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Contact Edgar Baltins, 9335 8254

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

7 September 1999

Dear Sir/Madam

Enquiry into employee share ownership in Australian enterprises

I refer to our earlier submission dated 30 April 1999 and wish to make the following further submission on the above mentioned topic.

1 The complexity of the present tax regime should be removed

Employee share schemes are the subject of specific tax legislation contained in Division 13A of the *Income Tax Assessment Act, 1936.*

Division 13A determines the time at which any benefit resulting to an employee from participating in an employee share scheme will be taxed to him/her and also provides the means for quantifying the benefit.

The specific rules are complex but can be summarised as follows:

- An employee may elect to be taxed on the discount received at the time the share is issued.
- Alternatively, provided the shares are considered to be "qualifying shares" the time for assessing the discount can be delayed until the happening of a future event.

There are similar rules relating to options/rights issued to employees under employee share schemes.

The foregoing taxing regime can cause an employee to have to dispose of part of his/her holding to meet the tax liability that results under Division 13A. This is an undesirable effect of Division 13A in that it can result in a reduction of an employee's holding of shares in their corporate employer.

Capital gains tax ("CGT") applies to shares acquired under employee share schemes with the market value at the time (or deemed time) of acquisition forming the cost base of the shares for future CGT calculation purposes.

The question arises as to what purpose Division 13A serves. The following points can be made:

- If the overall gain, for tax purposes, is calculated by subtracting from the ultimate sale proceeds the amount paid by the employee for the shares (which may be nil) the full gain is (but for CGT indexation) subject to tax either under Division 13A or under the capital gains provisions. If Division 13A did not exist the full amount would still be brought to account under the capital gains tax provisions. Subject to indexation, therefore, the same amount would be brought to account under the combined Division 13A/CGT regime as under a CGT regime.

- The Division 13A regime brings part of the ultimate gain to account for tax purposes at an earlier time; at a time when proceeds have not been released to enable any tax arising under Division 13A to be paid.

- The situation can arise that a loss for CGT purposes results on the sale of shares acquired under an employee share scheme when an amount has previously been included in an employee's assessable income under Division 13A. This has an adverse impact on the employee as the capital loss can only be offset against capital gains derived in the current or a future year.

- Tax arising under Division 13A can cause employees to dispose of shares acquired under employee share schemes prematurely to meet that tax liability.

2 Keeping up with global trends

In considering Australia's employee share scheme legislation, it is worth comparing how other countries have sought to encourage wider share ownership:

United Kingdom

Participation in approved employee share/share option schemes is generally only subject to capital gains tax on the ultimate disposal of the shares. To be an approved share or share option scheme, one of the conditions is that the shares or options must be under restriction for at least three years.

A capital gains tax exemption of GBP7, 100 (increased each year) is available each year, combined with taper relief which ensures that only 60% of any gain arising on the disposal of shares is taxed when the shares are held for at least ten years; this encourages longer term share ownership.

The UK government has recently announced that a new employee share scheme is to be introduced in the 2000 Finance Bill.

The key proposals of the new scheme are:

- Employees can allocate up to £1,500 each year of pre-tax income to shares in their employer's company 'partnership shares'.

- Employers can provide free matching shares of up to two free shares for each partnership share (i.e. up to £3,000 in value each year).

- Employers can also give free shares to employees up to a value of £3,000 each year.

- Employers will get a corporation tax deduction for the salary and shares allocated.

- Free and matching shares which are held in the scheme for three years are free of tax.

- When partnership shares are taken out there may be an income tax charge. The amount of the charge will depend on timing.

There will be an extensive consultation period prior to the introduction of the new scheme.

United States of America

Benefits from participation in an Incentive Share Option scheme are not generally subject to tax until the scheme shares are sold. This concession is available where the options, and the underlying shares, are held for more than three years (other conditions also apply).

To encourage longer term ownership, the capital gains tax rates for shares held for more than eighteen months is capped at 20%.

We understand that the USA is currently moving to a maximum 18% capital gains tax rate for shares held for more than five years.

New Zealand

New Zealand generally seeks to tax employees participating in employee share schemes on the amount of the discount at the time options are exercised or on allocation of shares or when any restriction over the disposal of shares is lifted.

Moreover, since New Zealand does not have a capital gains tax regime, no capital gains tax is payable on the disposal of shares acquired under an employee share scheme.

