4

Administration and taxation arrangements

Introduction

4.1 For the most part, two different areas of legislation regulate employee share plans: the taxation laws and the corporations law. Each type of legislation regulates different aspects of employee share plans. The effect of the taxation laws on employee share plans is examined in this chapter.

4.2 The Committee was advised about a large number of difficulties that employers face when operating employee share plans under Division 13A. There was agreement amongst the witnesses who criticised the present arrangements as to the core problems from which these arrangements suffer. These problems are examined in this chapter.

4.3 As noted earlier, the Committee wishes to facilitate the more widespread development of employee share plans for general employees. At the same time it is imperative that this does not open up opportunities for misuse of the tax system. With these constraints in mind, the Committee considers that in respect of the taxation laws, a number of relatively straightforward amendments should be considered. If implemented, these could rectify uncertainty in the legislation and remove various barriers to the creation and operation of employee share plans, and, if appropriate administrative arrangements are put in place, the opportunity for misuse will be substantially reduced.

Trusts and the effect of the Ralph Review of Business Taxation

4.4 The recommendations of the Review of Business Taxation (the 'Ralph Review') contained two significant implications for employee share plans, in relation to the way that trusts are treated within the taxation system and the taxation rates that apply to various employee share plans.

4.5 Trusts have been used extensively for implementing and administering employee share plans. One benefit of this approach has been that it reduced the number of entities subject to taxation and focused taxation liability on the beneficiary of the plan.

4.6 Under existing taxation arrangements, employee share plans operated through trust arrangements are exempt from tax. Liability for taxation resides with the beneficiary.

4.7 The Ralph Review recommended that trusts, with some exceptions, should be subject to the same taxation treatment as companies. At the time of making its submission the AEOA advised the Committee that it was not clear whether, under the recommendations of the Ralph Review, employee share trusts would be taxed as if they were companies or whether they would be exempt.[1] The AEOA advised the Committee that 'there have been informal and vague 'assurances' from various, and non-authoritative, sources on this point. … the AEOA finds it strange that the Government, so far, has taken no definitive steps to clarify this issue'.[2]

4.8 The AEOA urged that employee share plan trusts be clearly exempt from any taxation regime that proposed to tax them as if they were companies. The AEOA advanced the following reasons:[3]

1. Shares presently held for the benefit of employees in an ESOP trust would need to be treated as the legal and beneficial property of the company. Employees, therefore, would lose their legal interest in, or rights to, shares which, morally and legally, should be held for their benefit.

2. Distributions by ESOP trustees to employees could represent a capital disposal subject to capital gains tax and payable by the trustees.

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1 AEOA, submission no 5.4. See also RPC, submission no. 30.3.

2 Submission no. 5.4.

3 Submission no. 5.5, appendix C.

3. To accommodate dividends received by an ESOP trust would require the establishment of separate dividend imputation and franking credit accounts for each of its employees. This would be expensive and burdensome on the trustee, and the sponsoring company, and would be certain to discourage the implementation of ESOPs.

4. Shares distributed to employees would be treated as ordinary dividends in the hands of the employees. This causes a number of contradictions to exist in employee share plan taxation provisions including:

   (a) tax exempt employee shares would now be treated as fully taxable dividends;

   (b) shares held prior to 1996 to be distributed as eligible termination payments would now be taxed directly as dividends…;

   (c) dividend withholding tax credits cannot be passed on to employees under the corporate tax system;

   (d) bonus shares and rights issues received and passed on to employees would be fully taxable as dividends (ie. these are not usually taxable under the current regime);

   (e) loans to employees by the trustee could be considered taxable dividends under the newly implemented provisions of Division 7A.

4.9 The Ralph Review did contain a general recommendation that would appear to exempt the most common employee share plans from the entity tax regime and, as a result, exempt employee share plan trusts from being treated as companies for taxation purposes. The recommendation is:

> That where members of a trust are, as such, in the position of purchasers of the trust property under an uncompleted sale of the property:
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> (i) the trust of the property be ignored; and
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> (ii) the actions of the trustee be treated as the actions of those members.[4]

4.10 The precise effect of this and some other recommendations contained in the Ralph Review is unclear. However, in response to a written question on this matter from the Committee, the Australian Taxation Office advised the Committee that, '… we can see nothing in the BTR process that would be inconsistent with the policy objectives of Division 13A

4 Review of Business Taxation, *Report*, recommendation 16.14.

and that mainstream trust arrangements used in employee plans will not suffer any deleterious effects from the reforms proposed.'[5]

4.11 On this matter, the Treasurer advised the Committee that:

> In implementing a consistent entity tax regime, consideration will be given … to whether to exclude trusts from the regime, or to formally include them but with some modifications to maintain the necessary features of their current treatment … These issues are being considered as part of the consultation process on business tax reform.[6]

4.12 This assurance would seem to address most of the concerns raised by the AEOA. Specifically, the Australian Taxation Office advised the Committee that trusts that are established for 'absolutely entitled beneficiaries' and which meet certain criteria, or trusts where the beneficiaries are the purchasers of the trust property under an uncompleted sale of that property,[7] will be excluded from being taxed in a similar manner to companies. Nevertheless, the Committee notes the advice from the Australian Taxation Office that the 'consistent entities treatment rules, which tax trusts and companies in a similar manner, may apply to trusts used in employee share schemes in some situations'.[8] The example provided by the Australian Taxation Office is that of an 'employee share scheme trust in which the employee was neither absolutely entitled to the shares nor the purchaser under an uncompleted contract'. Such a trust would be one in which the employee may not receive the shares but another person may.[9]

4.13 The Australian Taxation Office also advised the Committee that 'policy in this area is still being developed and as a result, it is not possible at this stage [i.e. 25 February, 2000], to provide an absolute opinion as to how the employee share scheme tax concessions will be maintained. Ultimately, the matter is one for the Government.'[10]

4.14 In a letter to the Committee the Treasurer, the Hon Peter Costello MP, advised that legislation implementing the unified entity taxation regime will be introduced into Parliament later this year (2000). Prior to the introduction of that legislation, and as noted already, the Government is

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5 ATO, submission no. 24.2, p. 2.

6 The Treasurer, the Hon Peter Costello MP, submission no. 46.2, p. 5.

7 ATO, submission no. 24.2, p. 2.

8 ATO, submission no. 24.2, p. 2.

9 ATO, submission no. 24.2, p. 3.

10 ATO, submission no. 24.2, p. 3.

undertaking consultations with interested parties.[11] From this information, it appears to be the case that the Government is yet to make a decision on the way that *bona fide* employee share plan trusts will be dealt with under the unified entity taxation regime.

4.15 The taxation treatment of trusts used in employee share plans is a matter of concern. As noted, trusts are used extensively. They offer considerable advantages to the administration of share plans. The AEOA advised the Committee that trusts:

- allow for the bulk purchases of shares, leading to cost efficiencies;
- provide a 'warehouse' and market for shares;[12]
- provide an efficient means of enforcing conditions that may attach to shares and to ensuring that taxation requirements are met;
- result in the trading of shares being at 'arm's length' from the employer, thereby reducing the opportunity for insider trading or other forms of manipulation;
- allow for the provision of 'fractions' of shares. This is especially important when shares may be valued in the tens or hundreds of dollars;
- provide an economical way to manage a large number of small share holdings, or for a small company to operate an employee share plan; and
- 'insulate' employees from the debt associated with an employee buy-out, thereby reducing their personal risk.[13]

4.16 In the United Kingdom, trusts have been used for some time as a means of providing employee share plans. Their use has been actively promoted by successive parliaments. For example, the *Finance Act 1989* established Qualifying Employee Share Ownership Trusts (QUESTS). In order to better promote and facilitate the use of QUESTS, amendments were made to the legislation in 1996.

4.17 A QUEST is established by an employer for the purpose of acquiring shares in the employer company to be held on behalf of employees. The QUEST can be funded by the company (pre-corporation tax) or a bank. Shares must be distributed to employees within 20 years. A QUEST requires all employees to benefit on broadly similar terms. In order to foster the use of QUESTS, Parliament provided that companies

11 The Treasurer, the Hon Peter Costello MP, submission no. 46.3, 19 June, 2000.

12 This is especially important in unlisted companies.

13 AEOA, submission no. 5.5.

establishing a QUEST and share owners selling shares to a QUEST are eligible to receive taxation concessions.[14]

4.18 The use of the trust structure as a preferred means of operating an employee share plan is reflected in the Blair Government's proposal for the New All-Employee Share Plan. This plan is expected to become law later this year. The plan operates via a trust, which will acquire and award shares in accordance with the rules of the trust deed and other statutory requirements.[15] The plan and trust deed must be approved by the Inland Revenue.[16]

4.19 In the consultation process that led to the development of the New All-Employee Share Plan, consideration was given to using legal entities other than the trust structure. Inland Revenue was advised that other arrangements would lead to additional complexity for employees. Moreover, the consultation process revealed that companies are familiar with trusts. Consequently, the new plan reflected the existing practice for Inland Revenue approved share plans, which all use trust structures.[17]

4.20 The Committee considers that trusts, as a well established and accepted vehicle for employee share ownership plans:

- minimise the costs associated with the operation of the plan;
- are easier to administer to ensure compliance with taxation and corporations law; and
- are a well-established and familiar legal structure resting on a long established and clear body of law.

14 ProShare, 'Employees' trusts fact sheet', available at: http://www.proshare.org/eso/employeetrust.asp. Downloaded: 28 June, 2000. Existing and proposed employee share schemes in the United Kingdom are detailed in Appendix F.

15 Part I of the draft legislation, released November, 1999.

16 Proshare, 'New All-employee share plan fact sheet', available at: http://www.proshare.org/PDF/eso/newplan.pdf. Downloaded 28 June, 2000. This plan is detailed in detailed in appendix F.

17 'A New All-Employee Share plan: draft legislation and commentary', downloaded from: Http://www.inlandrevenue.gov.uk/shareschemes/index.htm on 11 November, 1999.

Recommendation 26

4.21 **The Committee recommends that the Government clarify the taxation treatment of trust arrangements that are used to operate bona fide employee share plans established under Division 13A, and legislate specifically to exempt such trusts from proposed entity taxation provisions.**

Deferring tax or electing to be taxed up front

4.22 Division 13A provides two types of concessional taxation treatment for qualifying employee share plans. Employees may elect to defer the payment of tax until a cessation event occurs: the so called 'tax deferral elections'. Alternatively, taxpayers may elect to pay tax in the year in which the benefit is received, and in doing so receive an exemption on the first $1,000 tax payable on the discount. This is the so called 'tax exemption election'.

4.23 For the most part, general employees receive small parcels of shares. Typically, these parcels provide a taxable discount of no more than $1,000. As a result, general employees select the tax exemption election and face no additional income tax liability. These elections were described by the AEOA as 'entry level schemes' and are intended, AEOA advised the Committee, to deliver wide, rather than deep, employee share ownership.[18] Such plans are particularly useful in encouraging access to employee share ownership and participation. In that way they seed employee involvement in their employer's business activity and foster the alignment of employee-employer interests.

