Chapter 6

Comments on proposed changes

General comments

6.1 This section examines the comments regarding the Government's proposed changes to the employee share scheme regulations.

6.2 The Institute of Chartered Accountants (ICA) noted, on the pre-budget position, that 'as a starting point, that there were no major flaws in the policy position or the legislation giving effect to the policy that warranted significant changes, other than changes aimed at improving and enhancing the reporting framework to address the integrity or the perceived integrity concerns identified by the ATO'. Their tax counsel considered that these changes could have been achieved through the reporting requirements without 'a need to substantially or in any material way change the underlying tax laws'. He further noted that the top priority is 'to provide certainty for both employers and employees'.[1]

6.3 The ICA noted that the Government's revised policy is not perfect' and that 'there are still some issues which require further changes' but that it 'is a significant improvement on the original [policy announcement]' and 'considered to deliver outcomes which will allow many Australian companies to re-instate [employee share schemes] that they had previously suspended'. The ICA submitted that whilst the revised position is a 'reasonable compromised outcome for all key stakeholders', 'there are some residual issues where further changes to the 1 July policy announcement could be made to further improve the overall outcome for all stakeholder groups'.[2]

6.4 According to the Corporate Tax Association (CTA), the Government's 'unexpected changes announced in the May 2009 Budget created unprecedented levels of concern among those companies and initially resulted in many plans being suspended' before the release of the Government's policy statement which 'largely restores the position' that existed before the Budget announcement. The CTA regards it as 'a positive signal' of the Government's 'continuing support through the tax system of employee participation in broad based equity plans'.[3]

6.5 However, most submissions and commentators have been more critical of the proposed changes and anticipate a series of consequences, including:

- Suspension of employee share schemes in many companies until there is more certainty about the legislation;

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1 Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, pp. 32 and 39.

2 Institute of Chartered Accountants, *Submission 16*, p. 2.

3 Corporate Tax Association, *Submission 26,* p. 1; see also Ernst&Young, *Submission 23*, p. 1.

- Increase in the number of equity allocations and requests for private binding rulings from the Australian Taxation Office;
- Decrease in voluntary and compulsory deferred share benefit programmes; and
- Replacement of deferred share benefits programs with deferred cash programmes.[4]

6.6 The following section outlines the main concerns expressed in the evidence to this inquiry. These include: consultation; tax exemption; income threshold; taxation point; real risk of forfeiture; and legislative and compliance matters.

Consultation

6.7 A number of submitters commented on the lack of consultation prior to the budget announcement regarding changes to the employee share schemes. Ms Sarah Bernhardt, Tax Adviser to Rio Tinto, noted that considering that the provisions had been in place for the past 14 to 15 years, she 'was quite surprised that…something like that was announced without any discussion' and that 'some discussion would have been a good idea'. She did acknowledge, though, that the Government mended the situation quickly afterwards.[5]

Committee view

6.8 The committee notes the lack of consultation with the stakeholders in the lead-up to the budget announcement regarding employee share schemes and the dismantling of the previous advisory group in this area. It considers stakeholder consultation very important, of which the public concerns regarding the proposed changes to the employee share scheme tax legislation and the Government's subsequent changes to the proposal are a testament.

6.9 However, noting the recent establishment of a new advisory body, to which the committee referred in an earlier chapter, the committee supports the Government in its endeavour to consult the stakeholders more formally. The committee urges the Government to ensure that the members represent a broad range of backgrounds to ensure that all angles are considered in its advice to the Government. The committee in particular refers to the coming together of various sets of laws and corporate governance, including human resource, in the administration of employee share schemes.

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4 CRA Plan Managers, *Submission 8*, pp. 10–12.

5 Sarah Bernhardt, *Proof Committee Hansard*, 27 July 2007, p. 31.

Tax exemption and income threshold

$1000 tax exemption

6.10 The Government has proposed a $1,000 tax exemption or concession for employee share scheme participants earning under $180,000. Many submitters considered the $1,000 exemption too low and suggested increasing it (to somewhere in the range of $1,500 to $5,000) to encourage employers to set up an employee share scheme.[6] They pointed out that with the exemption not having been indexed and marginal tax rates having changed 'significantly' since 1997, the tax benefit to employees was said to be no more than $315 or $395 today.[7] With median wages having risen by over 40 per cent, the exemption is now equivalent to less than two per cent of the median wage.[8]

6.11 As noted in Chapter 4, the Australian exemption limit is low in international comparison. Ernst&Young pointed out that in the UK, an employee can annually obtain £3,000 worth of shares tax free, and if he or she contributes to the cost of shares through pre-salary sacrifice, the annual limit doubles to £6,000 (approximately A$12,500). These limits do not include shares paid for by employees.[9]

6.12 The Howard Government rejected the indexation of the concession on the grounds that this 'would be anomalous given that neither personal income tax scales or the income free threshold are indexed'.[10]

6.13 Mr Hetherington noted that some of the taxation arrangements around the employee share schemes do not adhere to the simplicity principle. Currently, an employee can acquire $1,000 worth of shares tax free and either pay normal capital gains tax on 50 per cent of the gain upon disposal or defer taxation until a later time for up to 10 years, paying tax at regular marginal rates (deferral plan). According to Mr Hetherington, 'This level of tax can be up to double the amount of tax paid by someone holding the shares as ordinary investment'.[11]

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6 Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 48; also see David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 20.

7 Employee Ownership Group, *Submission 29*, p. 3.

8 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 20.

9 Ernst&Young, *Submission 23*, p. 4.

10 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. 27.

11 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 20.

Income threshold

6.14 The Government's proposal for eligibility for the $1,000 exemption is an annual income of up to $180,000. The concessions targeted the lower and middle income earners. This proposal has generated comments regarding both the exemption as well as the income threshold. The Treasury stated that the introduction of the income threshold would 'save in the order of $5 million a year'.[12]

6.15 The main concern among submitters and witnesses was that both employees and employers would not be able to assess employees' eligibility to participate in the scheme, particularly because many employees would have income from other sources.[13] Another concern related to situations where the majority of employees in a company earn in excess of $180,000 and employers might be reluctant to provide a tax exemption scheme because they would be 'unable to comply with the 75 per cent requirement' and because it would be 'unfair to large sections of their workforce'.[14] Guerdon Associates noted:

> This uncertainty will discourage employers from offering employee share schemes and discourage many employees from participating in such schemes, which will prevent the new provisions from achieving their stated objective.[15]

6.16 The Financial Sector Union supported aligning the means test to the top marginal tax rate because high income earners are more likely to be able to meet the immediate taxation requirements.[16]

Committee view

6.17 The committee notes that while some submitters and witnesses have argued for no cap on the income eligible for the $1,000 tax exemption, most believe that the Government's increase of the threshold from $60,000 in the budget measure to $180,000 is an improvement on the budget announcement. It notes the concerns regarding additional monitoring requirements on employers but that there were more primary concerns regarding the legislation.

Taxation point

6.18 There was confusion among the submitters and witnesses regarding the underlying policy rationale for tax concessions. Various aspects of the tax treatment

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12 Marty Robinson, *Proof Committee Hansard*, 27 July 2009, p. 16.

13 Australian Institute of Company Directors, *Submission 12*, Attachment 1, p. 2; also see Guerdon Associates, *Submission 6*, p. 7.

