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Private and confidential

The Manager
Philanthropy and Exemptions Unit
Personal and Retirement Income Division
The Treasury
Langton Crescent
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Dear Sir/Madam

EMPLOYEE SHARE PLANS

The Business Council of Australia and the Corporate Tax Association (the "BCA/CTA") welcome the Government's invitation to consult on their concerns with the Consultation Paper (the "Paper") released by the Government on 5 June 2009. The BCA/CTA would like to provide the following comments and submission in relation to a number of aspects of the Paper.

The BCA/CTA appreciate the fact that the Government has listened to the concerns of employers and others and released its Paper reflecting a significant move away from the original position announced in the Budget.

Based on the Consultation Paper, it is apparent that there is strong overall agreement on the benefits of employee share plans and the contribution they can make to strengthening the Australian economy. Notwithstanding this, the BCA/CTA contend that the proposals – as they presently stand - will continue to have unintended consequences contrary to these aims, and that further refinement of the proposal is required.

The BCA/CTA's position can be summarised as:

- It welcomes the introduction of employer reporting as it will operate to improve employee compliance with the complex employee share plan rules;

- However, the proposed employer reporting requirements are, prima facie, unnecessarily onerous and costly in requiring the reporting of estimated market values at grant. We have outlined below the level of reporting that should be required.

- While the BCA/CTA appreciate that the Government has increased the income threshold for the $1,000 tax exemption to $150,000 it remains our position that a threshold is unnecessary and increases the potential for increased administrative costs for employers and unsatisfactory compliance by employees.

- The BCA/CTA consider the current rules of taxing at the time there is no longer a prohibition on sale to be the appropriate point in time to tax the employee on employee share scheme income. Taxation at any earlier time is inconsistent with the normal principles of taxation and will lead to a reduction in employee participation in share plans.

- The introduction of the "real risk of forfeiture" concept is contrary to a policy of encouraging widespread employee share ownership. Such a requirement will mean that salary sacrifice, matching plans and mandatory minimum holdings will no longer be viable. If the Government wishes to encourage employee share ownership it should facilitate such arrangements.

- The BCA/CTA do not consider the taxation of employee share plan income at the time of termination of employment when the shares or rights remain unvested to be the correct outcome.

Income threshold

Imposing an income threshold on the availability of the $1,000 tax exemption is expected to cause confusion among the potential participants in the share plan as to whether or not they will be entitled to a tax exemption under the plan. An employee would generally commence acquiring shares under a plan at the beginning of a tax year but the income to be measured against the threshold will be the income for the whole of that tax year (and, therefore, could be impacted by such things as pay rises and bonuses the employee may receive during the year that may not have been anticipated at the time of joining the plan, as well as other factors such as capital gains arising from the unplanned disposal of assets).

The introduction of an income threshold on the $1,000 exemption severely restricts the ability of an employer to explain the taxation consequences of such an employee share plan with any certainty, even without going into personal advice. Unless the employer can explain to an employee (who is generally not particularly knowledgeable on either shares or taxation) exactly the choices and outcomes of participating in the plan, it is expected that many employers would not want to offer the plan. While all plans are offered on the basis that employees seek their own advice based on their circumstances, a lot of employees simply accept shares without seeking advice, and it is not in the interests of the employer to offer something to general employees that may have negative or uncertain taxation consequences.

Satisfying the 75% test may also be an issue. If there is a cap, some employers (if they have not closed plans completely) may not want to offer the $1,000 plan to everybody, and it may therefore be difficult or impossible to satisfy that requirement for exemption. The test should be the same as for ordinary qualifying plans, so that a deferred plan offer would count towards the 75% test for an exempt plan.

Many employers have expressed concerns that a discriminatory concession as proposed may create resentment on the part of employees who fall on the wrong side of the threshold. From a company's perspective, in determining whether to offer such plans, such an outcome could negate the objective of improving employee morale and achieving the alignment of employee interests with those of shareholders.

