**A speech by Dr Brendan Nelson MP, Chair, House of Representatives' Employment, Education and Workplace Relations Committee, to the Australian Employee Ownership Association 1999 Annual General Meeting, Thursday, 18 November, 1999.**

Ms Hunt, Ladies and Gentlemen. Thank you for your kind invitation to address the annual general meeting of the Australian Employee Ownership Association. It is a pleasure to speak with you this evening.

As you are aware, the Employment, Education and Workplace Relations Committee is currently inquiring into the extent and nature of employee share ownership in Australia. I value this opportunity to bring the association, one of the major stakeholders in the inquiry, up to date on its progress.

As you can understand, the inquiry involves a detailed consideration of distinct public policy goals. On the one hand, the general policy objective, to which all parties are committed, of fostering and promoting employee share ownership; on the other hand, ensuring the equitable treatment of all citizens and taxpayers. It is then quite a complex inquiry, as any reading of the evidence will reveal.

No doubt you will be eager to know what conclusions the Committee has reached and recommendations it plans to make. Unfortunately, until the Committee has presented its report to Parliament, I am not permitted to do so. In any case, the Committee still has ahead of it the task of converting evidence into a plan of action.

What I can say is that at this stage we hope to table the report in the first quarter of next year. Once it is tabled, copies will be sent to all those

who have assisted the Committee by providing evidence, including your association. Comments will be invited.

This evening I would like to speak with you about two broad topics. Firstly, I want to briefly talk about the Parliamentary Committee system, and the importance the Parliament places on receiving evidence from citizens and interested organisations. I will then outline the major themes that have emerged from the inquiry.

The House of Representatives, like the Senate, maintains an extensive Committee system. The House appoints and administers nine general-purpose standing committees.[1] These committees monitor and report on most of the areas of Commonwealth administration. The role of the general-purpose standing committees is to assist the House in the consideration of policy and legislation and in the scrutiny of executive government administration.

In addition, and in conjunction with the Senate, Members of the House participate in twelve joint committees. These committees report to both Houses and enable Members and Senators to work together on the same matter.

It is important to note that there are differences between the means of appointment and powers of joint committees. However, I shall not elaborate upon those differences tonight. Instead, I will concentrate on the House general purpose standing committees, of which the Committee I chair is one.

The purpose of parliamentary committees is to perform functions that the Houses themselves are not well fitted to perform, owing to their

size and the limited amount of time the Parliament has to deal with any issue. These functions include:

- investigating and reporting on matters of public concern and importance;
- holding ministers and public servants accountable for their administration of the Commonwealth and, in particular, for their spending of public monies;
- investigating the prudence of various policy or legislative proposals;
- maintaining a flow of information, from the community to those who make decisions, so that their decisions will be better informed and grounded;
- informing public debate by maintaining the flow of information in the other direction, from the Administration to citizens, so that they are in a good position to evaluate the performance of executive government, its policies and proposals, as well as those of the Opposition.

Inquiries may arise because the Committee has sought a reference from the Minister, or on the Minister's own initiative. Alternatively, we may, on our own initiative, inquire into any matter mentioned in the annual report of a government department or related agency.

One advantage of using committees is that several committees can operate at the one time, thus allowing examination of a number of different areas simultaneously.

As well, by concentrating on specific tasks, subjects, or portfolio areas, committees also offer the benefits of specialisation and a

systematic approach to ensuring accountability of government, as well as responsiveness to the needs and views of the community.

The committee system addresses a fundamental truth about democratic society. At the heart of our democratic process is community debate and deliberation. So that community debate is nurtured, it is essential that active involvement from interested members of the community is fostered. For this to occur, Parliament and the community need a forum and a process for information to be exchanged; they need to be informed and they need high quality information upon which to base their decisions. Committees are an essential element in this exchange of information.

Moreover, citizens have considerable visibility in our system of government. But visibility is not always sufficient. Citizens must also be heard. They must have standing. Committees provide not only visibility to citizens, but also provide recognition and standing. They do this by providing a direct voice in the parliamentary process for all members of the community, should they wish to be involved. Parliamentarians can hear directly from their fellow citizens about the successes and the deficiencies of administration, and suggestions for improvement. Canberra can be seen as remote from Perth, the Kimberleys or Rockhampton. Committees are one mechanism that reduces this isolation.

