Chapter 3

Governance and taxation

Legislation

3.1 Australian governments have 'sought to reform the taxation regime' to facilitate employee share ownership since the mid-1970s, with the first legislative provision introduced in 1974. Changes to the legislation have been made in the mid-1990s.[1]

Income Tax Assessment Acts 1936 and 1997

3.2 The main legislation governing employee share schemes are Division 13A of the *Income Tax Assessment Act 1936* and Subdivision 130-D of the *Income Tax Assessment Act 1997*. They outline the treatment of shares and rights acquired from a scheme regarding both income and capital gains tax (CGT).[2] The Government's proposed changes will amend the ITAA 1997.[3]

3.3 Division 13A applies concessions to shares or rights in the employer company or a holding company of the employer. Shares need to be ordinary shares and need to have been acquired at a discount. While shares or rights can also be provided to employees or their associates, only shares or rights provided to an employee are eligible for the tax concessions.[4]

3.4 Under Division 13A, the issuing of employee shares or rights is treated 'as a substitute for cash income for services', with tax imposed at marginal income rates at acquisition. [5] A taxpayer participating in a qualifying employee share scheme, subject to certain conditions, can choose whether to pay tax upfront or defer the taxation until

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1 Ann O'Connell, Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 5–6.

2 ATO, Employee share schemes—answers to frequently asked questions by employees, http://www.ato.gov.au/print.asp?doc=/content/24703.htm (accessed 7 July 2009).

3 The Hon Senator Nick Sherry, Assistant Treasurer, 'Taxation of Employee Share Schemes', Press release No. 011, 1 July 2009.

4 Ann O'Connell, Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 9–10.

5 Ann O'Connell, Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 8.

a later time.[6] 'The taxable income is adjusted to add reportable fringe benefits, superannuation contributions and negative gearing losses'.[7]

3.5 Qualifying schemes must satisfy the following relevant requirements:

- a share or right is acquired under an employee share scheme;
- the company from which the shares are acquired is the employer;
- the shares are ordinary shares;
- at least 75 per cent of the permanent employees of the company were entitled to acquire shares under any employee share scheme of the employer; and
- after acquiring the shares, the employee does not hold more than either five per cent of the total shares in the employer or more than five per cent of the voting rights.

3.6 Non-qualifying schemes are taxed upfront.[8]

Tax-exempt scheme

3.7 Under the current tax-exempt scheme, up to $1,000 of shares annually are free of income tax.[9] There is no income limit in relation to the upfront taxation.[10] In addition, the shares or rights:

- must meet all the relevant conditions for a qualifying scheme;
- must be subject to no risk of forfeiture;
- cannot be disposed of for a minimum of three years (unless employment ends earlier); and
- must be acquired under a scheme operated on a non-discriminatory basis.[11]

3.8 An employee will have to declare any discount (difference between the market price and the price paid at acquisition) as income.[12] The discount is included in

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6 The Hon Wayne Swan MP, Treasurer, 'Better targeting the employee share scheme tax concessions', Media release, 12 May 2009, No. 063.

7 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 35.

8 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 6, footnote 1.

9 The Hon Senator Nick Sherry, Assistant Treasurer, 'Taxation of Employee Share Schemes', Press release No. 011, 1 July 2009.

10 Michael Willcock, *Proof Committee Hansard*, p. 7.

11 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 7, footnote 2.

the assessable income in the income year the shares or rights are acquired (section 139E election).[13] Any subsequent capital gains are subject to capital gains tax (CGT), and the 50 per cent CGT discount may apply.[14] If the shares are held over 12 months, half the capital gain is taxed at the employee's marginal income tax rate; if held for less than a year, CGT is levied on the entire gain.[15] A study noted:

> This may mean that it is advantageous to bring forward the taxing time under Division 13A and receive less of any relevant gain in the value of shares or rights as an 'income' gain subject to tax under Division 13A and more of any relevant gain as a 'capital' gain.[16]

Tax-deferred scheme

3.9 Under the current legislation, the tax-deferred scheme allows employees to defer income tax payments on the value of received shares. Income tax becomes payable on the full value on the day of sale or after 10 years, whichever is sooner. If shares are held beyond 10 years, capital gains tax is payable on any growth after that date.[17] The $1,000 tax exemption does not apply.[18]

3.10 The *Tax Laws Amendment (Budget Measures) Act 2008* (Act number 59 of 2008) requires employees to make an election and 'disclose the amount of the discount in respect of shares or rights in income tax returns of employees' from the 2008–09 income year onwards.[19]

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12 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p.6.

13 ATO, Employee share schemes—answers to frequently asked questions by employees, http://www.ato.gov.au/print.asp?doc=/content/24703.htm (accessed 7 July 2009).

14 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 13.1.

15 David Hetherington, 'Employee share ownership and the progressive economic agenda', 2009, p. 13.

16 Ann O'Connell, Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 16.

17 David Hetherington, 'Employee share ownership and the progressive economic agenda', 2009, p. 13.

18 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 13.2.