14 Guerdon Associates, *Submission 6*, p. 7; also see Ernst&Young, *Submission 23*, p. 3; Deloitte, *Submission 28*, p. 7.

15 Guerdon Associates, *Submission 6*, p. 7.

16 Financial Sector Union, *Submission 22*, p. 4.

are said to be inefficient and biased towards listed companies. There is also different tax treatment of employee share owners compared with other investors and different types of employee remuneration.[17]

6.19 For example, under Division 13A of the Income Tax Assessment Act (ITAA) deferred-scheme shares are 'effectively subject to twice the level of tax on capital gains' relative to those acquired by ordinary means. There were calls for similar treatment for all capital gains, including in relation to the taxation of unrealised capital gains on shares held for more than 10 years under the deferred-tax scheme.[18] A report noted calls for the value of shares to be taxed as capital gains similarly to tax exempt scheme shares, instead of as income, explaining:

> As there is no limit on the amount of shares that can be obtained through the deferred tax liability concession, this differential treatment arguably favours the plan that is *less* likely to facilitate individual employees' owning more shares. The counter argument, however, is that these changes would only increase the complexity of the relevant taxation provisions, and potential complexity raises the prospect of some new form of tax avoidance.[19]

6.20 A number of submitters expressed concern that the five per cent limit in relation to share ownership and casting votes in qualifying schemes would be problematic to small businesses and in succession planning.[20] In the coming years, a large number of small businesses will be closing when baby boomers retire 'unless they can find buyers for their businesses'. Employee share schemes could facilitate retirement through maintaining and improving productivity and employment; preserving retirement equity; and offering the possibility of full sale to employees.[21] However, the current five per cent restriction prevents employer buyout. The Employee Ownership Group proposed that the new employee share scheme rules exclude 'employees purchasing a controlling interest in a company'.[22]

6.21 Discussion during the hearing noted the risk in concentrating shares in one entity, such as the employer company, and noted the loss some US employees

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17 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. 28.

18 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 19.

19 Jarrod Lenne, Richard Mitchell and Ian Ramsay, *Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes*, Employee Share Ownership Project, University of Melbourne, 2005, pp. 23–24.

20 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. 26.

21 Dwyer Lawyers, *Submission 7*, p. 1.

22 Employee Ownership Group, *Submission 29*, p. 6.

suffered in the global financial crisis.[23] Mr Paul Ellis, Member, Employee Ownership Group, noted that 'a large part of that issue in the US was because the employer-funded retirement plans were investing in the company's own shares. We do have safeguards within the superannuation legislation here in Australia that will prevent that happening'.[24]

6.22 Another difficulty identified in the evidence relating to small businesses is the requirement to offer schemes to three-quarters of permanent employees that have been employed for at least 36 months. New companies may not be able to satisfy this requirement. However, the Commissioner of Taxation has the discretion to determine that the condition has been satisfied if the offer has been made at least to 75 per cent of current employees in a new company.[25]

6.23 It was understood that the proposed legislation would allow employees to participate in both the tax-exempt and tax deferred schemes.[26]

Taxing upfront

6.24 The Government's policy proposal to tax shares and rights upfront on acquisition is aimed at ensuring compliance, particularly in relation to taxpayers who move overseas after ceasing employment in a company whose shares they possess.[27]

6.25 Most submissions and studies commented on the timing of taxation of shares and options. There was little if any support for taxing at acquisition, with most comments supporting taxation at the realisation of income. They pointed out that taxation on acquisition is 'out of step with global standards'. A study found that none of the 40 countries surveyed had a similar taxation arrangement; rather, they taxed shares at realisation of benefits.[28] In addition, the employee receiving the award should not be prohibited from selling the awards. Submitters agreed that the vesting date should be 'the date the employee physically receives the shares'.[29] 'As a fundamental principle, individuals should not be required to pay tax before they have realised the cash gain'.[30]'

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23 Senator Hurley, *Proof Committee Hansard*, 27 July 2009, p. 73.

24 Paul Ellis, *Proof Committee Hansard*, 27 July 2009, p. 74.

25 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. 26.

26 Paul Ellis, *Proof Committee Hansard*, 27 July 2009, p. 71; also see Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 83.

27 Guerdon Associates, *Submission 6*, pp. 6–7.

28 Baker and McKenzie, *Submission 1*, p. 2.

29 Rio Tinto, *Submission 9*, p. 2; see also Hay Group, *Submission 15*, p. 8.

30 Institute of Chartered Accountants, *Submission 16*, p. 3.

Refund

6.26 Upfront tax payment gives rise to a tax refund in cases where an employee has paid tax on rights or options that have never vested. However, an employee is not eligible for refund if he or she has chosen to forfeit the right or option.[31] This situation could arise when options are out of the money. It was argued that while choosing to forfeit the options, the options 'do not become out of the money' as a result of an employee's choice. Denying a refund is said to 'to create a bias towards granting options or rights with lower exercise prices to ensure that options or rights are never "out of the money"'.[32]

6.27 Mr Michael Willcock, General Manager, Treasury, explained that the refund provisions are not in place to 'insulate a person from market risk'. The Government considers that a taxpayer that enters into a share scheme arrangement needs to consider the risk of market circumstances changing.[33] Associate Professor Ann O'Connell also noted that there is a policy issue about whether the Government wants to provide protection for employees in share schemes which other investors do not get.[34]

6.28 Submitters pointed out, however, that many situations falling under 'choice' are in effect not a result of a real choice, including redundancy, retrenchment, disablement or death.[35] Retirement due to health concerns was not considered being 'motivated by protecting the individual from market downfalls' and 'would appear to be contrary to the policy of the reforms'. Further concern was raised regarding the proposed policy making entitled to a refund 'an employee who is terminated (even be it for gross misconduct)' but not an employee who resigns for health reasons, even in the case of a terminal illness.[36] Guerdon Associates proposed an exemption in cases where the employment is terminated as a result of redundancy, retrenchment, disablement or death and certain other reasons.[37]

Deferral of taxation

6.29 The Government's proposed changes introduce limited deferral for schemes where there is a real risk of forfeiture. This means that the taxing point for shares and rights will be a point at which the taxpayer has no longer a real risk of losing the share [or right] and no restriction preventing the taxpayer from disposing of them. Further

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31 Investment and Financial Services Association, *Submission 30*, p. 5.

32 Mallesons Stephen Jaques, *Submission 19*, p. 3; Investment and Financial Services Association, *Submission 30*, p. 5.

