

# Labor Senators' Dissenting Report

## Chapter 1

### Introduction

1.1 Labor members are extremely concerned about the implications of the majority report recommendations for the integrity of the Australian taxation system, and the impact on revenue. In particular, the report appears to allow for ongoing tax avoidance and encourage increased concessions leading to a lack of equity.

1.2 Labor members believe that large scale avoidance has been allowed to continue for far too long, aided and abetted by the Coalition's failure both when in Government and now in Opposition to support any measures to better target eligibility for the employee share scheme (ESS) tax concessions and reduce opportunities for tax avoidance.

1.3 The Government's proposed measures have a significant impact on revenue—\$135 million over the forward estimates period. These measures while ensuring equity and integrity will also protect Commonwealth revenues needed to secure long term economic prosperity in face of the global recession.

1.4 The majority report has failed to recognise the problems with the current laws and demonstrates the Coalition committee members' continued willingness to turn a blind eye to tax avoidance and evasion, excessive concessions to high income earners and the use of ESS by executives as a device for tax minimisation rather than a means by which to align their interest with shareholders.

1.5 Labor members recognise the value of employee share ownership, not only to companies and employees but to the broader economy. We strongly support employee share schemes and the role of the tax system in encouraging employees to be involved in such schemes.

1.6 However, measures to support employee share ownerships must balance both the benefits of employee share ownership and the need to maintain the integrity and equity of the tax system.

1.7 Labor members support the Government's measures to improve the integrity of employee share schemes.

## **Summary of proposed changes**

1.8 The Treasurer announced in the 2009 Budget that the Government will better target eligibility for the employee share scheme tax concessions and reduce opportunities for tax avoidance. The Budget savings measure was designed to improve horizontal equity in the tax system by treating all forms of remuneration more consistently, to target employee share scheme tax concessions more closely to low and middle income earners, and to reduce the scope for losses to the Commonwealth revenue through tax evasion and avoidance.

1.9 Tax on the discount for shares and rights acquired under an employee share scheme will be paid upfront except where there is a 'real risk of forfeiture' and the scheme satisfies the existing conditions for a qualifying employee share scheme.

1.10 The upfront tax exemption will be means tested: The \$1,000 tax exemption will only be available to taxpayers with an adjusted taxable income of less than \$180,000.

1.11 Employees accessing the tax deferral arrangements will be able to defer tax until there is no longer a real risk of the employee losing the share or right and no restriction preventing them from selling or exercising the share or right. Eligibility for the deferral treatment will flow from the structure of the scheme rather than from a choice made by an employee and the maximum time for deferral of tax is reduced from ten years to seven years.

1.12 A new annual reporting requirement will be introduced for employers.

1.13 To improve the integrity of the tax system the refund rules will not apply to protect taxpayers from commercial losses. The rules are designed to refund tax in situations where executives have failed to meet performance hurdles or minimum employment requirements, not to protect taxpayers from the market risks of owning shares.

1.14 In order to simplify the existing arrangements, the new rules will be rewritten into the Income Tax Assessment Act 1997.

1.15 The changes aim to improve the alignment of employee and employer interests. They recognise the economic benefits derived from employee share scheme arrangements via tax concessions for employees participating in employee share schemes.

1.16 Tax support is provided on the grounds that aligning the interests of employees and employers encourages positive working relationships, boosts productivity through greater employee involvement in the business, reduces staff turnover and encourages good corporate governance.

1.17 The proposed new reporting requirements boost the integrity of the taxation of share schemes, addressing concerns that the current employee share scheme rules are not being complied with.

