

Level 2  
95 Pitt Street Sydney, NSW 2000  
**Telephone** 02 8223 0000  
**Facsimile** 02 8223 0077  
**Email** [tia@taxinstitute.com.au](mailto:tia@taxinstitute.com.au)  
**Website** [www.taxinstitute.com.au](http://www.taxinstitute.com.au)  
**ABN** 45 008 392 372



11 June 2009

Manager  
Philanthropy and Exemption Unit  
Personal and Retirement Income Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: [ESSreforms@treasury.gov.au](mailto:ESSreforms@treasury.gov.au)

Dear Sir/Madam

### **Employee Shares Schemes – Consultation**

The Taxation Institute of Australia (**Taxation Institute**) welcomes the opportunity to provide comments on the *Reform of the Taxation of Employee Share Schemes Consultation Paper (Paper)* and the exposure draft for the Tax Laws Amendment (Employee share schemes) Bill 2009 (**Bill**) which were released on 12 June 2009.

Prior to addressing each of the specific approaches outlined in the Paper, it is important to highlight the Taxation Institute's primary concerns in relation to the reforms.

The first main concern is the 'real risk' concept. In this regard, there is a lack of clarity and guidance in relation to this concept which will lead to uncertainty in relation to whether:

- upfront taxation or deferral treatment applies; and
- if deferral treatment is applicable, when the taxing point will occur.

For example, it is unclear what type of performance hurdles, retention clauses, good/bad leaver clauses and sales restrictions will be considered 'real risks'. Detailed examples of how such uncertainty may arise are outlined below. The Taxation Institute considers that it is crucial to resolve this issue for the reforms to achieve their objectives.

Secondly, there are serious issues associated with forfeiture and the 'choice' principle. Under the proposed reforms, if an individual forfeits a share/right, a refund for taxes already paid will not be available if the forfeiture is a result of a 'choice' made by the individual. This could lead to inappropriate outcomes particularly given that individuals will not be able to choose whether to be taxed upfront or not. For example, it appears that an individual who forfeits shares/rights as a result of being forced to retire for health reasons will not be entitled to a refund for tax paid upfront even though his/her 'choice' is not designed to protect against market conditions. In the Taxation Institute's view, such an outcome is inappropriate and is not in line with the policy of the reforms. Further examples are provided below.

Finally, the Taxation Institute recommends that the Bill be amended to provide that upfront taxation applies to all taxpayers unless they meet specified deferral requirements *and* they elect to defer the taxing point (ie participants should be entitled to elect upfront taxation even where they are eligible to apply deferral treatment).

The following comments addresses the Taxation Institute's concerns regarding each of the specific approaches outlined in the Paper and the specific provisions of the Bill. As the comments include references to the Taxation Institute's earlier submission on these reforms, a copy has been attached for your convenience.

## 1. Income test for the \$1,000 tax exemption

### Proposed approach

1. That the \$1,000 tax exemption be income tested.
2. That the income threshold be set at an adjusted taxable income of \$150,000.

The Taxation Institute supports the increase in the income threshold to \$150,000.

## 2. Deferring the taxing point

### Proposed approach

1. That the general approach continues as announced in the Budget (i.e., tax on the discount upfront).
2. That a limited deferral arrangement be reintroduced.
3. That deferral should be limited to schemes meeting the qualifying conditions for deferral under the existing law with an additional requirement that any shares or rights obtained under the scheme be subject to a genuine risk of forfeiture.
4. That deferral treatment will flow from the structure of the scheme rather than the (non) exercise of an election by the taxpayer.
5. That existing taxing points under the deferred arrangements be modified to limit maximum deferral until the end of 7 years (disregarding any waiting period), cessation of employment or when the employee can pass title to the share or right.

The numbering below corresponds to the numbering of the proposed approaches listed in the above table.

