Research Report

EMPLOYEE SHARE OWNERSHIP PLANS IN AUSTRALIA: THE TAXATION LAW FRAMEWORK

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Employee Share Ownership Project

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

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

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EMPLOYEE SHARE OWNERSHIP PLANS IN AUSTRALIA: THE TAXATION LAW FRAMEWORK

Ann O'Connell[*]

1 INTRODUCTION

Taxation law has featured prominently in the regulation of employee shares ownership plans (ESOPs) in Australia. Indeed, it is largely through reforms to the taxation law framework over the past several decades that the Australian Government has sought to promote, and shape, employee share ownership.[1] This paper examines the taxation treatment of employee share ownership plans and the effect of these tax rules on current practice in the area. It also identifies the major criticisms of the current regulatory regime. While this paper is predominately concerned with broad-based employee share ownership plans – plans in which a majority of employees in the company are eligible to participate – it does briefly discuss executive-based plans. This is because it is impossible to discuss the regulation of broad-based ESOPs in Australia without discussing the perennial concern of regulators to prevent the abuse of such plans by company executives.

Part 2 of the paper identifies the key public policy rationales for the promotion of broad-based employee share ownership in Australia. An understanding of these objectives is crucial to understanding the nature and limits of the current regulatory framework. Part 3 briefly traces the relevant legislative developments. Part 4 examines the current taxation treatment of employee shares or options. Part 5 looks at current market practice in the area. Finally, Part 6 identifies some of the key difficulties associated with the current taxation regime of employee share schemes.

2 PUBLIC POLICY RATONALES FOR EMPLOYEE SHARE OWNERSHIP

Since at least the 1970s, broad-based employee share ownership has enjoyed bipartisan support in Australia. There are a myriad of rationales offered to support employee share ownership, 'informed by a variety of ideologies and intentions.'[2] The promotion of employee share ownership continues to be an objective of both the Liberal Party of Australia and the Australian Labour Party (ALP).[3] The current federal Coalition Government has committed to doubling the incidence of employee share schemes in the

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[1] There have, of course, also been reforms to the corporate law framework: see 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).

[2] Cited in House of Representatives Standing Committee on Employment, Education and Workplace Relations Report, *Shared Endeavours – An Inquiry into Employee Share Ownership in Australia* (September 2000) ('*Shared Endeavours*') 30.

[3] See Australian Labor Party, *ALP National Platform and Constitution*, as adopted at the 43rd National Conference, Sydney, 29 – 31 January 2004.

workplace from 5.5 percent to 11 percent of employees by 2009.[4] The ALP has recently foreshadowed an examination of measures to facilitate employee share ownership.[5]

In 1999, the Minister for Employment, Workplace Relations and Small Business, Peter Reith, directed a joint Parliamentary Committee to 'inquire into and report on the extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on: workplace relations and productivity in enterprises; and the economy.' The Committee's report, *Shared Endeavours,* was tabled in September 2000.

Shared Endeavours was overwhelmingly in favour of the promotion of broad-based employee share ownership plans in Australia.[6] The Dissenting Report by the Labor members of the Committee concurred with the Majority Report that broad-based employee share ownership schemes should be encouraged. Moreover, the Labor members supported a number of the Majority Report's recommendations for the promotion of these sorts of plans. They were cautious to note, however, that while the conclusion that broad-based employee share plans better aligned employer and employee interests and fostered increased productivity and workplace harmony, seemed logical, there was no clear and objective evidence to support these rationales.[7] Their report focused largely on their concerns with the capacity of employee share plans, as currently regulated, to facilitate tax avoidance by company executives.

Over the years, public policy makers in Australia have identified a number of key benefits arising from broad-based participation in employee share schemes. Some justifications are focused on the enterprise level, whereas others see ESOPs as part of a broader social or macro-economic project. The principal rationales that have featured in public policy discourse in Australia are outlined briefly below.

2.1 Improving enterprise performance

Employee share ownership is identified as a means of enhancing enterprise performance through promoting worker productivity.[8] The theoretical basis for this rationale is generally located in agency theory.[9] Agency theory proceeds from the basis that the fact that the interests of employees are not congruent with those of the firm imposes considerable costs on the firm. There are two commonly identified ways in which ESOPs

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[4] Kevin Andrews, Minister for Employment and Workplace Relations, *Media Release 04/104 – Promoting Employee Ownership* (2004).
[5] See Wayne Swan, Shadow Treasurer, 'Australia's Economic Future', Keynote Address to the Labor Business Forum, Sydney, 19 September 2006.
[6] The Majority Report identified a range of legislative and institutional reforms that would facilitate the public policy objectives identified. Of the 45 policy recommendations, however, the Australian Government rejected close to 30. The Government appears to have rejected further calls for legislative reform in favour of a 'lighter touch' approach, embodied in the establishment in 2003 of the Employee Share Ownership Unit (ESODU) within the Department of Workplace Relations.
[7] *Shared Endeavours,* above n 2, Dissenting Report, 290.
[8] There is an extensive body of literature from the United Kingdom and the United States on this subject.
[9] A Pendleton, 'Incentives, Monitoring, and Employee Stock Ownership Plans: New Evidence and Interpretations' (2006) 45 *Industrial Relations* 753.

reduce agency costs: through increased productivity as a result of employees feeling they have a direct interest in the performance of the enterprise (thus enhancing commitment to the objectives of the firm); and through lowering monitoring costs through aligning employee interests with those of the firm.[10] Prime Minister John Howard's policy statement in 2000, *Employee Share Ownership Plan Initiatives*, emphasised the importance of employee share ownership plans in providing incentives for employees to achieve high levels of productivity.[11]

The ALP has proved more circumspect in relation to the capacity of employee share ownership to improve enterprise productivity. In 2004, for example, in response to a motion in the House of Representatives for reforms to the employee share ownership framework, the Shadow Minister for Workplace Relations, Craig Emerson, observed that as a member of the Nelson Committee, he had discovered that the links between employee share ownership and productivity were elusive.[12] In mid-2006, the Shadow Treasurer Wayne Swan observed the link in empirical research between employee share ownership and productivity, though noted that this benefit only appeared to eventuate when ESOPs were coupled with participative management practices.[13]

Other commentators have doubted the effectiveness of ESOPs in improving enterprise performance. For example, Mong notes that not all employees will work harder as a result of share ownership as they will choose to 'free-ride' off the efforts of other employee shareholders and that rewards for increased productivity will be diluted by the number of shares held by non-employees. She also notes that incentive efforts may be offset by employees (usually executives) using financial products, such as options, to reduce their risk exposure and so may not be concerned with increased productivity.[14]

2.2 Industrial relations objectives

Employee share ownership is often identified as a means of facilitating labour-management cooperation through breaking down the 'them' and 'us' mentality in the workplace. The capacity of employee share ownership to promote cooperative workplace relations has been repeatedly emphasised by the Liberal/National Party Coalition Government. Employee share ownership, for example, featured in the Coalition's 1996 Industrial Relations Policy, *Better Pay for Better Work.*[15] John Howard's policy statement in 2000, *Employee Share Ownership Plan Initiatives*, also emphasised the importance of employee share ownership plans in building a sense of participation in

[10] Ibid. See also N Wilson, *ESOPs: Their Role in Corporate Finance and Performance* (1992) 24–6.
[11] John Howard, *Employee Share Plans Initiatives*, cited by Peter Reith, Minister for Employment, Workplace Relations and Small Business, 'The Role of Employee Share Ownership in the New Workplace' (Speech to the Australian Employee Ownership Association (AEOA) Breakfast Briefing: Future Directions in Employee Ownership, Canberra, 29 June 2000).
[12] Commonwealth, *Parliamentary Debates*, House of Representatives, Monday 1 March 2004, 25375.
[13] Swan, above n 5.
[14] S Mong, 'Employee Share Ownership Plans – Reform or Rethink' (1999/2000) 15 *Australian Tax Forum* 413, 416.
[15] See Peter Reith, Shadow Minister for Industrial Relations, 'Better Work for Better Pay: The Federal Coalition's Industrial Relations Policy', 1 January 1996, [8.1].