33 Michael Willcock, *Proof Committee Hansard*, 27 July 2009, p. 11.

34 Associate Professor Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, pp. 51–52.

35 Guerdon Associates, *Submission 6*, p. 8.

36 Taxation Institute of Australia, *Submission 10*, Attachment 1, p. 5.

37 Guerdon Associates, *Submission 6*, p. 8.

taxing points include the maximum time for deferral at seven years and the cessation of employment. Deferral is also available in relation to salary sacrifice-based employee share schemes that offer no more than $5,000 worth of shares, where there is no real risk of forfeiture and the rules 'clearly distinguish these schemes from those eligible for the upfront tax exemption'.[38]

6.30 Numerous submissions voiced their concern about the deferral provisions. There is said to be no clear policy objective for most of the limited deferral conditions.[39] The Corporate Tax Association has 'a problem' with the deferral concept as it:

> …implies there is some earlier benchmark time when the benefit should properly be taxed and compared to which taxpayers are given concessional treatment. That is quite the wrong way to look at things. The grant time should in no way be regarded as the benchmark since imposing a tax at that point would be to tax a 'benefit' to which the employee may never become entitled.[40]

6.31 Evidence showed little if any support for taxing at acquisition, with most comments supporting taxation at the realisation of income.[41] According to Allens Arthur Robinson, this would make it correspond to Division 13A, allowing a deferral if there are either restrictions preventing the disposal of the shares or forfeiture conditions until those rights are exercised.[42] The Australian Institute of Company Directors argued that this would no longer apply under the proposed changes.[43]

6.32 Deloitte noted that once an option has vested but has a trading restriction, the taxing point would arise at vesting due to there no longer being a real risk of forfeiture and no restriction preventing the employee from exercising or disposing of the right. However, if the options are then exercised, 'the taxing point could be deferred until the sale restrictions are lifted', meaning that:

> …employees who choose to exercise their options immediately would be taxed at a later point than employees who choose not to do so and the taxable amount may be very different. This would create issues for employer reporting as well as lack of equity between employees.[44]

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

39 Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 48.

40 Corporate Tax Association, *Submission 26,* p. 2; also see Sarah Bernhardt, *Proof Committee Hansard*, 27 July 2009, pp. 26–27.

41 See for example David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 19; Rio Tinto, *Submission 9*, p. 2; Ernst&Young, *Submission 23*, p. 3.

42 Allens Arthur Robinson, *Submission 18*, p. 1.

43 Australian Institute of Company Directors, *Submission 12*, p. 1.

44 Deloitte, *Submission 28*, p. 1; see also Allens Arthur Robinson, *Submission 18*, pp. 1–2.

6.33 A number of submitters expressed concern that taxing of shares on vesting would create liquidity limitations and distortion to share prices due to large numbers of company shares being liquidated on the same day as a result of companies issuing shares to employees on the same day. The Investment and Financial Services Association (IFSA) noted that 'This could lead to material share price declines'.[45]

6.34 Employees choosing not to sell shares take a significant risk as the tax liability is calculated on the vesting date whereas the shares could fall in value post-vesting. Selling of shares is often restricted to 'designated share trading windows which occur 3 to 4 times a year', with selling outside the windows 'prohibited due to concerns over insider trading activities'.[46] Fairfax proposed that the taxing point be the earlier of two years from the date of removal of the risk of forfeiture or seven years.[47] The Employee Ownership Group considered 'that there should be an appropriate exemption from the insider trading prohibition for the acquisition of securities under employee share schemes'.[48] The recommendation to provide an exemption for non-discretionary employee share schemes has been accepted by the Treasury.[49]

6.35 IFSA supported taxing 'where the share price exceeds the exercise price, and there are no other restrictions preventing the employee from disposing of or exercising the right'. Choosing not to exercise would cause a tax event, and if the share price dropped below the exercise price, a refund would not be available 'as it is related to a choice of the employee and a loss in the market value of the securities'.[50]

6.36 Mr Yasser El-Ansary, Tax Counsel, Institute of Chartered Accountants, noted that vesting rules may cause corporates to move away from offering options to granting of either shares or other forms of remuneration.[51]

Cessation of employment

6.37 The Government has proposed that the cessation of employment be one of the taxing points for deferred shares and rights. According to the CTA, the Government's policy 'stems from the misguided belief by policy makers' that the timing rules 'are

45 Investment and Financial Services Association, *Submission 30*, p. 3; Fairfax Media, *Submission 14*, p. 2.

46 Investment and Financial Services Association, *Submission 30*, pp. 3–4; Fairfax Media, *Submission 14*, p. 2.

47 Fairfax Media, *Submission 14*, p. 3.

48 Employee Ownership Group, *Submission 29*, p. 12.

49 Treasury, *Insider Trading —Position and Consultation Paper*, 2007.

50 Investment and Financial Services Association, *Submission 30*, pp. 5–6; also see Australian Bankers' Association, *Submission 31*, p. 3.

51 Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2007, p. 36.

highly concessional and should therefore be withdrawn immediately the employment relationship comes to an end'.[52]

6.38 Taxing at cessation of employment caused many comments.[53] Firstly, it was regarded as being inconsistent with international practice.[54] Secondly, it may tax benefits that may never realise and result in financial hardship to taxpayers when they are not able to sell the shares to pay their tax liability on vesting.[55]

6.39 Paying tax at cessation of employment for shares that never vest may trigger double taxation unless the employee obtains a refund on the forfeited shares. This is because at cessation of employment, the shares would return to the trust for reallocation to future employees 'who would again need to pay income tax on those share benefits'. On the other hand, if the employee could obtain a refund because the vesting conditions were not achieved, 'the employee would be receiving up to 46.5% of the value of shares that he or she should have never been entitled to'.[56]

6.40 Several submissions considered that the proposed policy went against good governance and best practice.[57] It was also seen as inequitable, as while the leaving employee was taxed at cessation of employment, the remaining employees would be taxed at the vesting of shares or later.[58] It was also deemed to be 'inconsistent with the concession provided in respect of other equity that is subject to genuine forfeiture due to long-term performance requirements during the term of employment'.[59]

6.41 Having a taxing point at cessation of employment was also said to conflict 'with the commercial objectives of many schemes' and work against the goal of aligning the long-term interests of employees and shareholders.[60]

6.42 A number of submitters called for guidance in relation to performance hurdles, retention clauses, good and bad leaver clauses and sale restrictions.[61] Good

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52 Corporate Tax Association, *Submission 26*, p. 2.

53 See for example Rio Tinto, *Submission 9*, p. 3.

54 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 19; see also PriceWaterhouseCoopers, *Submission 5*, p. 4.

55 Mallesons Stephen Jaques, *Submission 19*, p. 5.

56 Remuneration Strategies Group, *Submission 11*, p. 26; see also Australian Bankers' Association, *Submission 31*, p. 2.

57 Employee Ownership Group, *Submission 29*, p. 5; Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 68; Institute of Chartered Accountants, *Submission 16*, p. 4; PriceWaterhouseCoopers, *Submission 5*, p. 4.

