REFORM OF THE TAXATION OF EMPLOYEE SHARE PLANS – CONSULTATION PAPER

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The Employee Ownership Project, established in 2006 is a joint initiative of the Centre for Corporate Law and Securities Regulation, the Centre for Employment and Labour Relations Law and the Tax Group. It is funded by an Australian Research Council Discovery Project Grant. The Chief Investigators on the Project are Professor Ian Ramsay, Harold Ford Professor of Commercial Law and Associate Professor Ann O'Connell, Melbourne Law School and Professor Richard Mitchell (Monash University).

The Project has been considering the existing regulatory regime for employee ownership plans (ESOPs) in Australia in tax, corporate and labour law, and subjecting the regimes to technical and empirical scrutiny. It has been examining the current incidence and forms of ESOPs in Australia, the diversity of objectives that such schemes serve, the extent to which current corporate, tax and labour law inhibit ESOPs, and the case for regulatory reform for the regulatory framework.

The Project has produced a number of reports as follows:
Landau, R Mitchell, A O'Connell, I Ramsay and S Marshall, Broad-Based Employee Share Ownership in Australian Listed Companies: Survey Report (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, April 2009).

A O'Connell, 'Employee Share Ownership in Unlisted Entities: Objectives, Current Practices and Regulatory Reform' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, December 2008).

M Brown, I Landau, R Mitchell, A O'Connell and I Ramsay, 'Why Do Employees Participate in Employee Share Plans? A Conceptual Framework' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, February 2008).
I Landau, R Mitchell, A O'Connell and I Ramsay, 'An Overview of Existing Data on Employee Share Ownership in Australia' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, March 2007).
I Landau, R Mitchell, A O'Connell and I Ramsay, 'Employee Share Ownership: A Review of the Literature' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, March 2007).

I Landau and I Ramsay, 'Employee Share Ownership Plans in Australia: The Corporate Law Framework' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, March 2007).
A O'Connell, 'Employee Share Ownership Plans in Australia: The Taxation Law Framework' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, March 2007).

We are also in the process of conducting a survey of employee attitudes to ESOPs and hope to publish our findings by the end of the year.

We welcome the opportunity to comment on the Consultation Paper. However, we note that the time for consultation is extremely limited and that the original proposal was made without the opportunity for debate on many of the issues that we have been considering. We urge the Government to allow a greater period for discussion of these matters.

We do welcome a number of features of the proposal. In particular, we agree with the following:

- In many cases the appropriate taxing point is the time of acquisition and that what is taxed at this point should be the difference between the market value at acquisition and the amount paid (the acquisition gain). A further taxing point would be when the shares or rights are disposed of and any gain (ie the difference between market value on acquisition and consideration on disposal) (the disposal gain) should be taxed as a capital gain. However, this is not the appropriate taxing point where the shares do not vest at this time. The formula proposed in the legislation for deferral is quite limited and needs greater consideration. Another outstanding issue is how to determine market value where the shares or rights are subject to significant restrictions (these are currently ignored but this is not a very realistic view).

- We note that the reference in proposed s 83A-25 is to shares or rights to acquire shares and that this addresses a concern under existing rules that simply refer to "rights". We also note that the references are not uniform however and that it may be more appropriate to define a "right" as "a right to acquire a share".

- We note that the concessions will potentially be available to contractors and welcome this, particularly in view of changing work practices. However, we note that the concessions are only available where the shares are shares in the employer or in a holding company of the employer and is not more widely available eg to shares in a related company.

We would also make the following comments:

1. There seems to be a general consensus that “broad-based” ESOPs should be encouraged. There is not the same consensus in relation to “narrow-based” plans. The proposed changes are not restricted to broad-based plans.

2. That the existing concessions favor listed entities and do not encourage the use of ESOPs in unlisted entities. The proposed changes do not adequately address this issue. In particular we note that there are significant valuation issues under the existing rules. Although changes are proposed there are still likely to be issues, especially for unlisted entities.

3. That the exemption concession of $1000 which has operated since 1997 is too low in relation to the cost of implementation of such schemes. The proposed changes retain the $1000 and make it more difficult to qualify.

4. That the tax rules relating to ESOPs do not interact well with the CGT provisions.

5. That any review of the tax rules should also give consideration to reforming the *Corporations Act* in relation to ESOPs.

We set out our views on these matters below.

1. Broad based v narrow based schemes

Our research has identified a number of rationales for ESOPs that appear to enjoy bi-partisan support. They include:

- Improving enterprise performance;
- Workplace relations objectives;
- Contributing to national savings;
- Promoting innovation;
- Flexibility in remuneration;[1]
- Facilitating employee buyouts and succession planning.[2]

[1] Although not identified elsewhere as an objective in its own right, such flexibility has been consistent with general government policy of allowing flexibility and choice in work practices and arrangements.
[2] Identified in the Shared Endeavours Report (2000) but does not appear to be something that government has taken into account in formulating government policy.

In our survey of listed entities, respondents were asked to select the extent to which they agreed or disagreed that the plan they implemented was done to achieve certain objectives. We found that overwhelmingly ESOPs were viewed as a mechanism for fostering identification between the company and the individual employee and aligning employee actions with employer interests.[3]

The focus of our survey of listed entities was on the use of broad-based schemes, which we described as schemes that were open to the majority of employees within the company, as opposed to narrow-based schemes which were not available to the majority of employees. Such schemes would typically be available to a limited number of employees such as senior executives. In our survey, 56.8% of companies had at least one broad-based plan. Just over 40% of companies who responded had a plan that was only open to executives.