Recommendation

Our recommendation is that shares acquired under an employee share scheme be dealt with only under the CGT regime and not under the combined Division 13A/CGT regimes. While such a change would in most cases delay the collection of tax, it would not, in the overall scheme of things, result in less assessable income (except for indexation) being reported by the employee in respect of his/her holding of shares under employee share schemes. It would increase participation and encourage longer term holdings.

The $1,000 exemption could be a continuing feature of employee share schemes taxed solely under the CGT regime.

3 Employee share schemes are effectively limited to public companies

While our primary submission is that shares acquired under employee share schemes should be dealt with under the CGT regime, the way in which such shares are presently taxed (under Division 13A) provides a benefit, in the sense of a tax deferral, for qualifying shares acquired by employees under such schemes.

In a broad practical sense, the benefits of Division 13A (i.e. the tax deferral) are only available to employees of listed companies or widely held unlisted companies. They are not, practically, available to employees of closely held unlisted companies, partnerships, trusts, or to employees of the public sector. This is not a design feature of the legislation but, rather, a fact that employers which are closely held private companies, partnerships, trusts or the public sector cannot, easily, issue shares or rights to their employees.

A number of arrangements have been formulated which aim to provide similar benefits to employees in closely held private companies etc; these arrangements seek to provide benefits to employees in the form of deferred compensation i.e. a benefit which is, in a general sense, similar to the benefit provided under Division 13A.

At least one form of these arrangements has been ruled against by the Commissioner of Taxation (refer to Draft Ruling TR98/D12).

Recommendation

We recommend that the type of benefits provided under the present Division 13A should be available to employees of employers who are not able, readily, to take advantage of the employee share scheme legislation.

Stapled Structures

I enclose a copy of a letter dated 25 March 1997 to the Treasurer making a submission in relation to extending the benefit of the employee share scheme provisions to include stapled security structures.

Broadly, the issue in relation to stapled structures (which have gained popularity) is that one needs to analyse a stapled security or option arrangement in terms of both the income tax and fringe benefits tax legislation. This gives rise to multiple taxation of effectively the same benefit and is a major disincentive for clients of our firm from establishing employee share scheme arrangements which both management and employees want established

Appendix A illustrates the multiple taxation point by way of example.

Recommendation

The concept of "share" in the employee share scheme provisions should be extended to include a stapled security which could take the form of any combination of units in a unit trust and/or shares in companies. Consequential amendments to the FBT legislation is required to ensure that the benefit is only taxed under the income tax regime.

Should you have any queries concerning the above, please call either Edgar Baltins (phone (02) 9335 8254) or Andrew Purdon (phone (03) 9288 6648).

Yours faithfully

Edgar Baltins
Partner

Proposed Option Stapled Security Scheme
Tax calculations

Key Assumptions

Number of options	10,000
Option price	zero
Option term	5 years
Current market value of Stapled Securities	$0.75
Exercise price of option	$0.75
Market value of option at exercise	$0.85
Trust unit/share ratio	34/66
Employee share scheme rules apply to shares	
Stapled securities are sold when acquired.	

	Tax Value $	FBT payable by Group	Employee Income Tax $	Notes
Grant of Trust unit option				
Tax value=10,000 x 75cents x 34% x 11.6%	295.50			A
FBT thereon= $295.8 x 1.942 x 48.5%		278.61	Nil	
Grant of share option		Nil	Nil	B
Exercise of Trust unit option				
Tax value=10,000 x (85 less 75) cents x34%	340.00			C
FBT thereon= $340 x 2.129 x 48.5%		351.07		D
Exercise of share option				
Tax value=10,000 x (85 less 75) cents x66%	660.00			
Income tax=$660 x 48.5%			320.10	
Sale of Trust unit				
Tax value=10,000 x (85 less 75) cents x34%	340.00			
Income tax=$340 x 48.5%			164.90	E
Sale of share				
Tax value=10,000 x (85 less 85) cents x66%	Nil	Nil	Nil	
	$1,635.80	$629.68	$485.00	F
Actual Gain = 10,000 x (85 less 75) cents	$1,000.00			
Total tax paid	$1,114.68			
Effective tax rate	111.468%			

Notes

a. This calculation is based on the Black-Scholes model legislated in the income tax employee share scheme provisions.
b. Assume that the employee elects not to pay income tax at this time.
c. Nothing in the FBT rules adjusts the taxable value to reflect FBT paid on the value of the option when granted.
d. The higher FBT gross-up reflects the new factor introduced consequential to GST being introduced.
e. Effective double taxation of this amount arises because nothing deems the employee to have paid market value.
f. $975.80 of the $1,635.80 taxable value relates to Trust units and is 2.87 times the actual gain of $340.

