Research Report

EMPLOYEE SHARE OWNERSHIP IN UNLISTED ENTITIES: OBJECTIVES, CURRENT PRACTICES AND REGULATORY REFORM

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Employee Share Ownership Project

THE UNIVERSITY OF MELBOURNE

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The Employee Share Ownership Project is a joint initiative of the **Centre for Corporate Law and Securities Regulation**, the **Centre for Employment and Labour Relations Law** and **The Tax Group**. It is funded by an Australian Research Council Discovery Project Grant.

The project subjects the existing regulatory regime for employee share ownership plans in Australia – in tax, corporate and labour law – to technical and empirical scrutiny. It analyses how current legal regulation structures and constrains the use of ESOPs in Australian enterprises. It examines the current incidence and forms of ESOPs in Australia, the diversity of objectives that such schemes serve, the extent to which current corporate, tax and labour law inhibit ESOPs, and the case for reform of the regulatory framework.

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1. INTRODUCTION

The Employee Share Ownership Project, a joint initiative of the Centre for Corporate Law and Securities Regulation, the Centre for Employment and Labour Relations Law and The Tax Group of Melbourne Law School, has been examining the current use and regulation of broad-based employee share ownership in Australia. As part of that project a survey has been conducted of entities (public companies) listed on the Australian Securities Exchange (ASX). For research purposes, this group represents a discrete sector and the entities tend to share a number of characteristics – the entities are generally large by reference to turnover and often have large numbers of employees. The fact that the entity is listed also provides a mechanism for valuing any shares acquired by employees and a market that is a means of selling those shares when the time comes. It was also thought desirable to consider the use of broad-based employee share plans (ESOPs) in small and medium sized enterprises. Although size, however measured, may be a relevant determinant of the use and problems experienced by enterprises in relation to ESOPs, perhaps a more relevant determinant is that of being an entity that is not listed on any securities markets. The lack of a market presents particular problems of valuation and disposal of shares by employees. For that reason a separate research stream has been developed to consider the use and regulation of employee share ownership in unlisted entities. This report considers the objectives and current practice in this area and notes that employee ownership levels tend to be lower for unlisted entities than for listed entities. It also examines the regulatory obstacles to such ownership and makes recommendations for reform to facilitate employee ownership in this area.

As already noted, a significant part of this Project has been in relation to listed entities. Entities that become listed on the main Australian securities exchange, the ASX, must meet certain standards in terms of size. For example, there is a minimum size requirement (currently $1 million net profit over past 3 years and $400,000 net profit over last 12 months or $2 million net tangible assets or $10 million market capitalisation) and a minimum spread of shareholding (generally 500). This means that listed entities are by their very nature large. But small business plays a significant role in the Australian economy. Although there are more than 1 million companies in Australia, only about 1500 (about 0.1%) of them are listed on the ASX. According to statistics collected by the Australian

Tax Office (ATO), based on company income, most companies (79%) have income of less than $2 million and most income (and therefore most tax) comes from “large companies”, which according to the ATO means a company with income of more than $250 million. However, small business contributes approximately a third of tax paid and is a significant employer of labour in Australia. According to survey data published by the Australian Bureau of Statistics in 2001,[1] there were 1,233,200 private sector small businesses in Australia which represented 97% of all private sector businesses. These small businesses employed almost 3.6 million people, or 49% of all private sector employment. According to a submission to the Review of National Innovation, small business makes up more than 90% of businesses in Australia, produces one-third of Australia’s wealth and employs more than 40% of the Australian workforce.[2]

One of the difficulties with any discussion of the significance of “small business” is the problem of definition. A small business is variously defined by reference to turnover or profits, assets, number of employees or number of shareholders. For example, according to the *Corporations Act* a small proprietary company is a company that satisfies at least two tests based on maximum revenue ($25 million), maximum asset values ($12.5 million) and maximum number of employees (50).[3] This test is used for the purpose of determining reporting obligations.[4] According to the income tax legislation, a small business entity is defined by reference to aggregated (ie associate inclusive) turnover (less than $2 million).[5] This test is used to determine eligibility for a number of tax concessions, including Capital Gains Tax (CGT) relief, Simplified Tax System (STS) tax treatment (relevant for calculating capital allowances and trading stock liability, the Goods and Services Tax (GST), the Fringe Benefits Tax (FBT) and some other concessions. This unified definition was introduced in 2007 and replaced a number of different tests that applied some of which were based on turnover and some on asset values. In relation to the CGT concessions for small business it is still possible to rely on the former test that relates to the value of assets (must not exceed $6 million). The Australian Bureau of Statistics has two measures of small business. One definition defines a small business operator as one that employs fewer than 20 persons.[6] For non-labour related statistics, they adopt a test that looks at income and expenses and the range is $10,000 to $5 million.[7] According to the ATO a large business is one with turnover of $250 million or more, a small to medium size business is one with an annual turnover of

[1] Australian Bureau of Statistics (ABS), Small Business in Australia (2001), p 6.
[2] Innovation & Business Skills Australia (IBSA), submission to Review of National Innovation, April 2008.
[3] *Corporations Act 2001 (Cth)*, s 45A.
[4] *Corporations Act,* s 292(2).
[5] *Income Tax Assessment Act 1997* (ITAA 1997), s 328-110.
[6] ABS website, Counts of Australian Business Operators, 2006-2007.
[7] ABS website, Experimental Estimates, Regional Small Business Statistics, Australia 1995-2000.

between $2 million and $250 million and a micro business is one with an annual turnover below $2 million.[8]

Despite the different ways in which a small business can be identified, it is clear that this sector is a significant employer in Australia. It is also clear, according to research carried out by the Employee Share Ownership Unit (ESODU) within the Department of Employment and Workplace Relations (now disbanded) that private companies and small businesses generally were less likely to have an ESOP.[9]

Instead of adopting any of the definitions of small business, the focus of this report will be on unlisted entities. Apart from the likelihood that such entities are smaller than their listed counterparts, this group represents a common disadvantage, namely the lack of a ready market for their securities. The specific problems that arise from this disadvantage are addressed below.

For the purposes of this Project there is an obvious difficulty in collecting data about current practice and regulatory obstacles from such a diverse group of enterprises. The methodology used in relation to listed entities was obviously unsuitable. For this reason the Project held a workshop in April 2008 with representatives from government, business and advisory groups. Much of what is contained in this report is informed from the information provided by participants in that workshop.

2. OBJECTIVES AND CURRENT PRACTICE IN THE UNLISTED SECTOR

It is first necessary to consider the public policy objectives for which employee share ownership is currently promoted and to consider whether these objectives are relevant to unlisted entities. In earlier research[10] we identified the following objectives for employee share ownership:

- *Improving enterprise performance*. It has been noted that employee share ownership is a means of aligning the interests of employees with the company and providing an incentive for employees to achieve high levels of productivity;

- *Workplace relations objectives*. There are a range of human resource management rationales for employee share ownership. These include

[8] Commissioner of Taxation, Annual Report 2007-8, p 55.
[9] TNS Social Research, “Employee Share Ownership In Australia: Aligning Interests Executive Summary (2004)”, para [3.3]
[10] I Landau, R Mitchell, A O’Connell and I Ramsay, “Employee Share Ownership in Australia: Theory, Evidence, Current Practice and Regulation” (2007) 25 *UCLA Pacific Basin Law Journal* 25 at 30-36.

facilitating co-operation through breaking down the “them” and “us” mentality and also as a means of enhancing industrial democracy;

- *Contributing to national savings*. It has been suggested that employee ownership can increase voluntary savings of Australian workers. This objective has not featured strongly in Australia, perhaps as a result of the growth of superannuation as the main source of savings for retirement;

- *Promoting innovation*. Government policy directed at innovation has included references to the role of employee ownership in small and medium unlisted companies, particularly in “sunrise” enterprises;

- *Remuneration objectives*. Although never clearly identified as an objective in its own right, it has been noted that encouragement of ESOPs is consistent with government policy of allowing employers and employees greater flexibility and choice in their working arrangements. However, concern has also been expressed that concessional treatment may simply facilitate tax effective remuneration for executives;[11]

- *Facilitating employee buyouts and succession planning*. The Shared Endeavours Report noted that it had received submissions that the encouragement of ESOPs could facilitate these activities but there was no real discussion of whether this was something that government had taken into account in formulating regulatory policy.

Although these objectives could apply to listed and unlisted entities, two have particular relevance to smaller business entities – promotion of innovation and succession planning.

The recent development of knowledge-intensive ‘sunrise’ industries provides another area for ESOPs to play an important remunerative role. ‘Sunrise’ enterprises are often small or medium size, less than 5 years old, technology-intensive and/or relying on venture capital.[12] They tend to face significant cash constraints and lack of finance (as indicated in the recent report published by the CSIRO and AEEMA, based on interviews with over 70 CEOs and managing directors in the SME high-technology sector).[13] Sunrise enterprises may therefore be unable to offer prospective employees competitive cash-based compensation packages. Thus, employee equity is used as a mechanism for overcoming the disadvantage sunrise enterprises face vis-à-vis more established competitors by operating as a form of deferred compensation or pay

[11] House of Representatives Standing Committee on Employment, Education and Workplace Relations, Shared Endeavours - an Inquiry into Employee Share Ownership in Australia Report (2000), (Shared Endeavours Report). This comment was contained in the Minority Report.
[12] Shared Endeavours Report, ibid, p xxiii.
[13] See Neil Temperley, James Galloway, and Jennifer Liston, ‘SMEs in Australia’s High-Technology Sector: Challenges and Opportunities’ by CSIRO and AEEMA, October 2004.

substitution.[14] In those enterprises, shares may constitute a significant part of an executive's or employee's 'salary' and employees invest their skills, labour and time rather than any monetary capital[15] on the basis that the options will provide considerable returns in the future.

