The Senate

Economics
References Committee

Employee Share Schemes

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Senate Economics References Committee

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Ms Hanako Jones, Executive Assistant

PO Box 6100
Parliament House
Canberra ACT 2600
Ph: 02 6277 3540
Fax: 02 6277 5719
E-mail: economics.sen@aph.gov.au
Internet: http://www.aph.gov.au/senate/committee/economics_ctte/index.htm

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Recommendations

Recommendation 1

4.15 The committee recommends that in consultation with but not limited to employee share ownership groups, unions and academics, the Australian Bureau of Statistics conduct a survey of employee share schemes in Australia every five years, starting at the end of the 2009–10 financial year. The survey should collect data on, but not limited to, the following:

- **number and type of employee share schemes;**
- **number, size and industry of companies offering these schemes;**
- **number of employees and equity held by them;**
- **breakdown of employees by occupation, educational level and wage;**
- **reasons for offering (employers) and participating (employees) in the scheme;**
- **perceived effects and effectiveness of the schemes for both employers and employees;**
- **perceived barriers in the take-up of the schemes; and**
- **breakdown of general employee (broad-based) versus executive (narrow) schemes in terms of the number of shares offered; number of participants and equity held.**

Recommendation 2

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

Chapter 1

Introduction

1.1 On 23 June 2009, the Senate referred to the Economics References Committee the operation of employee share schemes in Australia for inquiry and report by 17 August 2009.

1.2 This inquiry into the operation of employee share schemes follows a new budget measure announced on 12 May 2009. As part of the 2009–2010 Budget, the Treasurer, The Hon Wayne Swan MP, announced a new measure relating to the employee share scheme tax concessions. As a result of a wide disapproval of this measure, the Government developed a policy paper for public consultation. Based on the views expressed in over 60 submissions, the Assistant Treasurer, The Hon Senator Nick Sherry, announced on 1 July 2009 a revised proposal.

Conduct of the inquiry

1.3 The terms of reference for the inquiry include:

- the structure and operation of employee share schemes;
- the benefits of employee share schemes;
- the taxation issues relating to compliance of employers and employees participating in employee share schemes;
- the recent announcement of proposed changes to the treatment of employee share schemes, the background to these changes, consultation undertaken to develop these changes and the anticipated impact of these changes on employees, employers and Australian business generally;
- the rules governing employee share schemes in other countries; and
- any other related matters.

1.4 The committee invited written submissions by 17 July 2009. Details of the inquiry were advertised in *The Australian* on 1 and 15 July 2009 and placed on the committee's website. The committee also wrote to a number of organisations inviting written submissions. The committee received 33 submissions which are listed in Appendix 1.

1.5 A public hearing was held in Canberra on Monday 27 July 2009. A list of witnesses appearing at the hearing is in Appendix 2.

1.6 The committee thanks those who participated in this inquiry.

Chapter 2

Structure and operation of employee share schemes

What are employee share schemes?

2.1 Employee share schemes provide a means for employees to obtain shares in the company where they work and thus become part-owners of their employer's business.[1] They are used:

> …to align employee's interests with those of their employer so that employees benefit directly when the company does well and employers benefit through having a more committed and motivated workforce. An employee share scheme provides employees with a financial interest in the company they work for through the distribution of shares in that company.[2]

2.2 Several terms are used to describe these schemes or plans: employee share ownership schemes or plans, employee share schemes, etc. For the purposes of this report, the term 'employee share scheme(s)' is used (excluding direct quotations).

2.3 Most employee share schemes have the following features:

- shares or rights are acquired at a discount rate to the market value;
- disposal is allowed after a qualifying period of employment or having met performance hurdles;
- employee forfeits shares or rights upon resignation or termination of employment if this occurs before the expiry of the qualifying period; and
- there is 'usually a period between the grant of the shares or rights and the time at which employees can first realise' their value.[3]

General and executive employee schemes

2.4 Employee share schemes can be categorised in a number of ways depending on the variable and the purpose, thus providing different costs and benefits.[4]

2.5 One distinction is between the narrow-based schemes offered to company executives and general schemes for a broad range of employees. Evidence suggests that most benefits are accrued in companies with schemes that are offered more

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1 Australian Employee Ownership Association, *Submission 4*, p. 1.

2 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 6, http://www.treasury.gov.au/documents/1559/PDF/consultation_paper.pdf (accessed 15 July 2009).

3 Taxation Institute of Australia, *Submission 10*, p. 2.

4 CRA Plan Managers, *Submission 8*, p. 5.

broadly, that is, also to ordinary employees.[5] Companies might set aside a percentage—five to 20 per cent—of their share capital to be issued to employees.[6]

2.6 With general employee schemes, there is little or no cost to the employee, risk is low and the design of the scheme simple. These schemes are offered to develop employee affiliation with the company rather than to provide financial rewards, which is why maximising employee participation is important.[7] Generally, schemes offering shares rather than options or rights 'are preferable for general employees, because they are less dilutive and provide a clearer alignment of value and benefit'.[8]

2.7 Executive schemes are a 'key strategic remuneration tool' linking remuneration to company performance and encouraging retention of key executives. Executive schemes aim to reduce the risk of 'short term actions at the expense of long term health of the company'.[9]

2.8 The Financial Sector Union observed that non-executive employees appear to have 'wide share holdings in minimal amounts', with 'far deeper share holdings being held by executives'.[10] A European study, surveying employee schemes in large European corporations, found that on an individual basis, a non-executive employee owner averaged €26,338 compared to €7.5 million for each executive. Top executives held 40 per cent of the capitalisation, compared with the non-executive employee owners holding 60 per cent.[11] Men were twice as likely as women to participate, potentially due to job segregation. Education also plays a role, with participation increasing with the level of education.[12]

Other categories

2.9 Plan types can also be categorised by their tax treatment into qualifying exempt or deferred schemes or non-qualifying employee loan and replicator schemes.[13] The qualifying schemes can be broken down further into share and option schemes. Loan participation plans operate in companies that do not have available

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5 See for example Hay Group, *Submission 15*, p. 3.

6 Remuneration Strategies Group, *Submission 11*, p. 11.

7 Hay Group, *Submission 15*, p. 3; Remuneration Strategies Group, *Submission 11*, p. 7.

8 Deloitte, *Submission 30*, p. 3.

9 Hay Group, *Submission 15*, pp. 4–5.

10 Financial Sector Union, *Submission 22*, p. 2.

11 Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 18.

12 European Foundation for the Improvement of Living and Working Conditions, 'Financial participation of employees in the European Union: Much ado about nothing?', Background paper, 2007, p. 20.

13 Replicator scheme is one which does not utilise shares but is based on performance rights and paid out as ordinary salary or wages. Remuneration Strategies Group, *Submission 11*, p. 11.

shares, such as joint ventures or franchises, where investments are made in other than the employer's shares. Option schemes are often provided for senior management.[14]

2.10 Replicator schemes refer to schemes that offer benefits that 'replicate share ownership but do not involve the acquisition of shares or rights'. They are used when the employer company is unable or unwilling to offer equities in the company. These schemes typically 'aim to provide the benefit at market value to avoid payment of tax' and funded through a low or interest-free loan or salary sacrifice arrangement.[15]

Operation

Establishment

2.11 There are three ways to structure an employee share scheme: the employer can issue shares directly to employees; or shares are issued to a trust; or the scheme can operate through a third party plan company.