58 Corporate Tax Association, *Submission 26*, p. 2.

59 Guerdon Associates, *Submission 6*, p. 5.

60 Ernst&Young, *Submission 23*, p. 7.

61 Mallesons Stephen Jaques, Submission 19, p. 3; Taxation Institute of Australia, *Submission 10*, p. 2; Investment and Financial Services Association, *Submission 30*, p. 5.

leaver clauses often allow an employee who otherwise would have to forfeit their shares at cessation of employment to retain them in situations such as 'death, incapacity, disability, illness, leaving to raise children, redundancy, and bona fide retirement', which should be included in the legislation.[62] The Taxation Institute of Australia noted:

> It is unclear whether such provisions would lead to the conclusion that there is no 'real risk' of forfeiture (ie because even if the employee leaves they will receive some vested shares/rights). If this was so, there would be no deferral for any such plans.[63]

6.43 A scheme might also provide for forfeiture for bad leavers but it is unclear whether there is a conclusion that there is no real risk of forfeiture as gross misconduct is an unlikely risk.[64]

6.44 Mr Geoff Price, National Manager, Computershare Ltd, explained that in Australia today, employees are not provided any particular incentive to keep their shares after vesting or changing employment. Because cessation of employment is a taxing point, employees are 'effectively forced to sell unless they can afford to self-fund the tax liability'. He argued that the policy objective of assisting people fund their retirement is possibly not currently met.[65]

Partial vesting

6.45 The Government's proposed 'partial vesting' requirement means that companies should enable employees ceasing employment to sell part of their shares or rights to fund their tax liabilities. Evidence to the inquiry did not support this proposal. It was seen to become an issue regarding employment contracts with performance-based conditions.[66] Also, it would represent 'a reward that has no performance basis' and would reward good and poor performers alike.[67]

6.46 Vesting of otherwise unvested benefits to pay tax is said to count against the salary cap for termination payments without shareholder approval, whereas any benefits vesting after termination of employment would not.[68] The Australian Institute of Company Directors noted that 'If the commercial circumstances of the company

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62 Investment and Financial Services Association, *Submission 30*, p. 5.

63 Taxation Institute of Australia, *Submission 10*, pp. 2–3; see also Investment and Financial Services Association, *Submission 30*, p. 5.

64 Taxation Institute of Australia, *Submission 10*, pp. 2–3.

65 Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 80.

66 PriceWaterhouseCoopers, *Submission 5*, p. 4.

67 Guerdon Associates, *Submission 6*, pp. 5–6.

68 Guerdon Associates, *Submission 6*, p. 6.

require ongoing vesting conditions or sale restrictions, taxation arrangements should not work against this practice'.[69]

Employees leaving the country

6.47 One of the underlying issues for taxing at cessation of employment is the Government's intention to ensure that employees who have shares but move overseas after ending employment pay tax in Australia. This was not considered a valid reason as the problem 'is not peculiar to share schemes'.[70] The proposed employer reporting and withholding requirements were regarded as sufficient to address this tax integrity concern.[71]

Salary sacrifice and other schemes

6.48 The Government's tax deferral also applies to salary sacrifice-based employee share schemes limited to $5,000 worth of shares and where there is no real risk of forfeiture.[72]

6.49 Many submissions noted that the cap of $5,000 is too low. This affects executive and director level employees in particular as many companies allow or require them to obtain shares through salary sacrifice arrangements.[73] Out of the ASX200 companies, 36 per cent 'operate plans under which [non-executive directors] NEDs may sacrifice fees to acquire shares'.[74] For example, each Fairfax director is required to sacrifice 25 per cent of the director's fee into the tax deferred plan.[75] The submissions suggested the cap 'may force the abolition of these plans' when they are 'strongly supported by shareholders and governance advisory groups and should not be discouraged by the application of tax penalties'.[76]

6.50 The cap was also regarded as increasing administrative requirements for employers in ensuring that employees understand the implications of the schemes and do not contribute over the limit.[77] It was also seen as preventing employees from

69 Australian Institute of Company Directors, *Submission 12*, p. 2.

70 Australian Institute of Company Directors, *Submission 12*, p. 2.

71 Ernst&Young, *Submission 23*, p. 7; see also Sarah Bernhardt, *Proof Committee Hansard*, 27 July 2009, p. 28.

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

73 PriceWaterhouseCoopers, *Submission 5*, p. 2.

74 Ernst&Young, *Submission 23*, p. 4.

75 Fairfax Media, *Submission 14*, p. 1.

76 Hay Group, *Submission 15*, p. 1; Ernst&Young, *Submission 23*, p. 4–5.

77 PriceWaterhouseCoopers, *Submission 5*, p. 3; Ernst&Young, *Submission 23*, p. 4–5.

choosing according to their economic circumstances, companies from conserving cash flow and being more competitive in attracting and retaining employees.[78]

6.51 The submissions suggested that the cap be 'removed or substantially increased'. However, if a cap was required, the submissions suggested it be 'commensurate with the findings' of the Australian Prudential Regulation Authority, the Productivity Commission and the Henry Review.[79]

6.52 Submitters supported removing the cap, observing that while 'subject to some time-based restrictions':

> …salary sacrifice arrangements would not typically be subject to any substantive 'real risk of forfeiture' conditions as it would be unreasonable to expect that employees who direct a portion of their earned salary…would be exposed to a risk of losing those shares.[80]

6.53 In some schemes, such as where an employer provides free matching shares for every share purchased by an employee, or performance or other bonuses are taken in company shares, tax deferral is often achieved through a disposal restriction or a forfeiture condition. Under the proposed rules, a disposal restriction (no real risk of forfeiture) would no longer trigger tax deferral.[81] The proposed rules were said to also contribute to reduced employee savings, and increasing the number of executive share schemes, thus decreasing the level of broad share ownership. This appears to be contrary to the Government's intention of increasing broad-based schemes and is said to put Australia 'out of alignment with the rest of the world'.[82] The Employee Ownership Group proposed that deferral apply to matching schemes similarly to salary sacrifice schemes, and could be restricted to fixed terms of three, five and seven years.[83] PriceWaterhouseCoopers argued that tax deferral should be based on disposal restrictions alone and not be subject to forfeiture conditions.[84]

6.54 To be eligible for deferral in schemes with a real risk of forfeiture, the risk would have to be on the employer co-contribution. It is still unclear whether additional conditions need to be met for deferral on the $5,000 salary sacrifice component or whether it is automatic because it is within the limit.[85] Clarification was sought

78 Guerdon Associates, *Submission 6*, p. 8.

79 PriceWaterhouseCoopers, *Submission 5*, p. 4.

80 Institute of Chartered Accountants, *Submission 16*, p. 4; also see Ernst&Young, *Submission 23*, p. 4.

81 PriceWaterhouseCoopers, *Submission 5*, p. 2; also see Employee Ownership Group, *Submission 29*, p. 5.

82 PriceWaterhouseCoopers, *Submission 5*, p. 3.

83 Employee Ownership Group, *Submission 29*, p. 5.

84 PriceWaterhouseCoopers, *Submission 5*, p. 3.

85 Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 83.

regarding situations where amounts have been sacrificed by taxpayers prior to 1 July 2009 but the matching shares or rights were not acquired under the scheme prior to that date.[86]

Real risk of forfeiture

6.55 The Government proposed that in order to be eligible for tax deferral, the scheme has to meet certain conditions, including the real risk of forfeiture test, which has already been mentioned above.

6.56 The test for real risk of forfeiture is 'whether a *reasonable person* would conclude that there is a real risk that the share or right will not come home to an employee'. Real risk includes situations where shares or rights are subject to meaningful performance hurdles or minimum term of employment. Contrived schemes, that is, schemes with forfeiture conditions that are highly unlikely to arise, such as 'if the sun does not rise tomorrow'[87], fraud or misconduct, will not qualify.[88]

6.57 Taxing time for shares and rights differs. For shares, the taxation point is when there is no longer a real risk of the taxpayer losing the share and no restriction preventing the taxpayer from disposing of the share. For rights, the taxation point is when there is no longer a real risk of the taxpayer losing the right and no restriction preventing the disposal or exercise of the right. If, however, the underlying share is subject to forfeiture and restriction, the taxation point is when the restrictions no longer apply to the share. Other taxing points are the cessation of employment or seven years.[89]

6.58 The evidence to the inquiry did not support certain aspects of the real risk of forfeiture. Regarding the reasonable person test, it was commented that it is not objective as 'people are not going to be able to agree what a reasonable person thinks is a real risk of forfeiture'.[90] Further, submitters did not support the definition of real risks of forfeiture as it considers fraud or gross misconduct as not being real risks because they are unlikely to arise. However, IFSA pointed out that:

> Such a forfeiture clause does provide a real incentive for the employee to act in the best interests of the company and thus should be viewed as a 'real' risk of forfeiture. However this example suggests the test is not whether there is a real incentive, but whether the forfeiture is likely to happen.[91]

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86 PriceWaterhouseCoopers, *Submission 5*, p. 4.