It would appear that unlisted entities use ESOPs for a number of different reasons and try to achieve a diversity of objectives rather than just to align the interests of employees and employers.[16] Participants in the workshop, consistent with previous remarks[17] and overseas experience,[18] cited employee recruitment and retention as one of the most critical goals for unlisted entities to implement ESOPs in practice. This corresponds with quarterly survey findings from the Sensis Business Index,[19] which identifies that "finding and keeping staff" had repeatedly surpassed "lack of work" or "sales", "economic climate", "cash flows", "fuel costs" and other issues to be the most pressing concern faced by SMEs in the past five years.[20] Financial participation, including through shares or options, helps motivate employees to commit to building up their human capital[21] and, as workshop participants suggested, lowers the rate of employee turnover. This, in turn, enables employers to invest more in training opportunities for key employees. Indeed, this rationale is reported to be particularly dominant in the IT and knowledge-based industries in the UK[22] while anecdotal evidence also suggests that small and medium sized mining companies in Western Australia have in the past offered employees equity in the company in the face of a tight labour market.[23] More recently, the Australian Venture Capital Association Limited (AVCAL) has also voiced its concern that the complexity and cost of ESOPs in Australia has placed small businesses, especially start up firms in bio-technology and sustainable energy, in a disadvantageous position as leading

[14] C Rider, "Sellers of Labour or Investors of Intellectual Capital? Conceptual Problems in the Taxation of Employee Share Ownership in IP Spin-Off Companies" (Working Paper No 19/05, Intellectual Property Research Institute of Australia, The University of Melbourne, October 2005). A Pendleton (2003), 'Employee Share Ownership in SMEs' in O Jones and F Tilley (Eds), *Competitive Advantage in SMEs: Organising for Innovation and Change* (2003), pp 111–12.
[15] Rider, ibid.
[16] Commonwealth of Australia, Government Response to "Shared Endeavours: An Inquiry into Employee Share Ownership in Australia (2003).
[17] R Stradwick, 'Further Submission on the Australian Employee Ownership Association Survey to the Shared Endeavours Inquiry' (7 April 2000).
[18] The RM2 Specialist, *Employee share schemes: A guide for Directors 2006/2007 Edition* (2007), available at < http://www.rm2.co.uk/ > (accessed 17 September 2008). See also A Pendeleton, J Blasi, D Kruse, E Poutsma and J Sesil, "Theoretical Study on Stock Options in Small and Medium Enterprises: Final Report to the Enterprise-Directorate General, Commission of the European Communities" (2002), pp 175-7.
[19] Available at < http://www.about.sensis.com.au/resources/sbi.php>
[20] Since 2004, "finding and keeping staff" topped the list of primary concerns for SMEs in 12/19 survey quarters, and consistently stayed in the top 3 during the whole period except for the August 2008 quarter.
[21] Pendleton et al, above n 14, p 172.
[22] Ibid, pp 171-2.
[23] Barry Leahy, Evidence to the Shared Endeavours Inquiry (13 July 1999).

researchers and innovators are "being lured" to other countries that can offer a "piece of the action" through their share plans.[24]

One objective that has been identified previously to be particularly relevant to the small business sector is implementation of ESOPs for succession planning purposes. In 2006, a survey by KPMG on family businesses in Australia found that 61 percent of respondents indicated that they would retire within the next 10 years and 58 percent of them were aged over fifty years.[25] However, the majority of them (78%) had no formal succession plan and 62 percent had not chosen a successor even though they wanted to pass their business to the next generation. Although the survey responses to succession questions were not unequivocal,[26] they did indicate that selling the business to employees, management and other owners was the second most popular choice after sales of business on the open market. It ranked above passing to other family members and significantly higher than publicly listing the company.[27] There is thus a great potential for the use of ESOPs as a vehicle for transferring ownership to facilitate smooth exit of current owners. This mechanism is very popular in the United States, with nearly half of all ESOPs there used by private firms to buy-out an owner.[28]

Given the diversity of objectives, all of which appear to be accepted by government as appropriate, it is desirable that government policy should be directed to ensuring that all entities are subject to regulation in an equal way and are able to access any relevant concessions in an equal way.

It is also necessary to consider what is known about employee share ownership in the unlisted sector. It is a well recognised fact that the take-up rate of employee share ownership since its introduction in Australia in the 1970s in the unlisted sector is significantly lower than in the listed sector.[29] The Australian Workplace and Industrial Relations Survey (AWIRS) in 1995 revealed that over 43% of businesses with over 200 employees had ESOPs whereas only 16% of workplaces within between 20 and 49 employees had ESOPs.[30] The most recent quantitative research commissioned by the Commonwealth Government's Employees Share Ownership Development Unit (ESODU)[31] in 2004 found the

[24] Australian Employee Ownership Association (AEOA), "Australia seriously lags in Employee Share Ownership", Policy Initiatives Seminar held in Sydney at Macquarie Bank, 30 July 2008.
[25] KPMG, Survey of Family Business Needs (2006), p 15.
[26] Ibid.
[27] Ibid.
[28] The National Centre for Employee Ownership (NCEO), "A Comprehensive Overview of Employee Ownership", accessible online at http://www.nceo.org/library/overview.html (accessed 17 September 2008)
[29] Shared Endeavours Report, above n 11, pp 21-22.
[30] A Morehead et al, "Changes at Work: the 1995 Australian Workplace Industrial Relations Survey" (1997).
[31] The ESODU was established by the Coalition Government in March 2003 in partial response to the Shared Endeavours Report's recommendation to collect information about the barriers to further participation in employee share ownership. It was however dismantled four years later as financial support was withdrawn. Several resources and information kits produced by the ESODU

occurrence of ESOPs in less than 10% of private companies, companies with only one office in Australia or small companies with between 5 or 19 employees in contrast to the 52% of publicly listed companies. In addition, the incidence of broad-based ESOPs could be even much smaller, as findings indicated that only 22%[32] in 1995 and 44%[33] in 2004 of all the ESOPs offered were open to more than 75% of all employees across all sectors. Those statistics suggest that the majority of employees in Australia who are employed in the unlisted sector do not have the opportunity to own shares in the companies for which they work. Given the lower incidence of ESOPs within the unlisted sector, it is necessary to consider the current regulatory regime to see if the regulation in some way inhibits the incidence of employee ownership.

3. EVALUATING THE CURRENT REGULATORY REGIME: ISSUES IN TAX AND CORPORATE LAW

A key feature of the project is to consider the impact of regulatory obstacles to employee share ownership. This requires consideration of the corporate and tax law environment and a discussion of whether those rules discourage the growth of employee share ownership. It is also important to note that there may be other obstacles to such growth that are not specifically related to the regulatory environment.

One factor that appears to be particularly relevant to new and emerging businesses is that owners are sometimes reluctant to issue new equity which is thought to entail a lack of control over the business. Moreover, there may be good reasons for maintaining 100% ownership. It has been observed that owners of private companies may need to have full control of their company to satisfy borrowing covenants, and for estate planning, tax and stamp duty requirements.[34] This means that a private company may need to restrict an employee's rights under the plan to ensure full control, such as through a 'shareholder agreement' which could require the exiting employee to sell shares back to the employer. Any agreement to restrict the right to vote may mean that the shares are not voting shares and are therefore ineligible for the concessions. For these reasons, owners of such entities may prefer to rely on borrowed funds for expansion and to provide incentives to staff in other ways.

The fact that non-regulatory obstacles may inhibit the take-up of ESOPs in the unlisted sector has been noted in other countries. In 2004, a European Research Foundation published a report on barriers and potential solutions for financial

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which were once available on the Australian Workplace website, are no longer accessible there, see http://www.workplace.gov.au/workplace/Programmes/ESO/ (accessed 17 September 2008)

[32] A Morehead et al, above n 30, p 222.

[33] TNS Social Research, above n 9, p15

[34] ESODU, "Developing an Employee Share Plan" (2003), Information Kit. No longer available online, see above n 31.

participation for smaller companies, in which a number of non-regulatory obstacles were identified. They included inertia and resistance among owners to giving up control.[35] It was also noted that many small companies would not have professional human resources managers and as a result may not have access to information about how an employee share plan could be used to provide potential benefits to the business. Despite this apparent reluctance, anecdotal evidence suggests many small businesses are interested in at least exploring the possibility of implementing ESOPs. Studies carried out in the UK suggest that although ESOPs are fairly rare in smaller companies, a number of situations lend themselves to the use of share schemes – management buy-outs, dot-coms and other “new economy” firms, exits (such as retirements), and firms experiencing difficulty in recruiting and retaining personnel.[36]

3.1 Corporate law issues

3.1.1 Disclosure obligations

The *Corporations Act* requires a disclosure document for all offers of securities for issue, unless expressly excluded.[37] The most common type of disclosure document is a prospectus which must contain all the information that investors and their advisers would reasonably require to make an informed assessment whether to invest or not.[38] Although this requirement appears in Chapter 6D which is headed “Fundraising”, the provisions are not limited to fundraising activities by entities but extend to all offers of securities. The notion of what constitutes a “security” for these purposes is important because some rights provided by an employer may not be securities, and therefore not subject to the Chapter 6D disclosure requirements. A security is defined for the purposes of Chapter 6D as including a share, a legal or equitable right in a share and also an option to acquire, by way of issue, a share.[39] If what is being offered is not within this definition, Chapter 6D will not apply although the interests being offered may be otherwise regulated under Chapter 7 (see below). The reference to offering securities for issue indicates that a disclosure document is required where a company issues shares for the first time. By contrast a disclosure document is only required in limited circumstances where the shares are already in existence.[40] The legislation contains a number of exemptions from the disclosure requirement. They include an exemption for “small scale offerings”; for offers to persons associated with the issuer and offers for no consideration. The regulator, the Australian Securities and Investments Commission (ASIC) also has power to

[35] European Foundation for the Improvement of Living and Working Conditions (EFILWC), *Financial participation for small and medium-sized enterprises: Barriers and potential solutions* (2004).
[36] A Pendleton, above n 14.
[37] *Corporations Act,* s 706.
[38] *Corporations Act,* s 710.
[39] *Corporations Act,* s 700
[40] *Corporations Act,* s 707.

grant exemptions and has done so to a limited extent in relation to employee share schemes (discussed below). It should also be noted that it is possible to satisfy the disclosure requirement in the case of a capital raising of up to $10m by providing a more limited form of document known as an Offer Information Statement (OIS).[41]

Small scale offerings

A disclosure document is not required if the offer of securities satisfies the requirements for a small scale offering.[42] This requires that the offer be subject to a 20 investor and $2 million ceiling. The 20 investor ceiling will be breached if the offer results in the number of people to whom securities are issued exceeding 20 in any twelve months period. This is directed to the number of persons accepting the offer. The $2 million ceiling is unlikely to be an issue in relation to an employee share scheme. This means that the exception could be relied on if the number of employees who can take up shares in the scheme is limited to 20 or less per year. The ATO believes that many smaller companies have designed employee share schemes which are limited in this way to avoid the need to prepare a prospectus.[43] Potentially this means that employees will be provided with no information.

Persons associated with the issuer

Section 708(12) provides that an offer of securities does not need disclosure if the offer is made to certain persons associated with the body. The persons identified are senior managers of the body or a related body, certain relatives and a body corporate controlled by a senior manager or relative. The term senior manager is defined in a fairly limited way to mean a person (other than a director or secretary) who participates in making decisions that affect the whole or a substantial part of the business of the company or has the capacity to affect the financial standing of the company.[44] This exception could be relied on to offer securities to executives but could not be used if offers were to be made to a wider group of employees. Again, no information is required if the exception applies.

No consideration

Section 708(15) provides relief from disclosure to investors if the issue or transfer of securities is made with no consideration. Section 708(16) also has a similar provision for the offers of “free options for free securities” which requires that both the option and the underlying security on the exercise of the option must be

[41] *Corporations Act,* ss 709 and 715.
[42] *Corporations Act,* s 708(1)-(7).
[43] ATO, Submission to the Shared Endeavours Inquiry (30 April 1999), p 3.
[44] *Corporations Act,* s 9.

offered without consideration. This exemption captures cases where companies issue free bonus shares or options as a gift.[45] However, given the special employment nexus between employees and the company, most practitioners take this exemption with reservation[46] especially since ASIC appears to take a narrow view of this exemption[47] and treats non-cash consideration as part of remuneration package. In practical cases, where shares or options are given to attract and retain employees with a condition of continued employment attached or as deferred compensation in 'sunrise' industries, it is unlikely that unlisted entities could rely on this exemption to circumvent disclosure obligations.

ASIC relief

Another option for companies offering securities in an employee share scheme to obtain relief from the prospectus requirements is to seek class order or case-by-case relief from ASIC.