Committees serve to bring Parliament to the people by promoting access to the parliamentary process, public awareness and debate on matters being considered by the Parliament – no matter where you are in the Commonwealth.

What, then, is the outcome of an inquiry? An inquiry results in a report being presented to Parliament. After a report is tabled, the

government is expected to respond to the recommendations and the matters raised in the report in general. Three months is the target response time the government has set itself, although in some cases it may take considerably longer.

This lengthy digression about the nature of committees is important in understanding the time and effort put into inquiries and the importance of committee reports. When the report is tabled, I would urge you to write to the Minister for Employment, the Hon. Peter Reith MP, supporting those recommendations you wish to see implemented or providing reasons why those recommendations you do not support, should not be implemented. Such responses from stakeholders, such as the AEOA, are essential to the effective functioning of the Committee process. That process is part of a larger democratic process, as I have indicated. It is not too much to say that citizens and interested groups making their views known are a great assistance to parliamentarians and such involvement from the community is an essential element in a healthy democratic process and, importantly, in keeping it alive.

This brings me now to the present inquiry. The Employment, Education and Workplace Relations Committee examines matters administered by:

- the Department of Education, Training and Youth Affairs;
- the Department of Employment, Workplace Relations and Small Business; and
- the authorities which come under those portfolios.

In the information society, these are, arguably, central portfolio areas. Inquiries in these areas address fundamental issues in the evolving

educational and employment opportunities facing the community. For this reason, the Committee is particularly pleased at the enthusiasm shown by stakeholder groups to the current inquiry, including the AEOA.

The Committee has received a considerable amount of very detailed evidence from many interested parties, including your association. The evidence has been most informative, constructive and of a high quality. This is especially important in dealing with a matter that is regulated by Division 13A of the Income Tax Assessment Act. This division is quite complex to non-tax experts. It could be best described as “Byzantine”.

The evidence has pointed not only to the strengths of the existing legislative arrangements but also the areas that need to be examined in order for employee share ownership schemes to be fostered.

I should say at this point that interest in these schemes is shared by all the major parties in Parliament. For over a quarter of a century provision has been made for such schemes in the Income Tax Assessment Act, with clear legislative recognition being made in 1974. Division 13A was enacted in 1995. Finally, prior to the 1996 general election, the Prime Minister committed any coalition administration to fostering employee share ownership schemes. This commitment was honoured in the 1996 budget, which saw a number of amendments to Division 13A enacted.

Commonwealth administrations, in dealing with employee share ownership schemes, have faced a number of difficult questions in public policy. Some, concerning the purpose of schemes, I will discuss shortly. The major problem, however, has been to find a way that facilitates ESOPs but does not, at the same time, create a mechanism to facilitate a weakening of the revenue base –so called tax avoidance, tax minimisation or tax evasion schemes.

We all agree with US Supreme Court Justice Oliver Wendell Holmes, that taxes are the price we pay for civilisation. There are, regrettably, people in our community who want the benefits of civilisation without the burdens that PAYE taxpayers bear. This inquiry will not make any recommendation that facilitates the operation of any artificial scheme designed to avoid a person's or organisation's taxation responsibilities. Witnesses who have appeared before the Committee have forcefully supported this approach.

Nevertheless, the Committee has identified a number of areas that warrant detailed and extensive examination.

1. The nature of ESOPs

Witnesses view ESOPs as having a range of purposes. Some see ESOPs as a way of aligning the interests of businesses and employees so as to achieve better business results and provide benefits to employees. Other witnesses see ESOPs functioning as medium and long-term savings schemes, in effect a form of supplementary superannuation or a savings "pot" for significant life-cycle events. Some witnesses submitted that ESOPs should also be seen as a means of "democratising" capital; that is, spreading capital ownership and access to capital more widely in the community. Depending upon the way ESOPs are viewed they may be a savings vehicle, rewards for services performed or inducements to perform to a certain, higher standard. The purposes that ESOPs are thought to serve will affect the way that ESOPs are dealt with in legislation and the way that they are taxed. For example, should ESOP shares or options be taxed as income or as a capital gain, or in some

combination of both rates? The answer to that will be justified by the answer to the question: What is the purpose of an ESOP?