The only comment we would make is that although there may be a justification for encouraging both types of schemes, it is important to differentiate and identify whether encouragement is being given to both or whether it is more appropriate to encourage only broad-based schemes. Under the current arrangements a narrow-based scheme can access concessions if at least 75% of permanent employees are entitled or have been entitled to acquire shares or rights under the scheme or another scheme including an earlier scheme.[4] This rule is repeated in proposed s 83A-100(g) (relating to deferral) so that it would be possible to have two schemes – a broad-based scheme for the majority of employees and another scheme, perhaps more generous, for executives.

If the intention was to encourage the use of broad-based schemes and to discourage narrow-based schemes, this is not likely to be achieved. We also note that the restriction of the exemption concession to employees with an adjusted taxable income of $150,000 may give rise to compliance issues for the employer who is trying to determine eligibility. It may also be appropriate to index such amounts so that they thresholds are not eroded by inflation.

2. Listed entities v unlisted entities

We have also undertaken research into the current practice and regulatory obstacles faced by unlisted entities. We were interested to find out how smaller businesses responded to, inter alia, the tax regime for ESOPs. There is an obvious difficulty in collecting data from such a diverse group but we started from the position that such entities faced a common disadvantage, namely the lack of a ready market for their securities and considered the specific problems that arose as a result. We also conducted a workshop with representatives from

[3] Landau, R Mitchell, A O'Connell, I Ramsay and S Marshall, Broad-Based Employee Share Ownership in Australian Listed Companies: Survey Report (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, April 2009).

[4] Section 139CD(5) *Income Tax Assessment Act 1936*.

government, business and advisory groups to identify the relevant issues. Our findings are available in a Report dated December 2008.[5] The specific issues that we identified were:

- The tax concessions are restricted to companies. We noted that this meant that the concessions were only available to businesses whose legal form is that of a company to the exclusion of other legal structures suc as joint venture, trust and partnership despite statements from practitioners that companies are not likely to the vehicle of choice in the mid-market;
- The tax concessions are restricted to employees. We note that the proposed legislation extends the operation of the Division to contractors (proposed s 83A-325, Item 3) and welcome that extension;
- The criteria for obtaining the tax concessions are unduly restrictive. We noted that the requirements relating to the shares being ordinary shares, that the acquirer does not acquire more than 5% and that the scheme be open to at least 75% of current employees did not appear to have a clear policy justification, were not universally required in other jurisdictions and were often more difficult for unlisted entities to satisfy. The conditions for eligibility in the proposed legislation appear to have been repeated from the existing provisions and should be the subject of a more rigorous debate as to why they are justified. We also have some concerns about the expression used in proposed ss 83A-25(2)(d) and 83A-100((1)(e) that refer to there being a "real risk" that you will "never be able to control circumstances in which [the interest] will be disposed of" and how this is likely to be applied in practice ;
- Valuation of shares and options in unlisted entities present particular difficulties. In particular we noted that the absence of a market mechanism to determine the value of shares or rights was problematic and that the existing rules were imprecise or involved high costs. We suggested a *de minimis* rule and/or the adoption of a formula, approved by the ATO in advance to determine value. We note that it is proposed to undertake further examination of the valuation rules but that in the meantime, the proposed regulations will reproduce the existing valuation rules for unlisted rights (para 101). It is also noted that the existing rules for unlisted rights "have resulted in systemic undervaluation and therefore, frequent under-taxation" (para 99). It is hoped that the proposed review will consider all the valuation problems that may arise including the burden that may arise for unlisted entities as a result of any particular method;
- Lack of a ready market for disposal. In this regard we noted that the issue for employee-shareholders in an unlisted market was that it is not always practicable to find buyers. We also noted that the share buy-back provisions were onerous in their application to unlisted entities. Although the Board of Taxation has recently completed a review of the share buy-back provisions, it has not made any recommendations with respect to the

[5] A O'Connell, 'Employee Share Ownership in Unlisted Entities: Objectives, Current Practices and Regulatory Reform' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, December 2008).

interaction between the employee share scheme provisions and the buy-back provisions. We would recommend that this matter be given further consideration if it is thought desirable to encourage ESOPs in unlisted entities;

- The interaction between Div 13A and the CGT provisions is not clear. See below;
- There are issues of complexity and cost of implementing plans that fall more heavily on smaller enterprises. This was certainly the case under the existing provisions and the proposed legislation doe not appear to reduce the complexity. In particular the conditions for the concessions are still complex, particularly when compared with the provisions in the US and the UK;[6]
- The $1000 exemption is too low. See below.

3. The $1000 exemption is too low

We noted that the $1000 exemption was introduced in 1997. Since that time Average Weekly Earnings have almost doubled but the amount of the exemption has not increased. The Shared Endeavours Report in 1999 noted that if the exemption amount was increased to $2000 there would very likely be a significant increase in the number of ESOPs implemented and recommended an increase in the amount. We have noted that other countries such as the UK have more generous exemptions. We also note that in our listed entity survey, when we asked respondents to select reforms that they would like to see, there was very strong support for the proposition that the $1000 concession should be raised.[7]

4. Interaction with the CGT provisions

In our view it is appropriate to treat the discount on acquisition as subject to tax at that time and to treat any subsequent gain to be on capital account. We also noted that in the case of start up companies it may be inappropriate to treat equity as remuneration[8]. The Consultation Paper does not really discuss the interaction with the CGT provisions and in particular how they will apply in the deferral situation.

[6] Ibid, pp 33-8.
[7] Above, n 3.
[8] Ibid, para 3.2.9.

5. Corporations Act issues

We also noted a policy divergence between the tax rules which treat the acquisition of shares as being about remuneration and the corporations' law rules which treat the acquisition as an investment decision. We would recommend that any changes in relation to ESOPs also consider the *Corporations Act* provisions.