Companies will have difficulty providing employees with the opportunity for share plan participation in the knowledge that a proportion of their workforce will derive a greater net benefit than the balance of the workforce. It is expected that the workforce and relevant unions will require 'equal' treatment. As such, employers may be forced to terminate such plans as the costs and administration of same would make the arrangements uncommercial.

It is also relevant to recognise that the poor compliance around employee share plan income may be exacerbated if an income threshold is introduced. An income threshold will mean that employees will be required to self-assess their entitlement to an income tax exemption in respect of a complex share plan. Low and middle income employees will continue to be confused as to whether they are entitled to the exemption and, in many cases, can be expected to simply assume that they are so entitled. The end result will be continued unsatisfactory compliance. The Government, Treasury, and Tax Office would be aware of the difficulties experienced with the Family Tax Benefit threshold tests. Such thresholds create significant administrative costs for employers and the Tax Office, as well as the employee.

It is for these, as well as other reasons, that the BCA/CTA submit there should be no income threshold.

Limited deferral proposal

The Government's proposal to introduce a taxing point at a time when the employee no longer has a *"real risk of forfeiture"* of the shares or rights is considered by many employers to be an unnecessary change that will create further compliance and governance problems for employers, and inequity for employees. This will distort some of the key drivers behind many plans and could lead to closure of some.

The Paper indicates that the Government is concerned to ensure that "artificial deferral" of employee share plan income is no longer available to employees. In doing so, it has introduced the concept of a 'real risk of forfeiture'. In our view, it would not always be easy for employers and employees to readily determine when a real risk of forfeiture exists as in nearly all share plans there is a risk of forfeiture which is real, although the probability of that forfeiture occurring may be relatively low. Nevertheless, it is usually the intention under employee share plan arrangements that the employer retain the ability to forfeit shares or rights under various conditions.

It is also to be noted that while employee share plans provide for the forfeiture of shares and rights in the event of an employee departing under different circumstances, there is generally a discretion within the Board of the company as to whether such shares or rights are to be forfeited in individual circumstances. There can be occasions when the Board decides that it is commercially appropriate to allow the shares or rights to remain with the employee as pursuing forfeiture in the particular circumstances may lead to protracted litigation.

There are other circumstances in employee share plan arrangements where the plan rules provide for a risk of forfeiture albeit that the occasions of that happening may be low. In such circumstances employers will be particularly concerned if the Commissioner of Taxation was to interpret the plan rules or adopt a view that the risk of forfeiture was not ‘real’.

The language used in the Exposure Draft accompanying the Paper falls short of providing the level of certainty required to operate the majority of plans currently that are currently in use. There may be scope for improving the drafting – for example, we consider that the term “not insignificant risk of forfeiture”, while still somewhat uncertain, would better reflect the idea we think is trying to be expressed. The language used in the statute could also be clarified in the Explanatory Memorandum through the use of examples.

Real risk of forfeiture rule reflects the wrong principle

The “real risk of forfeiture” rule reflected in the Paper does have some conceptual merit. Another way of expressing it would to say that income from employment should be taxed when it has come home. But if the “real risk of forfeiture” rule is meant to be a proxy for the “come home” principle, then the rule may not always perfectly reflect the principle. In circumstances where employees are subject to an effective prohibition on selling, even after the performance hurdles and service requirements have fallen away, it is difficult to understand how it can be thought that anything has come home at the time the “real risk of forfeiture” rule is satisfied.

The recent upheaval in financial markets perfectly illustrates the inequity of taxing employees on a “benefit” worked out at the vesting time when the shares over which they have rights have dropped significantly in value by the later time at which the prohibition on selling comes to an end. The fact that this overtaxing could be partially addressed through an improved refund mechanism doesn’t make it right to tax employees at the earlier time when they do not have the capacity to pay and the value of the benefit may be much reduced by the time they are able to deal in the shares or rights.

We consider there is a competing principle which the Paper fails to properly consider, and that is the generally accepted tax design principle of not imposing a tax until such time as the subject of the tax is in an economic position to meet the liability. Just one example of the “capacity to pay” principle at work is the almost universal departure from the Schanz-Haig-Simons theoretical income model by taxing capital gains on realisation rather than on accrual.