Australian business through giving employees a direct stake in the enterprise in which they work.[16] Since this time, the capacity of employee share ownership to promote the 'mutuality of interests' in the workplace has been repeatedly identified by successive workplace relations ministers.[17] Tony Abbot, in particular, proved to be a passionate supporter of employee share ownership during his time as Federal Minister for Employment Services, Workplace Relations and Small Businesses from 2001 to 2003. In his words:

> … if we are ever going to have workplaces which are more like partnerships and less like battlefields, we need to have a situation where workers and managers have a better perspective on each others situation. And I think the best way to do that is through greater employee share ownership.[18]

For others, employee share ownership is a means of enhancing industrial democracy or of bringing the employee into corporate governance.[19] The ALP platform identifies the promotion of employee share ownership as a key principle to be pursued, as a means of 'Promoting Industrial Democracy and Cooperative Workplaces'.[20]

2.3 Contributing to national savings

The potential contribution of ESOPs to national savings was identified as a rationale for employee share schemes at least as early as the mid-1990s.[21] In 1996, the Federal Treasurer Peter Costello observed that giving 'blue-collar Australians' a 'stake in the business' will provide them with 'the opportunity to secure for themselves the kind of financial independence this government would like to see.'[22] The Prime Minister has emphasised the importance of employee share ownership plans in increasing the voluntary savings of Australian households and 'fostering a more balanced approach to retirement planning'.[23] In 2000, however, *Shared Endeavours* observed that the place of employee share ownership in 'a national savings program has not been fully considered by Parliament nor been the subject of clear policy.'[24]

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[16] Howard, above n 11.
[17] See, eg, Reith, 'The Role of Employee Share Ownership in the New Workplace', above n 11.
[18] Tony Abbott, Speech to the CEDA/ Telstra Political and Economic Overview Conference, 2 February 2001. Available from <http://www.tonyabbott.com.au/news/default.asp?action=article&ID=233>.
[19] G Winther and R Marens, 'Participative Democracy May Go a Long Way: Comparative Growth Performance of Employee Ownership Firms in New York and Washington States' (1997) 18 *Economic and Industrial Democracy* 393, 394.
[20] ALP, above n 3, Chapter 3, [112].
[21] See eg, the numerous second reading speeches delivered in relation to the *Taxation Law Amendment Bill (No 2) 1995.* Commonwealth, *Parliamentary Debates,* House of Representatives, 22 June 1995.
[22] 'Questions without Notice: Employee Share Ownership', Commonwealth, *Parliamentary Debates,* House of Representatives, 6 November 1996, 6665. See also Howard, above n 11.
[23] See Howard, above n 11, and John Howard , 'Competence, Philosophy and Future Challenges' (Address to the National Press Club, Canberra, 1 August 2001). Available from <http://www.australianpolitics.com/news/2001/01-08-01a.shtml>.
[24] *Shared Endeavours*, above n 2, 47.

2.4 Promoting innovation

Since 2001, employee share ownership has featured within the Government's initiative to promote science and innovation. The initial strategy document - *Backing Australia's Ability: An Innovation Action Plan for the Future* - published in 2001,[25] noted that a high-level Ministerial Committee responsible for overseeing the implementation of *Backing Australia's Ability* would, examine a number of areas in order to ensure that relevant policies provide the most effective support for R&D, its commercial application and skills development. The document identified as one of these specific areas the potential extension of employee share ownership schemes in small and medium unlisted companies, and companies in sunrise and new industries.[26]

2.5 Remuneration objectives

Although never highlighted as a policy objective in its own right, there have been a number of comments related to the desirability of giving employers and employees greater flexibility in determining the nature and mix of remuneration packages. For example, in a submission to the Nelson Committee, the Treasurer stated that ESOPs were 'consistent with Government policy of allowing employers and employees greater flexibility and choice in their working arrangements.'[27]

2.6 Other objectives

The Nelson Committee identified a further objective, namely that the promotion of ESOPs could facilitate 'employee buyouts and succession planning'.[28] The issues had been raised in submissions to the Committee and although there was no real discussion of the issues the Majority Report simply noted that using ESOPs in this way would greatly expand the level of share ownership in Australia.[29]

3 LEGISLATIVE HISTORY

Since the mid-1970s, Australian Governments have sought to reform the taxation regime so as to facilitate broad-based employee share ownership while also seeking to limit the scope for abuse of employee share plans for aggressive tax planning purposes.

The first legislative provision for the taxation of employee shares in Australia was introduced in 1974 by the Whitlam Government.[30] The impetus for the legislation was the decision in *Donaldson v FCT* [31] that had held that assessable income would include the

[25] The initial 2001 package, *Backing Australia's Ability*, which comprised $3 billion over five years to 2005 – 06, was extended on 6 May 2004. Together, the two packages constitute a ten year, $8.3 billion funding commitment, stretching from 2001 – 02 to 2010 – 11. See <http://backingaus.innovation.gov.au>.
[26] Available from <http://backingaus.innovation.gov.au/docs/statement/backing.rtf>.
[27] Noted in *Shared Endeavours*, above n 2, 2.78.
[28] Ibid, Recommendation 5.
[29] Ibid, 53–4.
[30] Ibid, 12.
[31] 1974 ATC 4192.

value of an option even though the option could not be assigned and could not be exercised for a period of 3 years. The value was said to be whatever a willing but not anxious person would be prepared to pay for it. The legislative reforms were introduced as one of a raft of taxation law amendments and did not form the basis of extensive debate in the Federal Parliament.

Section 26AAC was inserted into the *Income Tax Assessment Act 1936 (Cth)* ('ITAA') to govern the taxation of employee benefits in the form of share issues or grants of rights to acquire shares.[32] As the Australian Taxation Office (ATO) later explained:

> Section 26AAC and ESAS [employee share acquisition schemes] were intended to encourage employees to acquire an interest in their employer company and to allow employees some control.[33]

Section 26AAC provided for the taxation of benefits that arose from shares or rights that were acquired in a company under an employee share acquisition scheme where the shares or rights were a consequence of employment or services rendered by the taxpayer or a relative. The shares or rights acquired could be in the employing company or in another company. Section 26AAC provided for the value received under an option or share plan to be measured at the time of the exercise of the option or when restrictions relating to shares were lifted rather than, as had been held in *Donaldson,*[34] when the rights were acquired. This meant that if the shares were subject to restrictions or conditions, so that the employee was prohibited from disposing of the shares or the employee could be divested of ownership, then the employee was only taxed on the discount in the year when the restrictions or conditions were lifted. There was no limit on the period of deferral. The taxpayer could, however, elect to be taxed in the year that the shares or rights were acquired.

The second significant stage in the regulation of employee share ownerships schemes came in the mid-1990s. Reforms were inspired in large part by concerns that s 26AAC ITAA 1936 was being misused to create plans specifically designed for aggressive tax planning.[35] In its 1993 Budget, the Keating Labor Government announced a review of employee share plans, and in the 1994 – 95 Budget, the then Treasurer, Ralph Willis, announced significant reforms to employee share ownership in order to facilitate broad-based schemes whilst limiting the potential for misuse. In 1995, the Keating Government introduced Division 13A into the ITAA 1936. [36] In his second reading speech, the deputy treasurer, explained that the reforms were intended to reduce the unintended exploitation of the existing legislation and to increase the taxation benefits available to share schemes that encourage employees to own shares in the company for which they work.[37]

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[32] Inserted by *Income Tax Assessment Act (No 2) 1974* (Cth).
[33] *Shared Endeavours*, above n 2. See also ATO, 'Submission to the House of Representatives Standing Committee on Employment, Education and Workplace Relations' Inquiry into Employee Share Ownership,' Submission No 24, 30 April 1999, 6.
[34] 1974 ATC 4192.
[35] *Shared Endeavours*, above n 2, 12. See also ATO, above n 33, 4.
[36] *Taxation Laws Amendment Bill (No 2) 1995.*
[37] Commonwealth, *Parliamentary Debates*, House of Representatives, 22 June 1995, 2083.

The changes narrowed the concessions available to employee share schemes to those where the shares were issued in the employer or holding company of the employer and which were available to at least 75 percent of all permanent employees. The provisions provided that the amount to be included in a taxpayer's assessable income in respect of shares or rights acquired under an employee share plan would be the difference between the value of the share or right and any amount paid by the taxpayer to acquire the share or right. Generally, the amount was to be included in assessable income in the year that the share or right is acquired. However, providing the rights or shares satisfied certain criteria, an employee who acquired a share or right under an employee share scheme may have been eligible for the following:

- An exemption concession: an income tax exemption initially to a value of $500 per employee per year for qualifying shares that are issued to employees under a scheme operated on a non-discriminatory basis; or

- A deferral concession: a deferral of taxation initially for up to five years on qualifying shares and rights. In order to be qualifying the scheme offering the shares or rights had to meet certain requirements.