2.12 If the shares are not issued directly to employees, they are usually provided to a trust that holds the shares on behalf of the employees. Trusts may be set up to administer the various conditions that apply to a scheme and to manage small share holdings and registry costs effectively.[16] Trusts reduce the number of entities subject to taxation, focus taxation liability on the beneficiaries of the schemes and are eligible for tax deductions.[17] Trusts are said to 'offer many advantages' particularly 'in the context of the neglected unlisted "SME" sector'.[18]

2.13 The third structure is administering a share scheme through a third party plan company. This arrangement provides flexibility regarding the source of shares, that is, shares can be acquired on market or new shares issued by the company. Third party plan companies 'will generally not be entitled to claim a deduction despite the accounting requirement' of expensing the value of share and option grants.[19]

14 Remuneration Strategies Group, *Submission 11*, pp. 7, 9.

15 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 24.

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

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

18 Brash Solutions, *Submission 21*, p. 1.

19 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 19–20.

Share offer

2.14 Once the scheme has been established, the employer makes an offer to its employees to participate. The employee may be given shares, rights to shares, or securities related to shares.[20] The offer outlines the terms of participation, including the conditions for holding the shares and the vesting of them—for example length of service, performance and debt repayments—and the number of shares and their cost (if any). If the employee accepts the terms and conditions, shares or rights will be allocated to his or her account, to the trust or through other arrangements.[21] Generally, shares are held in trust 'for three years or restricted from trade for a similar period'.[22] When the employee has met all the conditions, the shares are fully vested and the employee acquires a right to transfer the shares out of the scheme or can agree to be paid out of the scheme, obtaining the value of the shares.[23]

2.15 In issuing shares, company directors are required to act 'in accordance with their duties under general law and statute', including acting 'in good faith in the best interests of the company', and issuing shares for a proper purpose. For example, to establish an employee share scheme that 'substantially benefits employees at the expense of the company' could be in breach of their duty to act in the interest of the company as a whole and the different classes of shareholders.[24]

Funding and cost

2.16 There may be a cost involved in obtaining shares. Shares can be funded through contributions from wages and salary, performance bonuses, profit or other financial awards, or through a bank loan either from the employer or a third party.[25] Funding generally involves 'some financial contribution from the company'.[26] The company is permitted to assist employees financially to obtain shares at less than market value, at low interest or for free if they are given under an employee share

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

21 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

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

23 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

24 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 12–14. Duties arise out of the *Corporations Act 2001*.

25 Australian Employee Ownership Association, *Submission 4*, p. 1.

26 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, p. 5.

scheme that has been approved in a general meeting of the company, and, if applicable, by the parent company.[27]

2.17 Shares can also be obtained through a salary sacrifice arrangement. Employees can salary sacrifice up to the $5,000 limit to purchase shares 'through subscription plans that also allow for the deferral of tax for a period of up to ten years, thus increasing their shareholding'.[28] The employee is eligible to 'derive any capital gains on the shares as a discount capital gain and only pay tax on 50 per cent of the nominal gain'.[29] Expanding broad share ownership could be encouraged through salary sacrifice arrangements, including employers providing free matching shares for every share purchased by the employees.[30]

2.18 A scheme is likely to pay out a departing member in a company 'that placed a high value on employee ownership and did not want to see the employee's stake in the business diminished when employees leave the company'.[31]

Rights of employee shareholders

2.19 Employee shareholders have 'a range of statutory and equitable remedies' available to protect their interests. The Corporations Act provides that employee shareholders may call an extraordinary general meeting if they hold at least five per cent of the votes that may be cast at a general meeting or constitute at least 100 members. However, their capacity to influence the conduct of business is considered to be limited because employee shareholders generally hold a very small minority of the company's shares.

2.20 Courts may impose a range of orders if a company's affairs are not conducted in the interests of the members as a whole or are discriminatory against a member or members. Further, 'if employee shareholders are recognised as members of a particular class, they may be afforded the statutory protections offered to class right holders', including regarding challenging a variation or cancellation of shares.[32]

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27 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 6–7.

28 Financial Sector Union, *Submission 22*, p. 2.

29 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 24.

30 Institute of Chartered Accountants, *Submission 16*, p. 4 and PriceWaterhouseCoopers, *Submission 5*, p. 2.

31 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

32 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 17–19.

2.21 Mr Rod Masson, National Director, Policy and Communications, Finance Sector Union, noted the benefits of employees owning shares in their employer company: as both employees and shareholders, employees are able to take their concerns to the broader group of shareholders, including concerns that may have an effect on the overall company performance. He particularly noted the social responsibility and industrial matters.[33]

Reasons for and benefits of establishing an employee share scheme

2.22 Three structural characteristics that influence the presence of employee share schemes in a company include centralised human resource function; company growth over the preceding 12 months; and the composition of the workforce.[34]

2.23 A University of Melbourne study on employee share schemes in Australian listed companies noted that the most popular reasons for establishing employee share schemes were: showing that the company values its employees; allowing employees to share the financial success of the company; and aligning employee and shareholder interests.[35]

Benefits for employers

2.24 For the employer, employee share schemes may be a vehicle for changing the workplace culture and creating common goals;[36] the employer may wish to use the scheme to plan retirement or succession;[37] or the company may wish to increase the existing capital.[38]

2.25 A survey found that Australian employers lose an additional $20 billion every year because of increased staff turnover (by 5 per cent) due to skills shortage and ageing population. Turnover rate was an average of 18.5 per cent. Long-term incentives (LTIs) such as employee share schemes 'assist in the retention of employees', meaning that the company can afford to invest on training of its employees, which in turn 'results in better qualified employees and a more productive and profitable business'. Remuneration Strategies Group noted that employee share

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33 Mr Rod Masson, *Proof Committee Hansard*, 27 July 2009, p. 65.

34 Ingrid Landau, Richard Mitchell, Ann O'Connell, Ian Ramsay and Shelley Marshall, 'Broad-based employee share ownership in Australian listed companies: Survey report', April 2009, p. 2.

35 Ingrid Landau, Richard Mitchell, Ann O'Connell, Ian Ramsay and Shelley Marshall, 'Broad-based employee share ownership in Australian listed companies: Survey report', April 2009, p. 1.