An issue that emerges from a consideration of this question is the use of equities other than ordinary shares in ESOPs. The AEOA and other witnesses urged the Committee to examine this question, which we are doing, and to recommend that ESOPs be allowed to contain equities other than ordinary shares. Some witnesses also added that in order to spread the risks associated with share or option ownership, that ESOPs be permitted to maintain a holding of equities in companies other than the employer company. As noted, answering such questions requires the Committee to grapple with the fundamental question already posed: What is the purpose of an ESOP?

2. The 5% problem

Many submissions, including those from the AEOA, indicated that an impediment to the creation of ESOPs amongst unlisted, small and medium sized businesses is that in order for the share or option to be a “qualifying” share, and so attract various taxation concessions, there is a 5% limitation on share or option ownership by a single individual. There is also a limitation of 5% on the votes at a general meeting over which one individual can exercise control.

In small, unlisted firms of under 20 employees, a single shareholder can exceed these limits.

Moreover, in the case of “sunrise” industries, an executive may be offered a considerable parcel of shares or options, often exceeding 5%, in return for his or her services. Such shares would be unqualifying and, therefore, they would not attract the various

taxation concessions available to qualifying shares or options. The Committee has been urged, by the AEOA and others, to increase this limit.

3. The 10 year tax point

At present, tax must be paid on shares or options at cessation times specified in legislation. One such cessation time is set at 10 years after the taxpayer acquired the share or the right. At this point in time, tax is levied. As a consequence, a taxpayer may have to dispose of a share or an option in order to meet their tax liability. Many submissions have urged that this limit be removed, because it is unfair to require a person to dispose of property in order to meet a taxation liability, when a useable benefit has not accrued to that person from the property.

This points to an apparent anomaly in the present taxation arrangements. Witnesses, including the AEOA, have testified that shares or options may be liable, under certain circumstances, to taxation on their value, even though the taxpayer does not have access to any actual benefit from those shares or options. The result is that the taxpayer may be required to sell their shares or dispose of their options in order to meet their taxation liabilities.

This raises a matter of general principle: Should shares and share options in ESOPs be taxed only at the point of disposal, as many witnesses, including the AEOA, suggest? Or should the present system be retained?

4. The $1000 tax exemption

A business can obtain a deduction up to $1,000 in respect of qualifying shares issued to an employee under an ESOP. The deduction relates to the value of the discount.

The Committee was advised, however, that the costs of implementation, compliance, tax sign-off and administration would significantly erode the benefit, to the extent that it would be more cost beneficial to award a similar benefit in cash, fully taxed. The Committee was advised that the $1,000 limit should be both increased and indexed. The figure of $2,000 has been mentioned.

5. The “No forfeiture” requirements

In order for a taxpayer to obtain the $1,000 tax exemption, certain conditions must be satisfied. Under section 139 CE (2) of the Income Tax Assessment Act, one of the requirements is that the ESOP does not contain any condition that would result in the forfeiture of the shares or rights acquired under the ESOP. Some witnesses have suggested to the Committee that the “No forfeiture” condition is too onerous. For example, under the present legislation, it cannot be a condition of the ESOP that the shares are forfeited in the case of fraud or dishonesty.

The recommendation put to the Committee is that the forfeiture condition be removed, as it was unreasonable and prevented the ESOP attaining one of its goals, namely, motivating employees.

6. The cessation rules

Under existing legislation, when a cessation event occurs, an ESOP member becomes liable for tax. Retirement, resignation and death are cessation times.

It has been put to the Committee that, in such cases, the value of the share is a “paper value” and the individual has not actually derived any benefit from the share value, apart from dividends, upon which tax would have been paid. The result is that many people who retire or resign may have to sell their shares in order to meet the tax payable. This acts as a disincentive to participation in ESOPs, especially for young people who leave one employer for another as part of a natural career progression. It also discriminates against people who are made redundant or who leave for family reasons, for example, to parent children.