In Regulatory Guide 49 "Employee Share Schemes" ASIC sets out its general policy on granting relief from the disclosure requirements of the *Corporations Act*. The basis for the relief is said to be the recognition that "the purpose of the offer is not fundraising but rather to enable employees to participate in the ownership of a corporation". The relief is available where the offer satisfies the conditions set out in the Regulatory Guide and expanded on in a Class Order CO 03/184. ASIC also notes that it may be prepared to give additional relief on a case by case basis in certain circumstances. In order to qualify for relief there are three basic conditions that must be met. The first condition is that there is a limit on the number of shares that can be issued under an employee share scheme. The limit is 5% of the total number of issued shares in that class at the time of the offer. This includes the number of shares in the same class issued during the previous five years pursuant to an employee share scheme. The purpose of this condition is said to be that the relevant offer is not fundraising. The second condition relates to the relationship between the offeror and the offeree. The Class Order limits relief to situations where the offeree is a full or part-time employee or director of the issuer or of an associated body corporate of the issuer. The purpose of this condition is said to be the nature of the mutual interdependence to justify relief. However, ASIC does note that it may grant case-by-case relief to casual employees who have been in employment with the company for more than one year and also to contractors where the contractor has worked for the company for more than one year and who received 80% or more of their income in the preceding year from the company. The third condition requires adequate disclosure to employees. This not only requires some prescribed forms of

[45] R Austin and I Ramsay, *Ford's Principles of Corporations Law* (2007, 13th ed), p 1028.
[46] See further Equity Strategies Ltd, Submission to the Shared Endeavours Inquiry (18 May 2000).
[47] J Sartori, 'Employee Share Ownership Plans – Issues Confronting ASX Listed Companies' (*2005*) 23 *Corporate & Securities Law Journal* 71. Indeed, in ASIC's explanation before the Committee, this exemption seems to provide relief for a typical case of issuing bonus shares for executive staffs rather than capturing the 'factory floor' level of employees. See Alan Cameron, Evidence to the Shared Endeavours Inquiry (13 July 1999).

disclosure (less onerous than a disclosure document) but limits the relief to shares that are in a class that is listed on the ASX or on an approved foreign exchange. Furthermore, the issuing entity must have been listed for at least 12 months although again relief may be given from the 12 month requirement in some circumstances.

Each of these conditions, but particularly the third condition, makes the relief unavailable for unlisted companies. Even without the listing requirement, the 5% limit means that new economy start up companies that wish to offer those contributing intellectual property in return for a stake in the company will not be able to receive a significant shareholding. The requirement, in most cases, for an employment relationship, or at least for an existing relationship between the offeror and offeree will also make the relief unavailable in the start up situation. Most significantly however the requirement for listing by definition excludes the sector under consideration. ASIC does not directly address the issue in the Regulatory Guide or Class Order but does state that the reason for the condition is to ensure that employees are offered shares that are priced on the basis of reliable market information (including information about price). In this situation the only option, if the exceptions are not available is to consider the disclosure document that is available for smaller capital raisings (see below).

In 2006 the government issued a Consultation Paper which considered the disclosure requirements for the issue of shares to employees of unlisted companies. In a subsequent Proposal Paper it was noted that although ASIC provides relief to listed entities, no similar relief was available for unlisted entities and that this contributed to the small number of employee share plans in such entities. It was also noted that "the discouragement of ESOPs in unlisted entities …does not accord with the general policy of supporting the introduction of employee share schemes".[48] In 2007 some amendments were made to the *Corporations Act* to provide relief for employee share schemes for unlisted companies.[49] However, the relief is primarily directed to the licensing[50] and hawking requirements of the Act.[51] A definition of an "eligible employee share scheme" was also introduced but this only relates to the minor relief referred to and mirrors the definition in RG 49 and CO 03/184. Indeed the relief is made available subject to the condition that a scheme must be accompanied by a disclosure document, although the type of disclosure document may be an Offer Information Statement (see below). The relief provided from the other provisions in the *Corporations Act* is discussed below.

[48] Corporate and Financial Services Regulatory Review, Proposal Paper, 2006, p 4.
[49] *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007.*
[50] *Corporations Act*, s 911A(2).
[51] *Corporations Act,* s 736(2).

OIS

An OIS is a simpler form of disclosure statement available for companies who seek to raise no more than $10 million in an issue.[52] The OIS imposes a lower level of disclosure than a full prospectus. This is due to the specific content requirements which reduce the need for legal advice and assistance in ensuring that the contents of the document are consistent with the requirements of the law. Furthermore, amounts raised under an "eligible employee share scheme" are not taken into account in calculating the amount that can be raised. An eligible employee share scheme is defined[53] as one where a disclosure document is prepared, the offers are restricted to employees as defined and the offers are for fully paid ordinary shares for issue[54] or options or units in such shares. The biggest issue for small companies in utilizing this alternative mechanism is the requirement that an OIS must include an audited financial report for a 12 month period with a balance date within the last 6 months before the securities are first offered under the statement.[55] Under section 301,[56] many smaller companies are not required to prepare financial reports or have them audited.[57] Furthermore, by requiring that the audited financial report must be for the 12 month period and have a balance date of less than 6 months old, this effectively prevents the use of OIS in start-up companies registered for less than 12 months[58] and limits the time frame for companies to offer shares to employees to a 3 month window each year (September to December) unless they go to the unreasonable expense of a mid-year audit.[59] The issue was raised in submission to Treasury in its review of regulation in 2006, but the legislation introduced does not deal with this matter.

3.1.2 Financial products disclosure and related issues

It is also possible that issuers will need to comply with the requirements of Chapter 7 of the *Corporations Act* which deals with financial services and markets. This could arise in three situations: what is being offered amounts to a right that is not a share or an option; what is being offered is a participation

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[52] This limit was increased from $5 million by the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007*
[53] *Corporations Act,* s 9.
[54] This means that an offer of securities for sale will require a prospectus: *Corporations Act*, s 709(4).
[55] *Corporations Act,* s 715.
[56] *Corporations Act.*
[57] *Corporations Act*, s 45A(2) defines a proprietary company as a small proprietary company if it satisfies at least 2 of the following conditions: (a) consolidated revenue less than $25 million; (b) consolidated gross assets less than 12.5 million; (c) have fewer than 50 employees.
[58] AOEA and EOG, submissions to the Shared Endeavours Inquiry (15 April 1999).
[59] AOEA submission (ibid). It was pointed out that preparing an audited financial report generally takes three months after the balance date of 30 June. This means an audited report is only available around September, with a balance date of 30 June, which gives effectively a company three months from September to December to prepare an offer for issue of shares with an audited report having a balance date of less than 6 months.

interest in addition to a share or option; or a share or option is being offered but it is necessary to consider the licensing requirements of Chapter 7.

Concerns were raised in the workshop with regard to the potential application of Chapter 7 disclosure as an obstacle for unlisted companies who contemplated the use of phantom share plans, also known as replicator plans. This plan gets its name because it tries to 'replicate' a real employee share plan, but does so without issuing real shares or options.[60] A replicator plan usually offers participants, for no or nominal cost, an entitlement to receive a cash payment in the future subject to satisfying predetermined performance and/or vesting conditions. While the amount of the cash payment may be linked to a security, the employee does not have any right to acquire the security, or any beneficial interest in the security.[61] Anecdotal evidence suggested that there could be good reasons for unlisted entities to use replicator plans due to the lack of liquid markets for their shares. Other reasons for having such a plan include mutli-national entities seeking to avoid the complex disclosure rules when they make offerings to their employees world-wide.

Although the use of such a plan does not involve the issue or transfer of a security, it is possible that the rights obtained by the employee will be a derivative or other financial product[62] and regulated under Chapter 7. ASIC appears to accept that replicator or phantom plans could be regulated under Chapter 7 by stating that it will not extend its class order relief to this product and only consider granting relief on a case-by-case basis.[63] Indeed, in the past, a limited number of case-by-case reliefs have been granted for derivatives.[64] It is also possible that Chapter 7 disclosure would be relevant when companies wished to grant some form of participatory rights to remunerate employees, as these could fit within the wide definition of "financial products". There is, however, a specific exception for "contribution plans" from the disclosure requirements of Chapter 7.[65] The term "contribution plan" is defined[66] to include conditions which must apply to the features and operation of the plan for it to qualify for relief. Important features include that the deductions made under the plan must be authorised by the employee and may be discontinued at any time at the election of the employee.

A further issue relates to the licensing provisions of Chapter 7. A person must hold a Financial Services Licence if they are providing a "financial service" that includes the provision of financial product advice, dealing in a financial product or

[60] Shared Endeavours Report, above n 11, p 20.
[61] Sarah Bernhardt and Adrian Chek, 'Using Employee Share/Option Plans to Attract and Retain Employees – Tax Issues' (Paper presented for Tax Institute, 17 February 2004)
[62] See *Corporations Act,* ss 763A and 764A.
[63] ASIC RG 49.30.
[64] For example, ASIC granted relief on 23 December 2004 to Westfield Holdings Ltd under Instrument No 04/1599.
[65] *Corporations Act,* s 1010BA.
[66] *Corporations Act*, s 9.

providing custodial or depository services.[67] It should also be noted that for these purposes, a financial product includes a security.[68] Where an offer document contains advice about the employee share scheme, a licence may be required. ASIC will provide relief if the advice given is of a general nature only and a warning is given that employees should consider obtaining their own financial advice.[69] Where the employee share scheme involves an offer of securities, this will amount to dealing and a licence will be required. In some cases the employer will be exempt from the licensing requirement based on the self-dealing exemption ie where a body deals in its own securities.[70] There are two restrictions on this exemption. The first relates to the fact that the exemption is limited to securities and is not available to other financial products. The second is that the exemption is not available for offers of securities or other financial products through a trust. In these cases, ASIC will grant relief if the dealing activity is outsourced to a licensed securities dealer. If an employee share scheme involves a trust structure, a licence may be required for providing a custodial or depository service. ASIC will grant relief where the custodial service is provided by the issuer or an associate of the issuer and the custodian performs its duties lawfully and in good faith, and has sufficient resources to perform its role.[71]

3.2 Tax law issues

Under the current tax regime, shares and rights provided to a person in respect of services provided will be subject to tax under Div 13A *Income Tax Assessment Act 1936* (ITAA 1936). There are, however, some concessions that are available provided the arrangement meets certain requirements. The concessions are either a $1000 exemption per employee per annum or a deferral of tax until certain events occur, up to a maximum of 10 years.

There are a number of tax issues that may impact on the take-up of employee ownership in unlisted entities and in particular in smaller and start up businesses. They include:

- Tax concessions are restricted to companies;
- Tax concessions are restricted to employees;
- The criteria for obtaining tax concessions are unduly restrictive;
- There are problems associated with the valuation of shares and options in unlisted companies;
- There is a lack of a ready market for disposal of employee shares and options;
- There is potentially inappropriate interaction between Div 13A and the CGT provisions:

[67] *Corporations Act,* s 911A.
[68] *Corporations Act,* s 766A.
[69] ASIC RG 49.59.
[70] *Corporations Act,* s 766C(2).
[71] ASIC RG 49.61-62.

- There are issues of complexity and cost of implementing plans that impact more heavily on smaller enterprises;
- The $1000 exemption is too low to offer encouragement for taking up shares and options; and
- It may be inappropriate to treat equity as remuneration in start up companies.

3.2.1 Tax concessions are restricted to companies

Where an employer provides a non-cash benefit to a person in respect of services provided, there will be a taxing point. Often the tax will arise under the *Fringe Benefits Tax Assessment Act 1986*. That Act imposes tax on an employer of the employee who receives the benefit at the top marginal rate, based on the "taxable value" of the benefit provided. The Act provides some specific valuation rules[72] but if no specific rule applies, the benefit will be treated as a residual benefit[73] and the taxable value is likely to be "the amount the person could reasonably be expected to pay to obtain the benefit from the provider under an arm's length transaction".[74] Where the benefit provided is a share or a right to acquire a share under an employee share scheme as defined in Div 13A, the *Fringe Benefits Tax Assessment Act* (FBTAA 1986) does not apply.[75] Those benefits are subject to tax under Div 13A ITAA 1936 to the extent that any discount is provided.