4.24 In contrast, executives participate in employee share plans that have a narrow membership focus: executives and directors of the enterprise. These limited plans allocate to executives and directors amounts of shares and options that are many times larger than those received by general employees. These plans are designed to deliver to employees larger share holdings in a tax effective manner.[19] Given the number of equities allocated, electing for income tax deferral tends to increase an

18 AEOA, submission no. 5.4.

19 AEOA, submission no. 5.4.

employee's personal wealth more effectively than any other option. These plans operate on the assumption that the employee will in fact take the tax deferral election, and executives who have access to limited plans operating under Division 13A could be expected to make that election.

4.25 The deferral of taxation liability provides an incentive for the employee to focus on developing 'deep' holdings: larger holdings, preserved over a long period of time. Tax deferral elections are not entry-level employee equity arrangements.

4.26 Division 13A allows an employee to participate, in any one tax year, in either of these plans, but not both. The election applies to all participation in that year, in employee share plans which provide equities at a discount.

4.27 Witnesses criticised this limitation. For example, Mr Jon Kirkwood of Ernst & Young told the Committee that if an employee is offered options and shares in the one year, a choice must be made between the tax exemption election and the tax deferral election. In order to obtain the $1,000 exemption, which is preferable in the case of shares, the employee must elect to be taxed up-front. However, the tax deferral election is preferable when an employee receives options. By making one election, the employee sacrifices access to the benefits that the other election confers. As a consequence, employees are unable to arrange their employee share plan participation in such a way as to minimise their taxation liability. 'There does not appear to me', Mr Kirkwood told the Committee, 'to be any sensible reason for this requirement.'[20]

4.28 The following examples illustrate the point that witnesses made. The requirement that an employee make a choice between the two different taxation treatments embodied in Division 13A may disadvantage an employee if that person has been offered the opportunity to acquire two parcels of shares or options in the one year. For example, if an employee elects to defer their taxation liability and the total value of the discount on the shares or options allocated does not exceed $1,000, then that person has lost access to the $1,000 taxation exemption.

4.29 In contrast, if the employee elects be taxed up-front, then that election applies to all participation in employee share plans in that year. If the employee subsequently is offered a second parcel of equities, and the value of the discount on the second offer, when combined with value of the discount of the earlier parcel, exceeds the $1,000 exemption, the

20 *Transcript of Evidence*, p. 123.

employee will face a taxation liability. The employee, not being able to defer taxation liability, may choose not to acquire the second parcel of shares in order to avoid an immediate taxation liability.

4.30 Mr John McIntyre, the tax manager of ESSO Australia provided an example of the way that this election requirement can disadvantage Australian employees of international companies. Mr McIntyre said:

> Another area of concern is the election available to employees in order to take advantage of the $1,000 exemption. The standard rule is that the employee will be taxable in the year of receipt unless the schemes are qualifying share schemes. Where they are qualifying schemes, the employee has a choice. He may go onto a tax deferred scheme, or he may take the $1,000 exemption arrangement. In order to take the $1,000 exemption arrangement, the employee must lodge an election, which is filed with the employee's tax return.
>
> What can happen in practice, however—particularly for an organisation like our own that is multinational—is that we may have a share scheme arrangement here in Australia for our employees, but our head office may also be running employee share or option arrangements that cover the whole group of Exxon companies around the world. You can find a situation where an employee, say, at the start of a financial year in Australia may wish to elect to take the $1,000 exemption under the Australian scheme. He may or may not know whether he will be entitled at some stage throughout the year to receive shares or options—pursuant to, say, a head office or Exxon Corporation incentive or bonus arrangement that exists. This can leave a person not really knowing what they should be doing. We have found that to be an area of practical difficulty.[21]

4.31 This concern was reinforced by evidence from AGL, which stated that participation in one of the share plans it offered was affected by the election employees had made in relation to an earlier share offer:

> …employees who don't take up this offer cite the lack of consistency in the rules of Division 13A. That is, an election in one share plan means that an election has been made in all share plans that an employee may participate in which in most cases disadvantages the employee financially.[22]

4.32 The practical effect of this is that because of the current legislative arrangements, employees will not be able to maximise their employee share plan holdings.

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21 *Transcript of Evidence*, p. 204.

22 AGL, submission no. 14.

4.33 The Committee sought the advice of the Treasurer on this matter. Mr Costello advised the Committee that the Government considered the current arrangements to be appropriate. 'An employee who has benefited from the $1,000 concession', the Treasurer advised the Committee:

> …should not also be allowed to benefit from tax deferral in that year. Allowing access to both would involve a significant increase in the generosity of the employee share ownership provisions.[23]

4.34 The Committee agrees with this assessment. Moreover, it is not known for certain to what extent the requirement, that a taxpayer elect to be taxed up-front or to defer taxation liability, disadvantages employees or deters acceptance of equities offered under a qualifying employee share plan. The Committee would not expect the number to be very large.

4.35 Furthermore, the Committee considers that the problem is addressed, to some extent, by recommendations made in this report:

- the increase in the amount of the discount that is eligible for a tax exemption; and
- replacing the existing cessation conditions with simpler, more generous rules.

4.36 Increasing the tax exemption would enable employees to receive larger total discounts without acquiring a tax liability, while the relaxation of the cessation conditions would remove a significant disadvantage of the deferred benefit plans as they stand at present. Under these changes there would be less of a disincentive to non-participation and more of an incentive to employers to provide more generous plans.

Rates of taxation

4.37 One of the most significant outcomes of the Ralph Review is the removal of the parity between the marginal income tax rate and the capital gains tax rate. Under the changes, taxpayers in the highest income tax bracket will continue to pay 48.5 per cent on that portion of their income that attracts the highest marginal tax rate. However, taxpayers will now be liable to 24.25 per cent tax on all capital gains, whereas previously they paid 48.5 per cent.

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23 Submission no. 46.2, p. 5.

4.38 For employee share plans, depending upon the election made a taxpayer will be liable to the payment of income tax at different times: immediately in the case of tax exemption elections, or at some other time, as determined by the cessation rules, in the case of tax deferral elections. The reason is that there are differences between elections in the timing of the assessment of a taxpayer's income tax liability and, consequent movement from the income tax regime into the capital gains tax regime.

4.39 Quite apart from the fact that the one option provides for a $1,000 reduction in the amount subject to income tax, clearly there will be different amounts of tax paid under the two alternative elections. The differences in the timing of the liability for income tax, results in different amounts of income being subject to assessment at income tax rates.

4.40 The AEOA and the RPC advised the Committee that breaking the alignment in the capital gains tax and marginal income tax rates is undesirable. According to the AEOA the misalignment between marginal income tax rates and capital gains tax rates will encourage share plans that operate outside of Division 13A because they will be subject to capital gains tax. This may well expose general employees to more risk, because the popular, yet very risky, interest free loan plan will be favoured by the CGT changes.[24]

4.41 RPC advised the Committee that the higher taxation rates attached to deferred benefit plans place pressure on employees to dispose of options when they are exercised or at other cessation times, in order to move outside the income tax system and into the capital gains tax system. In effect, the difference in taxation rates provides an incentive for employees not to develop a pattern of long-term shareholding, saving and wealth building, one of the aims of fostering employee share plans, but rather to engage in the practice of 'churning': selling assets in order to maximise short-term financial gain.[25]

4.42 Some media commentators have claimed that the different tax rates result in similar taxpayers being treated differently. The suggestion is that this is unfair.[26] It is also claimed that there does not seem to be any

24 AEOA, submission no. 5.5.

25 RPC, submission no. 30.3.

26 Michael Laurence, 'Taxation: Ralph report leaves share plans out in the cold', *Business Review Weekly*, 5 November, 1999, p. 76.

rational public policy basis for different taxation rates for the different share plans.[27]

4.43 Further, the different taxation rates will provide a disincentive to become involved in tax deferral elections, because they are subject to the higher rate of taxation and provide an incentive to move into tax exemption elections which enjoy the lower CGT rate.[28] In addition, the lack of alignment between the capital gains tax rate and the marginal income tax rate may well provide a further incentive for aggressive tax planners to attempt to use employee share plans to unreasonably shift income into the capital gains tax system.[29]

4.44 These apparent problems can be remedied, according to the AEOA, RPC and others by removing the incentive to move outside the income tax system. This can be done by reducing the marginal income tax rates on employee shares to the capital gains tax rate. RPC advised the Committee, that:

> To neutralise the impact of the proposed reforms we would recommend the Committee consider amending Division 13A (ITAA) to tax any gains on shares and options acquired under a Qualifying Division 13A (ITAA) Plan as a Capital Gain. Only discounts from market price should continue to be taxed as income.
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> This in effect would produce a ‘level playing field’.[30]

4.45 It must be pointed out that there are other ways to remove the incentive to move outside the income tax system or abandon Division 13A plans. The incentive could also be removed by increasing, to the marginal income tax rate, the tax payable on the capital gains attained by shares or options acquired under an employee share plan. This approach would allow equities that are obtained in highly concessional arrangements through employee share plans that are not available to the majority of taxpayers, to be subject to a single rate of tax. This would provide a form of equal treatment for all those within employee share plans but also ensure that no taxpayer receives a benefit through

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27 Michael Laurence, 'Taxation: Ralph report leaves share plans out in the cold', *Business Review Weekly*, 5 November, 1999, p. 76.

28 Hay Group, submission no. 51.

29 As also noted by Mr Geoffrey Lehmann, Senate Finance and Public Administration References Committee, Inquiry into the Government's proposals for business taxation reform, *Transcript of Evidence*, Thursday, 11 November, 1999, p. 139. This point is also made, with respect to employee share schemes, by Professor Chris Evans, *CGT Planning News*, CCH Publishers, 29 October, 1999, p. 5.

30 RPC, submission no. 30.3. AEOA, submission nos. 5.4, 5.5.

employment that remains outside the income tax net. This approach would also promote a level playing field for all stakeholders.

4.46 The Committee does not believe, however, that this is the direction that the taxation treatment of employee share plans should take. A better solution is one that is simple, straightforward and, from a taxation point of view, certain. It is to provide incentives within Division 13A to encourage employees and employers to participate in qualifying plans. The Committee believes that the recommendations in this report will do just that.

4.47 Nevertheless, serious difficulties have been raised concerning the effect of the lack of parity between the capital gains tax and income tax rates on employee share plans that operate within Division 13A. For this reason, and in order to frame effective and appropriate public policy, it is necessary to assess the strength of the incentive to move outside of Division 13A or, within Division 13A, to move from tax deferral elections to tax exemption elections. This must be done before any recommendation for disturbing the present circumstances can be contemplated. After examining the arguments, however, the Committee is not convinced that the incentive to move outside the income tax system by abandoning participation in the deferred benefit plans is as strong as claimed. There are two reasons for this.

4.48 First, central elements of the changes to the capital gains tax adopted by the Government involve the removal of indexation and averaging when calculating the capital gain on a share or option. The amount subject to capital gains tax will be larger under the new system than under the old system, when only indexed gains were taxed. As a consequence, the reduction in capital gains rate is unlikely to lead to as great a reduction of tax payable on an asset held for a longer period as may first appear to be the case.