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Hon. Peter Costello MP
Treasurer
Parliament House
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Our ref 212-Thakrl97-2002-L-ESAS

Contact Edgar Baltins 9335 8254
Scott Farrell 9335 7366

25 March 1997

Dear Sir

Employee share acquisition schemes and stapled securities

The purpose of this letter is to draw to your attention an unintended oversight concerning tax legislation effecting government policy on Employee Share Acquisition Schemes ("ESAS').

Income tax legislation currently provides concessions to encourage employees to invest in their employer through the ESAS regime in Division 13A of Part III of the Income Tax Assessment Act.

The ESAS regime currently only applies where employees are issued ordinary shares, or rights to acquire ordinary shares, under an employee share scheme. It does not apply simply where employees are issued with other types of equity, such as stapled securities, which have gained increasing popularity in recent years.

Where investors are issued with units in a unit trust and shares in a company which are stapled together and jointly listed on the Australian Stock Exchange, the securities are commonly referred to as "stapled securities". The stapled unit and share form a single tradeable security which may not be traded separately.

Submission

The ESAS income tax regime should be amended to apply where employees are issued stapled securities or rights to acquire stapled securities by their employer. This is consistent with the policy objectives of these provisions to encourage employee investment in their employer. Consequential amendments should ensure that the FBT legislation does not apply to ESAS arrangements involving stapled securities.

It is submitted that the necessary amendments are probably relatively minor and simple to effect.

Discussion

Appendix A lists a number of groups that are currently listed on the Australian Stock Exchange which have issued stapled securities to investors.

If such groups wish to provide incentives for employees to invest in their employer's business by establishing an employee share scheme:

- the ESAS provisions will apply to the issue of shares or rights to acquire shares. The employee will then be assessed if the shares or rights are issued at a discount; and

- the issue of units or rights to acquire units in a unit trust would be subject to the fringe benefits tax ('TBT') regime as the ESAS provisions have no application. Any FBT liability would be imposed on the employer.

This, technically, appears to be the situation even though the "stapling" of shares and units prevents the units and shares being traded separately. Indeed, the income tax and FBT legislation currently requires a stapled security to be notionally or artificially split into its constituent units and shares and for these constituent parts to be notionally valued separately, even though the commercial reality is that stapled securities must be traded as if they are single securities.

This discourages such groups from establishing employee share schemes due to the imposition of FBT on the employer and the potential for double taxation as the employer and the employee may, effectively, be subject to tax on the same benefit.

> For example, if the stapled securities are issued to employees at a discount, the employer may have an FBT liability on the discount in respect of the units in the unit trust. However, this discount would not be reflected in the WT cost base of the units to the employee.

This is contrary to the intention of the ESAS provisions and Government policy as:

1. The explanatory memorandum to the ESAS provisions stated that one of the purpose of the provisions was to:

   > "ensure that the concessions available are directed at employee share schemes which encourage investment by employees in their employer company, or in their employer company's holding company, and which are available to all permanent employees."

2. The Coalition tax policy in the 1996 Federal Election proposed to make the conditions for concessional treatment of employee share ownership plans easier to fulfil.

We recommend that the ESAS income tax provisions be amended so as to apply to the issue of stapled securities or rights to acquire stapled securities. This would enable listed groups, which have issued stapled securities to investors, to encourage employee investment in their business in the same way as employer companies. Moreover, this is clearly consistent with the policy objectives of the ESAS regime.

Should you have any queries in relation to this request, please contact our Messrs Edgar Baltins or Scott Farrell.

Yours faithfully

Edgar Baltin
Partner

Appendix A

Groups with stapled securities currently traded on the Australian Stock Exchange

Australian Tourism Group

Thakral Holdings Group

BT Hotel Group

Cash Converters International

Grand Hotel Group

Hills Motorway Group

Hoyts Cinema Group

Infrastructure of Australia Group

Matrix Telecom Group

Stockland Trust Group

Transurban Group