1. No comment.
2. The Taxation Institute supports the reintroduction of deferral arrangements. However, it appears that deferral will be limited and not be available where rights have vested but have not been exercised. The Taxation Institute does not support this limitation as it may result in financial hardship to individual taxpayers in circumstances where they are not able to sell the rights (eg due to sale restrictions) to pay the tax liability that arises on vesting. This would result in particularly harsh financial burdens where the value of the rights falls before they can be sold. The Taxation Institute recommends extending deferral treatment until rights can be exercised.
3. As noted in the summary, the Taxation Institute has concerns regarding the operation of the concept of a “real risk” of forfeiture as the method for limiting deferral. Specifically, the Taxation Institute is concerned that this requirement will create uncertainty for taxpayers as no clear guidance has been provided in relation to this concept. For example:
  - **Performance hurdles** – it is unclear what performance hurdles would satisfy the ‘real risk’ requirement. The Paper refers to performance hurdles imposed for the purpose of achieving future goals. However, it is unclear how it would be determined whether the purpose of a performance hurdle is really to achieve future goals.
  - **Retention clauses** – a scheme might provide that an employee must remain employed for a specified period (eg 5 years) for vesting to occur. Although the Paper indicates that such requirements would constitute a ‘real risk’ of forfeiture, it is unclear whether such clauses would always result in such a conclusion (eg what if the minimum term expires after only a few months).
  - **Good leaver clauses** – a scheme might provide that a ‘good leaver’ is entitled to vesting of a certain number of the shares/rights issued under the scheme on ceasing employment. It is unclear whether such provisions would lead to the conclusion that there is no ‘real risk’ of forfeiture (ie because even if the employee leaves they will receive some vested shares/rights). If this was so, there would be no deferral for any such plans.
  - **Bad leaver clauses** – a scheme might provide for forfeiture for bad leavers (eg for gross misconduct). It is unclear whether such provisions would lead to the

conclusion that there is no 'real risk' of forfeiture (ie because gross misconduct is an unlikely risk).

- **Sale restrictions** - a scheme might provide that shares/rights can not be disposed of for a specified period (eg 7 years). The Paper indicates that this would not constitute a 'real risk' of forfeiture. However, it is unclear whether such clauses could, in some cases, lead to the conclusion that there is a 'real risk' of forfeiture (ie because there is a real risk that the employee may leave before 7 years and hence not be entitled to the shares/rights).

The Paper notes that the 'real risk' concept is similar to that of an 'effectively non-contingent obligation' (**ENCO**) under the debt/equity provisions in the *Income Tax Assessment Act 1997*. Accordingly, the same problems arising in relation to determining whether an ENCO exists will arise. In this regard, it is noted that the lack of certainty regarding whether there is an ENCO has resulted in a situation where most advisers are forced to obtain opinions from Counsel or a class ruling in order to obtain comfort or certainty in relation to the existence of an ENCO.

The Paper also notes that the 'real risk' test is an 'objective test' (ie would a reasonable person conclude that there is a real risk that the share or right may not vest or may be forfeited). Given the difficulties in applying Part IVA of the *Income Tax Assessment Act 1936*, which is also based on an objective test (ie what would be concluded by a reasonable person), the Taxation Institute considers that this approach should be reconsidered.

Accordingly, the Taxation Institute does not support the 'real risk' concept as a method of limiting deferral.

4. As a result of the deferral treatment flowing from the structure of the scheme, it appears that upfront taxation cannot be elected if the scheme is eligible for deferral treatment. The Taxation Institute recommends that the reforms be amended to provide that upfront taxation applies to all taxpayers unless they meet specified deferral requirements and they elect to defer the taxing point (ie participants should be entitled to elect upfront taxation). This would appear to be more in line with the policy of the Budget announcements (ie taxation of the discount upfront).
5. No comment.

### 3 Reporting requirements for employers

#### Proposed approach

1. A new annual reporting requirement be introduced for employers offering employee share schemes.

As outlined in our previous submission to Treasury regarding employee share schemes dated 26 May 2009, the Taxation Institute considers that specific legislation is not required to address tax avoidance concerns in relation to employee share schemes. The Taxation Institute believes that the Commissioner of Taxation already has extensive powers to obtain the information required and to identify those individuals who have a vested interest under an employee share scheme (and hence a potential tax liability).

Further, targeted information gathering powers would merely increase the length and complexity of the law without notable enhancement and could even fetter the Commissioner's existing powers. If the issue is one of lack priority under the Australian Taxation Office's (**ATO**) Annual Compliance Plan due to competing compliance activities with greater risks then the evasion problem could be addressed through targeted funding of the ATO thereby ensuring that this perceived risk is accorded a higher priority within the ATO Compliance Plan.

The Taxation Institute also has specific concerns regarding the compliance burden on employers as a result of the proposed requirement for employers to provide an estimate of the market value of shares/rights at each deferred taxing point (refer proposed section 392-5(4)(c)(iii)). This requirement could mean that employers will need to provide an estimate each time an employee ceases employment and hence triggers a taxing event. Accordingly, the Taxation Institute does not support the introduction of the reporting requirements. If such reporting requirements are to be introduced, at a minimum, the valuation requirement discussed above should be removed or revised.