4.49 Second, the use of pre-tax salary sacrifice to purchase equities in an employee share plan, an approach that appears to be very popular amongst executives, enables a taxpayer to acquire almost twice as many equities as a person who purchases shares with post-tax salary. Pre-tax salary sacrifice, combined with the deferral election further increases the benefit gained. In effect, this neutralises the incentive to move into the capital gains tax system. These plans are outlined in a recent business publication:

> …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. …
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> Sydney actuary and financial planner Graham Horrocks… makes a crucial point: a participant in a tax-deferred share scheme, after all taxes are paid, will still be ahead of a person who invests after-tax salary to buy identical shares. This is because the participant in the share scheme can buy almost twice as many shares as the other investor.[31]

4.50 The motive operating in this area is not to move from the income tax system to the capital gains tax system, but to maximise the initial number of shares that an employee may acquire and to defer the payment of tax as long as possible, so as to maximise the taxpayer's benefit. The strategy that provides the best outcome in these terms will be preferred. This is acknowledged by experts in this field:

> [Mr] Chikarovski of Remuneration Planning Corporation says the main attributes of share plans from an executive's perspective, rather than an employer's, are the tax deferral, the benefit of any increases in share prices, and the growth in dividends (in the case of salary-sacrifice schemes). Chikarovski says: 'The amount of benefit from a share plan is not immediately diluted by tax.' So an executive is effectively gaining a leveraged position in the sharemarket because twice as many shares are acquired than could be bought if after-tax income were used. Chikarovski adds that executives benefit from any increases in share price. "Unlike cash, the shares endure as a reminder of past performances."[32]

4.51 Although tax deferral elections are available for the most part to executive employees, these comments apply to all plans of this type, no matter what class of employee is a participant.

4.52 For employees who have made a tax exemption election, typically general employees, there is no incentive to move outside the capital gains tax system, because they are already in it. In any case, the size of a general employee's employee share plan holding not of a size that would make the tax deferral election unattractive.

4.53 Share plans operating outside Division 13A will utilise a variety of funding arrangements, such as loans and pre-tax salary sacrifice arrangements. In these cases, whenever a benefit is vested in an employee, income tax is payable. After that occurs, the shares are the

31 Michael Laurence, 'Taxation: Ralph report leaves share plans out in the cold', *Business Review Weekly*, 5 November, 1999, pp. 74, 76.

32 Michael Laurence, 'Employee shares and options plans are coming up to harvest time', *Business Review Weekly*, 22 June, 1998.

property of the taxpayer and may be traded like any other share and are subject to capital gains tax.

4.54 Given the above, the Committee concludes that the alleged incentives either to move outside the income tax system or to abandon Division 13A plans, as a result of the changes to the rate of capital gains tax, have been overstated. Those incentives would be further reduced if the Committee's recommendations concerning changes to the cessation rules, limits on the amount of tax-free salary sacrifice, changes to the FBT exemption on interest free loans and other forms of financing, and increased powers for the Commissioner of Taxation to address aggressive tax planning were implemented.[33]

4.55 The remaining issue is whether the disparity between the taxation rates is consistent with established public policy.

4.56 In the case of tax exempt plans, the discount forms part of a taxpayer's income tax assessment in the year in which it is received. In other words, the benefit is taxed as income when received. When the taxpayer subsequently disposes of the share, capital gains tax must be paid on the increase in the value of the equities.

4.57 This taxation treatment is consistent with the taxation treatment of all taxpayers who receive taxable income in any taxation year. For example, a taxpayer who purchases equities on the open market, with post-tax income, will have paid income tax on the income (for example, their salary) that funded the purchase. The taxpayer will be subject to capital gains tax on the increase in value of the equities that occurred after they made their investment.

4.58 In both cases, that of the share plan participant and the investor, they are liable to income tax on a benefit that is properly considered income.

4.59 In the case of a deferred benefit plan, the taxpayer defers payment of income tax on the discount until some later time, as determined by the cessation rules. Deferral allows the parcel of shares, or the shares under the options initially acquired, to increase in value before any taxation is payable.

4.60 The community defers collection of the income tax payable on the discount until some later time. At this time taxation is levied on the increase in the value of the discount. The discount is still taxed but on the value to which it has increased through the natural increase in the value of the share or option. Simply put, the discount for which tax is

33 As discussed in Chapter 3.

payable, has grown in value. Therefore, whether taxed initially or deferred, in both cases it is the discount that is being taxed at income tax rates.

4.61 However, the value of an equity in an employee share plan has two elements: that created by the discount and that created by the consideration paid. The growth in that part of the value of an equity funded by the consideration paid is also taxed at the marginal income tax rate. In effect, income derived from two different sources (the consideration paid and the discount) is bundled together and taxed at the same rate.

4.62 Consequently, at the present time the entire capital gain on equities held under the tax deferral election[34] is taxed at marginal income tax rates when a cessation point is reached. This ignores the fact that part of the gain in value is 'created' by the discount and the other part by that portion of the value of the equity for which a consideration has been paid. Typically, the gain in value of an equity for which consideration has been paid is taxed as a capital gain. In this case, the portion funded via a consideration paid by the employee is taxed as income. This violates the fundamental principle that income should be taxed at income tax rates, while a capital gain should be taxed as a capital gain.

4.63 This, the Committee believes, is to miss an important point: taxation is levied on benefits, depending upon their type. When the benefit is income in nature, albeit income which has been allowed to grow before assessment, it is properly subject to income tax. When the benefit is a capital gain in nature, and based upon funds upon which tax has already been paid, it should be taxed according to the appropriate capital gains tax rate. Division 13A fails to separate the two different kinds of income and tax each appropriately. It is not consistent with the approach to income tax embodied in the Australian taxation system.

4.64 The Committee concludes that the gain in capital value should be broken into its constituent elements so that the element that is derived from the discount is subject to income tax and the element that is derived from consideration paid is subject to capital gains tax.[35]

4.65 In those cases where salary sacrifice has funded the purchase of the equity, the value of the sacrificed salary should be inflated by the application of compound interest, and then taxed at the marginal

34 Calculated by subtracting any consideration paid from the value at cessation.

35 This is an approach endorsed by, for example, the AEOA, see submission no. 5.5, p. 9; Ernst & Young, submission no. 20.2; RPC, submission no. 30.3, p. 8.

income tax rate. The reason for this is that sacrificed salary has not been subject to income tax.[36]

4.66 The Committee believes that the public policy basis for this approach is that sacrificed salary and deferring the tax on a discount represent a loan from the community to the taxpayer for that person to acquire equities in an employee share plan in a concessional way. It is appropriate that the portion of the transaction to fund the acquisition of equities in this way should be subject to a compounding interest payment, as this would tend to protect the real value of the tax deferred.

Recommendation 27

4.67 **The Committee recommends that the Government amend those sections of Division 13A of the *Income Tax Assessment Act 1936* providing for taxation of equities in tax deferral elections, currently 139B(3) and 139 CC(3) and 139CC(4), to give effect to the following taxation treatment of the gain in capital value:**

1. **That income tax be levied on: the value of the discount on the equity when originally allocated, inflated by the application of compound interest, for the period of time the equity has been held and at an interest rate as determined from time to time;**

2. **That if income tax or FBT has not otherwise been paid on sacrificed salary, then the amount of salary sacrifice that has funded the purchase of an equity, be liable to income tax calculated as the value of the sacrificed salary inflated by the application of compound interest for the period of time the equity has been held, at an interest rate as determined from time to time; and**

3. **That capital gains tax be levied on: the value of the gain in capital value less the inflated value of the discount and, if applicable, the inflated value of any salary sacrificed. In considering this recommendation, the advice of the Australian Taxation Office should be sought to ensure that it is satisfied with the integrity measures and that the amendment is made in the knowledge of its revenue implications.**

36 This suggestion is supported by the AEOA. See submission no. 5.5, p. 9.

Valuation issues

4.68 The method of valuing shares and options in Division 13A employee share plans attracted considerable criticism from witnesses. This report will not deal with each criticism in detail, but the Committee has noted a number of issues for recommendation.

4.69 Two distinct issues emerged concerning the valuation of shares or options. The first issue concerns the problems that occur because shares or options are valued on the day the employee acquires them. The day of acceptance of the offer may vary from employee to employee, and so, therefore, may the price. KPMG advised the Committee:

> Where an employer company proposes to provide employees with shares at a discount to market value, 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, as the relevant time for valuation of the benefit is the time of acquisition by each employee under the scheme.[37]

4.70 BHP advised the Committee:

> The current income tax law, which is based on the market value of ESP shares and options on the date of issue, provides both uncertainty for employees considering ESP offers, and significant administrative difficulties for companies which issue share and options progressively over a period which could cover several weeks to thousands of employees in numerous locations…[38]

4.71 According to BHP, the best remedy would be for the present income tax law to:

> … allow the continuation of the practices adopted under the previous law which permitted companies to calculate the market value of ESP shares and options for the purposes of calculating any taxable gain based on the five business days immediately before, or following, announcement of an ESP offer.[39]

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37 KPMG, submission no. 13.

38 BHP, submission no. 31.

39 BHP, Submission no. 31. This general approach was supported by KPMG: ‘We recommend that Division 13A of the 1936 Act be amended to allow employers to stipulate a value of the

4.72 Some attempt to address the concerns of stakeholders on this matter has been made. The Treasurer, the Hon Peter Costello MP, announced on 2 September 1999 that amendments providing for an alternative method of determining the market value of shares or unlisted rights acquired under an employee share plan would be introduced into Parliament. The method will be used when a public offer is made in a listed public company and an offer of shares or unlisted rights to acquire shares, under an employee share plan, is made in association with that public offer.[40] The amendment is intended to prevent a taxpayer being liable for tax when no actual taxable benefit has been received. It is also intended to remove various uncertainties in respect of a taxpayer's taxation liabilities under a Division 13A plan.[41]

4.73 Ernst & Young advised the Committee that while these amendments did address some of the issues surrounding valuation, other matters relating to valuation were still outstanding, including the manner in which an initial public offering was valued and the way that equities offered by unlisted and small companies were assessed. According to Ernst & Young, these companies would obtain no comfort from this amendment.[42] It appears then that additional work remains to be done in this area, and the Committee recommends accordingly.

4.74 Witnesses urged the ATO to promulgate reasonable methods of valuation for unlisted shares. [43] The main reason is that small, private employers are discouraged from offering employee share plans because of the complexity and uncertainty of the present valuation arrangements and the cost associated with obtaining a valuation.

4.75 Moreover, costs associated with establishing and administering a plan can also act as a deterrent to employers. Uncertainty and avoidable costs should be reduced or removed altogether, where their removal does not compromise the integrity of the taxation system.

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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'. Submission no. 13.

40 Parliament of the Commonwealth, House of Representatives, Taxation Laws Amendment Bill (No. 5) 2000, *Explanatory Memorandum*, paragraph. 2.1.

41 Parliament of the Commonwealth, House of Representatives, Taxation Laws Amendment Bill (No. 5) 2000, *Explanatory Memorandum*, paragraph 2.5.

42 Submission no. 20.3

43 Ernst & Young, submission no. 20, p. 4.

4.76 Furthermore, accurate and reasonable valuation of shares and options is essential for investors so that they are in a position to develop a reliable perception of a company's assets, liabilities and true value. In other words, it is a corporate governance issue.

