

22 October 1999

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

### **Employee Share Plans: CGT Reforms and Employee Buyouts**

Dear Sir,

On behalf of the AEOA I wish to offer the Committee some observations about important matters affecting the future of Employee Share Ownership Plans (ESOPs) the significance of which have become clearer only in recent weeks.

I refer especially to:

- the reform of Capital Gains Tax and its implications for ESOPs (cf. *The New Business Tax System*, Treasurer's Press Release, No. 58, 21 Sep.1999 and the final Ralph Report, *A Tax System Redesigned*);
- the limitations of Division 13A share plans in an employee buyout; and
- the exemption of ESOP trusts from the entity taxation regime.

This letter also seeks to identify the main themes which have emerged from the evidence given to the Committee and to integrate these with our considerations on the above matters.

#### **Impact of CGT reforms**

The changes in the taxation of capital gains will have the effect of re-aligning the relative tax advantages of various share plans:

- The **tax-exempt** Division 13A (Exempt) share plan will be advantaged by the tax reforms. Up to \$1,000 worth of shares, per employee per annum, can be acquired under a tax-exempt share plan. The acquisition value of these shares is exempt from all tax. However, any increase in value is subject to CGT when exempt shares are sold. Under the new regime the CGT will fall more lightly on this gain.
- The **tax-deferred** Division 13A (Deferred) plans will be disadvantaged relative to plans subject to CGT. This is because tax-deferred plans are subject to Income Tax. Tax is levied at the marginal rate on the full value of the shares when sold.
- Share plans which are structured around a loan and which, on this account, are subject to CGT, will be advantaged by the new system relative to the tax-deferred plan.

#### *Discussion*

The key implication seems to be that tax-exempt share plans and share plans utilising loan structures will be relatively advantaged by the changes in the CGT regime. The big winners

from this are more likely to be executives who would be especially attracted to leveraged structures with a lower CGT profile. One might predict that the traditional loan plan will get a fillip from the new tax system. This will not necessarily be the best outcome for rank-and-file employees for whom loan plans, though powerful, contain a heavier burden of risk.

For ordinary employees, the more steady and secure way of acquiring shares in their employer's company is through Division 13A Exempt and Deferred plans. Unfortunately, the CGT reforms favour the Exempt plan over the Deferred. This skews Division 13A in favour of a share plan which, by its very nature, is an 'entry level' structure intended to deliver 'wide' rather than 'deep' employee ownership.

For employees to develop a major stake in their employer's company requires widespread use of well-funded deferred plans. The *New Tax System* could, therefore, reduce employee ownership to small packets of shares for general employees. In order to pre-empt this possibility, the taxation of the Deferred plan needs to be aligned with that of the Exempt plan.

#### *Conclusion 1*

*To align the tax treatment of the Division 13A plans, the Deferred plan should be taxed in the following way: that the principal investment in deferred shares should be taxed at Income Tax rates while any gain in the value of the shares should be taxed at the new CGT rates.*

#### **Employee Buyouts**

It is possible that Australia has reached the point where employee buyouts could become an important feature of the market. The Committee has received evidence from a group of Ansett employees who have developed a proposal to buyout News Limited's half share of Ansett Holdings Limited.

There are other opportunities for employee buyouts. The decision by BHP to sell its long products businesses is likely to signal a widespread sell-off phenomenon as major corporations move to dispose of 'non-core' or poorly-managed businesses. Many of these could be targets for employee buyouts.

#### *Discussion*

The more relevant structure supplied by Division 13A which will support an employee buyout is the Deferred plan.

Deferred plans, however, have a major drawback for a buyout. If employees buyout a whole company, or a large slice of it, then in order to meet their tax liabilities at Year 10, either the employees would have to sell their shares to outside buyers or the company would have to guarantee to buy back the shares. In either case the purpose of the employee buyout would be subverted and in the latter the company would be financially crippled as well.

This problem could be solved - or at least managed - if the 10-year rule were replaced by a regime under which employees were taxed upon disposal of the shares. Alternatively, employee shares could be taxed upon sale or separation from the employer (whichever is the earlier).

#### *Conclusion 2:*

*In order that Division 13A can provide a share plan robust enough to support employee buyouts, the legislation needs to be amended to ensure that Deferred plans are taxed upon sale of shares.*

### **ESOP trusts and entity taxation**

Neither the final Ralph Report - *A Tax System Redesigned* - nor the Government's response to it - *The New Business Tax System* - specifies that share plan trusts will be exempt from the new entity taxation system under which trusts will be taxed as companies.

#### *Discussion*

One might infer from the fact that both Telstra 1 and 2 contain an employee share ownership element designed around a trust-based share plan that the Government does not intend to tax share plan trusts as if they were companies. Certainly, there have been informal and vague 'assurances' from various, and non-authoritative, sources on this point. But the AEOA finds it very strange that the Government, so far, has taken no definitive steps to clarify this issue.

#### *Conclusion 3*

*The Government needs to make, as a matter of some urgency, a clear and unambiguous exemption of share plan trusts from the entity taxation system.*

### **The ESOP agenda - recommendations**

The above observations suggest that the Federal Government needs to formulate, in the light of this Committee's advice, a national agenda for Employee Share Ownership and to implement it as an integral part of its existing program of taxation reform.

If one were to draw together the above considerations with the key issues which seem to have emerged from the evidence placed before your Committee, then it would seem that the Committee should recommend the following: -

1. **The need to tax employee shares at the time of sale.**
2. **The need to align the taxation of Division 13A plans.** Any increase in the value of both exempt and deferred shares should be taxed at CGT rates.
3. **The need for ESOPs to employ a wider range of equities** - indeed, any equity, in the employer's company.
4. **The need to liberalise the 5 per cent limit on an individual employee's acquisition of voting shares** - for example, a 10 per cent limit for companies with 100 employees or less.
5. **The need for prospectus requirements to serve rather than to restrict the spread of ESOPs.** The AEOA recommends the extension to ESOPs of the simplified prospectus requirements contained in the CLERP legislation.
6. **The need clearly to exempt ESOP trusts from the new entity taxation system.**

**General Conclusion**

The above measures could be implemented with limited, surgical amendments to Division 13A of the Income Tax Assessment Act. A major rewrite of the legislation does not need to be attempted - nor should it even be contemplated. These limited measures would amount to a major expansion of employee ownership in Australia, especially among private and unlisted companies.

Australia is on the threshold of a major change in the culture of the workplace where, increasingly, employees aspire to be more directly engaged in the businesses for which they work. To achieve this objective, however, Industrial Relations reforms cannot suffice. Active participation by employees in the ownership of businesses must accompany IR changes. This can only be achieved in an environment defined by flexible employee share plan legislation and by an ESOP-friendly tax administration.

The AEOA looks to the Committee to recommend to Government, in the most persuasive terms, the virtue of this proposal.

Yours sincerely

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1 November 1999

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

Attention: Andrew Brien

**Employee Share Plans: CGT Reforms and Employee Buyouts**

Dear Sir,

I refer to our conversation of earlier this day and to the AEOA's letter of 22 October on the above subject.

Unfortunately, there were some proof-reading errors in this document. I enclose a corrected version with which to replace the version you have already received. This corrected version is indicated by my initials on page 3, the corrected page.

Yours sincerely

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