The taxing rules in Div 13A do not specify that the shares need to be shares in the employer, however in order to obtain the concessions ($1000 exemption or deferral) the shares must be shares in a company which is the employer of the taxpayer or the holding company of the employer. One limitation that this imposes is that no concessions are available if the employee is employed by a joint venture company and is offered shares in the company which is the other joint venture partner.[76] Because the joint venture partner is not the holding company the concessions are not available. This also means that the tax concessions are only available to those businesses whose legal form is that of a company to the exclusion of other legal structures such as joint venture, trust and partnership despite statements from practitioners that companies are not likely be the vehicle of choices in mid-market. Other forms of equity interests may be subject to tax under the *Fringe Benefits Tax Assessment Act* with no concessions available.

3.2.2 Tax concessions are restricted to employees

The taxing provisions in Div 13A apply whenever a share or right is acquired under an employee share scheme. However, the definition of employee share

[72] FBTAA 1986, Divs 2-11.
[73] FBTAA 1986, Div 12.
[74] FBTAA 1986, s 50 and definition of "notional value" in s 136(1).
[75] FBTAA 1986, s 136(1)(ha)-(hc).
[76] KPMG, submission to Shared Endeavours Inquiry.

scheme makes clear that an employment relationship is not necessarily required. The legislation provides that a person will acquire a share or right under an employee share scheme if it is acquired in respect of any employment *or in respect of any services provided by the taxpayer* (or an associate of the taxpayer), whether directly or indirectly.[77] This means that a tax liability could arise where the parties are in a contractual relationship. However, in order to qualify for the concessions the provider of the shares or rights must be either the employer of the taxpayer or the holding company of the employer.

The different treatment of employees and contractors under Division 13A applies to all companies but is of particular significance in the unlisted sector and in smaller businesses in particular. The dichotomy can be criticised on the ground that it fails to take into account the dynamic nature of the labour market particularly in areas such as IT where an increasing part of the workforce prefers to work for a company in the capacity of a contractor[78] or to provide services through their own private companies.[79] Some industries, like the retail industry, have a high proportion of employees who have worked for a long period of time but on a casual basis to suit the nature of their businesses. The distinction will particularly have a negative effect on many unlisted entities and sunrise industries where the proportion of workers on contract is likely to be higher than in the listed sector.[80]

3.2.3 The criteria for obtaining tax concessions are unduly restrictive

To be eligible for tax concessions under Division 13A, there are a number of requirements in addition to the two already mentioned (the requirement that shares or rights in a company be provided and the requirement that there be an employment relationship). The additional requirements are that the shares are ordinary shares,[81] that the acquirer does not acquire more than 5% of the shares in the company[82] and, in the case of shares, that the scheme is open to at least 75% of current employees.[83] To be eligible for the exemption concession, there are further conditions to be satisfied, namely that the scheme be operated on a non-discriminatory basis, that there can be no forfeiture of ownership and that there are restrictions on disposing of the shares or rights.[84]

Ordinary shares

The requirement that what is offered is an ordinary share, or a right to acquire an ordinary share, is a particular problem for the unlisted sector for a number of

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[77] ITAA 1936, s 139C(2).
[78] Transcript of Evidence, Shared Endeavours Inquiry, p 152.
[79] Sarah Bernhardt and Adrian Chek, above n 61. ‘
[80] Shared Endeavours Report, above n 11, p 110.
[81] ITAA 1936, s 139CD(4).
[82] ITAA 1936, s 139CD(6) and (7).
[83] ITAA 1936, s 139CD(5).
[84] ITAA 1936, s 139CE.

reasons. It should be noted that it is now possible to issue stapled securities (ie an arrangement under which different securities, such as a share in a company and a unit in a unit trust, are offered together and cannot be dealt with separately) provided that this includes an ordinary share.[85] Two further problems are that the notion of an ordinary share requires that the shares carry the right to vote and that it is not possible to issue any sort of preferential shares or rights.

The argument was put to the Shared Endeavours Inquiry that the issuing of stapled securities would permit the broadening of employee share ownership. Although not discussed in great detail it was said that this would permit the securities to be based on the performance of the employee but retain the same rights as any other shareholder.[86] This change was introduced in 2007.[87]

The term "ordinary share" is not defined in the ITAA 1936 but it takes its ordinary meaning[88] and must carry with it a right to vote.[89] The requirement that employees must have a right to vote in the affairs of the employer stems from the notion that employee participation in a firm's decision-making leads to improvement in its productivity and performance.[90] In giving evidence to the Shared Endeavours Inquiry, the ATO indicated that in its view the rights contained in an ordinary share give employees some basic guarantees concerning what is being provided by the employer. It was also said that equities other than ordinary shares provide opportunities for misuse of the taxation system.[91] However, the rigid attachment of voting power to tax concessions effectively and systematically denies access to those small businesses where owners are sensitive about control issues. It has been generally reported in literature that independence and autonomy are highly critical for some existing small business owners psychologically[92] and thus many would be unwilling to give up their control even if they are prepared to allow employees to participate in

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[85] ITAA 1936, ss 139DSA-139DSI.
[86] Remuneration Planning Corporation Pty Ltd, submission to the Shared Endeavours Inquiry.
[87] Inserted by *Taxation Laws Amendment (2007 Measures No 1) Act 2007* (Act No 56 of 2007).
[88] ATO, Additional Submission to Shared Endeavours Inquiry (10 June 1999).
[89] Note that the UK Act also refers to ordinary shares to be qualified for tax concessions but their concept does not include voting rights. Shares could be non-voting. See RM2 Specialist, above n 18.
[90] P Costello, Submission to Shared Endeavours Inquiry.
[91] ATO, Additional Submission to Shared Endeavours Inquiry (10 June 1999).
[92] J A Katz and P M Williams, 'Employee Stock Transfers in SMEs: Understanding an Infrequent Event' in C L Cooper and D M Rousseau (Eds), *Employee versus Owner Issues in Organisations: Trends in Organisational Behaviours* (2001), p 117. This tension clearly was not limited to the US context as discussed in Katz and Williams' paper but also exists in Australia. This has been referred to as 'a very Australian thing' in A Burke, Implementing Employee Share Arrangements for Small Enterprises, Small Business Law Workshop (2001), 5 available from www.burkes-law.com

the profits of the company[93] and know that an ESOP could lead to growth and profitability in the business.[94]

The requirement that the shares be ordinary shares means that it is also not possible to provide shares having preferential rights. Typically a preferential share will carry an entitlement to be paid a fixed return in preference to other shareholders. This may be thought desirable in the start-up business where a person is contributing significant intellectual capital.

5% limit

In order to qualify for the concessions, immediately after the acquisition of the share or right, the employee must not hold a legal or beneficial interest in more than 5% of the shares in the company or be in a position to cast, or control the casting of, more than 5% of the maximum number of votes that might be cast at a general meeting of the company. It has been suggested that where what is acquired is an option there is no limit imposed because it is not until exercise of the option that the acquirer will have a legal or beneficial interest in shares or be in position to cast votes. The rationale for the 5% limit was considered by the Shared Endeavours Inquiry which noted two purposes. First, this was thought to prevent abuse of share plans through excessive grants of shares or options to employees at concessional rates. The second purpose was said to be that the concessions are to encourage widespread ownership and not to provide concessions to substantial shareholders. Whatever the rationale for the limit, it appears to impact more heavily on unlisted entities than listed entities. In a listed entity, there is a requirement that there be a minimum of 500 shareholders and it is highly unlikely that an employee would ever hold such a significant stake. In the case of unlisted and in particular smaller enterprises, it may be thought desirable to provide a greater proportion of the equity for a variety of reasons, including in the buy-out scenario or where a person is contributing significant intellectual capital to the business. The Shared Endeavours Report did recommend[95] that the limit should be relaxed for small and medium sized enterprises but this has not been introduced.

The requirement differs from the 5% requirement under relief for employee share schemes given by ASIC under the *Corporations Act*. That precludes more than 5% of the shares in the company from being offered under the scheme but does not limit the amount that can be offered to any one employee.

[93] J Kirwood, *Employee Share Ownership Plans: Comments regarding issues for small/medium companies and possible solutions to enable such companies to offer participation in ESOPs*, Submission to the Shared Endeavours Inquiry, p 2.
[94] Burke, above n 92.
[95] Shared Endeavours Report, above n 11, Rec 34.

75% of permanent employees are entitled to acquire shares or rights

This condition only applies if what is being acquired is a share. It does not apply if a right is being acquired. The condition provides that at the time the share was acquired, at least 75% of permanent employees were, or at some earlier time had been entitled to acquire shares or rights under the existing scheme or shares or rights in the employer, or in the holding company of the employer, under another employee share scheme. In one sense the condition is fairly broad and can be satisfied by having one scheme that is available to all, or a significant proportion of employees, and another more restrictive scheme that is only open to senior executives or some other selected group of employees. However, where only one plan is contemplated it can be difficult to satisfy. The term "permanent employee" is defined as a full-time or permanent part-time employee of the employer with at least 36 months service (whether continuous or non-continuous). The Commissioner does have a discretion to relieve a company from strict conformity with this test, if the Commissioner is satisfied that the employer has done everything "reasonably practicable" to ensure the condition is satisfied.[96] This will not be the case if the employer simply wishes to make a restricted offer to particular employees.[97] These requirements may prove quite onerous for smaller employers, may be difficult to satisfy in a labour market where working relationships are shorter and clearly does not take into account casual employees no matter how long they have worked for the company.

In order to take advantage of the exemption concession, there is a further condition that the scheme and any scheme for the provision of financial assistance must be operated on a non-discriminatory basis.[98] This requires the scheme to be open to at least 75% of permanent employees and that the essential features of the offer are the same for at least 75% of permanent employees.[99] This is even more onerous and applies whether the scheme offers shares or options.

