Chapter 5

Recent developments regarding employee share schemes

Background

5.1 On 12 May 2009, as part of the 2009–10 Budget, the Treasurer, the Hon Wayne Swan MP, announced new measures to target employee share scheme tax concessions and to reduce opportunities for tax avoidance.[1]

5.2 Currently, employees participating in an employee share scheme 'pay tax on any discount on the full value of a share or option'.

5.3 The Government's budget measures were put in place to remove the inconsistency which currently exists between upfront and deferred taxation. Some taxpayers had also used the deferral method to avoid tax. The measures 'help ensure everyone pays their fair share of tax'.

5.4 The Government proposed that:

- all discounts be 'assessed in the income year in which they are acquired';
- deferral option not be provided; and
- access to the $1,000 upfront concession is limited to those employees with a taxable income of less than $60,000.

5.5 The Government justified the income limit by data collected by the Australian Bureau of Statistics suggesting that a majority of employees now holding shares are below the $60,000 threshold.

5.6 The Government noted that the abolition of upfront tax exemption would 'adversely affect low to middle income employees who predominantly use' it. Employers providing shares or rights eligible for the upfront concession will remain eligible to deduct up to $1,000 per each employee who has received shares or rights.[2]

5.7 However, these conditions caused many concerns. They related to the $60,000 threshold which was said to be too low and discourage participation in employee share schemes and result in additional administrative costs. Further:

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1 Information is based on the following source unless otherwise indicated: The Hon Wayne Swan MP, Treasurer, 'Better targeting the employee share scheme tax concessions', Media release, 12 May 2009, No. 063.

2 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraphs 51– 52.

- many companies do not have enough employees with incomes below the threshold to justify the additional costs;
- upfront tax liability may occur in relation to benefits that may never be realised;
- changes 'run counter to best practice' in remuneration and will increase cash remuneration;
- small and early-stage companies are particularly adversely affected; and
- changes will discourage employee share schemes.[3]

5.8 In addition, there was dismay at the Government not having consulted the stakeholders about the new policy.[4] Many big scheme providers put their schemes on hold in anticipation. The Government developed a policy paper for consultation.

5.9 Mr Michael Willcock, General Manager, Treasury, noted that there have been longstanding provisions in tax legislation for concessional treatment of employee share schemes in certain circumstances, facilitating the alignment of employer and employee interests in the operations of the company.[5]

Consultation

5.10 On 5 June 2009, the Treasurer and the Assistant Treasurer, The Hon Chris Bowen MP, released a briefing paper 'Reform of the taxation of employee share schemes' and draft legislation for consultation. The Government stated:

> Given the community concerns with the changes announced on Budget night and the possible unintended adverse impacts on employee share scheme arrangements for ordinary employees, the Government has fast-tracked the consultation process.[6]

5.11 The Government noted that the taxation of discounts on shares and rights upfront 'will remain its starting principle'. It modified its budget measure by the following:

- raising the income threshold for the $1,000 tax exemption from $60,000 to $150,000;
- introducing a limited deferral of the taxing point for some schemes to be the earliest of 'a point at which the taxpayer will no longer have a real risk of not

3 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraphs 34 and 55.

4 See for example Remuneration Strategies Group, *Submission 11*, p. 24.

5 Michael Willcock, *Proof Committee Hansard*, p. 3.

6 Treasury, 'Reform of the taxation of employee share schemes', http://www.treasury.gov.au/contentitem.asp?ContentID=1559&NavID=066 (accessed 14 July 2009).

being able to exercise the share, cessation of employment or seven years after acquisition of the right (down from 10 years);[7]

- introducing an annual reporting requirement and associated withholding arrangements by companies that participate in these schemes;
- reviewing the existing rules for valuing discounted and deferred shares and rights; and
- modifying the rules relating to the refund of income tax for forfeited benefits.[8]

5.12 These modifications aim to address the compliance and excessive concessionality problems.[9]

5.13 In relation to the above points, the Government considered it important to maintain the 'no risk of forfeiture' condition for the eligibility for the $1,000 exemption.[10] This includes performance hurdles and requirement to serve a minimum term of employment. However, 'a condition that merely restricts an employee from disposing of a share or right for a specified time carries with it no genuine risk of forfeiture'.[11]

5.14 The Government also introduced partial vesting conditions, that is, an employer offering an employee share scheme should allow an employee with shares that have otherwise not vested to obtain some of the shares at cessation of employment to cover any taxation obligations.[12]

5.15 Regarding upfront taxation, a taxpayer would be treated 'as having never acquired a right' that does not vest or is 'forfeited without the taxpayer having either exercised or transferred it'.[13] A refund is available if the shares are genuinely forfeited.[14] However, a refund would not be available if the forfeiture or inability to vest is a result of the employee's choice. An example of this is a situation where a taxpayer has obtained rights to shares but loses them without having exercised them as

7 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraphs 64 and 65.