1.18 Overall the changes will:

- (i) improve equity and fairness in the tax system by treating all forms of remuneration more consistently;
- (ii) target employee share scheme tax concessions more closely to low and middle income earners; and
- (iii) Reduce the scope for losses to tax revenue through tax evasion and tax avoidance.
- (iv) Have an estimated revenue impact of \$135m over forward estimates

### **Structure of the report**

The structure of the dissenting report is as follows:

Chapter 2—deals with the nature of employee share schemes and addresses the need for reform

Chapter 3—provides a rebuttal of some of the majority report recommendations and views

Chapter 4—provides Labor Senators comments on other issues raised during the inquiry

Chapter 5—provides a summary of the report

## Chapter 2

### Employee share schemes

2.1 Finance Sector Union (FSU) explained that there are generally two types of employee share schemes. The first are 'genuine' schemes that are available to all employees and have as their 'predominant purpose' to align the interests of employees and the employer to increase productivity and workplace harmony. The executive share schemes are available to executive, high income employees and 'have as their real purpose the tax effective or tax free provision of remuneration'. According to FSU, these schemes are 'described by the ATO as 'blatant, artificial and contrived'.<sup>1</sup>

2.2 The Finance Sector Union pointed out that there is 'an acute difference in the depth of employee share ownership' between executive and general employees, with 'wide share holdings of minimal amounts being held by non-executive employees' and 'far deeper share holdings being held by executives'.<sup>2</sup>

2.3 Labor Senators fully support bona fide ESS plans.

### Why reform is necessary

2.4 The Government is committed to employee share ownership but will not allow high paid executives to use them to avoid paying tax. If there is one thing that everyone agrees on, it is that these schemes have been exploited particularly by people on very high incomes. This is costing the Australian taxpayer many tens of millions of dollars.

2.5 The committee heard evidence from the Treasury of examples of the current rorting of employee share schemes:

2.6 In one case, a taxpayer had acquired options over several years and deferred tax liability to a future time. However, when exercising the options at two different occasions, the taxpayer did not include any discounts nor paid tax on them. An audit was conducted and determined that the taxpayer was liable for additional tax to the amount of \$439,733. In another case, a taxpayer had acquired options, some of which the taxpayer exercised and sold the shares. The tax payer did not include any discount in their tax return but incorrectly included a capital gain and applied the 50 per cent capital gains tax discount. An audit determined that the taxpayer was liable for \$580,340 of additional tax.<sup>3</sup>

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1 Finance Sector Union, *Submission 22*, p. 4.

2 Finance Sector Union, *Submission 22*, p. 2.

3 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, pp. 8–9.

2.7 Given the global recession has ripped \$210 billion from tax revenues, it is essential to ensure everyone is paying their fair share of tax. The proposed changes protect the tax base and cut down on potential avoidance and confusion by those using employee shares schemes at the high end while also maintaining the current support for employee share ownership schemes, particularly for low and middle income employees.

2.8 The Finance Sector Union submitted:

We note recent evidence from the ATO in Senate Estimates regarding their audit of individuals earning over \$1 million per annum which found substantial compliance issues relating to their use of employee share schemes. The examples cited regarding two individuals (one at CEO level) who had unpaid tax liabilities of around half a million dollars each demonstrate that aggressive tax planning in employee share schemes by executives and high income earners has continued unabated despite the 2000 Inquiry.

That being the case, the question then goes to how the Government of the day seeks to amend the legislation to ensure fair application of tax rules, while ensuring the objectives of employee share ownership are met.<sup>4</sup>

2.9 Labor members oppose the majority report recommendation 2 to delay the introduction of the proposed changes. The changes maintain all of the options available to low and middle income earners - \$1000 per annum upfront tax concession, deferral of tax on up to \$5000 of salary sacrificed into shares, and the deferral of tax on employer matched shares that have minimum employment period restrictions.

2.10 At the same time the proposed changes improve the equity and integrity of the taxation system and limit excessive concessions by improving reporting for ALL schemes, removing access to \$1000 upfront concession by high income earners, capping access to salary sacrifice tax deferral and restricting access to general tax deferral only to equity based pay that is subject to 'a real risk of forfeiture'.

2.11 Business, the tax profession and interest groups have acknowledged that there is an important tax integrity issue to be addressed with this measure.