Exemption conditions

In addition to the non-discrimination condition, there are two further conditions for the participant to be eligible for the exemption concession. First, the scheme must have no conditions that could result in the recipient forfeiting the ownership of shares or rights acquired under the scheme. This appears designed to ensure that the employer cannot simply recapture the benefit that has been provided. It has been noted, however, that this provision may have a wider ambit and may prevent employers in smaller enterprises from requiring that their shares not be sold to third parties.[100] Secondly, the scheme must be operated so that no

[96] ITAA 1936, s 139CD(8).
[97] See eg ATO ID 2003/24.
[98] ITAA 1936, s 139CE(4).
[99] ITAA 1936, s 139GF(2).
[100] Shared Endeavours Report, above n 11, p 160-1.

recipient is permitted to dispose of a share or right before the earlier of 3 years or when employment ceases.[101] This appears designed to ensure that employees hold the shares or rights in the employer (perhaps to meet the enterprise performance or industrial relations objectives) rather than being able to realise gains in the short term by selling them. There may also be commercial reasons why an employer wishes to impose restrictions on disposal eg if the scheme involves a loan plan and the shares are security for the loan.[102] The condition has been criticised as being inflexible[103] and the policy justification for preventing employee shareholders from disposing of shares whatever the market conditions does not appear convincing. The provision also gives rise to problems of valuation because realistically the inability to sell shares or rights will impact on the value but the legislation indicates that such a restriction is to be ignored.[104]

3.2.4 Valuation of shares and options in unlisted companies

Under Div 13A shares and rights must be valued at various times to calculate the tax liability. Unless the shares or rights qualify for deferral, they must be valued at the time they are acquired. The time of acquisition may differ between employees even though they may have been offered the shares or rights at the same time. This may create an administrative burden for employers and uncertainty for employees. Another issue that arises is that employees will generally be subject to tax at the "cessation time". In the case of shares and rights this includes when employment ceases and in the case of rights, when the right is exercised.[105] In each of these cases, there may be no actual disposal of the share or right. It may be that the shares or rights will need to be sold to pay the tax liability. Although both of these issues apply to listed and unlisted entities, the issues are more acute for unlisted entities given the absence of a market mechanism to determine the value. In the case of unlisted shares, the legislation provides that the market value of the share is the arm's length value specified in a written report provided by an independent auditor, or the value as calculated by a method approved by the Commissioner as a reasonable method.[106] Such a process was estimated to cost between $5000 and $30,000 in 1999,[107] and was identified as one of the main reasons that unlisted entities were discouraged from offering ESOPs.[108] The Shared Endeavours Report recommended the development of simplified valuation methods.[109] The Government response was that this should be dealt

[101] ITAA 1936, s 139CE(3).
[102] Andrew Clements, "Legal and Practical Issue in Implementing and Administering an Employee Share Plan" Taxation Institute Seminar, 25 May 1999.
[103] Shared Endeavours Report, above n 11, p 169.
[104] ITAA 1936, s 139FD.
[105] ITAA 1936, ss 139CA and 139CB.
[106] ITAA 1936, s 139FB.
[107] Australian Venture Capital Association Limited (AVCAL), *ESOPs - Reforms to help Australian Companies attract key executives,* Submission to the Shared Endeavours Inquiry.
[108] Shared Endeavours Report, above n11, p110.
[109] Shared Endeavours Report, above n 11, Recs 28 and 29.

with by the Australian Accounting Standards Board (AASB)[110] but no simplified methodologies have been adopted.

In the case of unlisted rights, the legislation provides that the market value is the greater of:

- the market value of the share less the exercise price; and
- the value determined in accordance with the Tables provided (or in some cases as determined by a qualified auditor).[111]

It has been stated that the Tables can provide anomalous results.[112] For example, the tables may result in a taxable value of the right, which when added to the exercise price results in an amount that is greater than the market value of the shares to which the right relates.[113] It has also been stated that the Tables are unnecessarily difficult to apply.[114] If the market value of the right is nil or cannot be determined, the market value of the right is the same as the market value of the share on that day.[115] It has also been stated that the Tables do not recognise an amount paid for the option, nor do they recognise a restricted open period for exercise and/or price hurdles for exercise.[116] There are also problems where the exercise price is variable but cannot be determined until it is paid. It has also been noted that non-transferability means that the options have a lower market value but this is not reflected in the Tables.[117] Indeed, the legislation expressly provides that conditions and restrictions are to be disregarded in calculating the market value of a share or right.[118]

Possible solutions to this problem include having some sort of *de minimis* rule. This type of rule is appropriate where the benefit being provided is small and the cost of valuing it seems disproportionate. Such a rule operates in relation to fringe benefits provided to employees where the total value of benefits provided during a year is less than $300. A suggestion to this effect was made to the Shared Endeavours Inquiry based on the number of options issued to an employee.[119] Another possible solution is to permit the employer and employee to adopt a formula, approved by the ATO in advance, which would determine the disposal consideration and represent the value for tax purposes.

[110] Government Response to the Shared Endeavours Report, above n 16, p 10.
[111] ITAA 1936, s 139FC.
[112] KPMG, Submission to the Shared Endeavours Inquiry, p 4.
[113] Ibid.
[114] Ibid.
[115] The market value of the right will be nil where the exercise price is significantly higher than the market value of the share: ITAA 1936, s 139FL(1).
[116] KPMG, above n 112.
[117] BHP, submission to Shared Endeavours Inquiry, p 6.
[118] ITAA 1936, s 139FD.
[119] KPMG, above n 112.

3.2.5 Lack of a ready market for disposal

When an employee wishes to sell his or her shares to realize the gain in value, or upon leaving the existing employer, the absence of a market restricts the ability to do so. There are potentially three sources of buyers: new shareholders, existing shareholders and the company itself, which appears to be the most practical option for commercial reasons given its financial position[120] and that it is not always practicable to find willing buyers to match supply.[121] Where the employer is prepared to buy the shares, it will be necessary to comply with the requirements in the *Corporations Act* dealing with share buy backs.[122] That legislation recognises that share buy backs are often used to provide a mode of realization for employees holding employee shares. A share buy back will also have tax consequences that depend on whether the buy back is on-market or off-market. In the case of an on-market buy back all of the disposal consideration will be treated as on capital account.[123] This means that provided the shares have been held for more than 12 months the CGT Discount will be available to calculate the tax liability.[124] In the case of an off-market buy back part of the consideration will be on capital account but part will be a deemed dividend and subject to tax under s 44 ITAA 1936.[125] Only some of the consideration will get the benefit of the CGT Discount. The provisions governing off-market buy backs under Division 16K ITAA 1936 are complex.[126] In essence, unlike an on-market buy back, part of the purchase price under an off-market buy back is considered a dividend in the hand of the taxpayer, the exact value of which is determined based on the difference between the purchase price and the amount debited to the company's share capital account.[127] This "dividend" amount is included in the taxpayer's assessable income.[128] The rest of the purchase price, generally after adjustments for market value and reduction amount is treated as disposal consideration for capital gain tax purpose,[129] the calculation of which is arithmetically complicated.[130]

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[120] Board of Taxation, *Discussion Paper: Review of off-market buy back* (2007), p 10. Available online at <http://www.taxboard.gov.au/content/share_buybacks.asp> (accessed 19 September 2008)

[121] A Pendleton (2003), above n 14, p 110. In the UK experience, employees/shareholders would often wish to cash out when share prices are high but clearly when prices are high, existing shareholders and potential third party buyers would be discouraged to buy in. There may also be restrictions on selling to third parties under a "shareholder agreement".

[122] *Corporations Act,* s 257B.

[123] ITAA 1936, s 159GZZZR.

[124] ITAA 1997, Div 115.

[125] ITAA 1936, s 159GZZZP.

[126] The complexity is illustrated in a Practice Statement issued by the ATO: Practice Statement Law Administration PS LA 2007/9.

[127] ITAA 1936, s 159GZZZP(1*).)*

[128] Board of Taxation, above n 120, Appendix H, pp 123-4.

[129] ITAA 1936, s 159GZZZQ(1)-(9),). See also Explanatory Memorandum, *Taxation Laws Amendment Act (No.1) 1996*, [2.6-2.17].

[130] For illustration, see the hypothetical case and calculation of capital gain and loss from off-market buy back of listed shares in Tax Determination TD 2004/22.

An unlisted company buy back is obviously off-market. Indeed, an off-market share buy back is often used in closely held unlisted companies to enable existing owners to exit the company with ease.[131] This can also facilitate succession planning in the unlisted sector.[132] However, as a result of adverse tax consequences many companies establish trusts to hold and re-purchase shares under an ESOP when some form of buy back could be administratively simpler.

The Board of Taxation is currently undertaking a review of the off-market buy back provisions in the tax legislation. In its Discussion Paper it raised the issue of the interaction of the employee share scheme provisions and the off-market buy back provisions. It provided a number of examples which demonstrated that where employees receive discounted shares, the buy back rules can result in a greater tax liability than if the shares were sold to a third party.[133] The situation is also administratively burdensome for employers as they may need to obtain a ruling from the ATO every time such a buy back occurs to determine the dividend component. The interaction between ESOP practice and share buy backs has been summarized by the Institute of Chartered Accountants in Australia, as "making it harder for unlisted companies to undertake share buy backs"[134] and "producing adverse outcomes for employees that are neither fair nor appropriate."[135]

Furthermore, shares under an employee share scheme are often subject to vesting or performance conditions under which shares are forfeited if those conditions are not met and in such cases, the employees may have neither a gain nor a loss. However, if shares were originally offered directly from the company and the transaction later was structured as a buy back, the employee would be forced to recognise a dividend component as income, notwithstanding the transaction was otherwise neutral.[136] If the company debits the total amount of the buy back to share capital so that the dividend amount was nil, such an arrangement could be captured by the anti-avoidance rules relating to capital streaming in section 45B.[137] This necessitates an onerous administrative step by the entity to obtain an ATO ruling.[138]

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[131] CPA Australia, *CPA Australia Comments on Issues Raised in the Board of Taxation Discussion Paper on Review of Taxation Treatment of Off-Market Share Buy backs* (2007), Submission to the Board of Taxation Review, pp 1-4.
[132] Board of Taxation, above n 120, para [2.13]. Also agreed with by The Institute of Chartered Accountants in Australia (ICAA), *Submission on the Review of the Taxation Treatment of Off-Market Share Buybacks* (2007), Submission to the Board of Taxation, para [10.3]
[133] Board of Taxation, above n 120, Appendix H.
[134] ICAA, above n 132, p 21.
[135] Ibid, p 24
[136] Ibid. See also Ernst and Young (E&Y), *Board of Taxation Review of the Taxation Treatment of Off-Market Share Buy backs* (2007), Submission to the Board of Taxation Review.
[137] E&Y, ibid, p 13.
[138] ICAA, above n 132, p 21.

To counteract the undesirable tax outcome, employers often establish trusts to act as a purchaser and temporary holding vehicle for shares subject to forfeiture conditions. However, it has been noted that a more efficient solution could be adopted by the formation of a "carve-out" provision for employee share buy backs,[139] in line with the same special treatment for employee share buy backs under the corporate law framework.[140] It has been suggested that there should be a carve-out from the off-market share buy back provisions in relation to employee share plans.[141]One option would be that the law treat the buy back as a simple capital transaction (ie the same as an on-market buy back), so that the total amount of purchase price is consideration on disposal of the shares or rights[142] and is subject to tax under the capital gain tax regime.

3.2.6 Interaction between Div 13A and the CGT provisions

The intention of the taxing provisions in Div 13A is that any benefit in the form of a discount given to a person who receives shares or rights as a reward for providing services should be taxed, generally at the time the benefit is received, although the taxing point may be deferred if certain conditions are satisfied. The intention of the CGT provisions is that when an asset such as a share or option is disposed of, the net gain should be subject to tax. The special treatment that is accorded to taxation of capital gains makes the interaction between the two sets of provisions significant. Take for example an employee who acquires a share with a market value of $1 for 20c in Year 1. Under Div 13A there would be a liability to pay tax on the discount of 80c which could be deferred until "cessation time" ie until employment ends or the share is disposed of up to a maximum of 10 years. Assume that in Year 3, the employee disposes of the share for $3. In a non-employment situation this gives rise to a capital gain of $2 which will get the benefit of the CGT Discount so that only $1 will be subject to tax. But the legislation provides that if the disposal occurs within 30 days of the cessation time, the capital gain is disregarded and $2.80 will be subject to tax under Div 13A as opposed to $1.80 if some of the gain is subject to capital gains tax. This means that there is a strong incentive to pay tax up front under Div 13A on the discount. Although this applies to all taxpayers, it could be said that employees in smaller companies are less likely to have cash available to pay tax upfront when they acquire the shares or rights.