4.77 A process for valuing shares, or options when issued, should be developed that addresses these problems as well as the more general issues of taxation compliance and corporate governance. The present process, at a minimum, should be revised and articulated clearly. However, the valuation method should also protect the viability of companies and the revenue base against exploitation.

Recommendation 28

4.78 **The Committee recommends that:**

- **the Government direct the Australian Taxation Office and the Australian Securities and Investment Commission, in consultation with interested stakeholders, to develop appropriate and simplified valuation processes;**
- **the anomalies and uncertainties in the present valuation system be addressed and where possible removed; and**
- **model plans should be devised by the ATO, in consultation with stakeholders, and that these model plans specify appropriate, simplified and ATO-endorsed valuation processes.**

Valuation of unlisted options

4.79 The second issue concerns the process of valuation for unlisted options. Division 13A establishes various rules that must be used to determine the market value of an unquoted option on a particular day.[44] Valuation tables are central to these rules and are embodied in Division 13A.[45]

4.80 The ATO defended the valuation tables in response to criticisms made in submissions and hearings. The ATO said:

> We would like to highlight the following points:-

44 ITAA, s. 139FC.

45 ITAA, ss. 139FJ to 139FN.

- there are limited numbers of qualified persons who can value options and the process can be expensive;
- calculations only take a few minutes; and
- provision of the tables seeks to provide small to medium enterprises with a low cost, low level of complexity and level playing field environment in which to issue options.[46]

4.81 The ATO also advised the Committee that it would consider any proposed method of valuation for such equities, but that it could not endorse a particular method for use in all circumstances.[47] Moreover, the ATO has also recently 'developed a new service aimed at taxation arrangements or products'. This service, the ATO advised the Committee, provides a 'product service ruling'. Product developers can provide the ATO with the details of a plan and obtain a technical clearance in respect of the income tax consequences.[48]

4.82 Even with this system in place, the present approach to valuation does appear to cause considerable concern amongst operators and potential operators of employee share plans. For example, a number of witnesses criticised this process and identified the valuation tables as an area of concern.[49] Some claimed that the tables were very complex, 'unnecessarily difficult to apply'[50] and led to anomalies and unfairness. They argued for simplification. Ernst & Young advised the committee:

> 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).[51]

4.83 BHP advised the Committee that the valuation tables should be amended because, 'the non-transferability means the options have a lower market value…'[52] and as a result the tables provide a distorted valuation.

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46 Submission no. 24.2.

47 The Treasurer, the Hon Peter Costello MP, submission no. 46.2. See ITAA s. 139FB(6) for the legislative basis for this claim.

48 ATO, submission no. 24.2.

49 See submission nos. 11, 13, 14, 20, 31.

50 KPMG, submission no. 13.

51 Ernst & Young, submission no. 20. These concerns were supported by KPMG. See submission nos. 13 and 13.3.

52 BHP, submission no. 31.

4.84 A number of solutions were proposed. The solution suggested by Ernst & Young was that:

> 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).[53]

4.85 KPMG advised the Committee to use a stepped process:

> The valuation tables should only be used when a threshold number of rights are issued to an employee, 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.[54]

4.86 While such simplified approaches are attractive, it is important also to ensure that they do not allow opportunities for aggressive tax planning or foster market distortions and manipulations. Any simplified process should, therefore, contain adequate provisions for monitoring and ensuring compliance with the provisions of Division 13A and its stated intentions.

4.87 The regulatory agency mentioned earlier is essential to this process, along with a requirement for approval of share plans and, as is presently the case, valuing methodologies. In addition, in cases of abuse, the ATO or the Australian Securities and Investment Commission should be empowered within the employee share plan legislation to disallow a valuation or a valuation methodology and impose an alternative regime at its discretion.

4.88 As noted elsewhere in this report, the Committee is mindful that uncertainty surrounding the operation of a share plan affects participation and can also act as a disincentive to establishing a plan.[55]

53 Ernst & Young, submission no. 20.

54 KPMG, submission no. 13.

55 For example, Chapter 3, passim.

Recommendation 29

4.89 **The Committee recommends that the Australian Taxation Office and the Australian Securities and Investment Commission, in consultation with interested stakeholders, develop appropriate and simplified processes for valuing the discount on shares and the value of untraded shares or options.**

Cessation issues

4.90 Division 13A provides that employees may defer the assessment of their liability for income tax on the discount received on qualifying shares or rights until some later time. The precise time that tax becomes payable is determined by a 'cessation' event. These are specified in Division 13A[56] and are, for example:

- when disposal of the share or option occurs;
- the time when employment ceases in respect of which the share or option was acquired; or
- ten years after the share or option was acquired by the taxpayer.

4.91 In practice, the most common cessation event is cessation of employment. This can be triggered by events such as retirement, resignation, death or redundancy due to downsizing, or corporate mergers.

4.92 The purpose of legislated cessation events is to ensure that Division 13A serves the purposes intended by Parliament, including, as noted earlier, to:

- provide for the taxation, at the appropriate rate, of the discount an employee receives in respect of a benefit allocated under a qualifying employee share plan;
- counter aggressive tax planning; and
- ensure that employee share plans operate so as to align the interests of employees and employers and foster the employer-employee relationship.[57]

56 ITAA, ss. 139CA and 139CB.

57 The Treasurer, the Hon Peter Costello MP, submission no. 46.2.

4.93 The Government supports the retention of the present cessation conditions, including taxation liability occurring when an employee ceases employment in respect of which the equities in the employee share plan were obtained. The Treasurer, the Hon Peter Costello MP, advised the Committee that in the Government's view this cessation event:

> …is appropriate given that, after termination of employment, continued tax deferral can't be justified in terms of encouraging the employer-employee relationship. A taxpayer is not unfairly treated in these circumstances. Rather, the taxpayer has already had the benefit of deferring tax for some period of time.[58]

4.94 Witnesses advised the Committee that company structures that alter as a consequence of a merger or a takeover may result in an employee having to dispose of their interest in an employee share plan.[59] As a consequence, employees may be forced to dispose of their holdings acquired under an employee share plan operating under Division 13A.

4.95 The Committee has considered the Treasurer's argument. While the present arrangements may not treat a taxpayer unfairly, they do operate to discourage long-term participation in employee share plans. The present arrangements also work to discourage the creation of employee share plans (especially for employee buyouts) in small, medium and unlisted enterprises. As a result, they impede the development of the employer-employee relationship in some sectors of the workforce.

4.96 These disincentives arise because the practical effect of the cessation rules is that the discount is taxed even though an employee may not actually have sold the shares or options. In such cases, the value of the share is a 'paper value'. As a result, the cessation rules act as a disincentive to employee share plans in two ways.

4.97 First, employees who cease employment may have to sell some or all of their shares in order to meet the tax payable. This may bring to an end an employee's participation in a share plan. As KPMG advised the Committee:

> Division 13A of the 1936 Act does not allow for the effective treatment of employee 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

58 The Treasurer, the Hon Peter Costello MP, submission no. 46.2.

59 Ernst & Young, submission no. 20; KPMG, submission nos. 13 and 13.3.

> 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.[60]

4.98 The Committee was further advised by KPMG that some sort of 'rollover relief' should be provided:

> 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.[61]

4.99 The Committee sought the advice of the Treasurer on this matter. Mr Costello advised that when…

> …a takeover or merger occurs the previous employer-employee relationship no longer exists. In this circumstance, continued tax deferral cannot be justified in terms of encouraging the employer-employee relationship. We do not consider that a taxpayer is poorly treated in the circumstances. Rather, a taxpayer has already had the benefit of deferring tax for some period of time.[62]

4.100 This argument rests upon the assumption that the sole purpose of employee share plans is to foster the employer-employee relationship. As can be seen from Chapter 2, while this remains a dominant purpose, it is not the only purpose. Employee share plans and the concessional treatment they receive have other purposes, including fostering savings, promoting employee share plans in small and medium enterprises, and promoting employee buyouts.

4.101 A much more difficult issue is whether rollover relief should be provided to new equities that are not qualifying under Division 13A. In such cases, this would allow an employee to exit a Division 13A plan and participate in another plan using non-qualifying equities, but on the same terms and concessional treatment as provided by Division 13A.

4.102 The Committee believes that this would undermine the intent of Division 13A, which is to provide for concessional taxation treatment for

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60 Submission no. 13. Also supported by BHP, submission no. 31; Mr Richard Stradwick, submission no. 25, p. 8.

61 KPMG, submission no. 13.

62 The Treasurer, the Hon Peter Costello MP, submission no. 46.2, p. 4.

certain defined types of equity for certain purposes. Consequently, the Committee concludes that such rollover relief should be provided only if the equities offered in the subsequent plan are qualifying equities under Division 13A and the subsequent plan itself complies with Division 13A.

4.103 The Committee believes that the other concessions recommended in this report, namely the taxation concessions available if an employee invests some of their employee share plan assets in preserved superannuation holdings, provide an adequate trade-off for not allowing complete relief from the disposal requirements.

4.104 When these reasons are considered, the Committee concludes that continued tax deferral may be justified in respect of qualifying equities, in order to promote the other goals of employee share plans, as well as the accepted goal of promoting the relationship between employer-employee in the unlisted, small, medium and sunrise sectors.

4.105 Secondly, the ten year cessation point acts as a disincentive for employee buyouts of small and medium concerns and unlisted companies. Employee shareholders could find themselves liable to tax at that time and this may force them to sell their interests or otherwise dilute their interest in the company. The Committee was advised by the AEOA that:

> … the “10 year rule” poses a major threat to the viability of worker buy-outs, since employees would be obliged to sell part, or all, of the business at 10 years to pay tax. Why would employees buy-out a company only to have to sell at least half of it again just to comply with an arbitrarily imposed taxing point? An employee-owned company might well wish, at some point, to dilute employee equity to raise new capital, or to acquire new management skills or technology. These are legitimate commercial decisions. But to be forced into selling out, or into taking on a new (and perhaps uncomfortable) partner, in order to meet the “10 year rule” is anti-commercial and hostile to the long term, viability of worker-owned businesses. [63]

4.106 It was suggested that the best remedy for the problems posed by the cessation requirements would be to remove them and provide for only one cessation event: sale of the shares or options. This would allow the deferral of the tax liability until the shares or options are sold. The

63 AEOA, submission no. 5.5; see also submission no. 5.4, pp.v-vi. The impediment to employee buyouts produced by the operation of the cessation rules was also noted by other witnesses. See Ernst & Young, see submission no. 20.1, p. 3; Mr Chris Costello, RPC, submission no. 30.

anticipated consequences of this change were outlined to the Committee by the AEOA:

> … Taxing shares upon disposal rather than at cessation of employment would greatly enhance the retention of shares by individual employees and facilitate diversification of risk, by enabling employees to build a portfolio of shares gathered from time spent with different employers. Taxation upon disposal, therefore, could only enhance the spread of employee ownership.[64]

4.107 The Committee was advised by the Treasurer that the Government considers that the ten-year deferral of:

> …tax is already generous. The effect of removing the 10-year cessation period would be to allow tax deferral indefinitely, resulting in a significant increase in the generosity of the scheme.[65]

4.108 Employee share plans that involve an election to defer taxation are, for the most part, plans open only to executive employees, rather than general employees. The reason for this is that while tax deferral plans may be used by general employees of small, medium enterprises to buyout their employer, the cessation rules act as a disincentive. Consequently, the primary beneficiaries of a general relaxation of the cessation conditions would, in the short term, be executive employees, rather than general employees.