2.12 The Employee Ownership Group has advocated for improved employer reporting and compliance over a number of years.<sup>5</sup> Mr Geoff Price, Computershare Ltd, explained:

A reporting obligation placed on employers offering division 13A plans was all that was really required to secure tax integrity. No further changes, we believe, are really necessary.<sup>6</sup>

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4 Finance Sector Union, *Submission 22*, pp. 4–5.

5 Mr Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 74.

6 Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 78.

2.13 Mr John Fauvet, PriceWaterhouseCoopers, supported the introduction of reporting requirements. This:

...by definition will reduce the opportunity for people either to not report at all or to get it wrong'. I do not think there is any doubt that there has been some lack of compliance, so the reporting condition will fix the compliance. The other things will not fix the compliance because they are all points of detail and points of interpretation, but reporting requirements will give the ATO a lot, if not all, of the information they need.<sup>7</sup>

2.14 The Institute of Chartered Accountants submitted that:

Following the Budget announcement there was a measure of dismay in the business sector and many existing Employee Share Schemes were suspended. The Government then issued a public consultation paper which sought to better understand the concerns of industry, and canvas a number of options to improve the taxation of employee share schemes.<sup>8</sup>

2.15 Evidence was also provided to the committee that business requires certainty. Mr Yasser El-Ansary, Institute of Chartered Accountants, explained that for businesses 'the highest degree of certainty on the way forward is absolutely essential at this point':

...in the interests of providing certainty and not continuing to operate in a hiatus period where businesses cannot make informed decisions and employees cannot fully understand their remuneration arrangements I think it is important that everyone is focused on getting to a position where maximum certainty can be provided for business.<sup>9</sup>

### **History of the need for reform**

2.16 When Labor was last in Government the then Liberal opposition blocked the Labor Government's attempts, following recommendations from the Treasury, to combat significant tax avoidance through employee share schemes with the Taxation Laws Amendment Bill (No. 4) 1994.

2.17 In 1995 Labor introduced *Taxation Laws Amendment Bill (No. 2) 1995*, introducing the new Division 13A that remains in place today. The opposition again opposed these amendments however the measure was passed with the support of the Democrats and the Greens. In welcoming the passage of Division 13A the then Treasurer said:

The Coalition's opposition to the legislation in the Senate today demonstrated that if elected to Government, they would take the tax system back to where it was when they were last in Government - riddled with opportunities for abuse by those on high

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7 Mr John Fauvet, *Proof Committee Hansard*, 27 July 2009, p. 39.

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

9 Mr Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, p. 37, 39–40.

incomes while those on low and middle incomes would be required to pay higher taxes to make up the lost revenue. Many of the existing schemes are no more than executive remuneration packages designed to convert salary into shares or share rights in order to take advantage of the open ended tax deferral opportunities available under the existing legislation.<sup>10</sup>

2.18 For 12 years, the Liberal Government continued to turn a blind eye to integrity issues raised by employee share schemes. This was to the great detriment of commonwealth revenue as they failed to protect the tax system from exploitation by high income earning executives attempts to avoid tax.

2.19 For over a decade excessively generous tax concessions have been allowed to subsidise the income of Australia's high paid executives undermining the equality of the tax system and directing revenue away from critical areas such as health, education and infrastructure.

2.20 The failure to address these issues has done nothing to support genuine employee share ownership, demonstrating a fiscal irresponsibility that while never acceptable, is completely untenable given the current economic circumstances.

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10 Treasurer Ralph Willis, Press Release No. 169, 1 December 1995.

## Chapter 3

### **Promotion of ESS as an alternative to superannuation**

3.1 Labor senators strongly oppose the committee's view to promote employee share schemes as an alternative to superannuation and consider this suggestion highly irresponsible.

3.2 Whilst acknowledging that having an interest in your employer boosts productivity, encourages better employment relations and reduces staff turnover, Labor senators believe employees should ensure that they diversify their savings.