8 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 6.

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

10 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 50.

11 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 61.2.

12 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 18.

13 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 110.

14 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 18.

a result of not meeting performance hurdles or if the employee has chosen to forfeit due to adverse market conditions.[15]

5.16 Regarding reporting requirements, the employer is required to provide an annual statement to the Taxation Office stating the number of shares, estimated market value, etc., for each employee who has received shares.[16]

5.17 The Government proposed limited withholding requirements for the employer in cases where an employee refuses to provide their tax file number (TFN) or Australian Business Number (ABN). It acknowledged that withholding may raise 'both legal and practical difficulties, since there is no payment from which to withhold' in the case of non-cash benefits. It considered that since the 'case' is stronger when an employee refuses to provide their TFN or ABN to the employer, a limited form of withholding would apply to these cases.[17]

5.18 The new arrangements commenced on 1 July 2009, with the existing law applying to shares and rights acquired before that date.[18]

5.19 The Treasury received 65 submissions, of which 53 were public submissions and 12 confidential.[19] Industry representative bodies put their members' concerns to government.[20] The submissions suggested a number of changes to the operation of employee share schemes, including:

- taxing of benefits when shares vest or when they are sold or otherwise disposed of instead of taxing them upfront;
- removing the option to elect upfront taxation, including $1,000 exemption;
- providing concessions to small businesses;
- introducing additional compliance activities for the ATO rather than new legislative powers; and
- improving reporting arrangements through introduction of tax file number-based reporting, tax withholding and employer reporting.

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15 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 109, 111.

16 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraph 73.1.

17 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 21.

18 Treasury, 'Reform of the taxation of employee share schemes', http://www.treasury.gov.au/contentitem.asp?ContentID=1559&NavID=066 (accessed 14 July 2009).

19 Treasury, 'Reform of the taxation of employee share schemes', http://www.treasury.gov.au/contentitem.asp?NavId=066&ContentID=1573 (accessed 14 July 2009).

20 Michael Willcock, *Proof Committee Hansard*, p. 5.

5.20 Consultation also highlighted opposition to the changes applying to the financial year 2008–09.[21]

Final policy position

5.21 Responding to the proposals from the consultation round, the new Assistant Treasurer, The Hon Senator Nick Sherry, announced the particulars of the new scheme on 1 July 2009:

5.22 Tax is to be paid upfront 'except where there is a real risk of forfeiture or where it comes from a capped [eligible] salary sacrifice based scheme';

- The income tax threshold for eligibility for the upfront tax concessions was further lifted from $150,000 to $180,000;
- The deferred taxing point is the earliest of:
  - for *shares*—a point at which 'there is both no longer a real risk of the taxpayer losing the share and no restriction [at acquisition] preventing the taxpayer from disposing of the share';
  - for *rights,* (options)—a point when 'there is both no longer a real risk of the taxpayer losing the right and no restriction [at acquisition] preventing the taxpayer from either disposing or exercising of the right';
  - cessation of employment; or
  - seven years.
- The deferral of tax is allowed, in particular for salary sacrifice-based schemes, for up to $5,000 worth of shares;
- An annual reporting requirement for employers offering schemes—Employers are required to estimate the market value of shares and rights at an employee's taxing point; and report the number of shares and rights at both grant and taxing point;
- A limited form of withholding is introduced in cases where an employee fails to provide their employer with a tax file number (TFN) or Australian Business Number (ABN); and
- Refund of income tax will apply to forfeited benefits unless forfeiture or inability to vest is a result of choice by the taxpayer.[22]

5.23 The Assistant Treasurer said that these changes would increase integrity through reporting and improve corporate governance outcomes 'by requiring most

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

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

schemes to feature a real risk of forfeiture to gain access to the deferral tax concession'.[23]

5.24 The Government recently advised that it is conducting 'a two-week consultation period on a draft Exposure Bill' in August. More than a month after the release of the draft Exposure Bill, the Board of Taxation is to report on the consultation on technical issues.[24]

5.25 The Board of Taxation, due to report by 28 February 2010, is also conducting a 'comprehensive' review on:

- 'how to best determine the market value of employee share scheme benefits; and
- whether shares and rights under an employee share scheme at a start-up, R&D or speculative focused company should have separate tax deferral arrangements'.[25]

5.26 The Assistant Treasurer stated that following the consultation process, the legislation will be introduced into Parliament in the spring sittings.[26]

Current reviews

5.27 In addition to the Government's reviews, there are a number of other bodies that are conducting reviews on similar or related matters.