The Shared Endeavours Report was presented at about the same time as the CGT Discount was introduced. The report noted that there was the potential for adverse tax outcomes where tax liability was deferred under Div 13A.[143] The Report made some recommendations designed to ensure that any gain in value

[139] Ibid.
[140] *Corporations Act,* s 257B.
[141] ICAA, above n 132,
[142] *ITAA 1936*, s 159GZZZR.
[143] Shared Endeavours Report, above n 11, pp 137-9.

between acquisition and disposal of the shares or rights was treated as capital,[144] but this recommendation was not accepted by the government.[145]

3.2.7 There are issues of complexity and cost of implementing plans that impact more heavily on smaller enterprises

The current regulatory framework has been strongly criticised for being overly complex and prescriptive, with legislation affecting employee share plans "scattered across a number of pieces of legislation, each of which is itself very complex".[146] Div 13A and the CGT rules in particular have been identified as giving rise to "a great deal of confusion and concern regarding how the law should be interpreted and administered".[147] Many listed companies also face this complexity and continue to have difficulties despite the investment of significant resources and personnel. However, issues of complexity tend to impact most heavily on unlisted and smaller entities as they do not have the same access to resources and expertise as listed companies.

This complexity in the tax legislation can have a number of consequences. The first is that entities may be faced with high costs associated with establishing and maintaining plans to ensure that they comply with the relevant laws. Related to the cost issue is that many entities may be deterred from implementing plans because of the need to tailor the plans to the legislative requirements and to meet the needs of the enterprise. Submissions to the Shared Endeavours Inquiry noted the significant costs associated with setting up and maintaining schemes[148] and the fact that such costs were a disincentive and fell most heavily on smaller businesses.[149]

The issue of complexity can also be important in relation to compliance and it appears that there is a significant non-compliance issue in relation to ESOPs. Compliance issues impact on both employees and employers. While it is the employee who is likely to suffer an ATO audit, the ultimate burden of compliance is borne by the employer as, except for high income earners, in practice it is unlikely that general employees could afford specialists' income tax advice. As such, employees to a large extent depend upon the employer for information about the ESOP tax implications so that they can make an informed decision regarding their participation. Australian tax rules, which are designed with a focus on the employee-taxpayers, appear oblivious to this dependency and inconsiderate to assisting employers to manage the implementation of their ESOPs successfully.[150]

[144] Ibid, Rec 27.
[145] Government Response to Shared Endeavours Report, above n 16.
[146] Ibid, p 67.
[147] E&Y, above n 136.
[148] ATO, Submission to Shared Endeavours Inquiry.
[149] CEA Technologies, Submission to Shared Endeavours Inquiry.
[150] An illustration of this shortcoming can be found, for example, in the timing of tax liability. Under Division 13A, the tax liability for discount given in an employee share scheme arises when it is

The issue of complexity can also impact on the structure of the ESOP. One of the issues that has already been noted is the absence of a market for disposal of shares and options by employees in unlisted entities. One possibility is for the employer company to buy back the shares from the employees. The problem here is that the tax rules relating to buy backs off-market are extremely complex (see above). This can be alleviated to a great extent by the establishment of a trust which acts as a warehouse and administrator of the scheme and thus plays the role of an internal market. The benefits of a trust structure in facilitating employee share scheme in unlisted entities are numerous and commonly recognised across different countries promoting employee equity.[151] In particular in this context, the most significant usage of a trust is that it creates a simple and most efficient exchange mechanism equivalent to an internal market for unlisted companies to overcome the structural obstacles[152] and so adds value to the shares or rights offered under an ESOP. Shares or rights are assigned to trustees, who hold them on behalf of the employees, and depending on its structure, the beneficiaries are able to enjoy rights to dividends and voting power while the shares are held in the trust. This is seen as an economical way to warehouse employee shares, handle a large number of small transactions with individual employees and provide privacy for both the company and its employees as there is no legal right to search the trust register (compared with share register). A trust is also an effective way for enforcing various conditions in relation to performance or length of services under which shares could be offered, released or forfeited in the event that the conditions are or are not satisfied without the unwanted tax effect of the off-market buy back provisions.

Nevertheless, despite its potential usefulness, the situation in Australia is that the trust structure has not been looked upon favourably by the ATO for "fear for tax abuse" by introducing "artificial features"[153] that "go beyond the original policy intention."[154] While some of the concerns were based genuinely on observations of tax avoidance arrangements in "controllers" trusts,[155] for many other cases, it

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acquired by the taxpayer, the timing of which could vary from one employee to another. This causes administrative costs to record the exact dates of acquisition and estimate different values of the underlying securities offered. In comparison, other jurisdictions such as US and UK look at the other end of the transaction and attribute significance at the point of granting instead of obtaining the shares or rights with a clear intent to give a better indication of the exact date of the occasion where timing is important. Such intention was provided clearly in paragraphs 2099 and 2142 of the Explanatory Note for the *Income (Earnings and Pension) Act 2003 (UK)*. The US Securities Exchange Commission has also recently provided for clarification of the various references to "the date of grant" of an option for consistent treatment. See Internal Revenue Service, *Employee Stock Purchase Plans Under Internal Revenue Code Section 423*, Proposed Rule July 29, 2008 (Volume 73, Number 146) at <http://edocket.access.gpo.gov/2008/E8-17255.htm> (accessed 17 September 2008).

[151] ESODU guideline, no longer available online. See above n 31. See also RM2 Specialist, above n 18.

[152] The absence of a market exchange mechanism is identified as a structural problem for unlisted entities in EFILWC, above n 35.

[153] Michael D'Ascenzo, Evidence to the Shared Endeavours Inquiry, 10 June 1999.

[154] Ibid.

[155] ATO, Submission to Shared Endeavours Inquiry (30 April 1999), p 12.

was contended that those “contrived arrangements” that small businesses often ended up with were unintended consequences of difficulties with the tax framework [156] including the uncertainties surrounding deductibility and the interaction between Division 13A and the CGT and fringe benefit tax provisions.

One of the issues that arises for an employer establishing an ESOP is deductibility. If the employer simply issues shares at a discount this will not give rise to a deductible outgoing by the issuing company even though it clearly would involve some form of “cost” to the shareholders of the employer company.[157] However, it is generally accepted that an employer will be entitled to a tax deduction under s 8-1 ITAA 1997 in respect of non-refundable contributions made to an employee share trust for the purpose of the trust using those funds to provide shares to employees.[158] This is implicitly recognised by s 139DB which deals with the timing of deductions for such contributions and provides that no deduction is available until the employee acquires the share or right.

Another issue concerns the interaction between Div 13A and the Fringe Benefits Tax Assessment Act (FBTAA). The definition of “fringe benefit” in s 136(1) excludes the following:

> (ha) a benefit constituted by the acquisition by a person of a share or a right under an employee share scheme within the meaning of Div 13A;
>
> (hb) a benefit constituted by the acquisition by a trust of money or other property where the sole activities of the trust are obtaining shares, or rights to shares, in a company (the employer), or a holding company of the employer and providing those shares or rights to employees of the employer.[159]

The exclusion in para (ha) only applies where there is an employee share scheme within Div 13A. This means that a scheme that involved acquiring shares at market value would not be covered by the exemption. The exemption in para (hb) only applies where the trustee is acquiring shares in the employer or the holding company of the employer. The ATO became concerned about the establishment of employee incentive trusts and initially took the view that the FBTAA could apply where an amount was given to a trust to acquire shares for distribution to employees in the future, where those shares were not shares in

[156] E&Y, *Jon Kirkwood’s response to 14 questions attached to the standing committee - inquiry into Employee Share Ownership Plans* (1999) Submission to the Shared Endeavours Inquiry.
[157] However, costs associated with establishing the ESOP should be deductible under ITAA 1997, s 8-1. See also ITAA 1936, s 139DC which provides a limited deduction in relation to exempt plans.
[158] S Bernhardt, “Traditional Employee Share Plans: Current and emerging issues” Taxation Institute of Australia seminar, 25 May 1999.
[159] Related paragraphs also exclude acquisitions of stapled securities: FBTAA 1986, s 136(1) paras (haa) and (hbb).

the employer or its holding company.[160] However, in *FCT v Indooroopilly Children Services (Qld) Pty Ltd*[161] it was held that a gift of shares by an employer to a discretionary trust did not give rise to a fringe benefit because the shares were not provided in connection with any particular employee. The implication is however, that if a particular employee is identified the FBTAA could apply. At the very least employers need to consider carefully any FBT implications.

3.2.8 The $1000 exemption is too low

The current exemption of $1000 per employee per annum was introduced in 1997. Since that time Average Weekly earnings have almost doubled[162] but the amount of the exemption has not increased. Evidence to the Shared Endeavours Inquiry in 1999 suggested that if the exemption amount was increased to $2000 per employee per annum, there would very likely be a significant increase in the number of ESOPs implemented.[163] The concession focuses on the employee but the employer carries the cost and so it is the employer that needs encouragement. An employer may not think it is worthwhile to implement a plan if the benefit for employees is restricted to $1000 per annum. Of course the level of the threshold impacts on listed entities as well as unlisted entities but the suggestion has been made that when smaller companies weigh up the costs of implementing ESOPs with the benefits that they confer for a smaller number of employees, the cost is likely to exceed the benefits available.[164] It was also noted in the Shared Endeavours Report that other countries, such as the UK, have more generous exemption thresholds.[165] The Report did recommend an increase in the threshold[166] but this was rejected by government.[167]

3.2.9 It may be inappropriate to treat equity as remuneration in start up companies

A further point to note is that although there will be many instances where the issue of shares is clearly remuneration for services provided, there will also be situations in which shares are being provided in return for the contribution by a person of intellectual capital. If that person then provides services to the enterprise it may be difficult to separate out what constitutes remuneration (and so should be taxed under Div 13A) and what constitutes an investment by the individual in the enterprise. It has been suggested that where the individual is contributing to the enterprise in this way, it is more appropriate for them to be taxed under the capital gains tax provisions in the same way that a non-

[160] Taxation Ruling TR 99/5 (now withdrawn).
[161] 2007 ATC 4236.
[162] ABS, Average Weekly Earnings in Australia (6302).
[163] KPMG, Submission to Shared Endeavours Inquiry.
[164] Ian Crichton, Transcript of Evidence, Shared Endeavours Inquiry, p 33.
[165] Shared Endeavours Report, above n 11, p 154.
[166] Shared Endeavours Report, above n 11, Rec 32.
[167] Government Response to Shared Endeavours Report, above n 16.

employee would be taxed. According to Rider who considered the position in relation to IP spin-off companies:

> "The traditional employee does not take a position of significant investment risk in relation to the company which rewards them for the sale of their labour (or labour time); instead they receive a guaranteed, fixed and regular cash wage of salary which is legally due and payable regardless of the economic fortunes of the enterprise. By contrast, the share investor does take a position of significant investment risk in relation to the company in which they acquire shares; the return on their shares – *including, in particular, the ultimate realisation of any acquisition discount* - is neither guaranteed, nor fixed nor regular, but rather depends wholly on the economic fortunes of the enterprise…..
>
> It is submitted that, for employee shares in [a start up] company, a position of substantial investment risk is taken in relation to *the ultimate realisation* of any acquisition discount, and that accordingly capital gains tax treatment should be afforded the acquisition discount. In other words, the discount should not be taxed unless and until it is actually realised on disposal of the employee shares, and at that time it should attract the CGT discount."[168]

3.2.10 Policy divergence between corporations law and tax law

Finally, many problems around employee share schemes appear to be due to the divergence in policy treatments of ESOPs. There does not seem to be a clear line between employment-related issues and shareholder-related issues. The differences can be seen in the corporate regulatory environment and in tax. Although the *Corporations Act* refers to "eligible employee share schemes" and provides some minor relief, the disclosure obligations in relation to such schemes are subject to ASIC's discretion. Although ASIC partly acknowledges that employee equity is not about capital-raising,[169] ultimately it still treats the employee's decision to join an ESOP as an investment decision[170] and puts an onerous burden on unlisted entities to satisfy disclosure and other requirements. The *Corporations Act* does not regulate the provision of other non-cash remuneration to employees. The tax legislation on the other hand assumes that ESOPs are about employment remuneration. The provisions that deal with the interface between deferred remuneration and the return on investment (ie the capital gains tax consequences) are not appropriately drawn. Furthermore, no distinction is made between the traditional employee and those who contribute intellectual property to an enterprise in return for shares in the business. The ATO is prima facie cynical of arrangements that create or facilitate the flow of funds from the income tax regime to the capital gain tax regime to achieve a

[168] Rider, above n 14, p 4.
[169] ASIC, Regulatory Guide 49 (2003).
[170] Ibid.

better overall tax outcome. The corporate perspective is that ESOPs are about investment and the tax perspective is that ESOPs are about employment. This policy divergence may be part of the reason why it is difficult to achieve significant reform in relation to employee share ownership.