The reforms were supported by the Democrats and the Greens but opposed by the Liberal/National Party opposition.[38] While supportive of employee share schemes and cognisant of the need for reform of the existing provisions in s 26AAC, the opposition criticised the reforms on the basis that the 'complex set of income tax rules' would 'make employee share acquisition schemes less attractive and less available to the Australian work force.'[39] They would, according to numerous opposition members, both threaten the viability of existing schemes and restrict the proliferation of schemes in the future. In particular, the opposition criticised the qualifying conditions for obtaining the tax concessions as too restrictive, including the requirement that the shares be ordinary shares, thus excluding from the concessional and deferral regime those types of companies that do not issue ordinary shares; the tax treatment of share options for taxing a potential gain that may never be realised; and the five-year maximum deferral period for being too short (thus resulting in many international share option plans attracting tax before employees acquire shares). Despite the opposition the measures came into force and apply from 28 March 1995.

Even before his election to office in 1996, John Howard expressed his commitment to the promotion of employee share plans. In the 1996-7 Budget, the newly-elected Coalition government provided for the amendment of the taxation concessions for employee share schemes to 'build a greater sense of employee participation in the success of Australia businesses.' This would be achieved through doubling the value of shares or rights that were eligible for the tax concession under a share scheme from $500 to $1000 a year per employee, with a corresponding increase in the deduction available to employers; and

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[38] Commonwealth, *Votes and Proceedings*, House of Representatives, 22 June 1995, 2214; 20 November 1995, 4324.
[39] Commonwealth, *Parliamentary Debates*, House of Representatives, 22 June 1995, 2087 (Peter Costello).

reducing the participation conditions for the concessional arrangements from three quarters to two thirds of permanent employees.[40]

The Coalition Government's election commitments were included in one of a litany of proposed, and largely unrelated, amendments embodied in the *Taxation Laws Amendment Bill (No 4) 1996* and debate surrounding these other amendments appeared to overshadow those relating to employee share schemes.[41] Nevertheless, there appeared a broad consensus in both Houses of Parliament that broad-based employee share plans should be promoted and thus that the increase in the value of shares that could be exempt from $500 to $1000 was desirable. Debate over the proposed amendments to employee share plans in the Senate, however, focused on the proposed reduction of the required threshold for employee share schemes from 75 percent to 66 percent and a change from 'employees' to 'permanent employees'.[42] Both of these proposed changes were opposed by the Labor opposition and the Democrats on the basis that it was restrictive of the development of employee share schemes that were open to as many employees as possible and on a fair basis.[43] The proposal to reduce the threshold from 75 percent to two-thirds was rejected in the Senate.

The Coalition Government also amended the corporate law requirements for employee share schemes. The *Corporate Law Economic Reform Act 1999* relaxed the prospectus requirements for companies initiating employee share plans, subject to a number of conditions.

4 THE CURRENT TAX TREATMENT OF EMPLOYEE SHARES OR RIGHTS

The taxation regime for shares acquired by employees in respect of employment is found in Division 13A of Part III *Income Tax Assessment Act 1936* (ITAA 1936) and Sub-division 130A of the *Income Tax Assessment Act 1997* (ITAA 1997) (the capital gains tax provisions). Division 13A of the ITAA 1936 applies to the acquisition of a share or right under an employee share scheme. The general rule governing the taxation treatment of employee shares is that the issuing of shares or rights under an employee share scheme is treated as a substitute for cash income for services. Tax is imposed, at marginal income tax rates, at the time the share or right is acquired. The amount to be included in the employee's assessable employment income is the difference between the market value of the share or right and any consideration provided: that is, the amount of the discount provided to the employee or service provider.[44] For example, where a company issues an

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[40] Peter Costello, 'Meeting Our Commitments', 20 August 1996. Available from <http://parlinfoweb.aph.gov.au/piweb/view_document.aspx?id=4&table=BUDGET> 75. The budget statement identified the financial implications of this amended concession to be a reduction of $15 million dollars for each year from 1996–1999.

[41] This Bill originated in the House of Representatives as the *Taxation Laws Amendment Bill (No 4) 1996* on 12 December 1996, and was introduced into the Senate as *Taxation Laws Amendment Bill (No 1) 1997* on 17 March 1997.

[42] See Commonwealth, *Parliamentary Debates,* Senate, 27 June 1997, 5444.

[43] See Commonwealth, of Australia, *Parliamentary Debates,* Senate, 27 June 1997, 5444, 5464 (Nick Sherry); Commonwealth of Australia, *Parliamentary Debates,* Senate, 27 June 1997, 5449 (Cheryl Kernot); and Commonwealth of Australia, *Parliamentary Debates,* Senate, 27 June 1997, 5464–5 (Dee Margetts).

[44] Sections 139B(2) and 139CC(2) ITAA 1936.

employee a share with a market value of $1.01 and the employee paid one cent as the issue price for the share, the employee would include the $1.00 acquisition discount in their taxable income. Rules are provided for calculating the market value of the share or right. Despite the reference to *employee* share schemes, this treatment also applies to shares acquired by contractors in exchange for services rendered.[45]

Under Division 13A two alternative concessions are available for shares or rights provided under schemes that satisfy certain requirements. The first type of concession allows for discounts of up to $1000 to be provided tax free to an employee or service provider per income year (the *exemption concession*). The second type of concession allows for tax on the discount to be deferred for up to 10 years (the *deferral concession*).

This section looks first at when an employee ‘acquires a share or right under an employee share scheme’ for the purposes of Division 13A. It then outlines the two concessions available to ‘qualifying rights’ under the Division.

4.1 Acquisition of a share or right under an employee share scheme

Division 13A applies where any shares or rights are acquired under an employee share scheme. Shares or rights are acquired under an employee share scheme if the shares or rights are acquired in respect of, directly or indirectly, employment or services rendered. The shares or rights may be acquired by an employee or a service provider or by an associate of the employee or service provider. The Division contains rules for determining the amount to be included in assessable income.

4.1.1 *Any shares or rights*

Division 13A applies when an employee or service provider acquires any shares or rights under an employee share scheme, whether they are shares or rights in the employer company, a related company or any unrelated company. However, in order to obtain access to the concessions, it is necessary for the shares or rights to be in the employer company or a holding company of the employer.[46] It is also necessary that the shares are ordinary shares and that the options only give rights to acquire ordinary shares.[47] In the 2006 Budget, the Government announced that it would allow certain stapled securities to be provided and legislation to introduce the amendments has now completed its passage through Parliament (see below).

The term ‘rights’ is not defined but is commonly taken to mean rights to acquire shares, e.g. options. An option involves the right, but not the obligation, to acquire shares in the future at a fixed price (the exercise price). In some cases the person acquiring the option pays to acquire that right but commonly in the employment case the option is acquired for no consideration. In a recent Class Ruling, CR 2006/101 (the BHP-Billiton Ruling), the Commissioner takes the view that an employee will not acquire a ‘right’ (i.e. a right

[45] Section 139(C) ITAA 1936.
[46] Section 139CD(3) ITAA 1936.
[47] Section 139CD(4) ITAA 1936.

to acquire a share) under an employee share scheme for the purposes of Div 13A on the grant of the right where, at the time that the right is granted, it is conditional and subject to the exercise of the employer company's absolute discretion.

In another Class Ruling, CR 2006/103 (the Brambles Ruling), the Commissioner ruled that regardless of whether or not a participating employee is given a choice to receive cash instead of a share, it is accepted that the employee will retain the right to acquire a share on exercise of an option or share right. The Commissioner did note that where the scheme is operated so that the employer makes the ultimate decision as to whether an employee receives a share or cash in lieu of a share, the right granted to the employee will not be considered a right to acquire a share for the purposes of Div 13A.

