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Ernst & Young
200 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
ey.com/au

The Standing Committee on Tax and Revenue
PO Box 6021
CANBERRA
Canberra ACT 2600

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Inquiry into the Tax Treatment of Employee Share Schemes – Ernst & Young (EY) submission

Dear Sir / Madam

Ernst & Young (**EY**) is pleased to provide this submission to the Standing Committee on Tax and Revenue (the **Committee**) in relation to its inquiry into the effectiveness of the 2015 Employee Share Scheme (**ESS**) changes (**2015 Changes**).

The key points in our submission can be summarised as follows:

1. **The effectiveness of the 2015 Changes in bolstering entrepreneurship in Australia and supporting start-up companies**:

   Although the 2015 Changes have simplified the operation of ESS for Australian start-up companies (**Start-ups**) from a tax perspective, simplification of the legal / regulatory framework for ESS is required for Start-ups to be able to fully utilise the 2015 Changes.

2. **The costs and benefits of the concessional taxation treatments, and deferred taxing points for options, to the broader community**:

   The concessional taxation treatment for Start-ups and deferred taxing points for options / rights to acquire shares (**Rights**) have benefitted the community by:

   i. Making Australia more attractive to entrepreneurs, investors and key talent with the introduction of the start-up tax concessions

   ii. Removing significant complexities in the taxation of options which has helped Australian organisations become more competitive in the global talent market.

3. **The relevance of the current tax treatment of ESS to start-up companies and whether any changes are appropriate to ensure the taxation treatment remains relevant**:

   The operation of the ESS concessions for Start-ups would be simplified by extending the safe-harbour valuation method (which uses the Start-up's net tangible asset (**NTA**) value to determine a simplified market value of the Start-up's shares) to all companies that meet the start-up conditions.

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4. **The current structure of ESS arrangements and how the taxation treatment affects companies' decisions on structure:**

   Three key areas of the current ESS income tax rules that should be addressed are:

   i. **Taxation of ESS on cessation of employment** – the taxation of ESS interests at cessation of employment is inconsistent with encouraging long-term employee share ownership and out of step with the taxation rules in other jurisdictions. In the current recessionary environment, when job losses are increasing and share prices are volatile, the adverse consequences for individuals of taxing ESS interests when participants cease employment are amplified. In our view, the taxing point on cessation of employment should be removed.

   ii. **Different conditions for tax deferral for grants of shares and Rights** – the different conditions to allow for tax deferral on grants of shares compared to awards of Rights cause unnecessary complexities and discourage companies from awarding shares to employees. We recommend the tax deferral conditions for shares are made consistent with the conditions that apply for Rights.

   iii. **Tax deductibility of cost to provide ESS interests to employees** – the absence of a statutory tax deduction for the cost of providing ESS interests to employees has led to unnecessary red tape and additional administrative complexity for companies. In our view, and consistent with tax policy of some of our major trading partners, employers should be entitled to claim a statutory tax deduction equal to the ESS benefit on which employees are taxed.

5. **The challenges faced by companies in setting up an ESS arrangement and how the standard documents by the Australian Taxation Office (ATO) introduced in 2015 assist in the process, and whether additional improvements should be made**:

   The standard documents introduced have been helpful but we suggest that additional guidance is incorporated to assist companies using the documents understand the complexities of implementing an ESS.

Further detail on each of above points above is set out in Appendix A. We have provided our comments in summary form to highlight the key issues and, so, would welcome the opportunity to discuss our comments in more detail. We look forward to continuing to be involved in the inquiry process.

Yours sincerely

Chris Galway
Partner – People Advisory Services

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Appendix A

1. ***The effectiveness of the 2015 Changes in bolstering entrepreneurship in Australia and supporting start-up companies***

- The introduction of the start-up ESS tax provisions as part of the 2015 Changes has simplified the implementation and operation of ESS for Australian Start-ups from a tax perspective, allowing them to offer competitive equity incentives to attract and retain key talent.

- However, the current legal and regulatory framework for ESS for unlisted companies requires significant simplification for the start-up ESS tax provisions to be fully utilised by early stage businesses. Without changes to the Australian legal framework for unlisted companies offering ESS, the benefits of the 2015 Changes for start-ups, and unlisted companies more broadly, will not be fully realised. Refer to Appendix 1.2 and 1.3 of our submission to the Treasury, 'Employee Share Schemes consultation' dated 30 April 2019 for an outline of issues related to the current legal and regulatory framework.