4 DEVELOPING CRITERIA FOR A BETTER LEGAL FRAMEWORK – THE POSITION IN OTHER JURISDICTIONS

The position in both the UK and the US appears to be a more favourable regulatory regime than in Australia, both in relation to corporate and also tax requirements. The position in both jurisdictions is considered below.

United Kingdom

The European Union (EU) Prospectus Directive requires any company offering shares to the public in the EU to issue a prospectus which complies with the rules issued by the relevant member state. The *Financial Services and Markets Act 2000 (UK)* (as amended in 2005) provides for a number of exemptions from the requirement to produce a prospectus. One such exemption is for securities offered to employees but only if the securities are listed.[171] Another exemption is where the offer is made to fewer than 100 persons.[172] It has also been suggested that an offer of options to existing employees would not amount to a public offer and so would not require a prospectus.[173] If the exemption for listed securities applies there is a requirement to produce a document containing information on the number and nature of the shares and reasons for and details of the offer. If the offer is otherwise exempt there does not appear to be any requirement to produce a simpler version of information to assist employees to decide whether to take up shares or not.

The UK tax legislation recognises a number of schemes that encourage employee ownership by providing a number of tax advantages. The four types of schemes are:

- Share Incentive Plans (SIPs);
- Company Share Option Plans (CSOPs)
- Save As You Earn schemes (SAYE); and
- Enterprise Management Incentive schemes (EMI).

Share Incentive Plans (SIPs) offer shares rather than options and, provided certain rules are met, offer considerable tax advantages. Employers may offer shares worth up to £3000 in any tax year ("Free Shares") and employees may also purchase shares with contributions from salary of up to £1500 per annum (or

[171] Prospectus Rule 1.2.2R(5).
[172] *Financial Services and Markets Act 2000 (UK)* s 86(1)(b).
[173] Financial Services Authority, *List*, Issue No 10, June 2005, p 3.

10% of salary if less) ("Partnership Shares").[174] If an employee does acquire Partnership Shares, the company can award additional free shares ("Matching Shares") at a ratio of up to 2:1. The maximum share value that can be acquired by an employee in this way is therefore £7500 per year. Additionally, a participant can receive shares in lieu of cash dividends that he or she already holds in the Plan up to an annual limit of £1500. The shares must be ordinary shares in the employer or a related company but this can include non-voting shares. All shares are held in a trust for a minimum three year period. After this period if the shares are released, tax will be payable on the lower of the value at that time or when allocated/purchased. Any subsequent increase in value is taxed as a capital gain, with the benefit of available relief. In an unlisted company, the value of the shares must be agreed with HM Revenue and Customs.

In a Company Share Option Plan (CSOP) employees may be granted, selectively, options to acquire shares with an aggregate value of £30,000 each. If the options are granted with an exercise price less than market value, income tax is payable in the year the options are granted. If the exercise price is at least equal to market value, no tax is payable on grant and if the options are exercised after three years, no income tax is payable on exercise of the option or on the sale of the shares acquired.[175] Gains on the sale of shares acquired will be subject to capital gains tax but concessions may apply. For unlisted companies, market value is negotiated with HM Revenue and Customs.

Under an approved SAYE Share Option Scheme, employees agree to save up to £250 per month with a bank or building society. They receive tax-free bonuses after fixed periods of 3, 5 or 7 years. The company also grants employees the option to use the proceeds of their SAYE schemes to purchase company shares when their savings contracts mature. The option must be exercised within 6 months of the maturity of the savings contract. All employees with a minimum length of service (which can be set at a maximum of 5 years) must be invited to participate, except for those interested (broadly speaking) in more than 25% of the share capital. The exercise price at which company share options can be granted may be up to 20 per cent less than the agreed market value of the shares at the time of grant. This "locks in" an immediate substantial gain for the employee, free of all income tax or national insurance, even before the SAYE contract has begun. No income tax is payable when the share options are granted, when they are exercised, or when the shares are sold.[176] As with other approved share schemes, there is a potential liability to capital gains tax, but concessions may apply.

Enterprise Management Incentive schemes (EMI) permit certain companies to offer options over shares with a market value of up to £100,000 at the date of grant, to any number of employees, subject to a maximum share value of £3

[174] *Income Tax (Earnings and Pensions) Act 2003*, s 488.
[175] *Income Tax (Earnings and Pensions) Act 2003*, s 521.
[176] *Income Tax (Earnings and Pensions) Act 2003*, s 516.

million under option at any one time.[177] Companies offering EMI options must be independent, that is not owned by any other company and certain business activities are excluded – dealing in commodities or securities, financial activities, legal and accounting services, property development, hotels and nursing homes. If EMI options are granted with an exercise price less than fair value, income tax is payable but not until the option is exercised. The amount on which tax will be payable is the difference between the exercise price and the lower of the market value at the date of exercise or at the date of grant. On the sale of the shares acquired, gains will be taxed as capital gains, but concessions may apply. The fair value of shares at the date of grant and market value must be agreed with HM Revenue and Customs.

It is also possible in the UK to issue options that do not comply with any of these schemes.[178] The advantage is that the employer does not have to comply with the rules and regulations that apply to statutory schemes. All gains on the grant of such options to employees will be subject to income tax (and national insurance contributions) but the tax is deferred until the option is exercised.

United States

In the US, companies intending to offer securities must comply with registration and disclosure requirements under the *Securities Act 1933*. Rules promulgated under that Act provide exemptions for companies offering equity to their employees.[179] The exemption originally provided an exemption if the value of the total securities issued was US$5 million or less. The Rule was substantially amended in 1999 and now exempts offers and sales within a twelve month period if the aggregate amount of securities does not exceed the greater of:

- US$1 million;
- 15% of the total assets of the issuer (or the issuer's parent); or
- 15% of the total outstanding amount of the class of securities being offered or sold in reliance on rule 701.

If the exemption does apply, the Rule requires a more limited form of disclosure which must include a summary of the material terms of the plan, information about the risks associated with investment in the securities sold and financial statements required by Form 1-A under Regulation A. An important point to note here is that the financial statements need not be audited.

The position in the US in relation to tax is that special rules apply when an employee acquires shares from an employer.[180] The rules also apply to a person who provides services in some other capacity, such as a consultant or a director. The rules apply if the shares are received for no consideration or if they are

[177] *Income Tax (Earnings and Pensions) Act 2003*, s 527.
[178] *Income Tax (Earnings and Pensions) Act 2003*, s 474.
[179] *Securities Act 1933*, Rule 701.
[180] *Internal Revenue Code*, s 83(a).

purchased in connection with providing services. If the shares are fully vested when received, an amount will be included as compensation income at that time, equal to the value of the shares less the amount paid for them, if any. If the shares are not vested, tax will be payable at the time the shares vest equal to the value of the shares at vesting time. If the shares acquired are not vested, an election can be made within 30 days under which the value of the shares is reported as income when the shares are acquired instead of the year they vest.[181] This election can be very beneficial if the employee paid full value or if the shares are expected to rise in value.

Another form of compensation is for an employer to offer a "nonqualified" share (stock) option. This is in contrast to the qualified schemes set out in the *Internal Revenue Code* (discussed below). This form of compensation also has tax advantages because no amount is included in income on receipt.[182] When a nonqualified share option is exercised an amount is included as income equal to the difference between the value of the shares received and the amount paid to exercise the option. For an employee, this income is subject to withholding. When the shares are sold, there will be a capital gain (or loss) and the cost base includes both the amount paid for the shares and the amount of income reported at the time of the exercise.

In the US there are two types of plans that offer tax advantages:[183]

- Incentive Stock Options (ISO); and
- Employee Stock Purchase Plans (ESPP).

If an option granted to an employee meets certain requirements set out in s 422 of the *Internal Revenue Code*, it is an incentive stock option (ISO). These options are available only to employees — they are not available to a non-employee director or consultant. They can provide special tax advantages to the option holder, but at the cost of great complexity and some tax disadvantage to the employer. Like nonqualified options, no amount is included in income at the time of receipt. There is also no amount included when the option is exercised, subject to some rules relating to the alternative minimum tax (AMT).[184] If the shares are sold before a special holding period elapses, this is a "disqualifying disposition" and compensation income must be reported at that time. If the special holding period rules are satisfied, the sale of the shares will only give rise to a capital gain or loss. At that time it may be possible to claim a credit for some or all of the AMT paid in the year the option was exercised.

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[181] *Internal Revenue Code*, s 83(b).
[182] *Internal Revenue Code*, s 83(a) and Treasury Regs 1.83(7).
[183] *Internal Revenue Code*, s 421.
[184] The AMT provides an *alternative* set of rules for calculating income tax. In theory these rules determine *minimum* amount of tax that must be paid. If a person is already paying at least that much because of the "regular" income tax, there is no need to pay AMT. But if regular tax falls below this minimum, the person must make up the difference by paying alternative minimum tax.

The options may be granted selectively. They must be options to purchase shares in the employer or a related company. The shares may be voting or non-voting, common or preferred. The exercise price must equal or exceed the fair market value of the shares at the time of grant. No employee may own shares representing 10% of the voting power of all shares and the aggregate fair market value of underlying shares (at the date the options are granted) cannot exceed $US 100,000 in a year. Under s 422 the employee does not recognise ordinary income at the time of grant or exercise and in most cases will only pay tax on disposal of the share. If the disposal occurs within two years of receipt of the option or within one year of receipt of the shares, the employee will be subject to income tax on the difference between the exercise price and the fair market value at the time of exercise (the “bargain purchase element”), and capital gains tax on the difference between the fair market value of the share on the date of exercise and the consideration on disposal.

The second type of approved plan is the Employee Stock Purchase Plan (ESPP) which must comply with s 423 of the *Internal Revenue Code*. This type of plan is more commonly used for all employees (compared with ISOs which are primarily used for executives). All employees must be included other than employees of less than 2 years standing, employees who work less than 20 hours a week or 5 months in a calendar year and “highly compensated employees” (earning more than US$120,000 per annum and in the top 20% of income earners). No employee can own more than 5% of the voting power or 5% of the value of the shares in the sponsoring company.