- The Productivity Commission is conducting an inquiry into executive remuneration, with the results due in December 2009.[27]
- A review into Australia's future tax system (the 'Henry Taxation Review') is also due to deliver its report in December 2009.[28]
- The Australian Prudential Regulation Authority's (APRA) inquiry examines the governance of remuneration in APRA-regulated institutions, with the report expected to be released in September 2009; and

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

24 The Hon Senator Nick Sherry, Assistant Treasurer, 'Details of further industry consultations on employee share schemes tax reforms', Media release no. 017, 24 July 2009.

25 The Hon Senator Nick Sherry, Assistant Treasurer, 'Details of further industry consultations on employee share schemes tax reforms', Media release no. 017, 24 July 2009.

26 The Hon Senator Nick Sherry, Assistant Treasurer, 'Minister releases spring sittings program for major tax measures', Media release no. 029, 11 August 2009.

27 Productivity Commission, Executive remuneration home page, http://www.pc.gov.au/projects/inquiry/executive-remuneration (accessed 20 July 2009).

28 Treasury, Australia's future tax system, http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm (accessed 20 July 2009).

- The Senate Economics Legislation Committee is looking into the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009.[29]

5.28 A number of submissions pointed out that if the draft legislation was introduced in the Parliament in the spring sittings, the proposed changes would be 'happening ahead of, and in isolation from, the Productivity Commission enquiry into executive pay and the broader review of the tax system'.[30] Submissions and witnesses supported delaying the employee share scheme legislation until the results of the other reviews are available. The Institute of Chartered Accountants noted that 'It is imperative that the tax rules that apply to [employee share schemes] are considered to be consistent with, and supportive of, the broader best practice' and that the Government had indicated it is prepared to revisit the tax rules after Productivity Commission report is handed down.[31] They also urged the Board of Taxation to engage 'with those smaller companies' to hear from them directly in order to inform the new legislation.[32]

5.29 The Institute of Chartered Accountants supported the implementation of reporting requirements immediately from 1 July 2009, with 'any significant changes to the underlying policy objectives' being held off until the review findings are available.[33]

5.30 The Australian Bankers' Association (ABA) supported delaying the legislation until after the reviews have been concluded, at the same time noting, however, that 'the problem is that the banks want certainty as soon as possible over their employee share scheme arrangements so ABA's preference is for legislation to proceed quickly, albeit with the changes outlined above'.[34]

Committee view

5.31 The committee agrees with the submitters regarding the importance of having integration in legislation and recommends that the Government delay the introduction of legislation in the Parliament in order to take note of the other reviews underway and to provide certainty once and for all to employers administering the schemes. While delaying legislation is the preferred option, the committee notes that some

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29 For further details, see Senate Economics Legislation Committee, Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009, http://www.aph.gov.au/Senate/committee/economics_ctte/termintation_payments_09/index.htm (accessed 20 July 2009).

30 Hay Group, *Submission 15*, p. 1.

31 Institute of Chartered Accountants, *Submission 16*, p. 5, and Mr Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, p. 36.

32 Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, p. 43.

33 Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, p. 37.

34 Australian Bankers' Association, *Submission 31*, p. 3.

witnesses would also accept introducing some of the proposals, such as the reporting and withholding requirements, early and amending the legislation after the review findings have been handed down.

Recommendation 2

5.32 The committee recommends that the Government delay the introduction of the employee share scheme tax legislation in order to take note of the other reviews in this area, including the Productivity Commission and Board of Taxation and the Henry reviews, to maintain legislative integrity and coherence.

Expert panel

5.33 The Board of Taxation has established a panel of experts to advise on employee share schemes, with the first meeting held on 10 August 2009. The panel is expected to review the draft legislation and its consistency with the policy statement. A previous advisory body was broader in expertise, with representatives from tax and corporate law and human resources. It has not met since mid-2007.[35]

35 Sarah Bernhardt, *Proof Committee Hansard*, 27 July 2009, pp. 29–30.