2. ***The costs and benefits of the concessional taxation treatments, and deferred taxing points for options, to the broader community***

- Prior to the 2015 Changes, Australian companies in general were less likely to operate an ESS due to the complexities of the tax treatment for options. This was commercially problematic as:

    - Australia had fallen behind many of its major trading partners where we compete for talent (e.g., New Zealand, the United Kingdom and the United States) in being able to offer competitive equity incentive plans for highly-skilled people; and

    - Options are the prevalent equity instrument used by high-growth companies.

- The introduction of concessional tax treatment for companies who meet the start-up conditions and deferring the income taxing point until exercise for options / Rights have, to an extent, made Australian businesses more competitive in attracting talent.

  It is our view that the introduction of concessional taxation treatment under the start-up provisions and moving the deferred taxing point for options to exercise are unlikely to have given rise to a significant cost from a revenue perspective as equity incentive plans introduced since the 2015 Changes are typically in addition to existing remuneration arrangements.

- The start-up concessions as part of the 2015 Changes have benefitted the broader community in our view. Based on our experience and discussions with entrepreneurs and investors in Start-ups, investors are highly supportive of companies operating an ESS and are more likely to invest in companies that operate an ESS. As a result, it is likely the introduction of the start-up concessions has increased the attractiveness of Australian early stage businesses from both an investment and key talent perspective.

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3. The relevance of the current tax treatment of ESS to start-up companies and whether any changes are appropriate to ensure the taxation treatment remains relevant

- The current tax treatment of ESS has had a beneficial impact on start-up companies; however, we believe the changes below should be implemented so that the ESS taxation framework for Start-ups continues to support the growth of early stage businesses in Australia.

- The safe-harbour valuation provisions provide for two valuation methodologies for start-up companies – the NTA method or valuation by the company's Chief Financial Offer or a qualified valuer (**CFO / valuer method**). The NTA method is currently only available to start-up companies that have been incorporated for less than seven years and have not raised over $10 million in capital in the prior 12 months. For Start-ups that have been incorporated for more than seven years, but less than ten years (as required to be eligible for the start-up concessions), only the CFO / valuer method is available. The safe-harbour valuation provisions should be extended to all start-up companies meeting the relevant criteria (including companies that have been incorporated for more than seven years, but no more than 10 years), subject to the capital raising limit. This will simplify the operation of the provisions and enhance accessibility for start-up companies.

- It is unclear whether the 'associate rule' in section 83A.305 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) applies to ESS interests acquired by associates of employees under the start-up rules, and the interaction with the capital gains tax (**CGT**) discount. A tax determination or ruling by the ATO would provide clarity on the correct interpretation and confirm whether any changes are required to the legislation.

4. The current structure of ESS arrangements and how the taxation treatment affects companies' decisions on structure

- Outside the start-up regime, companies are grappling with complex ESS arrangements to deal with potentially adverse tax consequences under Division 83A of the ITAA 1997.

- We believe the key challenges under the current ESS tax regime are:

  a) Taxation of ESS on cessation of employment

  b) The differing income tax deferral conditions for shares and Rights

  c) Tax deductibility of costs to provide ESS to employees

  If these challenges are addressed, it will significantly simplify the process of implementing and managing ESS arrangements for all companies, align with the approach taken by our major trading partners with whom we compete for talent and allow Australian companies to be more competitive. An overview of EY's views on these issues is set out below.

a) Taxation of ESS on cessation of employment

- The tax rules in Division 83A of the ITAA 1997 currently provide that ESS interests which satisfy the tax deferral conditions are subject to tax at the time the employee ceases employment (if the ESS award has not already been subject to taxation). In our view, the taxing point at cessation of employment should be removed.

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As noted in our previous submission to Treasury dated 7 February 2014,[1] we believe the taxing point on cessation of employment is inconsistent with encouraging the long-term ownership of shares and the premise that employees should only be taxed on equity awards when they are able to realise a benefit.

Long-term share ownership is a common objective for companies when designing and implementing an ESS, and recently implemented and proposed regulatory changes (such as BEAR and prudential standard CPS 511 Remuneration (**CPS511**)) are aimed at restricting certain employees from disposing of ESS interests for up to seven years (even if a participant ceases employment). The cessation of employment taxing point is inconsistent with the objective of long-term ownership.

- It is also inconsistent with the taxation treatment of equivalent cash-based incentive awards, which are generally only taxed when the participant receives a cash payment. Imposing a taxing point when participants cease employment conflicts with the commercial objectives of many schemes and is out of step with the tax rules operated by most other countries.