The term 'rights' could also encompass other sorts of rights such as rights that vest without the recipient exercising an option or those rights that replicate shares, such as 'phantom shares.' However, as already noted, in order to access the concessions, the rights must be rights to acquire ordinary shares.[48]

The acquisition of a share as a result of exercising a right acquired under an employee share scheme is not treated as the acquisition of a share (presumably to avoid double counting).[49]

It is important to note that, in order to attract the operation of Division 13A, shares or rights must be acquired at a discount. The acquisition of shares for consideration equal to or greater than market value will not be within the Division even if accompanied by some other benefit such as a low or interest-free loan.

4.1.2 *Acquired by an employee or service provider (or an associate)*

A person acquires a share when it is transferred or allotted to that person or when a person acquires a legal or beneficial interest in the share from another person.[50] Division 13A applies to both employees and independent contractors acquiring shares.[51] Division 13A also applies if an associate of the employee or service provider acquires shares as a result of the employment or provision of services.[52] An associate in this context includes a relative, a partner, a trustee of a trust under which the taxpayer or an associate is capable of benefiting[53] and related companies.[54] In such a case the employee or service provider will be subject to tax on the discount received by the associate.[55] Although shares or rights provided to an associate will be subject to tax under Division 13A, only shares or rights provided to an employee will be eligible for the concessions.[56]

[48] Ibid.
[49] Section 139C(4) ITAA 1936.
[50] Section 139G ITAA 1936.
[51] Section 139C(1) and (2) ITAA 1936.
[52] Ibid.
[53] For the position where the trust is an employee share trust, see below.
[54] Section 139GE ITAA 1936.
[55] Section 139D ITAA 1936.
[56] Section 139CD(3) ITAA 1936.

4.1.3 *Under an employee share scheme*

Shares or rights will be acquired under an employee share scheme if they are acquired directly or indirectly in respect of employment,[57] or if the parties are not in an employment relationship, in respect of services rendered.[58] That is, there does not need to be any particular form of scheme but rather there must be some connection between the acquisition of the shares and the employment or services provided. If the acquisition falls within Division 13A it will be taxed under that Division rather than the other provisions of the income tax legislation. Furthermore, the acquisition will not give rise to fringe benefits tax (see below).

Shares will not be taken to be provided under an employee share scheme (and therefore not subject to Division 13A) if they are acquired for market value.[59]

4.1.4 *Calculating the amount to be included in assessable income*

The rules for determining the amount to be included in assessable income vary according to whether the discount is assessable immediately or is deferred.

When the discount is included in assessable income in the year the share or right is acquired, the amount is the market value of the share or right less any consideration paid or given.[60]

When the taxing time is able to be deferred (see below) and the taxpayer disposes of the share or right within 30 days of the relevant 'cessation time' in an arm's length transaction, the amount to be included is the amount received on disposal less any consideration given, including any amount paid to exercise a right to acquire a share.[61]

When the taxing time is able to be deferred and the taxpayer does not dispose of the share or right within 30 days in an arm's length transaction, the amount to be included is the market value of the share or right at cessation time less any consideration given, including any amount paid to exercise a right to acquire a share.[62]

Where a right to acquire a share is lost without having been exercised (whatever the reason), the right will be taken never to have been acquired and any tax paid will become refundable, through an amended assessment if necessary.[63] This reflects the fact that tax may become payable even before the rights vest and that an employee may be required to pay tax before any benefit is derived. The ability to claim a refund some time later may be of little comfort in these circumstances.

[57] Section 139C(1) ITAA 1936.
[58] Section 139C(2) ITAA 1936.
[59] Section 139C(3) ITAA 1936.
[60] Section 139CC(2) ITAA 1936.
[61] Section 139CC(3) ITAA 1936.
[62] Section 139CC(4) ITAA 1936.
[63] Section 139DD ITAA 1936.

4.1.5 *Complex valuations of shares or rights required*

Division 13A contains rules for determining the market value of both listed and unlisted shares and rights on a particular day.[64] This includes quite complex rules for determining the market value of unlisted rights depending on whether the right must be exercised within 10 years or not.[65] For example, a 10 year option with an exercise price equal to current market value of the underlying share will have a taxable value of 18.4 percent of the exercise price/current market value.[66] In the case of both unlisted shares and unlisted rights, the issuing company will often need to have valuations done by qualified valuers at the time shares or rights are being provided which could give rise to significant cost issues. More significant is the fact that valuations may need to be done on an individual basis at cessation time which could prove to be a significant ongoing cost for the employer.

4.2 Qualifying for concessions

In addition to setting out that the acquisition of shares by an employee at a discount will give rise to assessable income, Division 13A also offers employees two concessions if certain conditions are met. In order to be eligible for either concession the shares (or rights) must be 'qualifying shares or rights'. There are six conditions relevant to determining whether a share is a 'qualifying share' but only five of those conditions apply in determining whether a right is a 'qualifying right':[67]

(1) the share or right must be acquired under an employee share scheme;

(2) the share must be in the company which is the employer of the taxpayer or in the holding company of the employer company. The concessions are not available if the recipient is not in an employment relationship (i.e. a contractor) or if shares or rights are acquired by an associate of an employee or if the shares are shares in an unrelated company;

(3) the share must be an ordinary share and the right must be a right to acquire an ordinary share (although note the proposal to include 'stapled securities' – see below);

(4) in the case of shares, at least 75 percent of permanent employees must be entitled (or have been entitled) to participate in this or another employee share scheme. Permanent employees are those employed full-time or permanent part-time with 36 months service. It is still possible however to have two schemes – one that meets the 75 percent requirement and another scheme that is only available to, say, executives. This condition does not apply to schemes granting rights;

64 Subdivision F of Div 13A, ITAA 1936.
65 Sections 139FC and 139FJ to FN ITAA 1936.
66 Section 139FM ITAA 1936.
67 Section 139CD ITAA 1936.

(5) the employee's legal or beneficial interest in shares of the company must not exceed 5 percent; and

(6) the employee must not be in a position to control more than 5 percent of the votes that could be cast at a general meeting of the company.

If the shares or rights are qualifying shares or rights, the taxpayer may be able to claim the exemption concession or the deferral concession but not both as the taxpayer must make an election.[68]

(a) The exemption concession

A taxpayer who acquires a 'qualifying share or right' may elect to have the discount included in assessable income in the year in which the shares or rights are acquired and receive $1000 worth of discount tax-free[69] if three additional conditions are satisfied:

(1) there is no forfeiture of ownership conditions;

(2) shares or rights may not be disposed of for a minimum of three years (unless employment ceases earlier); and

(3) the scheme and any related scheme for the provision of finance must be operated on a non-discriminatory basis.[70]

An employee share scheme or a related scheme for the provision of finance will be non-discriminatory if it is open to at least 75 percent of permanent employees and the essential features of the scheme are the same.[71]

(b) The deferral concession

The deferral concession is designed to address the problem that the acquisition discount is *prima facie* taxed as a realised gain on acquisition date, giving the employee a cash tax liability which they need to pay from other cash resources.[72] If the shares or rights are qualifying shares or rights and the taxpayer does not make an election to be taxed up-front, the discount amount will be deferred and included in assessable income at a future time (referred to as the 'cessation time').[73] However, if there are no restrictions preventing the taxpayer from disposing of the shares or conditions that could result in forfeiture, the cessation time will be the time at which the shares are acquired.[74]

[68] Sections 139BA and 139E ITAA 1936.
[69] Section 139BA(2) ITAA 1936.
[70] Section 139CE ITAA 1936.
[71] Section 139GF ITAA 1936.
[72] C Rider, 'Sellers of Labour or Investors of Intellectual capital? Conceptual Problems in the Taxation of Employee Share Ownership in IP Spin-off Companies' (Working Paper, Intellectual Property Research Institute of Australia, 2005) 16.
[73] Section 139B(3) ITAA 1936.
[74] Section 139CA(1) ITAA 1936.

Where *shares* are not subject to tax at the time of acquisition, the cessation time is the earliest of when the restrictions on disposal or possibility of forfeiture end, the shares are disposed of, when employment ceases or 10 years.[75]

Where *rights* are not subject to tax at the time of acquisition, the cessation time is the earliest of when the rights are exercised, when the rights are disposed of, when employment ceases or 10 years.[76] If the right is exercised to acquire shares and restrictions apply or the shares are subject to forfeiture, cessation time is when the restrictions end (to a maximum of 10 years).[77]

A problem that arises in this area is that a liability to pay tax can arise before any real benefit is received. For example, an employee may leave employment perhaps as a result of retirement and be required to pay tax even though the rights have not vested and may not vest for some time. As already noted, the ability to claim a refund at a later time under s139DD does not necessarily relieve the burden that this may impose.