36 Australian Employee Ownership Association, *Submission 4*, p. 2.

37 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

38 Australian Employee Ownership Association, *Submission 4*, p. 1.

schemes should be seen as part of the human resources management as they 'assist in the attraction, motivation and retention of employees'.[39]

Increased productivity and profitability

2.26 One of the main reasons to establish an employee share scheme is to increase the company's productivity and profitability through increased worker productivity. A recent study concluded that companies with an employee share scheme or a similar scheme (broad-based stock options, profit sharing and employee participation) 'demonstrate higher performance across a number of parameters':

> …companies that embraced any one of these four approaches experienced a 4% gain in productivity, a 14% gain in return on equity, a 12% gain in return on assets, and an 11% gain in profit margins (controlling for other factors).'[40]

2.27 Employee share schemes appear to be more successful in companies where the majority of employees participate in a scheme and own 'a significant part of the company'.[41] Schemes are said to provide incentives for employees to obtain further experience and skills.[42] Evidence indicates that employees with a 'significant direct equity stake in a business have a strong tendency to work and think like owners to the great advantage of the business which employs them'.[43] For example:

- In the US, companies with an employee share scheme had improved their productivity by approximately 3.5 per cent annually in comparison to companies without a scheme. In amongst the companies with a scheme, the most successful had high levels of employee participation through a variety of formal and informal arrangements;
- In Japan, productivity in companies with an employee share scheme increased by 4–5 per cent, the effect taking 3–4 years to manifest; and
- Another study concluded that companies with an employee share scheme had a return on assets 2.7 per cent higher than those without a scheme for each year of a four-year study and a cumulative total return 6.9 per cent higher then the average for non-scheme companies.[44]

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39 Remuneration Strategies Group, *Submission 29*, p. 17.

40 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, pp. 8–9.

41 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

42 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 9.

43 Australian Employee Ownership Association, *Submission 4*, p. 5.

44 Australian Employee Ownership Association, *Submission 4*, p. 5.

2.28 Employee participation is said to be greater where there is union involvement.[45]

2.29 However, some studies have shown that shares will not make all employees work harder. Instead, they may choose to '"free-ride" off the efforts of other employee shareholders', and that the 'rewards for increased productivity will be diluted by the number of shares held by non-employees'.[46] Another study claimed that companies with employee ownership 'tend to invest less, take fewer risks, grow more slowly, create fewer jobs, have worse free cash flow problems, and exhibit lower labour and total factor productivity relative to otherwise similar companies'.[47]

Increased flexibility and fairness

2.30 In addition to increased profitability and productivity, employee share schemes have been found to advance flexibility and fairness in the workplace. They broaden the range of remuneration options and provide a competitive advantage in the labour market:

> They offer employers greater control over cash flow, allowing them to offer non-cash remuneration and manage their cash distributions in line with the business cycle. Finally, [schemes] provide employers with an excellent mechanism for succession planning, an issues which has proven particularly challenging for small and medium-sized family-owned businesses.[48]

2.31 To reap these benefits, there is a need for employee share schemes to be 'extended widely to ordinary workers rather than concentrated at the top levels of management'.[49]

2.32 Other benefits said to flow from employee share ownership include promotion of innovation and science particularly in small and medium unlisted companies, new industries and start-up companies.[50]

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45 Klaas Woldring, *Submission 2*, p. 3.

46 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 3.

47 Cited in Jarrod Lenne, Richard Mitchell and Ian Ramsay, *Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes*, Employee Share Ownership Project, University of Melbourne, 2005, p. 15.

48 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 9.

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

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

Benefits and risks for employees

2.33 For employees, performance bonuses and incentive payments contribute to their savings.[51] Employee share schemes can complement the superannuation system, for example by providing access to finance prior to retirement, with employees having more direct control over the scheme and developing a different class of equity.[52] Companies with broad-based schemes are 'significantly more likely to have structures for communicating directly with employees'.[53] They are also more likely to offer better treatment for workers. Executive compensation appears to be lower in companies with an employee share scheme than in those without.[54]

2.34 Employee share schemes have been criticised for 'concentrating risk, for duplicating superannuation and for being regressive'. The risk has become evident during the global financial crisis, with many employees having lost their life savings when their employer company has collapsed. Mr David Hetherington noted, however, that the schemes are no more risky than other equity because the risk does not arise out of the employee share scheme structure. The employees have 'better information about the outlook of the company and a greater ability to influence its performance'. As with any assets, 'excessive concentration in a single asset is a risk' and according to Mr Hetherington, this could be managed by companies providing an annual consultation with an independent financial advisor.[55]

51 Australian Employee Ownership Association, *Submission 4*, p. 2.

52 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 10.

53 Ingrid Landau, Richard Mitchell, Ann O'Connell, Ian Ramsay and Shelley Marshall, 'Broad-based employee share ownership in Australian listed companies: Survey report', April 2009, p. 2.

54 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, pp. 11–12.

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

Chapter 3

Governance and taxation

Legislation

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

Income Tax Assessment Acts 1936 and 1997

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

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

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

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

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

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

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

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

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

3.5 Qualifying schemes must satisfy the following relevant requirements:

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

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

Tax-exempt scheme

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

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

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

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

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

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

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

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

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

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

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

Tax-deferred scheme

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

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

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

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

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

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

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

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

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

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

Tax treatment of employer

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

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

Other tax considerations

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

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

Corporations Act 2001

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

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

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

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

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

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

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

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

Other guidelines

Australian Stock Exchange Listing Rules

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

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

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

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

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

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

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

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

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

Accounting and other standards

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

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

Compliance

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

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

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

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

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

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

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

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

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

Chapter 4

Employee share schemes in Australia and overseas

Employee share schemes in Australia

4.1 In Australia, employee share schemes have operated since the 1950s and under legislation since 1974.[1] A number of submitters noted that employee ownership is 'still at an early developmental stage' in Australia, in comparison to the United States, United Kingdom, France and Japan where they are a 'significant workplace phenomenon'.[2] According to Dr Klaas Woldring, Australia 'is well and truly behind' by 20–30 years.[3]

4.2 A study found that a number of leading Australian corporations understand the importance of the employee share schemes for productivity.[4] Employee share schemes can bring advantages to Australia's economy if they 'can be transformed into broad based medium term savings vehicles' instead of treating them as risk-based remuneration schemes. Employee share schemes are also said to save jobs through capital investment, improving productivity, facilitating strategic change and cost effectively remunerating staff.[5] However, a submission suggested that legislators are seen to underestimate and often 'completely' misunderstand 'the scale, strategic application and importance of the employee share schemes'.[6] Employee share schemes are said to enjoy and have enjoyed bipartisan support.[7]

4.3 The Remuneration Strategies Group noted that Australia should not miss any further opportunities to develop employee ownership policies because 'Given looming demographic pressure, any future failure to promote commitment and productivity in the workplace will have a serious effect on this nation's prosperity and the distribution

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1 House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours—An Inquiry into Employee Share Ownership in Australia*, 2000, p. 9.

2 Australian Employee Ownership Association, *Submission 4*, p. 2.

3 Klaas Woldring, *Submission 2*, p. 2.

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

5 Australian Employee Ownership Association, *Submission 4*, pp. 3, 6.

6 CRA Plan Managers, *Submission 8*, pp. 2–3.

7 See for example House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours—An Inquiry into Employee Share Ownership in Australia* (2000), paragraph 2.16; Jarrod Lenne, Richard Mitchell and Ian Ramsay, *Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes*, University of Melbourne, 2005, p. 10.

of that prosperity'.[8] The Australian Employee Ownership Association recommended the establishment of an Employee Share Plan Promotional Unit to develop model or off-the-shelf plans for employers and employees.[9] Mr Fauvet thought a unit would help 'very definitely' and mentioned that they are in existence overseas, for example in the UK, where there is 'a whole unit dealing with share schemes' providing model plans etc.[10]

Committee view

4.4 Having heard the evidence to this inquiry, the committee sees benefit in promoting employee share schemes in Australia and supports the Australian Employee Ownership Association proposal of a promotional unit to encourage further uptake of employee share schemes.