87 Australian Bankers' Association, *Submission 31*, p. 2.

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

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

90 John Fauvet, *Proof Committee Hansard*, 27 July 2009, p. 33.

91 Investment and Financial Services Association, *Submission 30*, p. 4.

6.59 Submissions regarded the different taxation time rules for rights and shares as 'illogical and inconsistent' and creating a 'double jeopardy' because of the rights having been subject to performance hurdles before they were exercised to acquire the underlying shares.[92] It appears that usually an employee would not be subject to further risk of forfeiture once the rights have been exercised. Having a deferred taxing point at the time the rights are vested may have employees dispose of the rights or exercise the rights and immediately dispose of the shares in order to be able to meet their tax liability, which, according to the Institute of Chartered Accountants:

> …is not considered to be an appropriate reflection of sound corporate governance as it allows taxation policy outcomes to unduly influence the behaviour of employees to take decisions that are not necessarily in the longer-term best interests of themselves or their employer company.[93]'

6.60 The Australian Bankers' Association (ABA) and IFSA commented that forfeiture restrictions that have a commercial basis 'should be sufficient to allow for tax deferral to apply'.[94]

6.61 Submitters were unclear about the meaning of real risk of forfeiture.[95] Mr Martin Morrow, Chairman, Employee Ownership Group, observed that there is difficulty in defining the meaning of real risk of forfeiture because it may take three to four years until there is clarity about the effectiveness of clauses. The tax office will provide rulings but 'if they do not like what you are doing then you have to appeal' and the process could take a number of years. This leaves organisations with little certainty in the meanwhile.[96]

Start-up companies

6.62 A number of submitters stated that taxation at acquisition and the real risk of forfeiture rules are problematic in start-up and similar companies. Taxing employees 'at any time other than sale' is said to make Australia a much less attractive location for potential overseas employees. This is because the shares are not liquid and there is no market for them, which leaves the employees paying taxes on value that they are not able to realise.[97] Submissions supported the Government's referral of this matter to the Board of Taxation to examine whether there should be separate arrangements for these types of companies.[98]

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92 Corporate Tax Association, *Submission 26*, p. 3.

93 Institute of Chartered Accountants, *Submission 16*, p. 3.

94 Investment and Financial Services Association, *Submission 30*, p. 4; Australian Bankers' Association, *Submission 31*, p. 2.

95 Taxation Institute of Australia, *Submission 10*, p. 3, see also Marty Robinson, *Proof Committee Hansard*, 27 July 2009, p. 10.

96 Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 10.

97 Starfish Ventures, *Submission 17*, p. 1.

98 Sandra Roussel, *Proof Committee Hansard*, 27 July 2009, p. 14.

Executive remuneration

6.63 Executive remuneration through shares and options is perhaps the most well-known form of employee share schemes. Many ASX listed and unlisted companies in Australia offer employee share schemes to their employees. For example, Fairfax executives are allocated shares annually and the shares are 'subject to substantial vesting hurdles'.[99]

6.64 Submissions argued strongly that attracting and retaining overseas talent to take the risk and move to Australia to manage start-up and innovative R&D companies requires competitive remuneration. Often the remuneration is provided through shares and options because 'unlike large corporations, early-stage companies do not have the cash-flow'.[100] However, taxing at acquisition is said to deter overseas talent from coming to Australia. As noted above, immature companies have no market for their shares, which makes it difficult to establish a share value. It was argued that having to exercise and sell shares on acquisition to pay tax 'defeats the purpose of taking on these risky opportunities in the first place'.[101]

6.65 Hay Group submitted that 'it is important that the tax regime should not act in conflict with good reward strategy to achieve the desirable focus on performance and risk management'.[102]

6.66 Executive remuneration is also affected by the taxing point at cessation of employment. The Australian Institute of Company Directors argued that the changes work against encouraging 'long-term executive incentive plans continuing post-employment'.[103] Submissions noted the need to align the taxing point with APRA guidelines on sound executive remuneration practices.[104] This would also be consistent with practice in the US and other markets.[105]

6.67 According to the Treasury, the Government has aligned its policy regarding equity-based remuneration with that of 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. The goal will be achieved by deferring some or all of the 'performance-based remuneration until the end of a

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99 Fairfax Media, *Submission 14*, p. 1.

100 Starfish Ventures, *Submission 17*, p. 1.

101 Guerdon Associates, *Submission 6*, pp. 2–4.

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

103 Australian Institute of Company Directors, *Submission 31*, Attachment 1, pp. 2–3.

104 PriceWaterhouseCoopers, *Submission 5*, p. 4; Australian Institute of Company Directors, *Submission 12*, Attachment 1, pp. 2–3.

105 Deloitte, *Submission 28*, p. 6.

deferral period'.[106] The Productivity Commission is inquiring into executive remuneration.[107]

Global businesses

6.68 Evidence to the inquiry discussed the effect of the Government's proposals on global companies in their administration of employee share schemes across a number of countries.

6.69 Rio Tinto explained that it has employees in over 45 countries and has to comply with different tax laws regarding employee share schemes. It noted the benefits of having internationally compatible tax laws to reduce double taxation and cash flow issues for employees.[108] The proposed changes triggering taxation of shares and rights on vesting rather than on exercise was deemed to 'put Australia out of step with most other countries and is likely to cause significant practical issues for cross border employees who will be taxed on those options at a different time in other countries'.[109] Rio Tinto explained that the proposed legislation makes their share schemes 'much less attractive' and puts its Australian employees 'at a disadvantage compared to their overseas colleagues'.[110] Baker and McKenzie commented that none of the 40 countries they had reviewed had similar taxation arrangement.[111]

6.70 IFSA suggested that the 'legislation should provide a specific tax exemption for periods of non-residency' to avoid double taxation and to simplify taxation for employees moving between countries.[112] The 'number of individuals that would retain equity awards where the new employment overseas is not within the same corporate group (thus triggering a deferred taxing point on termination) is extremely limited'.[113]

International comparisons

6.71 Support for comparing Australian tax laws affecting employee share schemes to other countries was mixed. The Treasury did not consider it 'wise to make apples

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106 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).

107 Productivity Commission, Executive Remuneration, http://www.pc.gov.au/projects/inquiry/executive-remuneration (accessed 15 July 2009).

108 Rio Tinto, *Submission 9*, pp. 2–3; also see Sarah Bernhardt, *Proof Committee Hansard*, 27 July 2009, pp. 21–22; Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 82; Baker and McKenzie, *Submission 1*, p. 2.