4.109 Nevertheless, the Committee accepts the assessment of the effect of the cessation rules provided by the AEOA. It also concludes that one of the major impediments to the creation of employee share plans in small, medium enterprises and in sunrise industries, are the cessation conditions.

4.110 The Committee considers that this suggestion does have merit in the case of unlisted, and small and medium companies. It is in the national interest that employee share plans spread as widely as possible, and especially in those sectors where, at present, there are few plans. Therefore, the Committee supports the relaxation of the cessation conditions for small, medium enterprises and in sunrise industries. There are many community benefits to be gained by making an exception for such enterprises.

4.111 For tax deferral elections, which are selected mostly by executive-level employees, , it is unclear to what extent the ten-year cessation limit acts

64 AEOA, submission no. 5.5, p. vi.

65 Submission no. 46.2, p. 5.

as an impediment to the creation of, and participation in, employee share plans. Moreover, it is unclear to what extent the ten-year cessation event has any practical purpose as a taxing point. The reason is that the evidence suggests that employees dispose of the equities in tax-deferral elections before the ten-year period is reached. According to Mr Chris Costello, of the RPC, many employees do not stay with the one employer long enough to reach the ten-year cessation limit. Mr Costello advised the Committee that the ten-year cessation limit was…:

> A minor impediment. Initially, five years was proposed and that would have been a major impediment because you would have people selling shares to pay tax. This sends a negative message to other investors who do not realise and who say, 'Why are you selling your shares?' Moving it to 10 years overcame 90 per cent of the problems: we have a shrinking period of holding because people are moving from companies more and more. So we are really looking at an average of about three years now anyway. It used to be more like five or six. We do not believe it has a revenue impact; it has a small impact in terms of the perception of value. We do not see it as a major priority in terms of the impact.[66]

4.112 The Committee agrees with this assessment. Moreover, removing this cessation point would simplify the administration of those employee share plans subject to it. For these reasons, the Committee concludes, therefore, that the ten-year cessation point should be removed.

4.113 The Committee has previously noted that the purpose attributed to employee share plans and embodied in Division 13A, that of aligning the interests of employees and employers, has been somewhat diluted by the realities of the new labour market and evolution of Australian society. The argument for retaining the cessation rules is therefore undermined by what is occurring in the community (for example, augmenting remuneration, in a tax effective manner), and the practical considerations of encouraging employee share plans, employee buyouts, and developing national savings as an adjunct to superannuation. These considerations go beyond encouraging the employer-employee relationship. In the Committee's view, these additional considerations, when taken together support a decision to relax the cessation rules.

4.114 Moreover, it is worth noting that as a consequence of this dilution of purpose, pressure has developed to amend Division 13A so that it

66 *Transcript of Evidence*, p. 44.

reflects the realities of the contemporary use of employee share plans. As such, the Committee supports the direction of the suggested changes.

4.115 The Committee is mindful, however, that such an exemption could provide an inducement for those who are attracted by aggressive tax planning schemes. There is a need for the community and its revenue to be protected from such schemes. The concessions granted in Division 13A should be provided only on the condition that adequate legislative safeguards and powers to relevant authorities are provided to ensure that it is not misused.

4.116 This report forms an integrated set of proposals: The measures designed to prevent exploitation of share plans for aggressive tax planning purposes are as important as the policy initiatives designed to foster the growth of employee share plans in Australia and enhance economic opportunities for Australians. The Committee reiterates its earlier advice that the initiatives recommended in this report should be viewed as a package.

Recommendation 30

4.117 **The Committee recommends that the Government move to amend the relevant sections of Division 13A of the *Income Tax Assessment Act 1936*, so that when:**

(a) shares or options, in an enterprise which is subject to a corporate restructure, merger, takeover, or acquisition have to be exchanged for other shares or options; and

(b) the original shares or options are qualifying shares or rights, held under a Division 13A plan; and

(c) a tax deferral election had been made in relation to those shares or options; and

(d) the new shares or options are qualifying shares or rights, offered under a Division 13A plan; then:

- **any income tax liability from the proceeds of the compulsory disposal of the original shares or options should become payable when a cessation event for the new shares or options takes place; or the employee be given the opportunity to transfer the entire interest to a preserved superannuation fund, at the taxation rate applicable to contributions to superannuation contributions.**

Recommendation 31

4.118 **The Committee recommends that the Government move to amend the *Income Tax Assessment Act 1936* so that for shares or rights allocated under a Division 13A deferred election plan, liability for taxation occur at the time of disposal,[67] provided that:**

- **The plan is one open to 75 per cent of an employer's employees; or**
- **If the plan is open to a lesser number of employees (i.e. it is a restricted plan), then there was offered in that tax year or concurrently with the restricted plan, another plan that is open to 75 per cent of employees and meets the qualifying conditions in Division 13A; or**
- **If such a plan is not offered, reasons must be provided to the Employee Share Plan Regulatory Agency by the employer, explaining why either of the first two conditions have not been met.**

The $1000 tax exemption

4.119 At present, a business can obtain a deduction up to $1,000 in respect of the discount off the market value of qualifying shares or rights issued to an employee under an ESOP. Similarly, the employee can obtain an income tax deduction of up to $1,000 on the value of the discount.

4.120 Submissions from businesses, the AEOA, and accountancy firms identified the low level of these taxation concessions as an impediment to the creation of share plans under Division 13A. One witness set out this problem from an employer's point of view:

> A company with, say, 100 staff wants to award a $1,000 share benefit to each employee under a qualifying exempt plan. The benefit to staff under division 13A is tax free. However, in a circumstance like that, the costs of implementation, compliance, tax sign-off and administration would significantly erode the

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67 This would have the effect of removing all but one cessation event, sale of the equity, in plans open to general employees. Plans which offer participation to a limited number of employees, typically executive-only plans, and which operate under Division 13A in virtue of the 'piggy-back' provision of the division, ITAA, s. 139CD(5), would be excluded from the benefits of this recommendation.

> benefit, to the extent that it would be more cost beneficial to award a similar benefit in cash, fully taxed.[68]

4.121 From an employee’s point of view, the problem presented by the $1,000 threshold is that it can be easily exceeded, especially in those cases where an employee is offered ESOP participation in both share and option plans. Once the $1,000 has been exceeded, tax is payable by the employee on the value of the discount that exceeds that limit, which blunts the motivating effect of the concession. As the AEOA has noted, this limit encourages wide but not deep levels of share ownership.[69]

4.122 The Committee was advised that:

> For general employee plans the tax exemption concession has not been sufficient to lead to a strong spread of the use of these plans through “free” share allocations. The reason being that the cost to the company has been seen as too high for the perceived return to the company from the plan. Hence share purchase loan plans continue to be the main form of general employee share plan.[70]

4.123 This appears to be supported by survey results. The KPMG survey referred to earlier, revealed that:

> Of the schemes established, 29 per cent took advantage of the tax concession available. 25 per cent of companies that responded considered the current tax concession reasonable, while a similar number of respondents felt that conditions attaching to the tax exemption were too strict and inflexible. 35 per cent of respondents stated that they would introduce a share scheme if the tax exemption currently available was increased to $2,000 per employee, per year.[71]

4.124 This survey would seem to suggest that an increase in the exemption rate from $1,000 to $2,000 would see a significant increase in the number of share plans available to non-executive employees, operating under Division 13A.

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68 Mr Ian Crichton, *Transcript of Evidence*, p. 33. See also Macquarie Bank Limited, submission no. 18, p. 5.

69 AEOA, submission no. 5.4.

70 Hay Group Pty Limited, submission no. 51.

71 In a subsequent submission to this Inquiry, KPMG advised the committee that '32 per cent of these companies (ie those without an employee share or share option scheme) said that they would definitely implement a tax exempt scheme if the limit was raised to $2,000 per employee, per year.' See submission no. 13.2. This submission also indicated that the 35 per cent of employers referred to in the pamphlet referred to the total number of respondents to the survey.

4.125 The Committee approached the Treasurer for advice on this matter. The Treasurer reminded the Committee that the Government had increased the exemption from $500 to $1000 in the 1996 budget. The Treasurer also stated that indexing the concession would be inconsistent with current policy and that it would be an anomaly because personal income tax scales and the income free threshold are not indexed. .[72]

4.126 As can be seen from the review of employee share plans in Appendix 2, internationally the trend is towards generous concessional taxation treatment of employee share plans. To take one example from a jurisdiction most like our own in social and political organisation, the employee share plan proposed recently in the United Kingdom allows for:

- employers to be able to provide to employees up to £3,000 of shares free of tax and national insurance charges;
- employees to be able to buy up to £1,500 of 'partnership shares' from their pre-tax salary, free of tax or national insurance charges;
- employers to be able to provide employees up to two free 'matching shares' for each partnership share acquired by the employee.[73]

4.127 The Committee was advised that the $1,000 limit should be both increased and indexed. The figure of $2,000 has been suggested, and as noted supported by survey results.[74] The cost to the revenue of this change is difficult to calculate because sufficient information is not available from either the Australian Securities or Investment Commission or the Australian Taxation Office.

4.128 Moreover, since there is limited ongoing monitoring of share plans, the impact of this change would be difficult to gauge. The Committee notes that this contrasts with the approach taken in the United Kingdom, where the initiatives in employee share plans will be monitored to determine whether they are meeting their intended goals.[75] Nevertheless, provided that there is effective monitoring introduced, the Committee is prepared to support an increase in the tax exemption.

72 Submission no. 46.2.

73 The Rt Hon Gordon Brown, 'A New Employee Share Plan', downloaded from www.inlandrevenue.gov.uk/shareschemes on 11 November, 1999.

74 KPMG, submission no. 13.

75 And, according to Mr Tom Hardwick, the United States of America, where the Department of Labor tracks the number and type of employee ownership plans. See exhibit no. 18.

Recommendation 32

4.129 **The Committee recommends that the $1,000 concession available to share plans operating under Division 13A be increased. Though noting and being sympathetic to the view that it be raised to $2,000, a specific new level is difficult to recommend in the absence of Treasury estimates as to cost.**

Recommendation 33

4.130 **The Committee recommends that three years from the commencement of its operation, the Share Plan Regulatory Agency examine the operation of employee share plans and supporting legislation, and report to Parliament. In particular the agency should examine:**

- **the cost to revenue of employee share plans, whether they operate under Division 13A or not;**
- **participation rates;**
- **whether the legislation is achieving the public policy outcomes intended when it was enacted; and**
- **any possible improvements to the legislative arrangements that would promote the further spread of plans amongst general employees.**

The 5 per cent limitation

4.131 A number of submissions[76] indicated that an impediment to the creation of Division 13A qualifying plans is the legislative restriction that a beneficiary of an employee share plan shall not have a legal or beneficial interest in any more than 5 per cent of the shares in the company, or cast or control more than 5 per cent of the maximum number of votes that might be cast at a general meeting of the company.[77]

4.132 This limitation appears to have two purposes. First, to prevent, as far as practicable, abuse of share plans through excessive grants of shares or options to employees at concessional rates. This could have the effect of diminishing the value of the company, and in that way, affecting the

76 Submission nos. 5.4; 20.1; 25; 30.

77 ITAA, ss. 139CD(6), (7).

interests of non-share plan investors; or it could facilitate the takeover of the company on less than favourable terms to the majority of shareholders. In effect, the 5 per cent restriction is a protective provision, aimed at ensuring that plans that operate under Division 13A are used for their intended purpose.