Data

4.5 Evidence to the inquiry was clear about the lack of current 'comprehensive information on the number, nature and extent' of employee share schemes in Australia. In the early 2000s, there was an Employee Share Ownership Development Unit (ESODU) in the then-Department of Employment and Workplace Relations, collecting data on the prevalence of employee share schemes, but it was disbanded in the mid-2000s. The Australian Bureau of Statistics (ABS) or bodies such as the ATO or ASIC, despite their 'significant regulatory responsibilities in the area', do not collect data.[11] This has contributed to the near lack of:

> …understanding of how businesses in Australia are structuring their employee share ownership plans and how, if at all, they are integrating employee share ownership into their broader human resource management strategies.[12]

4.6 The lack of data also makes it 'difficult to identify whether the tax rules operate to encourage or discourage employee share ownership'.[13]

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8 Remuneration Strategies Group, *Submission 29*, p. 20.

9 Australian Employee Ownership Association, *Submission 4*, p. 6.

10 John Fauvet, *Proof Committee Hansard*, 27 July 2009, p. 42.

11 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 17–18.

12 Ingrid Landau, Richard Mitchell, Ann O'Connell and Ian Ramsay, 'An overview of existing data on employee share ownership in Australia', Employee Share Ownership Project, University of Melbourne, March 2007, p. 11.

13 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 17–18.

4.7 Previously collected data and surveys conducted by various organisations and companies are available but the information is hard to compare because of the lack of standardisation. However, findings indicate that there is 'significant diversity' regarding the type and nature of employee contribution and the conditions that must be satisfied.[14] Employee share schemes appear to be more likely in large and publicly listed companies and companies with overseas offices and among full-time employees and those with higher weekly earnings.[15] An ASX survey found that only nine per cent of the surveyed adult shareholders had obtained their shares through employee share schemes.[16]

4.8 A University of Melbourne study on Australian listed companies revealed that more than half (57 per cent) of the companies that responded to the survey 'had at least one broad-based' employee share scheme. Broad-based schemes are more common than narrow-based schemes and are structured to take advantage of the $1,000 tax exemption. The most common type of equity was options (48.7 per cent), closely followed by shares (46.7 per cent), and require a financial contribution from the employee to participate.[17]

4.9 Executive equity schemes have grown in importance in Australia particularly over the past decade and are 'a key strategic remuneration tool' linked to company performance. According to a 2008 Hay Group survey, overall, 46 per cent of senior executive and 31 per cent of chief executive officer incentive pay were subject to performance requirements.[18] Mr Hetherington argued that 'the benefits of Australia's 15-year economic boom have flowed disproportionately to investors (owners of capital) rather than workers (owners of labour)', a situation which employee share schemes could alter by offering employees access to returns on corporate profits.[19]

4.10 Remuneration Strategies Group noted that in 2002, 'a very high proportion', estimated to be around 90 percent, of Australian listed companies had an employee share scheme, including some executive-only plans. Only about 0.9 per cent of unlisted companies offered employee share schemes, as opposed to 90 per cent of both listed and unlisted US companies. The value of Australia's schemes was estimated to

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14 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 17–18.

15 Ingrid Landau, Richard Mitchell, Ann O'Connell and Ian Ramsay, 'An overview of existing data on employee share ownership in Australia', March 2007, p. 11.

16 ASX, 2008 Australian Share Ownership Study, p. 19.

17 Ingrid Landau, Richard Mitchell, Ann O'Connell, Ian Ramsay and Shelley Marshall, 'Broad-based employee share ownership in Australian listed companies: Survey report', Employee Share Ownership Project, University of Melbourne, April 2009, pp.1– 2.

18 Hay Group, *Submission 15*, p. 4.

19 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 9.

be between $3 billion and $4 billion, with about $1.5 billion in executive schemes. A 'significant' proportion of the total comes from a small number of very large firms.[20]

4.11 According to the 2004 ABS and the Employee Share Ownership Development Unit (ESODU) survey, 10 per cent of Australian businesses had some form of employee share scheme. Of nearly half a million employees in these businesses, 5.9 per cent held shares as a form of employment benefit. Manufacturing industry had the highest employee share scheme incidence (22 per cent), followed by finance and insurance (19 per cent) and communication services (15 per cent). Employee share schemes were least likely in the retail industry (14 per cent).[21]

4.12 According to a more recent CRA Plan Managers survey, 46 of the top 250 listed public companies issued securities under an employee share scheme in June 2008, with the gross value of $162 million.[22]

4.13 Remuneration Strategies Group expressed concern that there is 'conflicting and limited data regarding the implementation' of employee share schemes and 'no comprehensive (accurate) survey of the incidences' of the various scheme types by business type in Australia.[23] CRA Plan Managers submitted that 'detailed and properly funded research into the benefits of employee equity participation in Australian should be a mandatory precursor to any change'.[24]

Committee view

4.14 The committee notes the comments regarding the lack of recent data on employee share schemes in Australia. It acknowledges the University of Melbourne's project on employee share schemes and other surveys conducted by private enterprises to collect data. Considering that the latest survey by a government agency was conducted in 2004 and that there has apparently been an increase in the uptake of the schemes since, the committee recommends that a new survey be undertaken to establish the occurrence of employee share schemes in Australia. The committee hopes that the survey standardises the terminology relating to the various scheme types.

Recommendation 1

4.15 The committee recommends that in consultation with but not limited to employee share ownership groups, unions and academics, the Australian Bureau

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20 Remuneration Strategies Group, *Submission 29*, p. 31.

21 Ingrid Landau, Richard Mitchell, Ann O'Connell and Ian Ramsay, 'An overview of existing data on employee share ownership in Australia', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 1, 4.

22 CRA Plan Managers, *Submission 8*, pp. 2–3.

23 Remuneration Strategies Group, *Submission 29*, p. 30.

24 CRA Plan Managers, *Submission 8*, p. 7.

of Statistics conduct a survey of employee share schemes in Australia every five years, starting at the end of the 2009–10 financial year. The survey should collect data on, but not limited to, the following:

- **number and type of employee share schemes;**
- **number, size and industry of companies offering these schemes;**
- **number of employees and equity held by them;**
- **breakdown of employees by occupation, educational level and wage;**
- **reasons for offering (employers) and participating (employees) in the scheme;**
- **perceived effects and effectiveness of the schemes for both employers and employees;**
- **perceived barriers in the take-up of the schemes; and**
- **breakdown of general employee (broad-based) versus executive (narrow) schemes in terms of the number of shares offered; number of participants and equity held.**

Expanding take-up of employee share schemes

4.16 Evidence to the inquiry seems to agree that there is room for further uptake of employee share schemes in Australia. However, according to the Australian Institute of Company Directors (AICD), the Government's proposal 'still does not adequately recognise the fundamental imperative to promote *ongoing* share ownership'.[25]

4.17 The Institute of Chartered Accountants observed that a decade ago, the Government 'was actively encouraging Australian companies' to set up employee share schemes, with funding available to government agencies to actively promote them. This should be revisited to encourage the take-up of share schemes and would require tax rules that do not 'unduly jeopardise' or serve as a disincentive for employees.[26]

Impediments

4.18 Several impediments were identified in the evidence to the inquiry. They include prospectus requirements, several pieces of legislation, public awareness and perceptions.[27] According to a number of witnesses, the governance framework—the standards and best practice reward structures—should enhance the alignment of the long-term interests of employer, employees and shareholders.[28] Some witnesses also

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

26 Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, pp. 40–41.