4.3 Taxation treatment of employer

The issue of shares or rights by a company will not generally involve any cost to the employer and so there is no amount that can be deducted. However, recent changes to the Accounting Standards require companies to expense share-based compensation provided to an employee or director, measured at the fair value at the date of grant (generally when terms are agreed between the employer and employee).[78] This has led to concern that ESOPs will impact on the company's profitability even though there is no actual tax deductible expense.[79]

Where shares or rights are acquired on-market, for example by a trust established for the purpose by the employer company, a deduction will be available. The company providing the shares or rights under an employee share scheme (either the employer or the holding company of the employer company) may be entitled to claim a deduction for some of the costs associated with the scheme. For example, it should be possible to claim a deduction under the general deduction provision for the costs associated with setting up and administering scheme.[80] Where a deduction would not otherwise be available, Division 13A provides a deduction to a maximum of $1000 for shares or rights that are qualifying and also satisfy the exemption concessions.[81] Contributions of money or property to an

[75] Section 139CA ITAA 1936.
[76] Section 139CB ITAA 1936.
[77] Section 139CB(1)(c) ITAA 1936
[78] AASB 2 issued by the Australian Accounting Standards Board. International Financial Reporting Standards apply from 1 January 2005 – see IFRS 2.
[79] The Treasurer, Peter Costello, in Press Release 26/04 (30 April 2004) announced that there would be no change to the deductibility provisions despite changes to the Accounting Standards relating to expensing options granted to employees.
[80] Section 8-1 ITAA 1997.
[81] Section 139DC ITAA 1936.

employee share trust may also be deductible but only at the time the employee or associate acquires the shares or rights.[82]

A final issue for employers is whether the provision of shares or rights under an employee share scheme will give rise to a fringe benefits tax liability – this is discussed below.

4.4 Other taxing provisions

On general principles it is possible that the provision of shares or rights as remuneration could give rise to tax either as a non-cash benefit or as a fringe benefit. It is also possible that any subsequent disposal of the shares or rights could give rise to capital gains tax liability.

The provisions of Division 13A are an example of statutory income and as such an amount determined under the Division is included in assessable income.[83] If Division 13A applies then a number of other taxing provisions such as section s 15-2 ITAA 1997 (formerly s 26(e) ITAA 1936) (employment benefits) and section 21A (business benefits) are expressly excluded from applying.[84] However, those provisions may need to be considered if Division 13A does not apply.

Prima facie, the provision of shares or rights would give rise to a liability for the employer to pay fringe benefits tax. However, the definition of 'fringe benefit' expressly excludes a benefit constituted by the acquisition of a share or right that falls within Division 13A[85] or the acquisition of money or property by certain employee benefit trusts.[86] It should be noted though that the provision of other benefits, such as the provision of financial assistance to acquire the shares or rights, could give rise to fringe benefits tax liability for the employer.

A final point to note is that the subsequent disposal of shares or rights may give rise to capital gains tax liability. The interaction between Division 13A and the capital gains tax provisions is considered below.

4.5 Interaction with Capital Gains Tax

As outlined above, the general position is that the discount an employee receives on market value at the time of acquisition of the share will be taxed on acquisition under Division 13A (subject to the concessions). For capital gains tax purposes, the difference between the cost base (generally market value) and consideration on disposal will be

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[82] Section 139DB ITAA 1936.
[83] Section 6-10 ITAA 1997.
[84] Section 139DE ITAA 1936.
[85] Section 136(1) *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986), definition of 'fringe benefit', para (ha). There is also an equivalent provision for benefits provided under a previous legislative scheme applying to employee share schemes in existence before 1995 (para (h)).
[86] Ibid, para (hb).

taxed as a capital gain.[87] As a general rule, the disposal of a share or right will give rise to a capital gain if the consideration on disposal (or in certain cases the market value at disposal) is greater than the cost base of the share or right.[88] A capital loss will arise if the capital proceeds are less than the reduced cost base.[89] The cost base of a share or right acquired under an employee share scheme depends on whether the discount is subject to tax at the time the shares or rights are acquired or whether liability to tax is deferred.

If the discount on shares or rights is subject to tax on acquisition, the cost base of the share or right will be market value at the time of acquisition.[90] This means that the discount will be taxed under Division 13A and the taxpayer will then be able to use the market value at the time of acquisition to determine the capital gain or loss.

If tax is deferred and the share or right is disposed of within 30 days of cessation time, the capital gains tax provisions do not apply.[91] This means that the difference between market value of the share or right and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A.

If tax is deferred and the share is disposed of more than 30 days after cessation time, the cost base of the share is market value at cessation time.[92] This means that the difference between market value of the share or right at cessation time and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A. Any subsequent increase in the value of the share or right will be subject to tax as a capital gain.

An important point to note is that since September 1999, certain capital gains have been eligible for the 'CGT discount' which means that only 50 percent of the nominal gain is included in assessable income.[93] 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.

[87] Net capital gains and net capital losses are calculated under Parts 3-1 and 3-3 ITAA 1997. A net capital gain is included in assessable income (s 102-5). A net capital loss can be carried forward and offset against future capital gains (s 102-15).
[88] Section 104-10(4) ITAA 1997. Div 116 provides rules for determining 'capital proceeds.' Divisions 110 and 112 provide rules for determining 'cost base.'
[89] Section 104-10(4) ITAA 1997. The reduced cost base is a modified cost base used to calculate a capital loss. It does not include certain costs that can be included to determine a gain (Subdiv 110-B).
[90] Section 130-80(2) ITAA 1997.
[91] Section 130-83(2) ITAA 1997.
[92] Section 130-83(3) ITAA 1997.
[93] Division 115 ITAA 1997. A number of conditions must be satisfied to take advantage of the discount eg the shares must have been held for at least 12 months.

4.6 Recent developments

4.6.1 *Rollover relief*

Changes in 2004 provide for CGT rollover relief for shares acquired under an ESOP where a corporate restructure occurs. Where an employee has deferred tax liability under an ESOP, the taxing point could be triggered where the shares or rights are acquired under a takeover or other corporate restructure. From 1 July 2004 rollover relief is available in respect of the shares or rights provided the takeover or restructure is for 100 percent of the company, the consideration received is 'matching shares or rights' in the acquirer and certain other conditions are satisfied.[94]

4.6.2 *Cross border employee shares or rights*

Measures introduced in 2005 apply to an individual who works in more than one country or changes country of residence.[95] The legislation provides that where a person acquires shares or rights while employed offshore and then later becomes an employee in Australia while still engaged in employment or service relevant to the acquisition, the person will be subject to Div 13A at the point of becoming an Australian employee.[96] The measures generally apply from 25 June 2005.

4.6.3 *Stapled securities*

Current law requires qualifying shares to be ordinary shares and rights to give the right to acquire ordinary shares. In the 2006 Budget the Government announced that it would extend the employee share scheme concessions and related capital gains tax treatment to stapled securities that include an ordinary share and are listed on the Australian Stock Exchange. The measures are contained in *Taxation Laws Amendment (2007 Measures No 1) Bill 2007* which completed its passage through Parliament on 28 March 2007 and at the time of writing was awaiting Royal Assent.

5 CURRENT PRACTICE

One of the difficulties in identifying current trends is that comprehensive information on the number, nature and extent of employee share plans in Australia, and the number of employees in plans is not collected by any government department such as the Australian Bureau of Statistics. Nor is data collected by bodies such as the ATO or the Australian Securities and Investment Commission (ASIC) despite both bodies having significant regulatory responsibilities in the area. In *Shared Endeavours* it was suggested that over 5 percent of the Australian workforce holds equities under employee share plans.[97] This

[94] See ss 139DQ – 139 DS ITAA 1936 and ss 130-83 and 130-95 ITAA 1997.
[95] The measures were introduced by the *New International Arrangements (Foreign-owned Branches and Other Measures) Act 2005* (Cth).
[96] Section 139BA(2), (2A) ITAA 1936.
[97] *Shared Endeavours,* above n 2, 26.

contrasts with approximately 7 percent in the UK, 10 percent in the US and 23 percent in France.[98]

Despite the lack of official information, several private bodies have conducted surveys that provide some insights into current practice. In 2003, KPMG released the results of a survey of 800 Australian companies entitled 'Employee Share and Option Schemes Survey Report.'[99] That report identified that employees of public listed companies are significantly more likely to be offered equity based compensation schemes than employees of other companies. Specifically, 80 percent of public listed companies that responded had some sort of scheme compared with 38 percent of public unlisted companies and 16 percent of private companies.