3.3 Excessive investment by an employee in their employer puts the employee's savings at significant risk. Failure or underperformance of the employer would lead to both a loss of employment and loss of investments/savings. For example, there has been recent evidence of employees suffering large losses in the United States from undiversified employer sponsored savings plans due to the Global Financial Crisis. Employees do not need to hold significant interests in their employer for their interests be aligned.

3.4 The Government must balance these competing priorities whilst acting in a fiscally responsible manner.

3.5 An important part of retirement income policy is to ensure all members of the community have an adequate level of income in retirement. Substantial taxation concessions are provided for superannuation in order to encourage individuals to save for their retirement. However, restrictions are placed on the early withdrawal of superannuation savings to ensure they are used to provide for genuine retirement income.

3.6 Superannuation in Australia is subject to prudential regulation which seeks to protect the retirement savings of Australians. Other investments are not subject to the same restrictions and therefore do not receive the same level of concessions.

3.7 The proposed changes make it no more or less appealing for the average low and middle income employee to invest in the company they work for than the previous arrangements that were in place.

3.8 Employee share schemes while they provide employees with incentives to save (with the restrictions on eligibility for continued tax deferral limited by a maximum of seven years or end of employment) they are not a long term tax advantaged savings vehicle—and superannuation will always remain the most effective vehicle for long term retirement income savings.

3.9 However, the changes do maintain the ability for the low and middle income earners to invest in the company they work for; have a say as a shareholder and



possibly share in growth of the company and benefit through improvements in productivity that they have work towards.

3.10 There are also significant difficulties in comparing the tax treatment of employee shares or options in different jurisdictions because of different tax bases and different employee share plan structures and the differing rationale for their provision.

3.11 The Coalition senators did not explore application of this concept during the hearings, including the impact of employees retiring with shares in thinly traded companies, or the management of their portfolios especially where employees have worked for a significant number of companies during their working life.

### **Establishment of a promotional unit**

3.12 Labor members note that the previous Government—having established an Employee Share Ownership Development Unit (ESODU) in the Department of Employment and Workplace Relations following the release of the Shared Endeavours report—disbanded it in mid-2005.

3.13 An ESS consultative group was by established in the Treasury in 2005—but discontinued in early 2007 as it was considered more appropriate for the sector to raise concerns for consideration in a broader context, through the already available channels such as the ATO's National Tax Liaison Group.

3.14 According to the Finance Sector Union, 'there is a broad and bi-partisan acceptance that ESOPs can have a positive affect on the employee—employer relationship'.<sup>11</sup>

...taken in the whole with regard to remuneration models and with other progressive management practices that are about genuinely engaging with employees and giving them an opportunity to have a say in the organisation, I think we see that there would be productivity benefits. The other benefit that we have certainly witnessed is an employee engagement in some of the governance related decision making. For instance, their ability to participate at AGMs, their ability to have a look at board decisions and strategies, has been a good outcome for them, and in our experience they have used that mainly positively to raise issues of concern that affect them in the workplace. But, as an overall productivity measure, it is a little more difficult to immediately say yea or nay to.<sup>12</sup>

3.15 Mr Rod Masson, Finance Sector Union, continued:

If we were able to say that there is a direct correlation between lifting productivity therefore profitability therefore employment, I think I would be quicker to respond to you in the positive about that. It has been our

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11 Finance Sector Union, *Submission 22*, p. 2.

12 Mr Rod Masson, *Proof Committee Hansard*, 27 July 2009, pp. 59, 62; also see Finance Sector Union, *Submission 22*, p. 2.

experience that, whilst these schemes have been in place, there are still people being laid off and jobs being outsourced, and the pursuit of cost cutting is still very much to the fore of management decision making. I am unsure whether I could give you a definitive response on that...<sup>13</sup>

3.16 Government tax support is intended to be provided in tandem with support from employers. It is primarily the responsibility of business, not the tax system, to provide appropriate incentives to employees to encourage productivity.

3.17 That is, as a business derives considerable benefits from greater alignment of its employees to the business's interests, the firm should have sufficient incentive to offer the employee share scheme arrangement even in the absence of Government tax support. It would be inappropriate for taxpayers to fully subsidise the provision of employee share schemes when business and individuals derive substantial benefits from these arrangements.