4.133 Second, as advised by the Treasurer, the aim of a Division 13A plan is to encourage widespread employee ownership. Plans are not intended to provide concessions to substantial shareholders.[78] The 5 per cent limitation prevents the benefits of Division 13A plans being obtained by substantial shareholders. The Treasurer added, 'The number of employees in the company does not alter the need for a limit such as this to ensure that the concessions available under the plan are spread as widely among employees.'[79]

4.134 The Committee agrees with this last observation. However, the practical effect of this limitation is that plans which exceed the 5 per cent limitation, in respect of a single employee, do not qualify under Division 13A and, therefore, these equities do not attract the various taxation concessions. This has the effect of hindering the development of employee share plans in unlisted, small and medium sized businesses and sunrise companies. As well, this provision acts as a barrier to 'employee buyouts' in such companies, through the use of an employee share plan.

4.135 The reason is that small and medium enterprises typically have fewer than two hundred employees. According to evidence presented to the Committee, 95 per cent of businesses in Australia employ less than twenty employees.[80] As a result, it is very easy for one individual to exceed the 5 per cent limit of ownership or control over equities in an employee share plan.

4.136 This is particularly significant in small and medium businesses in which a small group of employees will seek to buy out the business, using an employee share plan as the mechanism to facilitate the purchase. As an example, suppose a group of twelve employees seeks to purchase 90 per cent of their employer. Each employee will exceed the 5 per cent limit.[81] As a consequence, an employee buyout could not occur under Division 13A.

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78 Submission no. 46.2.

79 Submission no. 46.2.

80 The Kenneths Group, submission no. 7.

81 The calculation is: Suppose the enterprise has 100 shares. The twelve employees will take ninety shares between them. Ninety divided by twelve equals 7.5 shares each.

4.137 In sunrise enterprises, it is not uncommon to award large numbers of equities to a small number of employees in order to attract them, retain their services, and facilitate the growth of the enterprise. In order to attract a particularly talented individual, the enterprise may offer that person more than 5 per cent of the shares or options.[82] Such a plan could not operate under Division 13A.

4.138 The current legislative arrangements operate as an impediment to the creation of employee share plans in sectors as diverse as unlisted, small and medium sized businesses, and companies in sunrise industries.

4.139 The issue that faced the Committee was the extent to which the limit should be relaxed. The AEOA suggested that the limit could be increased to '10 per cent…for companies with 100 or fewer employees'.[83] Ernst & Young suggested the Committee recommend a tiered system of limits:

> …so that the 5 per cent limit is increased progressively as the company becomes smaller. For example, for between 50 and 100 employees, the requirement could be lifted to say 7½ per cent; for 20 to 50 employees it could be lifted to say 10 per cent and for less than 20 employees it could be lifted to say 25 per cent.[84]

4.140 The problem with both suggestions is that neither provides for enterprises to be able to tailor the plans they operate to meet their specific needs. Nor would a blanket relaxation of the 5 per cent limit provide sufficient protection to investors or encourage the creation of employee share plans operating under Division 13A that are offered to general employees.

4.141 A workable solution would be to insert into Division 13A a section specifically designed for small, medium and unlisted enterprises and companies in sunrise industries. The 5 per cent limitation should be replaced by a 'floating rule' that varies the maximum permissible holding in accordance with the number of members of the plan, while also providing for access to share ownership for all employees. The new section should also provide for a further eligibility test, contained in the legislation to prohibit the misuse of share plans.

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82 Technology Taxation Alliance, submission no. 48.

83 Submission no. 5.4.

84 Submission no. 20.1.

Recommendation 34

4.142 **The Committee recommends that the 5 per cent limit on the number of qualifying shares or rights described in section 139CD(6) and (7) of the *Income Tax Assessment Act 1936*, be removed and replaced with a rule that:**

(a) stipulates that any allocation under an employee share plan that will result in an employee holding more than 5 per cent of the shares or controlling more than 5 per cent of the votes at a general meeting be advised to, and approved by,

- **a general meeting of owners; and**
- **the Share Plan Regulatory Agency on the basis that it is a genuine employee share plan established for a recognised purpose, such as:**

⇒ **an employee buyout;**

⇒ **spreading equity ownership throughout a small or medium enterprise; or**

⇒ **facilitating the creation and growth of a 'sunrise' enterprise.**

(b) allows an employee to hold as many shares as any other member in a particular share scheme, up to a maximum of 25 per cent for each employee in that scheme, provided that:

(c) if the scheme in (b) is restricted to a small number of employees, rather than provided to all employees, then there is at the same time another 'general' scheme open to at least 75 per cent of employees, which:

- **is not structured in any way so as to deter employees from participating; and**
- **provides for each member of that scheme to be allocated equities, the value of the discount of which must exceed the level of the discount allowable as a tax exemption under a tax exempt scheme operating under Division 13A. This is currently $1,000.**

The 'No forfeiture' requirements

4.143 In order for a taxpayer to obtain the $1,000 tax exemption under a tax exemption election, certain conditions must be satisfied.
Section 139 CE(2) of the *Income Tax Assessment Act 1936*, requires that the

share plan not contain any condition that would result in the forfeiture of the shares or rights acquired.

4.144 Some witnesses suggested that the 'no forfeiture' condition is too onerous.[85] The reason provided was that this condition enables an employee who has harmed a company in some way, for example, through fraud, to retain shares allocated under an employee share plan. Witnesses argued that it was wrong that a person who harmed a company should continue to benefit from its operation. RPC advised the Committee that:

> An obstacle to the introduction of an exempt share scheme for many companies is the legislative prohibition within Division 13A of the Act on forfeiture conditions.
>
> Shareholders do not want employees who have acted outside the interests of 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 objectives of a share scheme. A legislative exception to the forfeiture prohibition in sub-section 139CE(2) of the 1936 Act would increase the popularity of exempt schemes amongst shareholders.[86]

4.145 In cases of fraud or dishonesty the employee's interests have not been aligned with those of the company and the purpose of the share plan has not been attained. Putting employee share entitlements at risk of forfeiture in cases of proven misconduct would act as an incentive to align the interests of employee and company. The recommendation put to the Committee was that the forfeiture condition should be removed or at least relaxed so as to permit forfeiture in the case of proven fraud or other forms of misconduct.

4.146 Such an approach could present several problems. It would be necessary to frame the forfeiture conditions so as to allow forfeiture for specified reasons of misconduct without allowing the possibility of capricious forfeiture or victimisation. It would not be acceptable, for example, that a person might find themselves subject to forfeiture for participation in a union or for other activities, that while not illegal, could nevertheless be disapproved of by their employer. The removal of this condition, without the substitution of some sort of protection, would provide a

85 Submission nos. 13, 20, 31; *Transcript of Evidence*, p. 257.

86 Submission no. 13.

licence for victimisation. Yet, the addition of such modified conditions would make still more complex an already complex piece of legislation.

4.147 Moreover, to provide for forfeiture in the case of misconduct, would result in a person being punished in three ways: through the outcome of civil or criminal prosecution; through losing employment; and, loss of employee share holdings. This might be considered excessive.

4.148 Finally, the decision to forfeit interest in the employee share plan would be solely at the discretion of the company. Even where a formal process might be established, to provide impartiality and natural justice, it would be largely hidden from the wider community. The openness that is associated with the courts would probably be missing and the consequent mechanisms of accountability that lead to confidence in the system might well be absent. The consequences of this could be to foment poor relations within the company, work against encouraging employee participation,[87] and cause more problems than it solved.

4.149 It was not clear to the Committee just how much of a disincentive the no forfeiture condition provides. None of the proponents of this proposed change provided any evidence that the existing conditions present a major problem. Further, the estimated number of employees involved in share plans would seem to suggest a certain level of satisfaction with the broad direction of the present arrangements. The Committee, therefore, believes that the current arrangements, in respect of the forfeiture conditions, should remain unchanged.

4.150 Having reached this conclusion, the Committee does believe that the meaning of the provision is obscure, because the legislation does not specify clearly what counts as a 'forfeiture' condition. This may present a disincentive to establishing an employee share plan for some enterprises. These are, typically, small and medium unlisted companies. For these enterprises, it may be important to ensure that their shares are not openly traded. The major reason for this is to prevent dilution of ownership and potential takeover by non-employees, as well as a weakening of the employee share plan. In such cases, the enterprise (or the vehicle that manages the employee share plan) may wish to impose upon all employee share plan participants the requirement that shares can only be sold to the enterprise or the plan manager when an employee wishes to exit the plan.

4.151 Depending upon the way that 'forfeiture' is construed, such a requirement may well contravene the 'no forfeiture' condition in

87 Submission no. 46.5.

Division 13A, and as a result, the plan would not satisfy the division. Consequently, if an enterprise is unwilling to allow open trading of its shares, it may decide not to go ahead with an employee share plan or it may create a plan outside Division 13A but one that does not enjoy the same taxation concessions as the tax exemption election provided for in the legislation.

4.152 Clearly, this uncertainty disadvantages small, medium unlisted and sunrise enterprises which may wish to restrict the open trading of their equities. The Committee believes that such enterprises should be permitted explicitly to require employee share plan participants to sell equities acquired under an employee share plan only to the plan manager using a valuation method determined by the employee share plan regulatory agency.

Recommendation 35

4.153 **The Committee recommends that:**

- **the intent of section 139CE(2) of the *Income Tax Assessment Act 1936* be clarified, so as to remove doubt about its meaning; and**
- **unlisted enterprises be permitted to require employee share plan participants to sell any equities acquired through an employee share plan to the plan manager when they choose to dispose of the equities. The valuation method used should be determined by the Employee Share Plan Regulatory Agency.**

Equities other than ordinary shares

4.154 Employee shares plans that operate under Division 13A may offer only ordinary shares or options to ordinary shares. The Committee was advised that this limitation impedes the development of employee share plans in unlisted, small, medium enterprises and sunrise enterprises.