109 Allens Arthur Robinson, *Submission 18*, p. 4; Baker and McKenzie, *Submission 1*, p. 2.

110 Stephen Consedine, *Proof Committee Hansard*, 27 July 2009, p. 18.

111 Baker and McKenzie, *Submission 1*, p. 2.

112 Investment and Financial Services Association, *Submission 30*, p. 6.

113 Deloitte, *Submission 28*, p. 6.

and oranges comparisons between different countries' arrangements' because in addition to taxation legislation, there are other tax treatments and corporate and industrial relations law that affect the employee share schemes.[114] The Taxation Institute argued that it is inappropriate to adopt a taxation methodology simply because another country or countries adopt such an approach because they do not necessarily have internally consistent policies.[115]

6.72 However, many witnesses disagreed. Ms Sarah Bernhardt, Tax Adviser to Rio Tinto Limited, argued that understanding the fundamentals of a plan and what it is trying to achieve makes it 'pretty easy' to compare.[116] Witnesses supported learning from other countries' experiences as there is no need to reinvent the wheel.[117] Mr Paul Ellis, Member of the Employee Ownership Group, stated that the context of comparison between countries has to be taken into account but due to similar underlying reasons for setting up share plans across the countries, he did not consider the context being dissimilar from country to country.[118]

Legislation

6.73 Employee share scheme legislation has been identified as a major source of confusion and challenge.[119] Some of the concerns included compliance and legal complexity relating to offering schemes, valuation rules, disclosure requirements and regulation and information gathering process.[120]

6.74 A number of submissions called for a single piece of legislation 'to bring under one act all laws governing all employee share plans'.[121] This could reduce the cost of administering an employee share scheme which can be high due to obtaining external advice for each employee's circumstances, educating employees and the need to review plans and documents as a result of the 'rapid and numerous changes in tax law'.[122]

6.75 A University of Melbourne study noted that a 'one-size-fits-all approach' is inappropriate considering the diversity and flexibility of the work practices ranging

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114 Michael Willcock, *Proof Committee Hansard*, 27 July 2007, p. 3.

115 Taxation Institute of Australia, *Submission 3*, p. 3.

116 Sarah Bernhardt, *Proof Committee Hansard*, 27 July 2007, p. 26.

117 Ann O'Connell, *Proof Committee Hansard*, 27 July 2007, p. 49; Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 82.

118 Paul Ellis, *Proof Committee Hansard*, 27 July 2009, p. 75.

119 See for example CRA Plan Managers, *Submission 8*, p. 15.

120 CRA Plan Managers, *Submission 8*, p. 15.

121 See for example Australian Employee Ownership Association, *Submission 4*, p. 6.

122 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. 25.

from small start-up companies to large listed companies with transnational workforces.[123] The rules appear to make it easy for larger listed public companies to provide schemes but for smaller or unlisted organisations the provision of schemes becomes costlier.[124] In addition, the 'limited terms on which [employee share scheme] benefits may be provided and the limited component of overall remuneration which they can provide also reflect an outdated view of the appropriate taxation treatment of labour income'.[125]

6.76 Finally, the Employee Ownership Group noted a number of anomalies that would take place at the start of the application of the new rules on 1 July 2009, including option schemes where offers have already been made but not yet accepted, or if accepted, they are subject to shareholder approval; and in tax-exempt and deferred schemes where employees have elected to participate under the existing legislation but acquire shares under the new rules.[126]

Lack of definitions

6.77 Many concerns related to the lack of definitions in the proposed legislation, including what is an ordinary share or a right to acquire a share.[127] There does not appear to be a reason why the employee share schemes are restricted to ordinary shares when in other countries, non-voting shares can be offered.[128] Mr Martin Morrow, President, Employee Ownership Group, argued that 'if it looks like an ordinary share, acts like an ordinary share and behaves like an ordinary share, treat it like an ordinary share and put it in the employee share scheme rules'.[129]

6.78 Dwyer Lawyers called for the removal of the '75%, 5% rules as well as the 7-year rule in the case of small business'.[130] They explained that currently, concessionally-taxed employee share schemes cannot be used to facilitate employee buyouts, instead, non-concessional, share transfer or ownership plans must be used:

> In a small business buyout, there will rarely be twenty buyers with 5% each and only a small percentage of employees may be buying. Further, the

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123 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. 25.

124 Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 69.

125 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. 25.

126 Employee Ownership Group, *Submission 29*, p. 9.

127 John Fauvet, *Proof Committee Hansard*, 27 July 2009, p. 34; also see Employee Ownership Group, *Submission 29*, p. 7; PriceWaterhouseCoopers, *Submission 5*, p. 5.

128 Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 55.

129 Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 72.

130 Dwyer Lawyers, *Submission 7*, p. 2.

> requirement to dispose of shares after 7 years to pay the tax defeats the purpose of an enduring buyout.[131]

6.79 Further, the provisions do not seem to give the same recognition to different types of corporate form, only dealing with employee shares and not with businesses operating through trusts or partnerships and the like.[132] The Employee Ownership Group called for the new provisions to 'provide clarity in respect of the tax treatment of the instruments of unlisted entities' in order for an unlisted employer to be able to 'offer its employees interests which entitle the holder to dividends and an entitlement to capital', similarly to the listed company employees.[133]

6.80 In addition, submissions called for the concept of real risk to be clearly defined; forfeiture and refund provisions relating to choices amended to avoid unintended consequences; and employee reporting requirements reconsidered.[134] Confirmation is required regarding the availability of rollover relief for shares or rights provided under a takeover or restructure.[135]

6.81 Associate Professor O'Connell observed that 'there is a lot of detail that has not really been addressed. It has just been lifted from the old laws and had a bit added onto it'.[136]

6.82 A submitter called for materials explaining and defining the real risk of forfeiture to be set out in the legislation to minimise opportunities for ambiguity and uncertainty.[137] Mr Marty Robinson, Manager, the Treasury, told the committee that 'the real risk of forfeiture test will be in the legislation', not in the regulations.[138]

Capital gains tax

6.83 A study argued that 'ordinary Australian workers have little or no incentive to participate' in employee share schemes because of the impediments associated with the schemes.[139] One of the impediments under the tax-deferred scheme is that 'the entire capital gain is taxable at the employee's marginal income tax rate (rather than 50% of the gain being taxable, as with other investments over 12 months)'. This

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131 Dwyer Lawyers, *Submission 7*, p. 2.