A qualified ESPP can offer share options that are similar to ISOs.[185] Generally, they offer an opportunity to buy shares at a favourable price through payroll deductions. An employee who chooses to participate will have rights similar to an option but does not actually hold an option to purchase shares. Typically, employees who wish to participate sign up by a particular date to have from 1% to 10% of pay withheld to purchase company shares over a particular offering period. Money withheld will accumulate for that period of time, and then be used to buy shares at the end of the offering period. The price may be discounted as much as 15%, although companies can offer a smaller discount or none at all. Some companies provide a "look back," so that the price payable can be based on the price at the beginning of the offering period or at the end, whichever is lower. Usually an employee can choose not to purchase and get their money back at any time during the offering period. The tax advantage is similar to the ISO plans, that is, there is no tax on the grant of the right or the exercise of it. The employee is not taxed until the underlying shares are sold and this is generally recognised as a capital gain (or loss).

Two conclusions can be drawn from this survey of regulation in the US and the UK. First, the disclosure requirements for offerings of securities under an employee share plan are less onerous than in Australia. Secondly, the tax rules

[185] *Internal Revenue Code*, s 414.

in the UK relating to ESOPs contain special provisions dealing with smaller entities.

5 DEVELOPING CRITERIA FOR A BETTER LEGAL FRAMEWORK – GENERAL PRINCIPLES

In 1985, a Treasury White Paper[186] identified the three key criteria for assessing a tax system as "equity", "efficiency" and "simplicity". Those criteria have been used since that time to evaluate the effectiveness of the tax system as a whole and to judge individual proposals for reform. Similar principles apply to other areas of law, such as corporate law.

In relation to equity, the paper stated that a tax system which places significantly different burdens in taxpayers in similar economic circumstances is manifestly unfair.[187] In this regard it could be said that if tax concessions are to be provided in relation to employee ownership, those concessions should be available to all employees both in the listed and the unlisted sector.

In relation to efficiency, the paper indicated that tax has a clear impact on economic efficiency, noting that "any tax will tend to discourage the activity on which it is imposed".[188] Similarly, a tax concession can encourage a particular activity. However, the clear implication is that it is desirable to avoid distortions in decision making, for example, between different types of rewards for types of work and between returns on different types of investments. In the context of employee share ownership it could be said that although government has ostensibly supported employee ownership, the difficulties with the current regime are so great that employers and employees choose not the avail themselves of the concessions. In other words the relevant provisions are distorting decision making.

In relation to simplicity, the paper stated:

> "A good tax system should be as simple as possible. A complex tax system makes it difficult for people to understand the law and apply it to their circumstances. The present law has become so complex that it is difficult to convey its meaning simply and adequately on tax return forms and in other printed matter. Complexity imposes high compliance costs on the community and high administrative costs on the tax authorities. Complex tax laws also result in socially unproductive and costly tax litigation. These considerations suggest that, where possible, tax reform measures capable of ready comprehension and application should be preferred over more complex alternatives."[189]

[186] Treasury "Reform of the Australian Tax System*",* Draft White Paper, AGPS, Canberra, 1985.
[187] Ibid, para 1.03.
[188] Ibid, para 1.6.
[189] Ibid, para 1.8.

The Review of Business Taxation in 1999 also identified one of the major objectives guiding development of the tax system as "promoting simplification and certainty".[190] The Inspector–General of Taxation has also identified simplicity as one of the "fundamental principles" of tax policy.[191] In a recent Discussion Paper dealing with reform of the Australian tax system,[192] Treasury has noted the significance of simplicity as a guiding principle of tax reform in Australia since the mid-1970s.

The tax provisions dealing with employee share ownership clearly fail to satisfy the simplicity criterion. The provisions are complex and costly to implement and give rise to a great deal of uncertainty and potential non-compliance.

The White Paper also noted that the three criteria sometimes conflict. So, for example "measures to make the system more equitable might require complex legislative provisions and may also cause economic distortions".[193] However, any attempt to recast the provisions should at least attempt to achieve these objectives. That is, there is a need to make the system more equitable, more efficient and to reduce the complexity.

The conclusion that can be drawn about the current regulation of ESOPs is that it fails to meet the requirements of equity, efficiency and simplicity. First, the regulation fails to achieve equity because it treats unlisted entities and their employees differently from their listed counterparts. This arises in corporate law because the relief from disclosure is only available where the entity is listed and in tax law because the rules favour listed entities. Secondly, it fails to achieve efficiency because it does not encourage the use of ESOPs in accordance with government policy to do so. In fact it would appear that many entities structure arrangements with employees to avoid the operation of the regulation or alternatively decide not to take advantage of the concessions because of the onerous legislative requirements. Finally, the regulation is highly complex, especially the tax legislation so that entities require professional advice to set up the ESOP and ongoing advice to ensure that the arrangements comply with the legislative requirements.

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[190] Review of Business Taxation Final Report, "*A Tax System Redesigned: More certain, equitable and durable"* AGPS, Canberra, July 1999 at p 104.
[191] Inspector-General of Taxation *"Issues Paper No 2 – Policy framework for Review Selection"* 2003.
[192] Australian Treasury, Architecture of Australia's tax and transfer system (the Henry Review), Discussion Paper, August 2008, p 320.
[193] Ibid, para 1.10.

6 IDENTIFYING AND ASSESSING PROPOSALS FOR REGULATORY REFORM

In order to achieve equity, efficiency and simplicity it is necessary to make significant changes to the regulation of ESOPs. It is important to recognise that the legislation has become so complex and difficult that nothing less than a complete rewrite will suffice. In this part, four proposals will be considered as a basis for new regulation in this area. These proposals seek to achieve a balance between the notion that ESOPs are about both remuneration and investment. Another important point to note is that regulation of companies has become so burdensome that many businesses in the small to mid-market level do not view a company as the optimal operating structure. Consideration may also need to be given to other reasons why many mid-tier businesses do not utilise the employee share scheme provisions.

The first proposal is that the disclosure rules in Chapter 6D of the *Corporations Act* be amended to permit the offering of securities to employees without the need for a prospectus. The exception should be included in the legislation rather than arise by virtue of the exercise of ASIC's discretion. However, there should be a requirement to provide some information about the securities to be acquired. This is more consistent with principles of investor protection than having a blanket exception, and recognises that even if the ESOP does not require a cash contribution, it does involve the recipient forgoing some remuneration to acquire equity in the company. In the US, and under the listed entity exception in the UK, employees must be provided with a statement that includes a summary of material terms of the plan, information about the risks associated with investment in the securities and some financial information. Importantly, in the US there is not need for the financial statements to be audited and as this appears to be a serious impediment for unlisted entities, there is a strong argument for allowing unaudited financial statements.

The second proposal is that consideration be given to the most appropriate taxing point for ESOPs. This should be either on grant of the share or right or on disposal. As noted, at present a participant in an ESOP is not able to defer the taxing point beyond cessation of employment, even if the shares or rights are still subject to disposal restrictions. The most appropriate rule would be to make the acquisition of securities the prima facie taxing point (unless the concessions permit deferral) and that what is taxed at this point would be the difference between the market value at acquisition and the amount paid (the acquisition gain). A further taxing point would arise when the securities are disposed of and any gain (ie the difference between market value on acquisition and the amount received on disposal) (the disposal gain) should be taxed as a capital gain. This is in line with both the US and the UK. A related issue is how to determine the value of unlisted shares or rights for tax purposes. In both the UK and the US this is a matter of negotiation between the company and the revenue authority. The tax rules should also facilitate the disposal of shares or rights in unlisted companies back to the employer. In this regard there is a need for special buy back rules for employee share schemes that treat the buy back price as the disposal consideration and not as a dividend.

The third proposal is that the tax concessions for ESOPs be reviewed. At present a participant may be eligible for either a deferral of tax until cessation time or an exemption of up to $1000 per annum (but not both). In order to be eligible for these concessions the shares or rights must be qualifying shares or rights. If the shares or rights are qualifying, the acquisition gain will be taxed at the cessation time unless the participant makes an election to be taxed at the time of acquisition. In that case, provided further conditions are satisfied, the exemption applies. In the UK the main form of concession is an exemption concession. An employee can acquire up to £7500 per annum in share value or up to £30,000 in relation to options to acquire shares. One option for Australia would be to restrict the concession to an exemption concession, but to increase the amount of the exemption beyond the present amount of $1000 per annum. This may act as an incentive for employers to undertake the cost of implementing a plan and in that way benefit the employee/recipients. The US and the UK also provide for deferral of tax – in the case of shares, this is generally at the time the shares are disposed of, and in the case of options, the time at which the option is exercised. If a tax liability arises at a time when the participant is still an employee, a withholding tax could apply and this would address the difficulty that could arise for an employee who needs to pay tax but does not have the cash to do so.

The fourth proposal is that the conditions for eligibility for tax concessions should be completely rewritten and simplified. The conditions that must be met for the shares or rights to be qualifying require reconsideration. The first condition requires the shares or rights to be acquired under an "employee share scheme". This excludes the acquisition of shares or rights if the consideration is equal to greater than market value but this would not be within Div 13A in any event because there is no discount. This condition does not really serve any useful purpose and should be removed. The second condition requires that the shares or rights are in the employer or a holding company of the employer. Other jurisdictions have a similar requirement and this seems sensible given that the concessions relate to employee shares but, given the growth in corporate groups globally, the condition could be expanded to cover shares in related companies and perhaps shares in joint venture companies. It also seems to appropriate to expand the category of eligible recipient to include contractors given the changes in labour market practices. The third condition requires the shares to be ordinary shares and any rights to be rights to acquire ordinary shares. This has been extended to include stapled securities, but part of the stapled product must be an ordinary share. The US permits a greater variety of shares to get the benefit of concessions and the UK permits non-voting shares to be offered. There is scope for extending the concession to different types of securities and, indeed for permitting different types of entities, such as trusts, to offer participation rights to employees. The fourth condition requires share plans to be offered to at least

75% of permanent employees. This does not necessarily mean that all concessional plans will be broad based as a company can have two plans and satisfy the requirement. There does not appear to be any great mischief in permitting a plan to be offered either broadly or selectively and as the condition can cause difficulty, should be removed. If it is thought desirable to limit concessions to broadly based plans a more rigorous condition should be included. The fifth and sixth conditions relate to no employee holding more than 5% of shares or being in a position to control more than 5% of the company. This may be thought to restrict the concessions available although there are other means of doing that. It also offers protection to non-employee shareholders that their rights will not be swamped by employee shareholders. In the case of listed entities, the 5% rule has little significance. In the case of unlisted entities, the 5% rule may be inappropriate, especially in the context of start up companies. It may be more appropriate to have a different rule that allows a greater percentage to be approved by the shareholders of the company in general meeting, similar to the recommendation of the Shared Endeavours Report. In short, the concessions should be available to different types of employee participation, could include a condition that the plan be broad based and in most cases be limited by the amount that any one employee can acquire without the approval of other shareholders.

A final comment concerns the potential for abuse of tax concessions. This is clearly present whenever a tax expenditure measure or concession is introduced. Employers and employees will look to measures such as the ESOP concessions and to fringe benefits that offer tax advantages to provide remuneration in a tax effective way. However, the current measures dealing with ESOPs are inhibiting legitimate use of such schemes and making them only available to a limited section of the workforce. Removing the impediments and expanding the availability of the concessions should go some way towards achieving the government’s policy objective of encouraging employee share ownership. Any resulting abuses should be dealt with in a more direct way.