4.155 The Australian Taxation Office provided the rationale for this limitation to the Committee. Firstly, equities other than ordinary shares provide opportunities for misuse of the taxation system. In answer to the question, ‘Should a share scheme operating under Division 13A be permitted to use equities other than ordinary shares or rights to ordinary shares, (for example stapled securities)?’, the ATO said:

> The answer to this question is no. Division 13A requires that the shares or rights to acquire shares available under a scheme be ordinary shares. Experience with section 26AAC shows that there was a fair amount of abuse of other forms of securities, hence Division 13A was restricted to only ordinary shares.[88]

4.156 Secondly, the Australian Taxation Office advised the Committee that the reason:

> … that Division 13A of the ITAA only provides concessions for the provision of ordinary shares (rather than other types of shares) is that the rights contained in an ordinary share give an employee some basic guarantees concerning what is being provided by the employer. In particular, an ordinary share means that the employee has a right to vote in the affairs of the employer. One of the primary purposes of Division 13A is to strengthen employee participation in Australian businesses (in particular, their own employer's business), with the aim of achieving increased employee productivity.
>
> If the shares' voting rights are removed or reduced, or other share rights are removed, then the share becomes little more than a disguised salary sacrifice pay rise.[89]

4.157 The Treasurer advised the Committee that the effectiveness of employee share plans in fostering productivity and increases in performance is linked to employees possessing voting rights. Removal of voting rights, in the Treasurer's view, 'detract from the positive benefits that such schemes can generate'. The Treasurer then went on to say:

> …an ordinary share means that the employee has a right to vote in the affairs of the employer. One of the primary purposes of Division 13A is to strengthen employee participation in Australian business…hopefully leading to higher productivity. If shares' voting rights are removed or reduced, or other share rights are removed, then the share becomes little more than a salary sacrifice pay rise. The generous concessions contained in Division 13A were not intended to subsidise the cost [to] employers [of] wages.[90]

4.158 The ASIC suggested that other forms of equity may not promote the purposes of the employee share plan as well as ordinary shares and they present additional and higher levels of risk to employees. The AEOA advised the Committee:

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88 Submission no. 24.2, p. 11.

89 Submission no. 24.1; reiterated by the Treasurer. See submission no. 46.2, p. 7.

90 Submission no. 46.2, p. 7.

> …preference shares take many forms. Typically the rate of return on them is fixed. Sometimes preference shares are convertible into ordinary shares at the option of the holder or they convert automatically at a specified time. Arguably preference shares that are not convertible and which provide a fixed rate of return irrespective of the performance of the company, would not tend to foster an interdependent relationship between employer and employee. In contrast to this, preference shares which are convertible to ordinary shares in the company provide the employee with an interest in the productivity (and profitability) of the company and therefore are more likely to promote the employer/employee relationship.…
>
> Typically special classes or kinds of equity offered through employee share schemes will not be quoted on the stock market even if the company's ordinary shares are quoted. This means that the comfort that may be derived from there being an externally determined share price will not necessarily be available although it will depend on the extent to which the value of the securities are referable to the value of the ordinary shares. In any event, the information needed by employees to properly assess the merits of participating in the share scheme will be more extensive than what would be needed if the securities were ordinary shares.[91]

4.159 In particular, there is the risk that the value of the equities may fall below the price at which the equities were issued. In such cases, the employee may find that they face a financial liability. It is easier to reduce such risk by using ordinary shares.

4.160 A number of witnesses urged that Division 13A plans be permitted to offer equities other than ordinary shares or options. Several reasons were advanced.[92]

4.161 It was stated that the rationale advanced by the Australian Taxation Office applies equally well to other forms of equity, such as stapled securities. Price Waterhouse Coopers stated that:

> … it is recognised that the same "basic guarantees" which are attached to ordinary shares continue to be present in relation to stapled securities. For example, these employees also acquire a propriety interest in their employer organisation and similarly

91 ASIC, submission no. 16.3, pp. 3-4.

92 Submission nos. 5, 13.3, 20, 30, 50.

> enjoy the same benefits which are attached to this interest, such as "a right to vote in the affairs of the employer." By issuing stapled securities based on the personal performance of individual employees, these schemes are also able to achieve increased employee participation and productivity.[93]

4.162 Price Waterhouse Coopers also noted that as of 30 June 1998, 16 separate entities issued stapled securities on the Australian Stock Exchange, comprising $6 billion of market capitalisation.[94] The employees of such organisations would be unable to participate in an employee share plan operating under division 13A if the plan provided stapled securities rather than ordinary shares or options to ordinary shares. This reinforces the comment that, 'By limiting the operation of Division 13A to ordinary shares, or the right to acquire such shares … this legislation has restricted the number of employees who are able to participate in ESAS.'[95] Other evidence provided to the Committee would appear to substantiate this view. AEOA advised the Committee of two companies that had wanted to introduce broad-based share plans using stapled securities, but did not owing to the prohibition under Division 13A.[96]

4.163 Moreover, the Committee is of the view that it should be possible to exclude abusive arrangements that seek to use equities other than ordinary shares. One straightforward solution is to require any plan that uses equities other than ordinary shares to have the approval of the share plan regulatory agency or failing its establishment, the ATO.

Recommendation 36

4.164 **The Committee recommends that Division 13A be amended to allow stapled securities as qualifying equities in addition to ordinary shares or options to ordinary shares, provided that any plans that do use such equities have the approval of the Share Plan Regulatory Agency.**

93 Submission no. 50.

94 Submission no. 50.

95 Submission no. 50.

96 Submission no. 5.4. Mr Edgar Batlins provided the Committee with another example of an enterprise that decided not to proceed with an employee share scheme partly because of the restrictive nature of the equities that, under Division 13A, are considered qualifying. See *Transcript of Evidence*, p. 259.

4.165 Witnesses advised the Committee to go even further and recommend that a much wider range of securities be permitted under a Division 13A share plan.[97] For example, Ernst & Young said that,

> Whilst this requirement [that only ordinary shares or rights to ordinary shares be permitted under a Division 13A scheme] 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 ([since] listing usually requires widely held [equities]).[98]

4.166 Another problem that witnesses raised with the Committee is that the present arrangements result in employees having to concentrate their equity investments in their employer and one type of equity: ordinary shares or options to ordinary shares. These restrictions have been criticised as weakening the capacity of employee share plans to protect employees against the risks associated with concentrating investments in one source and type of equity.[99] Removing the restriction would enable the risk to be spread.

4.167 At its extreme, the suggestion would be not only that equities other than ordinary shares be allowable under a Division 13A plan, but also equities in companies other than the employee's employer. The AEOA claimed that the introduction of such plans was 'long overdue in Australia'[100]. RPC also supported allowing for such plans.[101]

4.168 This sort of plan is known in the United States as a '401(k) scheme', the name deriving from the section of the legislation that sanctioned it. The purpose of such plans is to allow employees to spread the risk across different enterprises and different types of investment.[102] The Committee has been advised that when the United States Congress legislated for 401(k) schemes, it:

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97 For example, Mr Edgar Batlins, *Transcript of Evidence*, pp. 259ff. Mr Batlins referred to unit trusts. See also RPC, submission no. 30.3; AEOA, submission no. 5.5.

98 Submission no. 20.

99 Mr Scarrabelotti, *Transcript of Evidence*, p. 6.

100 AEOA, submission no. 5.5.

101 RPC, submission no. 30.3.

102 RPC, submission no. 30.3; AEOA, submission no. 5.5.

> …obliged 401(k) plans to invest partly in non-employer equities as a prudential measure. In establishing the 401(k) plan, Congress sought to develop an alternative to the Kelso ESOP so that workers could take a stake in their employer's company without having all their eggs in the one basket.[103]

4.169 As noted earlier, employee share plans have two dominant purposes. The first is to promote the wellbeing of a company by better aligning the interests of employees with those of their employer. The second purpose is to provide additional income as a reward for productive work. What an employee does with this additional income is a matter for the employee and there is, at present, no encouragement for an employee to select one use over another, for example, to invest in retirement savings rather than increased consumption.

4.170 Although the second purpose, that of providing a source of additional income, would favour the expansion of Division 13A plans beyond ordinary shares or options, the other purpose, that of aligning the interests of employee and employer, does not support such an extensive expansion.

4.171 In order for the interests of employer and employee to be aligned, employees must feel engaged in their employer's wellbeing. A community grounded on shared purposes should be fostered. Employees feel involved for a number of different reasons. One is that they have a financial stake and are concerned that this should increase in value. Another is being in a position to influence the management of the business. Voting rights empower the employee and provide an additional foundation for an employee's participation in and interest in the wellbeing of the employer.[104] As a result, employee share plans are effective only if employees feel involved in the operation of their employer and feel that their actions and views can influence its wellbeing.

4.172 The view was presented to the Committee that employee participation by way of voting and other rights in shares or options is necessary if an employee share plan is to succeed:

> Financial participation projects which have a high degree of employee and union consultation in their design and which imply a high degree of employee participation in decision making, enabling employees to exercise some control over the factors that influence productivity, are likely to succeed. Those which are implemented without consultation, and which do not

103 AEOA, submission no. 5; Mr Scarrabelotti, *Transcript of Evidence*, p. 6.

104 Submission no. 37.

> involve any employee participation in decision making, are likely to fail.[105]

4.173 The Committee accepts therefore, that issuing shares to an employee while not permitting that person to exercise any voting control impedes the development of the alignment of interests between employer and employee, and the sense of two-way responsibility and mutual obligation that is one of the major reasons for promoting employee share plans.

4.174 There is another reason that speaks against removing entirely the restriction on the type of qualifying equity under a Division 13A plan. In the United States, 401(k) employee share plans are intended to offer access to long-term investment and savings with manageable risk. This is one reason why, according to evidence given to the Committee, participation in these plans increased to 25 per cent of all households between their inception in 1974 and 1993.[106]

4.175 At this stage the rationale for such plans does not exist to the same extent in Australia. All employees in Australia must be members of an approved superannuation plan. Many of these invest in a wide range of shares and options, and do so utilising the best professional advice and prudential practices.

Recommendation 37

4.176 **The Committee recommends that employee share plans operating under Division 13A and which are open to at least 75 per cent of a company's employees, not be confined to ordinary shares or options to ordinary shares. They should also be permitted to offer any other instrument or security in the employer which is able to be dealt with by an employee, provided that such an instrument or security confers no less ownership entitlements upon the employee shareholder than those usually conferred by ordinary shares in a company.**

4.177 The Committee does recognise, however, that there may be circumstances in which an employer might wish to offer an employee share plan but is not willing to do so because the type of equity that must be offered would dilute ownership of the enterprise. This point was made by RPC, which advised the Committee that restricting the

105 Submission no. 27.

106 V W Fitzgerald, *Saving Through the Firm*, 1993, exhibit no. 28, p. viii.

class of securities under Division 13A to ordinary shares or options to ordinary shares:

> …prevents many private companies who wish to maintain control of the business from implementing ESOPs because they would prefer to use a special class of share that enables them to offer equity participation to employees while maintaining control.[107]

4.178 Ernst & Young elaborated on this point, and advised the Committee that:

> … the critical right in the context of small and medium companies is the voting right because the 'existing shareholders' would usually be most unwilling to give up their control even if they are prepared, as is often the case, to allow employees to participate in the profits of the company. I have been told on many occasions that the employees would be quite happy to hold a share which can appreciate in value and participates in profit without a voting right. Unfortunately, it is very likely that such a share would not be considered to be an 'ordinary share' and accordingly participation in such a plan could not be qualifying.[108]

4.179 In such cases, which typically may involve unlisted, small, and medium enterprises, and companies in sunrise industries, the employees and employers should not be deprived of the opportunity to participate in an employee share plan that confers the benefits of Division 13A.

4.180 However, the Committee was not convinced that employers in these enterprises should be permitted to offer equities which confer fewer ownership entitlements on share plan participants but which would still attract the concessional taxation treatment. If an employer wishes to motivate employees or use an employee share plan for succession purposes then the equities that best attain these objectives are those which confer ownership rights upon employees. Consequently, the Committee believes that, at the present time, there is no compelling reason to change the existing policy.