19 Remuneration Strategies Group, *Submission 11*, p. 22; *Tax Laws Amendment (Budget Measures) Act 2008*, Part 2.

Tax treatment of employer

3.11 Employers providing shares or rights eligible for the upfront concession are eligible for a $1,000 deduction per 'each employee to whom shares or rights are provided in that income year'.[20]

3.12 Where shares or rights are acquired on market by the trust administering a scheme, a tax deduction will be available. The employer 'may be entitled to claim a deduction for some of the costs associated with the scheme'. Provision of financial assistance to employees in relation to acquiring shares or rights 'could give rise to fringe benefits tax liability'. An employer can provide a loan for an employee to acquire shares or rights at a discount without being subject to tax.[21]

Other tax considerations

3.13 Under a takeover or corporate restructure, an employee's taxing point could be triggered at the acquisition of shares or rights. However, under certain conditions, such as if the takeover or restructure is for 100 per cent of the company and the 'consideration received is "matching shares or rights"', rollover relief is available.[22]

3.14 For an individual who works in more than one country or changes their country of residence, Division 13A will apply at the point of that individual becoming an Australian employee.[23]

Corporations Act 2001

3.15 *Corporations Act 2001* is the leading piece of legislation governing corporations. It 'contains a number of general requirements relating to disclosure, fundraising and licensing that are relevant to the initial implementation and ongoing administration' of an employee share scheme. It does not 'provide for different

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20 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 13.1.1.

21 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 14–16, 22.

22 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 17.

23 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 17.

treatment of employee shares'.[24] The Corporations Act allows for the cancellation of employee share scheme shares 'pursuant to a buy-back or capital reduction'.[25]

3.16 Under the Act, companies with an employee share scheme are required to issue a prospectus to facilitate investors' access to information. Three exemptions are available from the disclosure requirements: the offer is small scale; it is provided at no cost; or, if the company is aiming to raise no more than $5 million, it may use a simpler form of disclosure document, an Offer Information Statement, instead of a full prospectus.[26] The legislation requires mandatory reporting of a company's remuneration policy.[27]

3.17 The Australian Securities and Investments Commission (ASIC) has power under the Act to specify exemptions from the disclosure requirements. ASIC Policy Statements and Class Orders 'provide conditional relief from specific disclosure and licensing provisions' for companies establishing eligible employee share schemes.[28] The policy applies to situations where the purpose of the share offer is to encourage employee involvement in the corporation; it does not cover fundraising purposes.[29] The exemptions follow from the perceived reduced risk of non-disclosure due to the employer–employee interdependency.[30]

Other guidelines

Australian Stock Exchange Listing Rules

3.18 Employee share schemes in Australian listed companies are also regulated by the Australian Stock Exchange (ASX) Listing Rules. Companies are not to release more than 15 per cent of their shares in any rolling 12 months or to issue equity securities to a person 'in a position to influence the entity'—other than an employee

24 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, p. 1.

25 Employee Ownership Group, *Submission 29*, p. 11.

26 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 2–3.

27 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 20.

28 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 1, 4.

29 ASIC, Employee share schemes, Regulatory Guide 49, p. 3.

30 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, p. 4.

under an employee share scheme—without shareholder approval. If providing financial advice in relation to an employee share scheme, companies must hold an Australian Financial Services Licence (AFSL). Exempted from this requirement are trusts and companies that clearly state their advice is of generic nature and that employees should seek independent financial advice.[31]

Accounting and other standards

3.19 Many associations, including the Investment and Financial Services Association (IFSA), the Australian Employee Ownership Association (AEOA), the Australian Shareholders Association (ASA) and the Australian Institute of Company Directors (AICD), set standards for the implementation and administration of employee share schemes in Australia. Employee Share Scheme Guidelines provide guidance in the development of broad-based schemes, including in the structure, number of shares, and transparency and accountability.[32]

3.20 In addition, the Australian Accounting Standards Board (AASB) provides guidance in relation to accounting practices, including requiring companies to disclose share-based transactions in their financial statements. These include shares issued under an employee share scheme.[33] Recent changes to the standards 'require companies to expense share-based compensation…measured at the fair value', which has caused concern that share schemes 'will impact on the company's profitability' without actual tax deductible expense. Accounting Standard AASB124 requires 'disclosure of the value of all forms of executive remuneration'.[34]

Compliance

3.21 The reasons behind the Government's introduction of new measures to the taxation of employee share schemes relate to identified compliance problems. Some taxpayers had:

- retrospectively attempted to elect to be taxed upfront on the 'discount' in order to gain access to the CGT discount for gains accruing since acquisition;

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31 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 8–10.

32 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, p. 11.

33 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, p. 11.

34 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 14, 20.

- failed to include the discount in their assessable income at the cessation time; and
- incorrectly applied the CGT rules to the 'discount' instead of including it in their assessable income.

3.22 The Government has aligned its policy regarding equity-based remuneration with that of the Australian Prudential Regulation Authority (APRA), considering performance-based remuneration to be '"at-risk" of forfeiture until the individual's performance can be validated'. This is to provide incentives for the executive to act in the best interests of the company and observe good risk management practices. This will be achieved by deferring some or all of the 'performance-based remuneration until the end of a deferral period'.[35]

35 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraphs 24–25, http://www.treasury.gov.au/documents/1559/PDF/consultation_paper.pdf (accessed 15 July 2009).