27 Australian Employee Ownership Association, *Submission 4*, p. 2.

28 Yasser El-Ansary, *Proof Committee Hansard*, 27 July 2009, pp. 40–41; see also Ann O'Connell, *Proof Committee Hansard*, 27 July 2009, p. 49.

argued that the tax system should provide greater concessionality to enhance employee share ownership.[29]

Solutions

4.19 Mr David Hetherington proposed linking share ownership schemes to superannuation. This would involve employees being 'entitled to take up to one fifth of their Superannuation Guarantee Contribution (SGC) in employee share allocations where employers offer such plans'. This arrangement should receive the same tax treatment as the SGC and the employee should be entitled to 'liquidate the shares after 10 years, rather than waiting until retirement'.[30] Mr Price observed that through applying capital gains tax on gains or through a rollover to superannuation, holding shares or other entitlements after their vesting could 'be considered as a form of adding to national saving'.[31]

4.20 Following international examples, tax deductions could be provided for the employer company to equal the value of rights and options provided to an employee, with a cap of, for example, $10,000 per year per employee.[32]

Committee view

4.21 The committee notes the impediments and solutions above regarding increasing the take-up of employee share schemes in Australia. It believes that there is merit in further examining these options and urges the Government to take note of these comments and adjust the legislation and policy accordingly. It considers that using schemes as an alternative form of retirement savings merits further examination, considering the increasing number of retirees in Australia. The committee notes that legislation should have in-built safeguards to ensure the spread of risk.

Comparison of Australian and overseas schemes

4.22 Overseas, employee share schemes are 'a significant workplace phenomenon', particularly in the United States, Great Britain, France and Japan.[33] Details regarding the schemes in the US and the UK are in Appendix 3.

4.23 Similarly to the current situation in Australia, international comparisons of employee share schemes are difficult with little data available and studies not

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29 John Fauvet, *Proof Committee Hansard*, 27 July 2009, p. 41.

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

31 Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

32 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, pp. 20–21.

33 Australian Employee Ownership Association, *Submission 4*, p. 3.

standardised.[34] However, evidence to the inquiry identified certain differences or similarities between Australian and overseas schemes.

4.24 The available data appear to suggest that while the incidence of schemes in Australia is lower than that in the US or Europe, it is on the increase.[35] Overseas, it is usual for companies to have three to five different plans at the same time to meet different remuneration objectives and directed at different levels of the organisation. In Australia, it is common for employers to have two plans (tax-exempted and deferred) for the staff.[36]

4.25 As opposed to the US and the UK where 'tax structure favour [employee share schemes] over ordinary equity investments', in Australia investments in the share market are favoured over the employee share schemes despite their 'wider economic benefits'. Mr Hetherington called for share schemes to 'incentivise investment in employee-owned companies'.[37]

4.26 Australia's tax rules appear to be more complex than those in most other countries.[38] This is said to discourage or at least not encourage employee share schemes. Ms Sarah Bernhardt, Tax Adviser to Rio Tinto Limited, noted that in the UK, taxing of the options at exercise attracts a capital gains tax treatment which is 'deliberately offered as an incentive' to encourage people to participate in the plan. In comparison, she noted that in Australia, employees are taxed 'on exercise on everything they made' at their income rate, which left UK participants 'in a much better position than the Australian participants'.[39]

4.27 The main difference between Australian and US schemes is that in Australia schemes are limited to listed companies, whereas in the US 'the overwhelming majority—according to some estimates, 90 per cent'—are unlisted businesses.[40]

4.28 A comparison of six schemes in terms of returns to employees and impact on government tax receipts and implications found that returns to employees in the UK and US were far higher than in Australia (approximately 10 per cent versus Australia's 5 per cent). In the UK and US schemes, tax exemptions and government co-contributions offset most of the taxes upon disposal whereas Australian schemes

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34 Ingrid Landau, Richard Mitchell, Ann O'Connell and Ian Ramsay, 'An overview of existing data on employee share ownership in Australia', March 2007, p. 9.

35 Ingrid Landau, Richard Mitchell, Ann O'Connell and Ian Ramsay, 'An overview of existing data on employee share ownership in Australia', March 2007, p. 11.

36 Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

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

38 Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 71.

39 Sarah Bernhardt, *Proof Committee Hansard*, 27 July 2009, p. 21.

40 Australian Employee Ownership Association, *Submission 4*, p. 4.

suffer from the 'effective doubling of the tax rate on capital gains in the tax-deferred scheme'.[41] The study argued that the Australian tax-deferred scheme is 'deeply unattractive' because 'the entire capital gain is taxable at the employee's marginal income tax rate' rather than 50% of the gain being taxable (capital gains tax), and saw 'no obvious economic rationale' for this. Thus, Australian schemes 'deliver the highest tax receipts to government' due to higher tax rates and lower tax discounts than in the US and the UK. The 'strong correlation between returns enjoyed by employees and tax forgone by government' suggests that in order to advance uptake of employee share schemes, the government should forgo some of the tax revenue as employees join these schemes for superior returns which rely on tax concessions.[42] The Treasury noted that most of the countries that Australia would compare itself to have arrangements for tax concessionality.[43]

41 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 16. The six plans were tax-exempt and tax-deferred schemes in Australia, Share Incentive Plan (SIP) and Save as You Earn Scheme (SAYE) in the UK and Employee Share Ownership Plan (ESOP) and 423 Plan in the US.

42 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, pp. 17–19.

43 Michael Willcock, *Proof Committee Hansard*, 27 July 2009, p. 3.

Chapter 5

Recent developments regarding employee share schemes

Background

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

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

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

5.4 The Government proposed that:

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

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

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

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

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

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

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

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

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

Consultation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Final policy position

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

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

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

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

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

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

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

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

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

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

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

Current reviews

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

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

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

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

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

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

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

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

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

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

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

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

Committee view

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

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

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

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

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

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

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

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

Recommendation 2

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

Expert panel

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

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

Chapter 6

Comments on proposed changes

General comments

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

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

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

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

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

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

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

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

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

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

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

Consultation

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

Committee view

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

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

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

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

Tax exemption and income threshold

$1000 tax exemption

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

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

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

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

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

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

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

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

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

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

Income threshold

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

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

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

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

Committee view

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

Taxation point

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

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

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

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

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

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

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

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

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

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

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

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17 Ann O'Connell, Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 28.