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107 Submission no. 30. A view supported by the AEOA. See submission no. 5, and the AEOA policy document available at: http://www.aeoa.org.au/policy.htm.

108 Submission no. 20.1.

Time restriction on share sales

4.183Another anomaly brought to the attention of the Committee is the restriction on the sale of shares or rights acquired under a tax exemption election and the fact that this may have unintended and undesired consequences. The Macquarie Bank advised the Committee that:

> … one of the eligibility requirements for the $1,000 exemption seems unduly restrictive. Currently, as noted above, an employee share plan will only obtain the $1,000 exemption if the plan has a condition restricting sale of the shares to the earlier of the time three years after acquisition of the shares by the employee or the time the employee ceases to be employed by the employer. The employee share scheme rules would be more practical if employers were also given the discretion to lift this restriction in appropriate cases, such as in cases of demonstrated hardship. At present, an employee suffering hardship must leave employment in order to sell the shares held in the plan.[109]

4.181 Examples of hardship would include maternity or paternity leave without pay, suddenly assuming the care of an aged or disabled relative or dependant, or drastic changes in family circumstances causing hardship, such as the dissolution of a marriage. The Committee believes that in cases such as these access to employee share plan holdings could assist employees and reduce the call upon income support services. Therefore, the Committee agrees that this anomaly should be removed.

Recommendation 38

4.182 **The Committee recommends that, in cases of genuine hardship, employees who are members of plans open to more than 75 per cent of the employees of an enterprise, be exempted from the three-year sale restriction limit. Exemptions would be granted only on application to the Employee Share Plan Regulatory Agency, that has been previously recommended. (Chapter 3, recommendation 18.)**

Australian legislation and foreign employers and employees

4.183 In an increasingly globalised economy Australian companies operating internationally wish to offer participation in employee share plans to foreign employees. Conversely, foreign corporations wish to offer

109 Submission no. 18.

Australian employees the opportunity to participate in employee share plans, either in their Australian subsidiary or in the foreign-based parent company, or in some other division of the company.

4.184 The Committee received conflicting advice concerning whether aspects of Australian law helped or hindered the operation of employee share plans across international boundaries. The AEOA advised the Committee that:

> The AEOA does not believe such impediments exist. The only restriction that exists is that Australian employees cannot borrow to buy foreign shares, a practice that is not really to be encouraged given the heavy financial risks of such an approach.
>
> There are many plans operating where Australian employees receive or acquire shares and/or options in their international parent companies. These plans operate very effectively.[110]

4.185 In a similar vein, RPC advised the Committee,

> We have designed a number of ESOPs under the present legislation for overseas companies with Australian employees. They have been no more difficult (in fact in some respects less so) than implementing ESOPs for Australian companies.
>
> We do note however, many foreign companies are unfamiliar with the unique Australian legislation and are unwilling to understand the differences between Australian ESOPs and their domicile country ESOPs. This however is not an Australian legislative problem.
>
> Australian companies willing to establish ESOPs for foreign tax resident employees need to comply with the taxation issues relevant in the country the foreign employees are domiciled. There is nothing we can do in Australia to change that - and nor should we.[111]

4.186 Other witnesses who operate employee share plans on a global basis advised the Committee that current arrangements did not pose any difficulties. Lend Lease advised the Committee, that ‘in the late 1990s, as Lend Lease’s business has become more globally based, employee share ownerships plans (in line with corporate core beliefs) have been rolled out in the US, Europe and Asia’.[112]

4.187 In contrast, a number of other witnesses referred to specific problems that face both Australian corporations operating overseas and foreign

110 AEOA, submission 5.5, p. 3.

111 RPC, submission no. 30.3.

112 Submission no. 26.

corporations operating within Australia. For example, Qantas advised the Committee that,

> …a company with an overseas workforce, such as Qantas, must consider whether the scheme appeals to employees under different country tax regimes. The majority of the countries where Qantas has employees were found to impose income tax on the fair market value of the shares at the time of receipt. This made the Qantas employee share ownership scheme, with its trading lock of several years, less attractive to employees than a cash bonus. The argument is supported by higher rates of refusals from overseas staff who were invited to participate in the Qantas employee share ownership schemes.[113]

4.188 Another problem identified by witnesses concerns the clarity of the taxation treatment of people entering Australia for employment who may have acquired interests in employee share plans while abroad. KPMG, advised the Committee that:

> …there is no clarity at all of the taxation treatment of employee shares or share options for non-residents. The ATO view depends to a large extent on the officer you discuss the matter with. Our clients are looking for certain and equitable treatment [and] at the moment they are offered neither.[114]

4.189 No evidence was provided to the Committee concerning the number of people affected by this apparent problem or the extent of the alleged inequity. The Committee was also unable to determine the extent to which the changes would create an opportunity for aggressive tax planning.

4.190 Mr Andrew Purdon of KPMG also brought to the Committee's attention what would, on face value, appeared to be a significant anomaly concerning the taxation treatment of inward-bound employees. Mr Purdon advised the Committee that:

> We also see another problem in respect of the move towards global companies and the global economy. The example I have here is the UK, but I believe it also applies in Canada and may apply in other countries. Where you have a non-approved share scheme, you can have the situation where an employee in the UK parent company receives options in the parent company and, let us say, four years down the track is seconded to Australia for two years. It could just so happen that the time when those options would be exercised falls during those two years. Under our legislation we would say, 'You have exercised

113 Submission no. 35.

114 Submission no. 13.3.

> those options whilst you were working in Australia as either a resident or a non-resident, and we will have tax on 100 per cent of the gain made on that exercise of the options.'
>
> In the UK legislation, it is taxed pro rata for the time that they were in the UK, so they would have a tax liability in the UK of 80 per cent of the gain on exercise of the options. Effectively, you are getting taxed on 180 per cent of the gain, not even on 100 per cent of the gain. There is no clear evidence in the legislation and the double tax agreement that you would even get a tax credit allowed between countries. We have spoken to the tax office about it; some say, 'We think you should get one,' and others have said, 'The legislation doesn't allow it, so you don't get one.'
>
> If it happens the other way, and an Australian is granted options in Australia and is seconded to the UK and exercises the options in the UK, then the UK says, 'They were issued in Australia, they are Australian options, we don't tax it.' So it only relates to 100 per cent. It is only a problem for secondees coming into Australia and exercising options while they are here, even if they are back in their parent company.[115]

4.191 The Committee sought the advice of the ATO on this matter. The ATO advised the Committee that:

> Australia has entered into an extensive number of bilateral taxation agreements with other jurisdictions, although there are no specific provisions in place that deal with share plans, to avoid circumstances where laws would result in double taxation. In the extraordinary event that a double taxing point did occur, the taxpayer could avail themselves of the mutual agreement procedure article in the relevant double taxation treaty which provides relief from double tax by way of a credit for any foreign tax paid.[116]

4.192 The Committee agrees that no employee resident within the Commonwealth who has shares or options issued in another country should be subject to a total taxation rate, when foreign taxes have been paid, that is greater than the highest rate applicable to an employee share plan operated solely within the Commonwealth. The issue needs to be resolved by international, bilateral agreements. It appears from the evidence available that such remedies exist.

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115 *Transcript of Evidence*, p. 264.

116 Submission no. 24.2.

4.193 Mr John McIntyre, the tax manager of ESSO Australia, provided a different example of the taxation treatment imposed upon equities of Australian origin and those of foreign origin:

> Another area of concern is the tax grouping rules—this is generally in the income tax area. In order for a company to benefit from the current group of, say, tax loss provisions or the capital gains rollover provisions, there must be 100 per cent commonality of ownership of entities within the group. For many companies operating in Australia with foreign parents, that commonality is traced back to the parent company—in our case, in the USA. It means that, in order to maintain that 100 per cent commonality of ownership between the elements of the Australian Exxon group, we cannot really issue shares to our employees out of the Australian companies. We have to issue shares in the parent company—Exxon Corporation of the USA.
>
> That in itself is obviously not too bad, it is a chance for our employees to have shares on an international basis, but it does preclude them from taking advantage of the Australian tax imputation system and leaves them open, not only to the normal risk of shares going up or down, but also to the foreign exchange risk associated with those shares.
>
> On the imputation side the difference is quite marked. Take as a simple example a dividend of, say, $64 paid by an Australian company—under our rules it is so-called fully franked—and a $64 dividend received from a US corporation. The effective rate of Australian tax on the $64 from the Australian company, due to our imputation system, is about 19 per cent, yet the tax rate applicable here in Australia on the $64 from the US company, for the same employee on the top marginal rate of tax, is 48.5 per cent.
>
> In other words, the effective tax rate on the actual cash dividend paid is basically two and a half times as great in respect of a foreign share as it is in respect of an Australian share. But we are basically forced into that position because of the inability to issue shares in an Australian company without breaching the tax grouping rules.[117]

4.194 In respect of the tax grouping problem, the ATO advised the Committee that this problem had been identified and was being addressed:

> Employee share ownership arrangements could also be impacted by the proposal to introduce a consolidated system of taxation for entity groups. Under this proposal, entities that are 100 per cent commonly owned may elect to be treated as a

117 *Transcript of Evidence*, p. 204.

> single taxable entity. Where employee share ownership arrangements dilute a 100 per cent shareholding, they have the potential to prevent an entity group from satisfying one of the fundamental criteria for consolidated tax treatment. However, this issue has been flagged at paragraph 26.6 of *A Platform for Consultation* where it is stated that consideration needs to be given to the question of whether there may be grounds for departing from the wholly owned requirement in the circumstances of employee share ownership.[118]

4.195 If the Government does decide to allow departure from the wholly owned requirement in the case of employee share plans, foreign listed corporations with Australian subsidiaries would be in a position to offer shares in those subsidiaries to their Australian employees. This would provide a way of overcoming the double taxation problem.

4.196 The Committee concludes that where the tax grouping rules may be preventing employees from participating in employee share plans, relief from them should be provided, so long as the plan is operated under Division 13A and it is a plan in which general employees are eligible to participate. Similarly, where the operation of Australian taxation laws creates an artificial and unjustified division between income from different sources, but which is of the same fundamental type (such as dividends), then the law should be amended to allow relief for certain classes of taxpayer so that all similar classes of income are subject to the same taxation treatment.

4.197 The Committee does not support any taxation arrangement that results in income being taxed more than once. Nor does it support taxation arrangements in which income fails to be taxed or in which the provisions of a law are uncertain.

118 ATO, submission no. 24, p. 11.

Recommendation 39

4.198 **The Committee recommends, subject to the Australian Taxation Office being satisfied as to the strength of the integrity measures, that:**

(a) where the tax grouping rules prevent the creation of employee share plans, case by case relief from them should be provided, so long as the plan is operated under Division 13A and it is a plan in which general employees are eligible to participate; and

(b) where a person becomes a resident of the Commonwealth, for taxation purposes, and has acquired before becoming a resident, equities as part of an employee share plan; then

- **any tax paid on those equities in a foreign jurisdiction should be taken into account in their taxation liability in respect of those equities in Australia; so that**

⇒ **any income derived from those equities should be taxed in such a way that the person will not pay tax on those equities at a higher rate than would be the case if the equities had been acquired by a resident of the Commonwealth.**