In framing taxation policy (and many other public policies) it is sometimes necessary to strike a balance between competing policies or principles. The BCA/CTA considers the "capacity to pay" principle itself represents a fundamental benchmark. Any departure from this benchmark, including departures to achieve competing policy principles, need to fully justified. Even if it is not accepted that the "capacity to pay" principle should generally prevail, we consider

- The "real risk of forfeiture" rule is not even a proper reflection of the "come home" principle, particularly where employees are prohibited from selling;

- the compliance risk, which we take to be a strong driver for the Government wanting to reduce what it regards as inappropriate "deferrals", largely falls away with the proposed reporting regime;

- continued deferral in circumstances where employees are prohibited from selling fosters a culture of long-term employee share ownership, which strengthens the goal alignment that is a key feature of any employee share plan; and

- because equity markets do rise over the long-term the Government would actually benefit quite considerably from deferrals since the amount of the gain subject to the CGT discount is reduced.

If the Government believes such employee share plan arrangements can extend the taxing point beyond a period it considers to be appropriate, it can provide specific legislation that enables employee share plans to operate under salary sacrifice and matching arrangements. These will continue to increase employee share scheme participation at the low and middle income earner level. The Government can provide legislation that enables employee share ownership by providing for salary sacrifice and matching plan arrangements up to the seven year period (or less if that is preferred) and for no more than a specified amount if desired.

There are various other implications arising from the proposed "risk of forfeiture" that would need to be addressed if the proposed approach is maintained.

Many employers have moved to providing short term incentives and long term incentives by deferring part of the award for a further period of time so that the performance can be properly assessed over an extended period. For example, an annual bonus may be delivered to an employee with one third paid in cash and two thirds of it delivered as shares or rights which will not fully vest for another two years. There may not even be a risk of forfeiture in such plans as the employee is regarded as having earned the bonus. Alternatively, it may be that the only occasion for the forfeiture may be an event of dismissal for misconduct.

There are many occasions when an employee will have a fully vested share or right to acquire a share but will not be able to sell the share or exercise the right because of trading windows, a further restriction period imposed by the employer, a minimum shareholding requirement or the employee being in possession of market sensitive information. It would, in our view, be inappropriate to levy tax at the point of time when the employee no longer has a risk of forfeiture but is "unable to deal" in the security to realise the funds necessary to meet the tax cost on the taxable value.

For the reasons outlined above, and many other reasons, the BCA /CTA submit that the time when the employee no longer has a "real risk of forfeiture" is not the appropriate *"ESS deferred taxing point".*

The BCA/CTA would like to submit that the Government should maintain the position that tax should be payable at the point in time when the employee is no longer mandatorily prohibited from disposing of the share, the right or the share acquired by exercise of the right.

Otherwise, as a minimum, the BCA/CTA submit that the *"ESS deferred taxing point"* should be:

1) The ESS deferred taxing point for a share should be the earliest of the following;

   (a) The time when the employee is first capable of dealing with the share without any prohibition on disposal or real risk of forfeiture; and

   (b) The end of the seven year period starting when the employee acquired the share.

2) The ESS deferred taxing point for a right should be the earliest of the following:

   (a) The time when the employee is first capable of dealing with the share acquired by the exercise of the right without any prohibition of disposal of the share or real risk of forfeiture of same, but not before the time when the market value of the share able to be acquired by exercise of the right is greater than the amount of the exercise price;

   (b) The time when the employee disposes of the right (other than by exercising it); and

   (c) the end of the seven year period starting when the employee acquired the right.

The objective of the above recommendations is to enable the taxing point to be no earlier than the time when the employee is first able to sell the shares, rights or the shares acquired from exercising the rights and is not prevented from doing so by a trading window or because the option is out of the money.

It is recognised that insider dealing policies and laws can of themselves prevent an employee from being able to realise the shares. The Commissioner of Taxation currently recognises and accepts that insider dealing policies and the law are a restriction preventing the sale of shares and, therefore, does not seek to tax employee shares and rights until such restrictions no longer apply.