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

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

20 Ann O'Connell, Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 26.

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

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

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

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

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

Taxing upfront

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

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

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

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

25 Ann O'Connell, Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 26.

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

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

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

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

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

Refund

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

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

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

Deferral of taxation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Cessation of employment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Partial vesting

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

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

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

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

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

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

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

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

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

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

Employees leaving the country

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

Salary sacrifice and other schemes

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Real risk of forfeiture

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Start-up companies

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

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

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

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

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

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

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

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

Executive remuneration

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

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

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

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

6.67 According to the Treasury, the Government has aligned its policy regarding equity-based remuneration with that of APRA, considering performance-based remuneration to be '"at-risk" of forfeiture until the individual's performance can be validated'. This is to provide incentives for the executive to act in the best interests of the company and observe good risk management practices. The goal will be achieved by deferring some or all of the 'performance-based remuneration until the end of a

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

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

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

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

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

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

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

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

Global businesses

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

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

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

International comparisons

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

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

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

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

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

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

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

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

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

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

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

Legislation

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

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

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

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

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

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

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

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

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

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

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

122 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 25.

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

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

Lack of definitions

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

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

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

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123 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 25.

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

125 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 25.

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

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

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

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

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

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

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

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

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

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

Capital gains tax

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

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

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

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

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

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

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

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

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

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

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

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

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

Valuation

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

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

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

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

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

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

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

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

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

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

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

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

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

Employer reporting requirement

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Other amendments

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

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

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

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

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

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

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

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

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

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

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

Compliance

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

- retrospectively attempted to elect to be taxed upfront on the 'discount' in order to gain access to the CGT discount for gains accruing since acquisition;
- failed to include the discount in their assessable income at the cessation time; and
- incorrectly applied the CGT rules to the 'discount' instead of including it in their assessable income.

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

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

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

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

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

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

incentives for the executive to act in the best interests of the company and observe good risk management practices. This will be achieved by deferring some or all of the 'performance-based remuneration until the end of a deferral period'.[167]

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

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

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

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

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

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

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

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

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

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

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

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

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

Current reviews

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

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

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

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

- capital gains tax rules

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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

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

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

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

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

Senator Alan Eggleston
Chair

Labor Senators' Dissenting Report

Chapter 1

Introduction

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

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

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

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

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

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

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

Summary of proposed changes

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

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

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

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

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

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

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

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

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

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

1.18 Overall the changes will:

(i) improve equity and fairness in the tax system by treating all forms of remuneration more consistently;

(ii) target employee share scheme tax concessions more closely to low and middle income earners; and

(iii) Reduce the scope for losses to tax revenue through tax evasion and tax avoidance.

(iv) Have an estimated revenue impact of $135m over forward estimates

Structure of the report

The structure of the dissenting report is as follows:

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

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

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

Chapter 5—provides a summary of the report

Chapter 2

Employee share schemes

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

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

2.3 Labor Senators fully support bona fide ESS plans.

Why reform is necessary

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

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

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

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

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

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

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

2.8 The Finance Sector Union submitted:

> We note recent evidence from the ATO in Senate Estimates regarding their audit of individuals earning over $1 million per annum which found substantial compliance issues relating to their use of employee share schemes. The examples cited regarding two individuals (one at CEO level) who had unpaid tax liabilities of around half a million dollars each demonstrate that aggressive tax planning in employee share schemes by executives and high income earners has continued unabated despite the 2000 Inquiry.
>
> That being the case, the question then goes to how the Government of the day seeks to amend the legislation to ensure fair application of tax rules, while ensuring the objectives of employee share ownership are met.[4]

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

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

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

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

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

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

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

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

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

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

2.14 The Institute of Chartered Accountants submitted that:

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

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

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

History of the need for reform

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

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

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

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

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

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

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

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

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

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

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

Chapter 3

Promotion of ESS as an alternative to superannuation

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

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

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

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

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

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

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

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

3.9 However, the changes do maintain the ability for the low and middle income earners to invest in the company they work for; have a say as a shareholder and possibly share in growth of the company and benefit through improvements in productivity that they have work towards.

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

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

Establishment of a promotional unit

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

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

3.14 According to the Finance Sector Union, 'there is a broad and bi-partisan acceptance that ESOPs can have a positive affect on the employee—employer relationship':[11]

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

3.15 Mr Rod Masson, Finance Sector Union, continued:

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

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

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

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

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

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

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

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

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

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

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

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

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

Consultation

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

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

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

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

Chapter 4

Salary sacrifice

4.1 The proposed legislation provides that:

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

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

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

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

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

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

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

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

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

Cessation

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

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

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

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

Risk of deferral

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

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

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

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

Chapter 5

Summary

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

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

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

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

Recommendation 1

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

Senator Annette Hurley
Deputy Chair

Senator Louise Pratt

Appendix 1

Submissions Received

Submission Number	Submitter
1	Baker McKenzie
2	Klaas Woldring
3	Confidential
4	Australian Employee Ownership Association
5	PricewaterhouseCoopers
6	Guerdon Associates Pty Ltd
7	Dwyer Lawyers
8	CRA Plan Managers Pty Limited
9	Rio Tinto
10	Taxation Institute of Australia
11	Remuneration Strategies Group Pty Ltd
12	Australian Institute of Company Directors
13	AIIA
14	Fairfax Media Limited
15	Hay Group
16	The Institute of Chartered Accountants in Australia
17	Starfish Ventures
18	Allens Arthur Robinson
19	Mallesons Stephen Jaques
20	The Treasury
21	Confidential
22	Finance Sector Union
23	Ernst Young
24	Mr Shann Turnbull
25	Business Council of Australia
26	Corporate Tax Association
27	DLA Phillips Fox
28	Deloitte Touche Tohmatsu Ltd
29	Employee Ownership Group
30	Investment Financial Services Association
31	Australian Bankers' Association Inc.
32	Johnson Johnson Family of Companies Australia
33	Alan Greig

Additional Information Received

TABLED DOCUMENTS

Canberra ACT
Monday, 27 July 2009

- Research report tabled by Associate Professor Ann O'Connell: 'Employee Share Ownership Plans in Australia - the Corporate Law Framework' (2007)
- Research report tabled by Associate Professor Ann O'Connell: 'Employee Share Ownership in Unlisted Entities: Objectives, Current Practices and Regulatory Reform' (2008)
- Research report tabled by Associate Professor Ann O'Connell: 'Why do Employees Participate in Employee Share Plans - A Conceptual Framework' (2008)
- Research report tabled by Associate Professor Ann O'Connell: 'An Overview of Existing Data on Employee Share Ownership in Australia' (2007)
- Research report tabled by Associate Professor Ann O'Connell: 'Employee Share Ownership - a Review of the Literature' (2007)
- Research report tabled by Associate Professor Ann O'Connell: 'Employee Share Ownership Plans in Australia - the Taxation Law Framework' (2007)
- Research report tabled by Associate Professor Ann O'Connell: 'Broad-Based Employee Share Ownership in Australian Listed Companies: Survey Report' (2009)