The view put to the committee is that it should be permissible to allow the deferral of the tax liability until the shares or options are sold. One suggestion is that the ESOP legislation should be amended so that no person who is a member of an ESOP should be required to dispose of their shares if they leave an employer for reasons of redundancy or other life-cycle events, such as parenting or career advancement.

## 7. Trusts

The Ralph review proposed that trusts should be taxed at the company rate. This recommendation, as you will be aware, has been subsequently endorsed by the Treasurer and is government policy. Trusts are a popular and effective way to establish and operate an ESOP. Many submissions raised concerns about the Ralph proposal,

in respect of ESOP trusts, but the policy announced by the Treasurer will apply to all trusts, including ESOP trusts. The issue that faces the Committee is whether ESOP trusts should be taxed at the company rate or at some different rate, applying only to ESOPs. Again, this is an issue upon which the AEOA has provided valuable advice. The matter is still under consideration by the Committee.

## 8. Information about ESOPs

One of the impediments that the Committee has faced is obtaining accurate information about the number, size and nature of ESOPs operating in Australia. Unlike the United States, where information about ESOPs is collected by various Federal agencies, no such database exists in Australia. There have been surveys carried out in this country, by private sector organisations. However, if public policy is to evolve over time, so as to facilitate these schemes, accurate information is required.

Moreover, ESOPs may well be a bargaining tool that potential employers and employees can use so as to create a still more competitive labour market. The issue then is whether the recommendation, made by the AEOA and others, that a committee be established to monitor the operation of ESOPs and make suggestions to the government, should be expanded, so that the proposed committee would also keep a comprehensive register of ESOP schemes.

## 9. Clarity of, and anomalies in, Division 13A of the Income Tax Assessment Act.

A number of witnesses pointed to various anomalies and a lack of clarity in the relevant legislation. Some suggested detailed amendments. I can assure you that the Committee will examine those suggestions in detail and if the matter is a simple technical amendment that would remove uncertainty, foster the development of ESOPs, while not at the same time encouraging the tax-loophole hunters, then the Committee will look favourably upon them. We have sought detailed comments from the Treasurer on the proposed amendments.

10. Access to ESOPs

At present, access to ESOPs is largely limited to employees in the private sector, in listed companies. For the reasons mentioned, the number and extent of ESOPs in the unlisted and so-called “sunrise” industries is limited. This is the opposite, the Committee has been advised, of the United States, where there are far more ESOPs in unlisted businesses than in listed businesses. The committee has received clear suggestions about policy options that would foster the development of ESOPs in the unlisted and “sunrise” sector.

Moreover, employees in the public sector, and the voluntary and charitable sector, can never directly participate in ESOP schemes. Effectively, employees in those sectors do not have access to ESOPs, and the advantages they provide to business organisations and their employees. It has been suggested that provision could be made for so called “replicator” schemes so that employees in the public, voluntary and charitable sectors may gain the same benefits. Whether these schemes provide the same advantages as ESOPs do to business organisations is a matter for investigation. Nevertheless, the

equitable treatment of those employees who seek to serve their community in the public, voluntary and charitable sector remains an issue for the Committee to consider.

## 11. The use of options in ESOPs

Issuing options to business executives is becoming an increasingly popular element of remuneration packages[2]; and issuing options to ordinary employees is also increasing. This raises a number of important questions that the Committee must examine. Ordinary employees may not possess the financial inside information of business executives. How aware are they of the risks? Is it right that ordinary employees be exposed to such risks, when they may have made salary sacrifices in return for shares or options?

## 12. Disclosure issues

The recently passed CLERP legislation will simplify the disclosure requirements that ESOP proposals must satisfy. This goes some way to addressing the suggestion made by a number of witnesses, including the AEOA, that the prospectus requirements be relaxed when the the level of risk associated with the ESOP is low. There are, however, a number of other disclosure issues. For example,

- What level of disclosure about the nature and size of ESOPs should be mandatory in annual reports?
- Do Australian Accounting Standards require an appropriate level of disclosure, particularly in relation to the issuing of options?