3.18 Labor senators believe that individuals in similar circumstances should receive similar tax treatment, and that all forms of payment for employment should be taxed consistently. Therefore, the economic value embodied in employee share scheme shares and rights is equivalent to any other form of employee compensation and should generally be taxed in the same manner.

3.19 A core tax principle underpinning the proposed changes to the taxation of employee shares scheme arrangements is horizontal equity in the tax system. Providing additional tax concessions brings with it significant tax integrity risks. Employers may seek to access the concessions with the aim of subsidising the provision of employee remuneration. This would provide little or no benefit to the employees or the public more generally.

3.20 As the level of concessionality increases so do the incentives for the tax avoidance. That is, many tax avoidance arrangements are not entered into because the compliance costs outweigh the tax benefits. As the tax benefits increase, the incentive to enter such arrangements increases.

3.21 There has been a long history in Australia of tax avoidance with employee share schemes. As previously highlighted in 1995, the then Government reformed the taxation of employee shares scheme to address significant tax avoidance.

3.22 The recent reforms seek to again improve the fairness and integrity of tax law in this area.

3.23 Labor Senators also reject the call for additional research into employee share schemes. The University of Melbourne has been conducting research in this area. The research is being conducted with funding from the Australian Research Council (\$323,000). The aim of the study is to continue to inform policy debate.

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13 Mr Masson, *Proof Committee Hansard*, 27 July 2009, p. 62.

## **Consultation**

3.24 Following the Budget announcement, there was a measure of dismay in the business sector and many existing employee share schemes were suspended. The Government then issued a public consultation paper which sought to better understand the concerns of industry, and canvas a number of options to improve the taxation of employee share schemes.

3.25 Labor Senators note the longstanding practice of not discussing Budget measure prior to their announcement but recognise the need to minimise disruption. We commend the government for responding to feedback and making appropriate changes to the legislation.

3.26 On 1 July 2009, the Government issued a Policy Statement setting out the taxation of employee share schemes. This statement contained changes to the Budget announcement which took account of industry concerns expressed in consultation, while still addressing the acknowledged problems of tax evasion and tax avoidance. Further consultation was then undertaken on the draft legislation.

3.27 The Board of Taxation is the appropriate body to consider how best to determine the market value of employee share scheme benefits. The Board of Taxation will also consider whether employees of start-up, research and development and speculative-type companies should benefit from a tax deferral arrangement despite not being subject to a real risk of forfeiture.

## Chapter 4

### Salary sacrifice

4.1 The proposed legislation provides that:

...employees who qualify [for \$1,000 tax exemption schemes] can also salary sacrifice to purchase more shares through subscription plans that also allow for the deferral of tax for a period of up to ten years, thus increasing their shareholding.<sup>14</sup>

4.2 Employees will be able to salary sacrifice up to \$5000 per annum of their before tax income to purchase shares where there is no real risk of forfeiture, provided those shares, as a requirement of acquisition, have a minimum holding period of 3 years. Tax would be required to be paid when the restrictions of trade imposed as a requirement of attaining those shares is lifted, upon cessation of employment or after seven years—which ever occurs earliest.

4.3 This measure limits the tax concessionality of deferral for salary sacrifice schemes to high income earners and better targets the benefits to the low and middle income earners. The \$5000 limit adequately reflects the amount the low and middle income earners are currently contributing.

Unions agree that deferred taxation is reasonable where there is a genuine risk of forfeiture regarding the shares in question or where there is a capped salary sacrifice scheme offering no more than \$5000 worth of shares. Again, this would allow for our members to continue to participate in the purchase of further shares, beyond the \$1000 tax exempt employer 'bonuses' where they are able to do so through salary sacrifice arrangements.<sup>15</sup>

4.4 Employees are free choose to invest any amount of their after tax income in shares of the company that they are employed by.