Appendix 2

Public Hearing and Witnesses

BERNHARDT, Ms Sarah Louise, Adviser,
Rio Tinto Limited

CONSEDINE, Mr Stephen John, Company Secretary,
Rio Tinto Limited

EL-ANSARY, Mr Yasser, Tax Counsel,
Institute of Chartered Accountants

ELLIS, Mr Paul Anthony, Member, Employee Ownership Group; and Partner,
Ernst & Young

FAUVET, Mr John Francis, Partner,
PriceWaterhouseCoopers

HOLLAND, Ms Erin, Deputy Commissioner, Micro Enterprises and Individuals,
Australian Taxation Office

LEGGETT, Mr Christopher, Senior Adviser, Personal and Retirement Income Division, Revenue Group, Department of the Treasury

MASSON, Mr Rod, National Director, Policy and Communications,
Finance Sector Union of Australia

MORROW, Mr Martin, Chairman,
Employee Ownership Group

NICHOLSON, Mrs Tracey, Assistant Commissioner,
Australian Taxation Office

O'CONNELL, Ann, Associate Professor,
University of Melbourne

PRICE, Mr Geoff, Managing Director,
Computershare

ROBINSON, Mr Marty, Manager, Household Modelling and Analysis Unit, Tax Analysis Division, Department of the Treasury

ROUSSEL, Mrs Sandra, Manager, Philanthropy and Exemptions Unit, Personal and Retirement Income Division, Revenue Group, Department of the Treasury

WATSON, Mr Andrew, Director, High Income Individuals, Micro Enterprises and Individuals, Australian Taxation Office

WILLCOCK, Mr Michael, General Manager, Personal and Retirement Income Division, Revenue Group, Department of the Treasury

Appendix 3

Overseas schemes

United States

1.1 The United States (US) has some 25 million employee owners with some €1,000 billion in assets.[1] Schemes exist in 'practically every industrial branch', from large, publicly traded firms to small, closely held companies.[2] Companies offer multiple schemes and employees participate in more than one scheme. Approximately 15 per cent of the workforce participate in some form of employee share scheme.[3]

1.2 The US legislation provides employee share trusts a special status which has led to a great increase in employee ownership.[4] Dr Klaas Woldring submitted that the fiscal and legislative measures make it 'attractive for both companies and employees to invest in employee ownership'. The measures facilitate the raising of loans from financial institutions for setting up a scheme and buying shares for employees, with loans repaid tax free from company profits and share dividends.[5] The growth has also been attributed to the better performance of companies with schemes.[6]

1.3 In the US, stock options for taxation purposes are categorised into two types: non-statutory, which are taxed under general principles of compensation and income, and statutory options.[7]

Non-statutory schemes

1.4 In non-statutory schemes, options are taxable upon grant if there is a readily ascertainable fair market value; if not, they are taxed at exercise. Subsequent gains are treated as capital gains, and taxation 'may be deferred if there is a substantial risk of forfeiture. Compensatory income can be converted into capital gains, and if done within 30 days of acquiring the option, the difference of the value and employee

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1 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 11.

2 Dr Klaas Woldring, *Submission 2*, p. 2.

3 Remuneration Strategies Group, *Submission 29*, p. 28.

4 Brash Solutions, *Submission 21*, p. 1.

5 Dr Klaas Woldring, *Submission 2*, p. 2.

6 Remuneration Strategies Group, *Submission 29*, p. 28.

7 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraph 2, http://www.treasury.gov.au/documents/1559/PDF/consultation_paper.pdf (accessed 15 July 2009).

contributions is taxed as ordinary income; on disposal, the excess is taxed as capital gain.[8]

Statutory schemes

1.5 Statutory schemes are plans approved by shareholders in order to grant employees options to purchase shares. Statutory schemes have two types of plans: incentive stock options (ISOs), often limited to key employees; and employee stock purchase plans (ESPPs), granted to all employees. In both types, the employer is generally not eligible to claim deductions, and both the employer and employee are subject to 'stringent reporting requirements'.[9]

1.6 Under ESPPs, there is no tax on the grant or exercise of a right. Any discount is taxed as ordinary income upon disposal of the right. Further gains are treated as capital gains. Discount can be 15 per cent at most but the shares cannot be sold within two years from the grant and one year after they are transferred. An employee's voting power or value of employer's stock must not exceed five per cent. Employers usually use payroll deductions to pay for the shares.

1.7 Similarly to ESPPs, taxation of ISOs occurs upon disposal, with gains treated as a capital gain. The part of the value exceeding $100,000 is treated as ordinary income. An employee's voting power or value of employer's stock is limited to no more than 10 per cent.

1.8 The three main employee ownership schemes in the US are Kelso or employee share ownership plans, the 423 plan and the 401(k) plan.

Employee share ownership plan

1.9 The employee share ownership plan (ESOP) or Kelso plan is the most popular employee share scheme type in the US, with 11,400 ESOPs and equivalent plans in existence, involving 13.7 million employee owners who held some €700 billion in assets in 2006.[10] ESOPs are leveraged share purchase instruments which enable employees to buy into their employer company over a period of time, on average over 3 to 5 years. It works in the same way as a corporate takeover. It can be used to

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8 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraph 3.

9 Information in this section is from The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 5–8.

10 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 11.

finance the expansion of a company's capital base.[11] Employees can purchase shares using pre-tax income and third-party loans.[12]

1.10 In an ESOP, the company establishes a trust. If it is funded through loans, the company can deduct up to 25 per cent of payroll for repayments of principal, with interest payments fully deductible. If the scheme is not funded by a loan, up to 15 per cent of payroll is deductible for principal repayments. Further deductions may include dividends if they are 'used to repay an ESOP loan or paid directly to workers'. Employees do not pay income tax as the shares are acquired by the trust but any gains outside the trust are subject to capital gains tax (CGT). 'If over 30% of an unlisted company's shares are sold into an ESOP trust, CGT is deferred for as long as the proceeds are continually reinvested in domestic (US) securities'.[13]

423 Plan

1.11 The 423 Plan is an employer share only scheme.[14] It is similar to ESOP, with the main difference being that the employees hold their shares personally, not through a trust. Employees can acquire shares or options at a maximum 15 per cent discount, with CGT payable upon disposal of the shares. The 423 Plans are more common in public companies.[15]

401(k)

1.12 The 401(k) schemes are set up for retirement savings such as superannuation.[16] They are funded out of remuneration, with shares in the employer company and other listed companies purchased through profit shares, salary sacrifice and matching employer contributions. The legislation requires partial investments in non-employer equities to spread the risk.[17]

1.13 The Australian Employee Ownership Association considered 401(k) important to the share scheme discussion in Australia for a number of reasons. Firstly, its financing is closer to Australia's typical unleveraged scheme than ESOP. Secondly, it is very effective in increasing worker ownership. While smaller than the ESOP,

11 Australian Employee Ownership Association, *Submission 4*, p. 3.

12 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

13 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

14 Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

15 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

16 Mr Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 76; Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

17 Australian Employee Ownership Association, *Submission 4*, p. 4.

401(k) still has about 2,000 participating plans with two million employees who own an estimated US$250 billion.[18]

United Kingdom

1.14 In the United Kingdom (UK), there are four types of employee share schemes. Two of them must be offered to all employees that meet the qualification requirements; the other two can be offered to selected employees. The schemes generally require an approval of Her Majesty's Revenue and Customs (HMRC). Income tax and national insurance are payable upon exercising the option to buy shares at discount.[19]

1.15 The two main schemes are share incentive plan (SIP) and Save As You Earn (SAYE) scheme. The other two main schemes are the company share option plan and the enterprise management incentive scheme.