132 Associate Professor Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 49.

133 Employee Ownership Group, *Submission 29*, p. 7.

134 Taxation Institute of Australia, *Submission 10*, Attachment 1, p. 5..

135 Mallesons Stephen Jaques, *Submission 19*, p. 2.

136 Associate Professor Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 55.

137 Ernst&Young, *Submission 23*, p. 5.

138 Marty Robinson, *Proof Committee Hansard*, 27 July 2009, p. 10.

139 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 4.

taxation regime is said to have 'no obvious economic rationale'.[140] In some situations upfront taxation is seen to be understandable. For example, in the UK and US an option is taxed upfront if it was granted at a discount; otherwise, there is generally no tax upfront, with capital gains tax applying on disposal.[141]

6.84 Allens Arthur Robinson regarded tax deferral, with taxation at marginal rates, as coming 'at the cost of the loss of the 50% capital gains tax concession on any capital growth'.[142] Deferral of tax on the discount was not regarded as 'a reason to deny capital treatment to the share itself'.[143]

6.85 In addition, applying CGT rules to shares retained after employment was considered to be a personal investment decision; and because the shares are 'no longer related to the source of the shares', after vesting they should not be differentiated from the tax treatment of other shares.[144]

Valuation

6.86 While some submitters were not clear 'what the primary concern is that the government is seeking to address' and considered valuation rules as 'a pretty good measure', others saw valuation rules as complex and in need for modification, particularly in relation to unlisted companies.[145]

6.87 As noted earlier in the report, unlisted companies and start-ups have illiquid shares and in effect no market on which to sell them. Currently, the law determines the value of unlisted rights or shares on the basis of a combination of a couple of financial models, which does 'not necessarily reflect properly the assumptions that are underpinning most other valuation methods'. This was said to result in the perceived undervaluing of the rights and shares.[146] No discount has been embedded in the provision of unlisted options to the employee, so where a discount is provided to the employee, 'they look like they are valued much lower, that is not accounted for in this accounting system and therefore they are paying very little tax on the options' provided to them.[147]

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140 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 18.

141 Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 48.

142 Allens Arthur Robinson, *Submission 18*, pp. 1–2; See also David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 19.

143 Dwyer Lawyers, *Submission 7*, p. 2.

144 Hay Group, *Submission 15*, p. 9.

145 Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, p. 44 and John Fauvet, *Proof Committee Hansard*, 27 July 2009, p. 34.

146 Christopher Leggett, *Proof Committee Hansard*, 27 July 2009, pp. 14–15.

147 Sandra Roussel, *Proof Committee Hansard*, 27 July 2009, p. 15.

6.88 Australia's current valuation rules were deemed 'extremely complex' by worldwide standards.[148] The complex rules pose particular obstacles to Australian unlisted companies regarding the determination of their share value and off-market share buybacks.[149] Division 13A requires that each time a share is given to an employee, an independent valuation of the shares must be undertaken, and because the shares in unlisted and small and medium-sized enterprises are illiquid, determining a value for them can be difficult and expensive.[150] A number of submissions called for simplifying the valuation rules.[151]

6.89 In the absence of a liquid market for unlisted companies' shares, it was considered necessary to establish a buyback or cancellation mechanism for employees in these companies to realise or dispose of their interests.[152]

6.90 Ms Sandra Roussel, Manager, the Treasury, noted that the valuation of options in non-listed and start-up companies has been referred to the Board of Taxation.[153]

Employer reporting requirement

6.91 The current withholding and reporting obligations regarding employee share schemes were regarded as being 'towards the lower end of compliance obligations—producing a greater than average risk of non-compliance'.[154] Mr Price, Computershare Ltd, noted that until now, the employee share scheme legislation had not imposed reporting responsibility on employers, which he considered 'unusual'.[155]

6.92 The proposed legislation introduced a new annual reporting requirement for employers offering employee share schemes. Employers will be required to estimate the market value of shares and rights at an employee's taxing point instead of at grant. In addition, they are required to 'report the number of shares and rights an employee has obtained at both grant and at the taxing point'. The legislation also introduced limited withholding requirement to apply to cases where an employee has refused to provide their TFN or ABN.[156] The changes aim to make it easier for employers to

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148 Baker and McKenzie, *Submission 1*, p. 2.

149 Mallesons Stephen Jaques, *Submission 19*, pp. 5–6.

150 DLA Phillips Fox, *Submisison 27*, pp. 1–2.

151 Mallesons Stephen Jaques, *Submission 19*, pp. 5–6; CRA Plan Managers, *Submission 8*, p. 15.

152 Mallesons Stephen Jaques, *Submission 19*, pp. 5–6.

153 Sandra Roussel, *Proof Committee Hansard*, 27 July 2009, p. 14.

154 Baker and McKenzie, *Submission 1*, p. 2.

155 Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 81.

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

administer the schemes as a result of every employee in the scheme being subject to the same reporting requirements.[157]

6.93 Most submitters and witnesses supported the tightening of the reporting requirements.[158] Mr Price explained that in his plan management company, there is already a requirement for participants to provide their TFN to the company in order to enable the payment of dividends without withholding tax. Mr Price believed this will make compliance with the proposed reporting requirements 'relatively' easy.[159]

6.94 However, some witnesses pointed out that there are still parts that need to be improved. A submission suggested that reporting could be simplified by reporting only at the taxing point rather than in both the year of grant and at the taxing point. This would make it correspond to the reporting regime of other forms of salary and wages.[160]

6.95 The ASIC requirement for both listed and unlisted companies to issue a prospectus was considered problematic particularly in the small business sector and seen in the current form as the 'single greatest obstacle in the way of expanding employee ownership in the unlisted company sector' in Australia.[161] A submitter proposed that an exemption from a prospectus or disclosure document be awarded to companies if the share offer is to fewer than 100 employees in a 12-month period and the value of shares does not exceed $2 million. For unlisted and private companies, a disclosure document should be required only when the share offer is under $5 million.[162]

Other amendments

6.96 The Employee Ownership Group made a number of proposals to amend the legislation.

6.97 Section 139DB allows a tax deduction to the employer after an employee first acquires shares or rights under an employee share scheme. The Employee Ownership Group noted that while it seems to be followed in practice, this section has not been re-written into the proposed legislation. It suggested that tax deduction be deferred if

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157 Michael Willcock, *Proof Committee Hansard*, 27 July 2009, p. 13.

158 See for example *Proof Committee Hansard*, 27 July 2009.

159 Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 81.

160 Paul Ellis, *Proof Committee Hansard*, 27 July 2009, p. 74; see also Deloitte, *Submission 28*, p. 10.

161 Australian Employee Ownership Association, *Submission 4*, pp. 2–3; see also David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 20.

162 Employee Ownership Group, *Submission 29*, p. 10.

no such acquisition has occurred and that the section be replicated in the proposed legislation.[163]

6.98 Under the current legislation, an employee participating in a scheme where shares are held in trust could be taxed on the shares at market value if the forfeiture was due to not achieving the performance hurdles. The Employee Ownership Group proposed that the legislation clarify that the market value substitution rule not apply in this case.[164]

6.99 The Employee Ownership Group noted that companies may need to cancel shares in the employee share scheme, for example if they have been forfeited or where the shares are surplus to the plan. However, difficulties arise from the requirement for employee agreement to the cancellation. The Employee Ownership Group proposed an amendment to section 258D of the Corporations Act to allow cancellation of shares if forfeited, 'provided the cancellation does not materially prejudice the company's ability to pay its creditors'.[165]

Compliance

6.100 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;
- 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.

6.101 Associate Professor Ann O'Connell explained that complexity often leads to non-compliance and that in a self-assessment regime this is 'bound to be an issue'. She considered that the proposed reporting regime should address some of the issues. Another way to address non-compliance could be to treat employee share schemes like 'another type of fringe benefit so that the liability is on the employer'.[166]

6.102 The Government has aligned its policy regarding equity-based remuneration with that of APRA, considering performance-based remuneration to be '"at-risk" of forfeiture until the individual's performance can be validated'. This is to provide

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163 Employee Ownership Group, *Submission 29*, p. 7.

164 Employee Ownership Group, *Submission 29*, p. 8.

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

166 Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 50.