4.5 Many employers in recognising the value to the company of employee share ownership offer share matching arrangements. These schemes match shares purchased by the employee with 'rights' to shares that become available after a defined period of employment. These schemes are designed by employers to encourage employees to invest in the company and align the long term productivity interests of employees and employers.

4.6 Under the new arrangements, with the 'right' to the matched shares being dependant on a minimum period of employment the matched shares would qualify for tax deferral. Further tax would not be due on these shares until any further restrictions placed on them at acquisition came in to operation (if the minimum holding period had expired or the employee ceased employment, or a maximum of seven years, which ever is the earliest).

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14 Finance Sector Union, *Submission 22*, p. 1.

15 Finance Sector Union, *Submission 22*, p.5

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## **Cessation**

4.7 Cessation of employment has been a taxing point in the law since 1995. Consultation on these measures was rightly focused on the changes proposed in the Budget and then in the following consultation paper.

4.8 Where shares or rights vest after an employee ceases employment with a company, it is open for the company to offer a 'partial vesting' arrangement to enable employees to dispose of a proportion of shares or rights to pay tax crystallised by a cessation of employment event.

4.9 On the broader issue of the use of equity-based payments for executives, the Government has asked the Productivity Commission to examine this issue, in coordination with both the Australian Prudential and Regulation Authority and the Australia's Future Tax System review as part of a broader review of executive remuneration practices.

4.10 Labor senators consider that the direction of the proposed employee share scheme changes is consistent with the general international corporate and risk governance trends of having portions of executive remuneration 'at risk', as they provide a tax concession in the form of deferred tax in situations where remuneration is subject to a real risk of forfeiture.

## **Risk of deferral**

4.11 The introduction of a risk of forfeiture test is intended to target schemes which contrive to defer tax without complying with the intent of the law, and to provide for deferral of tax only when there is a genuine performance incentive to the employee through having their employee share scheme benefits at risk.

4.12 Where there is a real risk that the benefits of shares or rights are never realised because the ESS interests are forfeited, deferral of taxation is considered the appropriate treatment. Providing for the deferral of tax in these situations recognises that the employee may never have a chance to recognise the economic value of the ESS interest, and that having employee remuneration 'at risk' in this manner is entirely consistent with the purpose of concessional tax employee share schemes, namely to align the interests of employees and employers.

4.13 The Financial Stability Forum (FSF) Principles of Sound Compensation Practices (which have been endorsed by the G-20 Leaders and Finance Ministers) emphasise the importance of aligning compensation incentives with risk. Labor members consider that the direction of the proposed ESS tax changes is consistent with this general principle, as they provide a tax concession in the form of deferred tax in situations where remuneration is subject to a real risk of forfeiture.

4.14 The introduction of the risk test is consistent with both the policy rationale for the concessional tax treatment of employee share scheme arrangements and principles of sound compensation practices which require performance based remuneration to be 'at risk'.

## Chapter 5

### Summary

5.1 Labor members believe the Government has an obligation to protect Commonwealth revenue to ensure the ongoing integrity of our tax system, and that our tax system applies fairly and equitably to all Australians.

5.2 The Government's changes demonstrate a real and genuine commitment to employee share ownership, striking the right balance by boosting integrity through reporting, better targeting support through an income threshold applying to the upfront concession and greatly improving corporate governance outcomes by requiring a scheme to feature a real risk of forfeiture to gain access to the deferral tax concession.

5.3 Labor members believe the Coalition committee members, by failing to support the Government's changes are not only deliberately impairing the Commonwealth tax system but are also failing in their duty to protect the integrity of legitimate schemes and support genuine employee share ownership in Australia.

5.4 Labor members of the committee believe that the current proposed changes are workable, consistent with remuneration practices and that current reviews underway will have limited impact on the core structure of these reforms.

### Recommendation 1

**5.5 The Labor senators believe that the Senate should pass the bill.**

**Senator Annette Hurley**  
**Deputy Chair**

**Senator Louise Pratt**