Share incentive plans

1.16 The share incentive plan (SIP) offers employees four classes of shares: partnership, free, matching and dividend shares. Companies must set up a trust to hold the shares.[20]

1.17 Using pre-tax income, an employee can acquire up to £1,500 in partnership shares annually.[21] In addition, an employee can be given up to £3,000 in free shares, provided they have been held in the scheme for five years. If the employee keeps the shares in the plan until they are sold, no CGT is payable; if the shares are sold after leaving the plan, CGT will apply.[22]

1.18 With post-tax income, an employee can acquire two matching shares for each partnership share held (up to £2,500 annually).[23] Taxation depends on how long the shares have been in the plan: similarly to the free shares, there is no income tax if the

18 Australian Employee Ownership Association, *Submission 4*, p. 4.

19 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 15–16.

20 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 22.

21 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

22 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 17–18.

23 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

shares are held more than five years. Free and matching shares can be forfeited if the employee ceases employment, and performance conditions can be included.[24]

1.19 In addition, an employee can reinvest tax free up to £1,500 of dividend shares in the employer company. Dividends 'used to buy dividend shares are taxed when the shares are withdrawn from the plan'.[25] In total, employees can receive up to £7,500 worth of shares each year in three components of £2,500 each. However, not all employers offer all three components but can choose the one(s) most suitable for their employee base.[26]

1.20 The employer is eligible for tax concessions regarding the 'costs of offering free and matching shares and the costs of offering partnership shares where this exceeds employee contributions'.[27]

1.21 A 2005 reform enabled people to roll their benefits out of the scheme into an individual savings account or a self-invested pension.[28]

Save As You Earn scheme

1.22 The Save As You Earn (SAYE) scheme differs from the SIP scheme in that the employee may acquire options to buy shares rather than actual shares. It has similar characteristics as the SIP plan but no risk for the employee: 'if the share price doesn't exceed the exercise price of the options, the employee can simply take the accumulated savings in cash'.[29]

1.23 Options are offered by the employer company at up to a 20 per cent discount to the current share price.[30] Employee savings accumulate in a special interest-bearing tax-free account.[31] The employee contributes a monthly post-tax sum for an agreed period (3, 5 or 7 years) after which the government makes a co-contribution tax-free, based on the duration of the saving. The funds can be used to exercise the options or

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24 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 19 and 21.

25 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

26 Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

27 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

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

29 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

30 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

31 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraph 24.

taken as cash. Upon exercising the options, the shares become liable to CGT.[32] Employees must enter into a special savings contract with a financial institution to buy the shares at the end of the fixed term. There is no income tax on grant of the options, and no tax when employees use their savings to buy shares.[33]

1.24 The employer may impose restrictions including that shares must be sold upon cessation of employment. Savings-related schemes may also require that the employees have been employed for up to 5 years to be eligible to participate in the scheme.[34]

Company share option plans

1.25 Company share option plans (CSOP) allow companies to choose the employees and directors to whom to grant options up to a maximum value of £30,000 at grant. No income tax is payable at grant or if the option is exercised after three years but before ten years after grant. On disposal, CGT is payable unless the gains fall below the annual exempt amount. Participation excludes employees owning more than 25 per cent of the company. Employers may place restrictions on the disposal of shares.[35]

Enterprise management incentive scheme

1.26 Enterprise management incentive schemes are designed for small companies and exclude businesses in banking, insurance and farming. Employees can be granted options over shares up to £120,000 in value. There is no tax on the grant or exercise of the option unless the exercise price is less than the market value, in which case the discount is subject to income tax. When sold, shares are subject to CGT from the date of grant.[36]

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32 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

33 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 23–24.

34 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 23 and 26.

35 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 27–31.

36 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 32–33.

European Union

1.27 Employee ownership in European Union countries has grown in the last ten years. Because of the late uptake, Europe is behind the United States in the prevalence of the schemes.[37]

1.28 According to the 2008 European Union survey regarding employee ownership in large European corporations, the equity of the 9.1 million employees working in these corporations mounted to €240.2 billion, a decline of 15 per cent from the previous year.[38] The average equity held by each of the 8.2 million European employee owners (excluding top executive) is €15,933.[39] Most of the shares are 'still held by top executive employees rather than ordinary employees (39.5 per cent for executives compared to 60.5 per cent for common employees).[40] Only around 12 per cent of European employees 'receive income from some form of profit sharing scheme'.[41]

1.29 On average 85.1 per cent of the European corporations provide some type of employee ownership, with all large Finnish and Irish corporations having these schemes. France has the highest number of companies with broad-based schemes (86.5 per cent), with the European average being 51.9 per cent.[42] The survey concluded that 'employee ownership is strongly involved in companies' governance and strategy.[43] European corporations renew or launch new schemes regularly, with a 3–4-year-old plan considered old.[44]

1.30 According to the study, employee ownership is going to double within the next 5–10 years in Europe, from the current 9.1 million employee owners to

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37 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 12.

38 European Federation of Employee Share Ownership, 'Economic Survey of Employee Ownership in European Countries in 2008', http://www.efesonline.org/Annual%20Economic%20Survey/2008/Presentation.htm (accessed 13 July 2009).

39 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 31.

40 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 18.

41 European Foundation for the Improvement of Living and Working Conditions, 'Financial participation of employees in the European Union: Much ado about nothing?', Background paper, 2007, p. 27.

42 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 25.

43 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 16.

44 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 13.

16 million, or from the current 28.2 per cent of employees in large European companies to 40–50 per cent. Capitalisation is estimated to rise from 2.6 per cent now to 4–5 per cent.[45] The study concluded that 'it seems highly probable that most European countries will increase to 40 per cent or more employee owners within the next 5–10 years'.[46]

1.31 There is 'a growing disparity' between countries such as France and the UK that have had schemes for a long time and countries 'with the least developed financial participation policies and institutions'. It is said that European countries need to share information and models and exchange experiences on best practices. Remuneration Strategies Group explained:

> The UK appears to be the country with substantial application of share schemes. France appears to be a country with mandatory profit sharing schemes. Spain appears to be a country with a tradition of co-operatives. Germany is a country with established capital accumulation plans for employees, and the Netherlands and Finland appear to be countries with a national wage saving system. These country differences determine the existence of schemes to a large extent. Most broad based employee financial participation appears to be a result of the possible benefits provided by government policies in certain European countries.[47]

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45 European Federation of Employee Share Ownership, 'Economic Survey of Employee Ownership in European Countries in 2008', http://www.efesonline.org/Annual%20Economic%20Survey/2008/Presentation.htm (accessed 13 July 2009).

46 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 29.

47 Remuneration Strategies Group, *Submission 29*, p. 29.