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'.[167]

6.103 A number of submitters indicated that there is no need for specific legislation to address tax avoidance as 'the Commissioner of Taxation already has extensive powers to obtain the information required and to identify those individuals who have a vested interest under an employee share scheme'. According to the Taxation Institute of Australia, additional legislation would only increase the 'complexity of the law without notable enhancement'.[168]

6.104 Hay Group noted that while there may be individuals who seek to avoid tax payments, 'it is clear from years of contact with plan participants that many are genuinely confused about their obligations'. Companies are restricted in providing advice due to legal requirements to 'keep the advice general and yet cover all possibilities', making 'the "simple" advice statements very complex'. Hay Group supported the Government's changes regarding compliance.[169] Mr Hetherington suggested that the abuse of the scheme 'can be overcome by placing a cap…on the total value of shares…that can be claimed annually under the scheme'.[170]

6.105 Regarding the proposed requirement for employers to withhold tax in case of an employee not providing their TFN or ABN, Baker and McKenzie noted that current reporting withholding and reporting obligations are 'towards the lower end of compliance obligations—producing a greater than average risk of non-compliance' and welcomed the Government's proposal for a more comprehensive regime.[171]

6.106 On the contrary, the Taxation Institute of Australia did not support the proposal. It considered the requirements to place 'an unfair burden' on taxpayers, potentially leaving them without a salary for a period of time. In addition, employers might be unwilling to offer shares to employees who do not provide a TFN.[172] Mallesons Stephen Jaques considered that the withholding regime 'is likely to discourage and prevent smaller companies from offering employee equity, due to the compliance costs'. It observed that 'only the largest companies will have sufficient resources to develop and operate a system that would be able to ensure compliance' with the TFN obligations.[173]

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167 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, paragraphs 24–25.

168 Taxation Institute of Australia, *Submission 10*, Attachment 1, p. 3.

169 Hay Group, *Submission 15*, p. 7.

170 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 5.

171 Baker and McKenzie, *Submission 1*, p. 2.

172 Taxation Institute of Australia, *Submission 10*, Attachment 1, p. 4.

173 Mallesons Stephen Jaques, *Submission 19*, pp. 2, 7.

6.107 The Australian Information Industry Association (AIIA) explained that their members in the US and the UK 'can only sell their shares or exercise their options through [the] organisation's globally nominated broker' that withholds the tax at the rate determined by the Government and which the employer is obliged to pay to the tax authority. It said 'There is no way for an employee to override the withholding': organisations only issue shares or options in the employee's name, not to a trust or super fund. Exercised rights are reported as ordinary income against the TFN, 'which makes evasion virtually impossible'.[174]

6.108 CTA supported the proposed reporting requirements and believed that 'that is the most important part of the package, and should account for most of the projected revenue gains'. CTA also recommended that ATO redesign the personal income tax return form 'to better assist taxpayers'.[175]

Current reviews

6.109 As noted earlier in the report, there are a number of reviews being undertaken that relate to employee share schemes. A submitter proposed that the Board of Taxation review of 'start-up, research and development and speculative-type companies extend to the taxation of employee equity granted by unlisted companies more generally'.[176]

6.110 Another submitter suggested that the executive remuneration arrangements as part of employee share schemes be reviewed as a result of the global financial crisis, with particular focus on 'whether the changes will exacerbate this problem or create new inequalities'.[177]

6.111 Associate Professor Ann O'Connell pointed out that there are inconsistencies regarding the different legislative provisions regulating employee share schemes. She explained that corporate law considers shares in an employee share scheme as an investment and insists on disclosure, bringing costs and potentially discouraging employers from offering them. However, the tax law considers shares as a non-cash benefit that 'needs to be taxed as soon as possible'.[178]

6.112 Because of the employee share scheme rules interacting with other legislative provisions, the following provisions are said to need amending to implement the scheme rules:

- capital gains tax rules

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174 Australian Information Industry Association, *Submission 13*, p. 3.

175 Corporate Tax Association, *Submission 26*, p. 2.

176 Mallesons Stephen Jaques, *Submission 19*, p. 2.

177 Investment and Financial Services Association, *Submission 30*, p. 2.

178 Ann O'Connell, *Proof Committee Hansard*, 27 July 2007, p. 56.

- temporary resident rules
- fringe benefits tax legislation
- rules governing employee termination payments, and
- State payroll tax legislation that was 'recently harmonised across all the states to ensure it applied consistently with Division 13A'.[179]

Conclusion

6.113 The committee has heard concerns regarding the Government's proposals affecting employee share schemes. While the submissions supported certain aspects of the proposal, such as the introduction of reporting and withholding requirements for employers, and considered the Government's proposal to be an improvement on the original budget measure, there were still many concerns about the rules.

6.114 Of the more general observations, the committee draws attention to four of them. Firstly, the committee notes the lack of consultation in the lead-up to the budget announcement. The committee is disappointed that the Government chose to change policy without warning, without consultation and, according to some witnesses, without any major reason. It hopes that the lesson has been learnt about the importance of consultation—the effects of not consulting have been loud and clear.

6.115 Secondly, there is a lack of data regarding the prevalence of employee share schemes in Australia. The committee made a recommendation that this situation be rectified (Recommendation 1).

6.116 Thirdly, submitters noted the need for this policy and legislation to be consistent with the findings of the reviews underway addressing related concerns, such as executive remuneration. In addition, as part of this inquiry, the Government has initiated a Board of Taxation inquiry into start-up companies and the valuation of unlisted and start-up company shares. The committee strongly agrees with the need for consistency and has recommended that the Government delay the introduction of employee share scheme legislation to take notice of the findings of the other reviews (Recommendation 2).

6.117 And finally, submissions noted that Australia's employee share scheme laws are inconsistent with the international practice. While the Australian legislation mainly regulates companies and individuals in Australia, it also needs to provide for those who work across countries and continents. The committee urges the Government to ensure that our legislation does not trigger double-taxation for either our own citizens and companies or international employees.

6.118 The committee understands that employee share scheme policy and legislation have a dual function: it is expected to motivate workers to participate in the schemes

179 Deloitte, *Submisison 28*, p. 13.

and to provide incentives to companies to set up employee share schemes to enable that. However, the committee is contemplating what the Government's role should be in encouraging employee share ownership through concessions. The Government has to balance between the interests of those who benefit from the schemes and those who work outside of the private sector and cannot obtain these benefits; and between scheme shareholders and general investors.

6.119 The committee notes Associate Professor O'Connell's comments about the various laws treating employee share scheme shares differently and considers that this may be a sign of the Government not being clear about its position in relation to the employee share schemes. The committee encourages the Government to develop a coherent employee share scheme policy, building its views on current and accurate data. This would include taking note of the current reviews by the Productivity Commission, Board of Taxation and the Henry Review.

6.120 In relation to the data, during the inquiry, the committee heard about the effect of employee share schemes on employees and employers. There appears to be no information available on their effect on the economy as a whole, although based on overseas information, schemes seem to generate national benefits. Once the statistical data about prevalence of employee share schemes in Australia is available, the committee sees significant benefits in the Government conducting a study on the effect of employee share schemes on the Australian economy. The committee looks forward to learning about the results in due course.

Senator Alan Eggleston
Chair