The level of disclosure of options in annual reports and the manner in which options are counted in the financial reports of corporations has become a pressing issue in the United States. Some analysts have suggested that the true profit situation of those corporations which make generous issues of options is somewhat worse than the financial reports seem to indicate.[3] The Chairman of the Federal Reserve Board, Dr Alan Greenspan, said in August this year: "This distortion, all else [being] equal has overstated growth of reported profits according to Fed staff calculations by one to two percentage points annually during the past five years."[4] As the Chairman of the US Securities Exchange Commission, Mr Arthur Levitt said in September 1998:

> The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situations in Asia and Russia are stark examples of this new reality. These markets are learning a painful lesson taught many times before: investors panic as a result of unexpected or unquantifiable bad news. If a company fails to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate for no discernible reasons; and the trust that is the bedrock of our capital markets is severely tested.[5]

In conclusion, I would like to make these points. The Committee acknowledges and is indebted to witnesses for the high quality of

evidence received and for the ongoing interest and assistance that stakeholders, such as the AEOA, have provided to the inquiry.

As noted, all political parties support ESOPs and the Committee can identify a number of initiatives that could be implemented that would foster the development of ESOPs.

The Committee agrees, with AEOA and other witnesses, that one of the major benefits of extending share ownership throughout the community, is that it promotes the involvement of the community in the world of business. ESOPs focus the attention of a larger number of people on the underlying conditions that need to be maintained if the prosperity of the nation is to be sustained and extended. An essential element in this process is involving employees in the fortunes of the business that employees them.

ESOPs can do more than simply align the interests of employees with those of their employers. There is another positive benefit of employee share ownership that has received little attention: making business responsive to the needs and values of the community. In other words, aligning the activities of business with the values of the community. Employees often know more about a corporation than anyone else. They are then in a unique position to know where improvements can be made and how best to implement them. They want to see their corporation prosper and flourish.

Encouraging employees to develop an emotional as well as financial investment in a corporation results in employees taking an interest in the management of the corporation, and ultimately, attempting to influence the corporation’s activities. This has an important consequence. There are some things that are more effectively dealt with by individuals and

companies than Parliament. The involvement of employees through ESOPs imposes upon corporations a more effective and efficient discipline than any imposed by Parliament, since share holders are directly involved.

Since shareholders must be heard at meetings, they are in a position to exercise some measure of control over corporations in areas that are of concern to the community, and do so more quickly and effectively than any regulatory agency. For example, in the past few years, environmental issues, executive remuneration packages, workplace safety and health, and investment within this country and in other countries in which that corporation may operate have all been questioned. In short, in some matters, shareholders are much better placed than Parliament, to impose business ethics on business corporations.

I am reminded here of Baron Thurlow's famous remark in a corporate law case, two hundred years ago: "Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked." Thurlow then added in a stage whisper: "And by God, it ought to have both!"[6] While employee share ownership may not create a body and soul, it does provide a mechanism whereby those who manage corporations are accountable to a broader group of people rather than a closed collection of institutional investors. Extending accountability in that way, engaging employees in the activities of their employer, and improving corporate performance at all levels through employee share ownership schemes, can only be a good thing.

Thank you. I am happy now to take questions.

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[1] Information on the nature, role and powers of committees in the Parliamentary process can be found at: http://www.aph.gov.au/house/committee/index.htm

[2] See Damon Kitney and Brett Clegg, "CEO pay increases 22pc: Top earners hold 975m in shares and options", *Australian Financial Review*, 1 November, 1999, pp. 1, 25-29. [See also the other articles on this topic by these writers and the article by Trevor Sykes, all in this same issue.]

[3] In a document accompanying submission 49, it was reported that, "…Microsoft, the world's most valuable company, declared a profit of $4.5 billion in 1998; when the cost of options awarded that year, plus the change in value of outstanding options, is deducted, the firm made a loss of $18 billion…", *The Economist*, 7th August, 1999, p. 20.

[4] "New Challenges for Monetary Policy", speech at Jackson Hole, Wyoming, 27th August, 1999. URL: http://www.bog.frb.fed.us/boarddocs/speeches/1999/19990827.htm

[5] "The Numbers Game", speech at NYU Center for Law and Business, 28th September, 1998. URL: http://www.sec.gov/news/speeches/spch220.txt

[6] Edward, Baron Thurlow (1731-1806), Lord Chancellor.