In relation to the types of schemes being offered there would appear to be significant diversity as to the type of equity, the nature of the employee contribution (if any) and the conditions that must be satisfied. For example, the survey found that the most common types of schemes were option or option- based schemes as opposed to share plans (49 percent of schemes were in this category). The key differences relate to an entitlement to dividends (not available under an option plan) and downside risk protection (not generally available under a share plan). Under an option plan employees are offered options which can be exercised after a vesting period (usually 3 to 5 years) for a stated exercise price. The option itself (as opposed to the underlying share) is granted for nil or nominal payment. There is no commercial downside risk in holding options. That is, if the shares are 'out of the money' (i.e. the share price is less than the exercise price), the employee simply does not exercise the option. Rather the option is only exercised if and when the shares are 'in the money' (i.e. the share price exceeds the exercise price). If the shares remain out of the money, the options are simply allowed to lapse. Prior to the exercise of the option, the employee does not receive dividends and has no other shareholder rights. The survey found that the most common type of option plan set the exercise price at the market value at the time the options were granted (MEPO) but there were also plans with lower exercise prices (LEPO) as well as zero exercise price options (ZEPO). Plans with a zero exercise price have been becoming more common. Another significant feature is the development of Performance Rights Plans which generally involve the issue of options for no consideration with a nil exercise price but subject to the satisfaction of various performance criteria. This is particularly the case with executive remuneration as opposed to all-employee schemes. The most common performance hurdle was found to be Total Shareholder Return (TSR) but others included earnings per share (EPS) and share price performance.

The survey also identified that 12 percent of companies with a scheme had a $1000 tax-exempt plan. As already notified to access this exemption the employee must elect to be taxed upfront. The view was expressed in the survey that the decline in the use of such plans could be linked to the state of the share market generally in the period covered by

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[98] J Lenne, R Mitchell and I Ramsay, 'Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes' (2006) 14 *International Journal of Employment Studies* 1.

[99] Another survey by Mercer Human Resources Consulting was released in 2002.

the survey and that companies are less likely to offer free or discounted shares to employees during periods of slow profit performance.

If the acquisition of shares or rights requires some contribution by the employees there are various methods available to achieve this other than requiring the employee to provide cash. For example, the acquisition may occur as a result of a salary sacrifice so that the employee elects to receive part of their remuneration as shares, rather than as cash (ie the employee's cash salary is reduced). Provided the requirements of Div 13A are met, the employee will be entitled to tax deferral. One high profile salary sacrifice arrangement is that of the CEO of ANZ who was reported to have earned only $49 in cash salary last year (i.e. less than $1 per week), receiving the rest of his remuneration in shares and performance rights in ANZ. Loan plans, discussed above are also a common way of financing acquisitions. Typically the loan will be limited in recourse to the value of the shares so that there is no downside risk.

There has also been a trend by employers to have plans operated through a trust or to use a third party 'plan company'. This is seen as providing flexibility as to the source of shares to be provided under the plan, that is, either existing shares acquired on market or new shares issued by the company. The use of a third party can also address the issue of deductibility. The introduction of accounting standards in 2004 which require companies to expense the value of share and option grants has highlighted the fact that such companies will generally not be entitled to claim a deduction despite the accounting requirement.

Another trend identified in the press has been the practice of executive employees hedging shareholdings, that is, locking in profits but still holding shares in order to seek concessional capital gains tax treatment and/or to limit disclosure to shareholders. For example, the CEO of Channel Seven recently exercised 500,000 options and immediately entered into put and call options over the resulting shares. The CEO of Westpac recently exercised 677,886 options and immediately entered into cap and collar arrangements with CBA.[100] This hedging trend appears to replace the sale of vested option arrangements which were common a couple of years ago. The Australian Council of Super Investors found that 34 companies were engaging in hedging even though many companies did not respond to its call for information.[101]

What does appear to be the case is that ESOPs are strongly based on Australian income tax law and changes to it. For example, in the early-mid 1990's ESOPs were put on hold for 2 years between the period starting when the Government announced that the old tax regime (section 26AAC) would be replaced and ending when the Government announced the rules now comprising Division 13A. Similarly, a current trend is to implement plans for stapled securities in light of the 2006 Federal Budget announcement. This is a very major development given the prevalence of listed property trusts and infrastructure funds in the market.

[100] *The Australian,* 12 June 2006.
[101] *The Australian,* 29 May 2006.

5.1 Performance hurdles

One trend that has been identified is that companies are becoming more likely to include various performance hurdles that must be met before the rights are exercised. This cannot be attributed to any changes in the tax treatment of ESOPs but can probably be linked to changes in corporate legislation and changes in shareholder expectations relating to executive remuneration, especially in light of media reports of extremely large payouts to (often failed) executives.

For example, the AASB introduced Accounting Standard AASB 124 in 2005 which requires disclosure of the value of all forms of executive remuneration. Furthermore, the Corporations Act was amended in 2004 and now requires mandatory reporting of a companies remuneration policy. The Australian Stock Exchange urges companies to 'remunerate fairly and responsibly' and provides for shareholders of listed companies to ask questions about, or comment on the remuneration report and also to pass a non-binding resolution on the adoption of the remuneration report.

The issue, especially in relation to CEOs, generally seems to be about how much remuneration should be fixed and how much should be variable or 'at risk'. There is also generally considerable discussion about the appropriateness of various measures of performance.

5.2 The provision of shares or rights using an employee share trust

The provision of shares or rights through an employee share trust involves transferring shares or right or money or other property to a trustee to enable the trustee to acquire shares on-market and subsequently provide those shares or rights to employees or their associates. The use of such a trust can provide a number of benefits to an employer. For example, according to *Shared Endeavours* one benefit is that it reduces the number of entities subject to taxation and focuses taxation liability on the beneficiaries of the plan.[102]

The provision of shares or rights to a trust, or the transfer of money or property to enable shares or rights to be acquired, will have no immediate tax consequences for the employee. This is because the employee will only acquire the share or right when they acquire the legal or beneficial interest in the share or right from the trustee. This is implicitly recognised in Division 13A which provides for deductibility in respect of the provision of money or property to a person for the purpose of enabling another person (the ultimate beneficiary) to acquire a share or right under an employee share scheme, but not until the ultimate beneficiary acquires the share or right.[103] This suggests that the acquisition by the trust will not be treated as an acquisition by an associate of the

[102] *Shared Endeavours*, above n 2, 124–8.
[103] Section 139DB ITAA 1936.

employee even if the employee is ‘capable of benefiting under the trust’.[104] Furthermore, the section dealing with acquisition of a share or right merely refers to acquisition from another person (not necessarily from the employer).[105] For capital gains tax purposes, the first element of the cost base (or reduced cost base) is market value when the employee first acquired a beneficial interest in the share or right.[106]

The trustee of the employee share trust does not acquire a share or right under an employee share scheme if it is ‘the trustee of a trust whose sole activities are obtaining of shares, or rights to acquire shares, and providing those shares or rights to employees of a company or to associates of those employees’.[107] This is consistent with the general tax treatment of trusts. For capital gains tax purposes, where a beneficiary of an employee share trust becomes absolutely entitled to a share or right, any capital gain or loss the trustee (or beneficiary) makes is disregarded if the beneficiary is an employee of a company; the terms of the trust require or authorise the trustee to transfer shares or rights; the rights where acquired under an employee scheme and the employee did not acquire the shares for more than the trustee's cost base.[108]

An important consideration for the employer proposing to provide shares or rights at a discount is the issue of deductibility.[109] This is because the issue of shares or options by a company does not generally involve a deductible outgoing, even though it clearly involves some sort of ‘cost’ to shareholders of the issuing company. However, it is generally accepted that an employer will be entitled to a tax deduction under the general deduction provision[110] in respect of a non-refundable contribution made to an employee share trust for the purpose of the trust using those funds to provide shares to employees of the contributor (by way of subscription or on-market acquisition) as part of an employee's remuneration package. This is implicitly recognised by a provision that allows a deduction where money or property is provided under a trust arrangement (although not until the employee actually acquires the shares or rights).[111]

An advantage of establishing an employee share trust is that the provision of money or property to a trust will not attract fringe benefits tax where ‘the sole activities of the trust are obtaining shares, or rights to acquire shares in the employer company or its holding company and providing those shares or rights to employees or associates of the employees.’[112] As noted below, the provision of other benefits, such as financial assistance, may give rise to fringe benefits tax liability for the employer.