The BCA/CTA submit that this principle should be reflected in the redrafted legislation.

Taxation on termination of employment

As is evident from this submission, members of the BCA/CTA do not consider the termination of employment to be an appropriate taxing point. Australia is the only country that continues to use termination of employment as a taxing point. It is inappropriate in the current governance environment to use this time as a taxing point because employers are increasingly being required by shareholders to use deferred share plan arrangements as compensation for their employees.

Shareholders want to see employees' compensation tied to shares for an extended period even if that period is past the time of termination of employment.

The Consultation Paper notes that the Government is concerned that, having ceased employment, employees can move overseas and not meet their compliance requirements. The BCA/CTA believe that the employer reporting should provide a data trail for the Commissioner of Taxation that should, at a minimum, facilitate enforcement of compliance. Employers do not believe that the occurrence of this type of avoidance is at such a level as to warrant the tax impost at time of termination in all circumstances.

It is inequitable to impose tax at a time when the employee is unable to realise the value. Further, such taxable value may ultimately be greater than the economic value, if any, that is realised by the employee. In such circumstances the employee's effective rate of tax would ultimately be higher than his or her top marginal rate.

It would seem from the Consultation Paper that the employee in this type of circumstance would not be able to get a refund of the tax paid and would have a capital loss. Again, this represents an inappropriate taxation of an amount that may never actually be derived.

While the BCA/CTA note that APRA has indicated in its guidelines that employers should be able to release a sufficient proportion of shares to enable the employee to meet the tax liability, the BCA/CTA consider this to be inappropriate reflection of policy. That is, the taxation legislation would be dictating governance standards, rather than governance standards being the primary driver of compensation arrangements.

Reporting proposal

The BCA /CTA welcome the Government's proposal to require employer reporting of employee share scheme grants and income.

However, employers have indicated that the level of reporting will impose a significant administrative burden particularly in the first three years of the arrangements. Importantly, it is not clear why employers are required to provide details of estimated market value of shares and rights granted to employees in the year of grant.

The BCA /CTA submit that the reporting requirements be modified as follows:

- For the year commencing 1 July 2009 employers be required to provide:
  - name, address and TFN / ABN of employees to whom shares or rights are granted in that year;
  - the number of shares or rights granted to the employee; and
  - the type of security granted to the employee.
- The income tax return for the year ending 30 June 2010 should include in its design a specific label field for employee share scheme income. We believe this would significantly enhance compliance under self assessment, rather than relying on the Taxation Office to detect non-compliance after the event through data matching.
- For the first year after 1 July 2009 in which the taxing time occurs (as determined in the final legislation) employers should be required to provide:
  - name, address and TFN / ABN of employees whose shares or rights have reached the ESS deferred taxing point in that year;
  - the number of shares or rights that have become taxable; and
  - the type of security held by the employee.

Refund of income tax for forfeited benefits

The BCA/CTA supports the proposal to allow a taxpayer to claim a refund of income tax for rights that have been subject to tax on acquisition, but have lapsed without the taxpayer exercising them.

However the discussion paper also proposes that the refund rules should not apply where the employee chooses to forfeit their entitlements. One consequence of this would be to effectively prevent employees from obtaining a refund where "out of the money" options lapse. The exclusion, therefore, is likely to discourage companies from offering securities where there is a significant risk of this occurring. The BCA/CTA contends that this is an inappropriate outcome because, amongst other things, the offering of securities to employees that may lapse for being "out of the money" is important from a corporate governance perspective.

Accordingly, we suggest the submission propose that the exclusion from being able to obtain a refund where the employee chooses to forfeit their shares or rights be removed.

Summary and conclusions

The BCA/CTA believe that the improved reporting requirements combined with employee education will significantly improve compliance without any further need for reporting by the employer.

We look forward to the government taking up the suggestions outlined in this submission. The BCA/CTA would of course be willing to discuss the issues outlined above in further detail.

Yours sincerely

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