  Further, because of the current recessionary environment due to COVID-19, it is likely job losses will significantly increase in the coming months. In these circumstances, the taxing point on cessation of employment will have a greater adverse impact as:

  - Employees will be taxed on their ESS awards at a time when they have unexpectedly lost employment in difficult circumstances; and

  - Whilst some participants may be able to sell shares to fund the tax liability when ceasing employment, they will be forced to dispose of their holding at a time when markets continue to be volatile, potentially realising lower value from their ESS award.

b) The differing income tax deferral conditions for shares and rights

- For a grant of shares to qualify for tax deferral under Division 83A ITAA 1997, at least 75% of Australian tax resident permanent employees with at least 36 months' service must have been eligible to participate in an ESS operated by the company (commonly referred to as the **75% test**). The 75% test must be met (along with the shares being subject to a 'real' risk of forfeiture) for employees to defer tax on their shares until a later date (commonly, when the shares are first able to be sold). However, the 75% test does not apply to grants of rights or options to acquire shares.

  The requirement for a grant of shares to satisfy the 75% test causes unnecessary complexity in comparison to a grant of Rights. It is our view that the tax deferral conditions for a grant of Rights should also apply for a grant of shares (effectively removing the 75% test) so that there is a uniform approach to the conditions for tax deferral, regardless of the equity instrument the company decides to use. This will reduce complexity and promote the use of shares as a vehicle to deliver greater alignment between employees and shareholders. An ESS that delivers shares upfront will also benefit employees who would typically be entitled to dividends and voting rights from the time of grant.

[1] 'Inquiry into Employee Share Schemes and Start-up Companies – Ernst & Young submission in response to face-to-face consultation', submitted as a follow up to the Sydney consultation meeting hosted by The Treasury on 31 January 2014.

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We are aware of companies that have wanted to introduce a share-based plan, but instead have introduced a Rights plan to simplify the tax treatment for employees and provide access to tax deferral. This can distort the commercial rationale for offering the ESS and increases complexity for the company and participants.

c) *Tax deductibility of costs to provide ESS to employees*

- Employers in the UK, USA and New Zealand are entitled to tax deductions in relation to grants of ESS interests made to employees. In our view, this is appropriate tax policy as ESS interests are considered part of an employee's remuneration.

  Whilst ESS interests acquired by employees are subject to income tax (generally at the deferred taxing point), employers are not normally entitled to tax deductions for the provision of ESS to employees, unless they have incurred specific costs (e.g., buying shares on market or making an irretrievable contribution to an employee share trust (**EST**)) or ESS interests are provided to employees under the $1,000 "tax exempt" plan. As such, we see many clients using funding structures or arrangements, such as ESTs, and making applications to the ATO for PBRs to gain certainty on the income tax and Fringe Benefits Tax implications for the company. This creates unnecessary red tape, complexity and additional administrative burdens for companies and the ATO.

  In our view, employers should be entitled to claim a **statutory tax deduction** equal to the ESS benefit on which the employee is taxed. This will simplify the administration of ESS arrangements for companies, reduce red tape for employers and the ATO and align with the approach taken in the UK, US and New Zealand. From a cost perspective, given the EST arrangements that many companies already operate, we would not expect the introduction of such a measure to have a significant impact on revenue.

Additional considerations

- In addition to the above, we recommend increasing the tax-free limit for the grant of shares to employees under the "tax exempt" share plan. Currently, only awards valued at up to $1,000 per tax year to each employee are exempt from income tax (provided certain conditions are met). The $1,000 tax-free limit has not been adjusted since 1997 and no longer represents a meaningful incentive / reward to employees.

- We also suggest that the $5,000 limit for employees who acquire ESS interests under salary sacrifice arrangements should also be increased to encourage employees to save more in a concessional environment.

- It would also be beneficial to introduce voluntary income tax withholding for ESS so that employers can choose whether to operate withholding of tax on ESS interests for employees who would otherwise have relatively simple tax returns if not for their ESS benefits. Moving to a voluntary withholding regime would simplify arrangements for employees, by allowing the employer to take on the tax collection and payment obligation on behalf of participants, and result in earlier revenue collection for the ATO.

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5. ***The challenges faced by companies in setting up an ESS arrangement and how the standard documents by the ATO introduced in 2015 assist in the process, and whether additional improvements should be made***

- The standard documents provided by the ATO have been useful to Australian start-up companies setting up new ESS arrangements. We would suggest the following changes to enhance the utility of the standard documents:
    - Due to the complexities of the legal and regulatory framework, a more prominent disclaimer encouraging companies to seek legal advice prior to the implementation of the ESS arrangements.
    - The sample performance conditions in the standard documents need to be clearly flagged as being for illustrative purposes only to mitigate the risk that companies may adopt the sample performance conditions in the standard documents.