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[104] Although the Commissioner has long held the view that the trustee could be an associate (see TR 1999/5), the Full Federal Court has recently confirmed that this is not the case: *FCT v Indooroopilly Childrens Services (Qld) Pty Ltd* [2007] FCAFC 16 (22 February 2007).
[105] Section 139G(d) and (e).
[106] Section 130-85(3) ITAA 1997.
[107] Section 139C(5)
[108] Section 130-90 ITAA 1997.
[109] Other benefits of establishing an employee share trust include the fact that it facilitates forfeiture and disposal where necessary.
[110] Section 8-1 ITAA 1997.
[111] Section 139DB ITAA 1936.
[112] Section 136(1) FBTAA 1986, definition of ‘fringe benefit’ para (hb).

5.3 The provision of shares or rights accompanied by a low or interest-free loan

The provision of a loan by an employer (or associate or a third party under an arrangement) to an employee (or an associate) will attract the operation of the *Fringe Benefits Tax Assessment Act 1986* (Cth) as a benefit provided in respect of employment.[113] The value of the benefit is the difference between a benchmark rate of interest and the rate of interest actually paid.[114] If the loan is provided interest-free or at an interest rate below the benchmark rate, the difference will be subject to fringe benefits tax and tax will prima facie be payable by the employer at 46.5 percent on the 'grossed-up value' as defined. However, as the loan is used to acquire income producing assets (the shares or rights), the value of the benefit will be reduced to zero under a rule known as the 'otherwise deductible' rule.[115] The employer will not be subject to tax with respect to the loan benefit provided. Furthermore, the employee will not be subject to tax with respect to the loan.[116]

If the loan is used to acquire shares or rights at a discount, Division 13A will apply to the discount and if the conditions discussed above apply the employee will be able to access the concessions.

If the loan is used to acquire shares or rights at full market value, the shares themselves will not be subject to Division 13A and the employee will not be able to access the concessions.

A point for private (i.e. non-listed) companies is that the making of a loan to an employee who is a shareholder in the company (or an associate of a shareholder) could be treated as a deemed dividend from the company and therefore included in the assessable income of the recipient.[117] There is however an exception if the loan is made solely for the purpose of enabling a shareholder or associate to acquire shares or options under an employee share scheme but only if the shares or rights are qualifying shares or rights within Division 13A.[118]

An alternative way in which to finance the acquisition of shares may be to offer the shares or rights at market value and enter into a salary sacrifice arrangement with the employee (see below).

5.4 Plans that fall outside Division 13A

If shares or rights are offered at a discount to employees but the shares or rights are non-qualifying, the benefit received will be subject to tax under Division 13A but no concessions will be available.

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[113] Section 136(1) definition of 'fringe benefit' FBTAA 1986.
[114] Section 18 FBTAA 1986. The 'benchmark interest rate' is determined by the Reserve Bank. For the FBT year ending 31 March 2006 the rate was 7.05 precent.
[115] Section 19 FBTAA 1986.
[116] Sections 23L ITAA 1936.
[117] Section 108 and Div 7A (ss 109B to 109X) ITAA 1936.
[118] Section 109NB ITAA 1936.

Examples include:

- Shares or rights in a company that is not the employer or the holding company of the employer;
- Where the recipient is not in an employment relationship but is an independent contractor;
- Where the recipient is an associate of an employee;
- Where the plan or another plan relating to shares is not open to at least 75 percent of permanent employees (i.e. employees with at least 3 years service with the company);
- Where the employee becomes entitled to more than 5 percent of the shares in the company;
- Where the shares are not ordinary shares or the rights are rights to acquire shares that are not ordinary shares; or
- Where the rights are provided in a business structure other than a company, e.g. units in a unit trust[119] or interests in a partnership.

Where a scheme falls outside Division 13A it is necessary to consider other taxing provisions such as ss 6-5 and 15-2 (employment benefits) ITAA 1997. There are two other situations that need to be considered. The first is a scheme that involves the provision of shares or rights at full market value and the second involves schemes that offer interests that are not 'shares or rights'.

5.4.1 Offering shares or rights at full market value

The acquisition of shares or rights for a consideration equal to the market value of the shares or rights when they are acquired is not an acquisition under an employee share scheme and therefore not covered by Division 13A.[120] Generally, the provision of shares or rights to employees for market value would not give rise to a benefit and so would not attract any tax liability. An employer may, however, prefer to provide the benefit by other means. For example, the provision of an interest free loan will generally not attract fringe benefits tax liability where the loan funds are used to acquire income-producing assets such as shares (see above). However, the making of a loan in these circumstances may attract the deemed dividend provisions and the exclusion that applies where the loan relates to an employee share scheme within Division 13A will not be available (see above). Alternatively, the acquisition of shares or rights may be financed by a salary sacrifice arrangement. The main issue here will be to ensure that the salary sacrifice arrangement is 'effective'. The Commissioner has indicated that such an arrangement will be effective if the arrangement is entered into before the amount to be sacrificed has been earned.[121] If the arrangement is not effective, the Commissioner will treat the amount as having been derived by the employee and require the amount to be included in

[119] The recent changes that permit the issuing of stapled securities do permit entities such as listed property trusts to come within Division 13A.
[120] Section 139C(3) ITAA 1936.
[121] Taxation Ruling TR 2001/10.

assessable income. The normal practice is to make these arrangements at the start of an income year to ensure that they are treated as effective. Regardless of how the acquisition is financed, the employee will be able to derive any capital gains on the shares as a discount capital gain and only pay tax on 50 percent of the nominal gain. This may be regarded as a preferable way to provide the benefit particularly as it means that the shares or rights do not have to try to fit within the restrictive conditions that must be satisfied to enable an employee to access the Division 13A concessions.

5.4.2 Schemes that offer interests that are not shares or rights.

Division 13A only applies when the interest being provided is a 'share or right'. Some employers have chosen to step outside the Division and offer benefits that replicate share ownership but do not involve the acquisition of shares or rights. These schemes are sometimes referred to as 'replicator share plans' or 'phantom', 'synthetic' or 'shadow' plans. *Shared Endeavours* noted that replicator share plans are used 'where the company cannot or is unwilling to issue equities in itself.'[122] The plans provide benefits that 'mimic the benefits they would have received had they held shares in the company.'[123] Benefits provided under such plans will not be subject to tax under Division 13A and will not be eligible for concessions under that Division. Any non-cash benefit received by an employee in respect of employment will be subject to tax either under s 15-2 ITAA 1997 (which requires the recipient to include the value to the taxpayer of the benefit in assessable income) or as a fringe benefit (in which case the employer will pay tax on the value of the benefit as determined under the FBTAA 1986). Typically the plan will aim to provide the benefit at market value to avoid payment of tax and to provide the benefit either in the form of a low or interest-free loan or salary sacrifice to fund the acquisition of the interest. Alternatively, or in addition, the benefit may be derived if the shares when subsequently disposed of are eligible for discount treatment.

Although these types of schemes may avoid the operation of Division 13A, *Shared Endeavours* noted that they were not used very much in Australia.[124] This may be related to the fact that under the Financial Services Regulation provisions in the *Corporations Act 2001* (Cth), such rights will probably be treated as derivatives and be subject to the onerous disclosure obligations in Chapter 7 of the *Corporations Act.*

6 Difficulties with the current tax regime

There are a number of problems in the use of the tax concessions as a tool for regulating employee share schemes. These issues are outlined broadly below.

