provided in the legislation in the event of death so that an employee's legal personal representative or beneficiary should effectively be

able to stand in the shoes of the employee insofar as the application of Division 13A is concerned.

Forfeiture Conditions

An obstacle to the introduction of an exempt share scheme for companies is the legislative prohibition within Division 13A on forfeiture conditions.

Shareholders do not want employees who have done the wrong thing by the company to be able to nonetheless retain ownership of shares, notwithstanding the loss of other entitlements of employment.

If forfeiture were permitted in events of proven misbehaviour such as fraud, theft, and other serious offences, we believe that no harm would be done to the overall scheme. A legislative exception to the forfeiture prohibition in s. 139CE(2) would increase the popularity of exempt schemes amongst shareholders.

Trusts

For shares or rights to be issued under an employee share scheme, the scheme must meet the requirements of s. 139C.

Where shares or rights are issued to employees via a trust, s. 139C(5) states that the shares or rights will not be acquired by the trust where the sole activities of the trust are obtaining shares and providing those share to employees.

We consider the “sole activity” requirement of s. 139C(5) to be an onerous requirement. The trustee should be able to undertake reasonable activities such as the disposal of the shares at the direction of the employee.

Sub-section 139C(5) should be amended to replace the “sole activity” test with a “predominant activity test”.

Takeovers, Restructures and Mergers

Division 13A does not allow for the effective treatment of shares and rights in takeovers, corporate restructures and mergers.

For example, employees of a target vehicle may be required to dispose of shares acquired through the target employer’s employee share scheme. The shares may have attracted concessional treatment and there may be tax deferral still to run in those shares. The takeover

may require the employees to dispose of their shares in return for new shares in the acquirer. The employee will then be assessed on the original shares as they have been disposed of, and possibly subject to tax on the new shares when acquired if they are not qualifying shares.

We would recommend roll-over relief in these situations, whereby the employee could elect to transfer the remaining deferral period on the original shares to the new shares and thus ensure no disadvantage arises from an event beyond the employee's control. Rights may also be adversely affected in this scenario.

Rights and Performance Hurdles

There is an emerging trend amongst publicly listed companies for any offer of rights to an employee to be tied in with performance hurdles and corporate targets. The employee beneficiary of such a scheme may elect to be taxed up-front. If he or she does so there is generally no problem if the rights are lost as Division 13A contains a correcting mechanism in s. 139DD.

However, it is not uncommon for such schemes to contain a bonus element. For example, the employee may receive a certain number of rights to be exercised in the event of reaching a certain target, but if the target is exceeded by a certain amount, then more rights will be exercisable.

The employee is left in the uncertain position, if he or she wishes to be taxed up-front, of having to estimate the correct amount of tax on the basis that there is a right to acquire a share. Currently both taxpayer and tax office have to deal with legislation which is based on the idea of a single right for a single share, whereas multiple performance related rights are becoming more prevalent.

We recommend the legislation be amended to offer more clarity on this issue.

Exemption Threshold

The current tax-free amount is $1000. Consideration should be given to increasing this to $2000. As our survey found, this would increase the number of schemes in existence, and would increase share ownership amongst employees within existing schemes. This is clearly the intent of the original legislation.

We also recommend that the threshold, whatever the amount, should be indexed each year to take account of inflation.

Non-residents

The jurisdictional application of Division 13A is uncertain.

There is uncertainty in the provisions themselves with respect to the fundamental question of whether in-bound employees, in possession of rights acquired in non-resident employment with a non-resident Australian employee will be taxed under Division 13A on exercise of those rights. This causes concern to non-residents entering Australia for employment.

We note that the U.S.A and the United Kingdom have adopted a tax-sharing proportional approach in these situations. Similar amendments to Australia's double tax agreements, or preferably and more simply, amendments to the tax legislation, would resolve this problem. Increasing employment mobility between jurisdictions, coupled with the increase in the use of performance related rights in salary packaging, have exacerbated problems in this area.

Longer Term Plans

The earliest taxation point for employee shares and rights is not until the shares or rights are acquired. Where the plan has conditions that need to be satisfied before shares can be acquired, there is uncertainty as to whether the rules will change so that the regime which applies at the time the conditions are set may be different to the tax regime that applies at the time the shares are acquired.

Joint Venturers

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 Division 13A concessions because the vehicle is not a group company of any of the venturers. Division 13A should be amended to allow employees in this situation to be deemed as employees of a venturer, not the special purpose vehicle.

If you have any questions with regard to any of these concerns do not hesitate to contact myself on 03 9 288 6648 or Alec Highnam on 03 9 288 6742.

Yours sincerely

Andrew Purdon

Enclosures:
KPMG SHare Scheme Survey