6.1 Cost and complexity

If an employer wishes to offer shares to employees it must comply with regulatory requirements in the *Corporations Act 2001* (Cth) designed to provide information to

[122] *Shared Endeavours*, above n 2, p xxi
[123] Ibid.
[124] Ibid, 20.

investors. Although ASIC has provided conditional relief from disclosure requirements for employee share schemes, the preconditions for accessing this relief can be quite difficult to satisfy.[125] Employers and employees also need to consider the detailed taxation requirements. As already noted there are different consequences depending on what is offered, on what terms the offer is made and a range of other structural issues. For these reasons start-up costs for employers can be very high. Legal drafting of documents is expensive as they must be precise (for tax purposes) and helpful for employees (in plain English). There are also costs of educating the administrators – for example, those in human resources or in the company tax group and legal groups. Standard or 'off the shelf' plans invariably fall foul of the tax rules with serious consequences. There are added costs if binding tax rulings are sought, which is common but often unnecessary.

On-going costs of administering an employee share plan can be high especially if an external administrator (such as Computershare) is used. Also, there may be costs associated with obtaining external advice for unique employee circumstances that continually arise. Educating employees (both administrators of the plans and participants) and responding to queries especially if they are not commercially literate can also be costly. Furthermore there is a need to review plans and documents each time an offer is made given the rapid and numerous changes in tax law.

6.2 Inflexibility

Work done to date suggests that a 'one-size fits all' approach to the concessions is increasingly less appropriate to meet the emerging diversity and flexibility of the workplace and work practices across the spectrum from small start-up companies in sunrise industries to large listed companies with transnational workforces. For example, the author has been involved in a study that highlighted the difficulty faced by a start-up company in meeting the conditions for the available tax concessions.[126] Rider has also argued that there are conceptual problems in treating an individual involved in an intellectual property commercialisation who receives shares in exchange for their labour in the same way as an employee who receives fixed cash salary regardless of the fortunes of the enterprise.[127] In his view such persons are more like at-risk investors and should receive the tax treatment available to investors.[128]

The limited terms on which ESOP 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] See Landau and Ramsay, above n 1.
[126] C Rider et al, 'Taxation Problems in the Commercialisation of Intellectual Property' (Working Paper, Intellectual Property Research Institute of Australia, 2005) Chapter 9.
[127] Rider, above n 72, 2.
[128] Ibid.

6.3 Stringency of requirements to access concessions in Division 13A

The qualifying rules for the two concessions in Division 13A have attracted significant criticism. In particular it is argued that the rules are too strict and have the effect of constraining the growth of employee share ownership in Australia.[129] The restriction of employee share schemes to companies that issue ordinary shares or rights is problematic for smaller companies.[130] Companies who cannot or are unwilling to issue ordinary shares to employees are unable to access the concessions in Division 13A. This is more likely to be the case where the company is small and control is highly valued by the owners. It is also clear that if the business is structured as a trust or a partnership rather than as a company, the provisions of Div 13A do not apply.

Limiting the availability of both concessions under Division 13A to employees who hold a legal or beneficial interest in more than 5 percent of the shares in the employer, or are in a position to cast, or control the casting of, more than 5 percent of the maximum number of votes that may be cast at a general meeting of the employer, has also come under sustained criticism. The 5 percent limit may prevent smaller businesses from accessing the taxation concessions. It also prevents employee buyouts from occurring under Division 13A.[131]

The requirement that the scheme or another scheme be available to 75 percent of permanent employees is also problematic for start-up companies with a small number of employees. It should be noted that the Commissioner does have discretion to determine that the condition has been satisfied[132] and it may be that, in the case of a new company, the Commissioner would do so if the scheme was open to 75 percent of current employees. The reference to permanent employees as full or part-time employees with at least 36 months service makes this condition impossible to satisfy for start-up companies. It may, however, be possible to obtain the deferral concession which is often seen as a more attractive option for providing executive remuneration.

Shared Endeavours made a number of recommendations to ease some of the requirements for qualifying shares and rights, particularly to facilitate the use of employee share schemes in 'sunrise enterprises'.[133] The Government, however, did not support any of these recommendations.[134]

6.4 The $1000 tax exemption

The $1000 tax exemption available under Division 13A has been criticised for being too low. According to Price, for example, it 'equates to the bare minimum of employee

[129] See, eg, Mong, above n 14, 416; Employee Ownership Group, 'Employee Share Ownership in Australia: The Future' (undated).
[130] See, eg, *Shared Endeavours* above n 2*;* Employee Ownership Group, above n 129, 5; Lenne, Mitchell and Ramsay, above n 98.
[131] *Shared Endeavours* above n 2, 155.
[132] Section 139CD(5) ITAA 1936.
[133] *Shared Endeavours*, above n 2, Recommendations 32–39.
[134] Treasurer's Press Release 14/03, 27 March 2003.

ownership.'[135] In submissions to the Nelson Committee, a number of companies and accountancy firms argued that the threshold was too easily exceeded, particularly where employees are given the opportunity to participate in both share and option plans.[136] The Australian Employee Ownership Association (AEOA) argued that the effect of the $1000 threshold was to encourage wide but not deep employee shareholding. In its submission to the Nelson Committee, KPMG presented results from its survey, which found that 35 percent of respondents stated that they would introduce an employee share scheme if the tax exemption was increased to $2000 per employee per year.[137] Submissions to the Committee also argued that the exemption should be indexed. These arguments were rejected by the Treasurer, who argued that the Government had already doubled the exemption (from $500 to $1000) and that indexing the concession would be anomalous, given that neither personal income tax scales or the income free threshold are indexed.[138] The *Shared Endeavours* Majority Report recommended that the tax-exempt concession be increased, though conceded that it was difficult to specify an increased amount in the absence of Treasury estimates of the costs associated with any such reforms.[139]

6.5 Capital Gains Tax treatment

An aspect of the current taxation treatment of employee shares that has attracted considerable criticism is the extent to which employee share schemes should attract the CGT discount treatment for capital gains. Price has argued that there is a 'glaring inconsistency' in the taxation treatment of plans under Division 13A in which tax-exempt plans attract CGT discount treatment but tax-deferred plans do not.[140] With tax-deferral plans, the gains in value on employee shares are also taxed as income. This inconsistency is also criticised by the Employee Ownership Group, who argues that this creates a bias towards exempt plans.

Shared Endeavours recommended that all employee share schemes should have the same CGT treatment afforded to superannuation and other tax-advantaged investment savings vehicles.[141]

6.6 Potential for Abuse

In its Dissenting Report to *Shared Endeavours*, the minority argued that although the original intention of the tax concessions for ESOPs was to encourage the ownership of shares in companies by the employees of those companies, over a number of years such plans had 'become vehicles for aggressive tax planning for the benefit of company

[135] G Price, 'Employee Ownership: Reform Opportunity Lost?' *Keeping Good Companies*, July 2003, 331.
[136] See *Shared Endeavours*, above n 2, 152–5.
[137] Cited in ibid, 153.
[138] Ibid, 154.
[139] Ibid, Recommendation 32.
[140] Price, above n 135, 330.
[141] *Shared Endeavours*, above n 2, Recommendation 27.

executives.'[142] Wariness of policy reform on employee share ownership in the past has been attributed in part to the fear of the Treasury of tax abuse.[143]

The lack of published information relating to the number, structure and incidence of ESOPs makes it difficult to identify particular types of abuses but this is an area that certainly requires more attention.

The Dissenting Report emphasised that the government should encourage the growth of what it termed 'genuine' or 'bona fide' employee share plans and should develop anti-avoidance measures to deal with the abuse of plans 'that are available only to executive, high income employees and have as their real purpose the tax effective or tax free provision of remuneration.'[144]

7 CONCLUSION

While a diverse range of rationales have been put forward for employee share ownership, it is difficult to determine precisely which of these underpin contemporary regulatory initiatives towards the practice.[145] Government needs to identify exactly what the underlying policy rationale is for providing the tax concessions that are currently available.

A further concern is that various aspects of the tax treatment imposed on ESOPs appear to be inefficient. Some of those concerns relate to the bias in favour of listed companies and against small and start-up companies, the different tax treatment that applies to employee share owners compared with other investors and the different tax treatment afforded to different types of employee remuneration.

An overriding concern is the lack of data available on various aspects of ESOPs. This lack of data makes it difficult to identify whether the tax rules operate to encourage or discourage employee share ownership and what steps any future government should take in either trying to encourage employee share ownership or to act to restrict potential abuses of the concessions.

[142] Ibid, 280.
[143] Price, above n 135, 331.
[144] Ibid, 277.
[145] This observation is also made in Lenne, Mitchell and Ramsay, above n 98.