## 4 Withholding arrangements

### Proposed approach

1. That a limited form of withholding be introduced in cases where an employee fails to provide their employer with a TFN or ABN.

The Taxation Institute has some concerns regarding the impact of this provision on both employees and employers. In relation to employees, there is a potential for withholding from their salaries at the top marginal rate. Depending on the amount of the discount, this could place an unfair burden on these individual taxpayers (ie it could potentially leave them with no salary for a period of time). For employers, if an employee has a salary which is insufficient to cover the tax payable, the employers will have to take other measures to recover the debt.

Practically, this may not be an issue as employers will be unwilling to offer shares to employees unless they provide their TFN. Accordingly, the Taxation Institute recommends reconsidering this requirement.

## 5. Valuation issues

### Proposed approach

1. That the general principles of market value should apply in determining the market value of listed and unlisted securities.
2. That the new framework allows for regulations to provide for a 'rule-of-thumb' where necessary.
3. That as an interim measure the existing valuation rules for unlisted rights be replicated in the regulations.
4. That the valuation rules be reviewed.

As outlined in our previous submission to Treasury regarding employee share schemes dated 26 May 2009, the Taxation Institute submits that, in the absence of empirical evidence establishing that the current approach results in over or undervaluations, the current approach should be retained. If it is established to the reasonable satisfaction of all concerned that the current approach results in over or undervaluations, then alternatives should be considered. In which case, the Taxation Institute would be pleased to comment at that time.

## 6. Need for Tax Office approval for employee share schemes to qualify for tax concessions

### Proposed approach

1. That employee share schemes should not have to be approved by the Tax Office or APRA to qualify for concessional tax treatment.

The Taxation Institute agrees that employee share schemes should not have to be approved by the ATO or APRA.

## 7. Refund of income tax for forfeited benefits

### Proposed approach

1. That the refund rules be extended to cover forfeited shares.
2. That the refund rules should not apply if the extinguishment, forfeiture or inability to vest occurs as the result of a choice the taxpayer makes (including choosing not to exercise a right).
3. That appropriate rules be put in place to prevent contrived situations.

The numbering below corresponds to the numbering of the proposed approaches listed in the above table.

1. The Taxation Institute supports the extension of the refund rules.
2. As noted in the summary above, the Taxation Institute is concerned about the proposal to disallow refunds as a result of a taxpayer's 'choice'. The Taxation Institute recognises the need to prevent taxpayers from obtaining a tax advantage by making a choice to extinguish or forfeit shares/rights to protect themselves against market conditions. However, the suggested approach may result in unintended and inappropriate consequences.

Further, given that the current provisions do not allow taxpayers to 'choose' upfront taxation or deferral treatment (ie because this is determined by the structure of the scheme), it will be inappropriate in some circumstances to penalise the taxpayer for making certain choices in relation to forfeiture. For example:

- **Retirement** - Assume an individual is a participant of a plan that requires upfront payment of tax. Further, assume that the plan requires an individual to remain employed by the relevant company until the vesting time. If such an individual chooses to retire before the shares/rights have vested, the proposed reforms would mean that the individual has no right to a refund of the tax paid upfront. The individual may be retiring for any number of reasons (eg health concerns, death of spouse) none of which are motivated by protecting the individual from market downturns. To deny a refund in such circumstances would appear to be contrary to the policy of the reforms.
- **Resignation for personal issues** - The same results could arise if an individual resigns from a job. Once again, an individual may resign for any number of reasons (eg progression/promotion, health, family issues or work harassment issues) none of which are motivated by protecting the individual from market downturns.

Further, the Taxation Institute is concerned that an employee who is terminated (even be it for gross misconduct) would appear to be entitled to a refund but an employee who resigns for health reasons (even in the case of a terminal illness) would not appear to be entitled to a refund. This approach appears to be inappropriate and inconsistent with the policy of the reforms (ie to reduce anti-avoidance and deliberate evasion).

Accordingly, the Taxation Institute recommends reconsidering this approach. At a minimum, there needs to be some carves outs from the 'choice' principle.

## 8. Need for specific anti-avoidance rules / additional penalties

### Proposed approach

1. That no new specific anti-avoidance rules or penalties be introduced at this time.

The Taxation Institute agrees that no new specific anti-avoidance rules or penalties are required.

## 9. Comments on draft Bill

### Consultation questions

1. Does the law properly give effect to Government's position as outlined in this consultation paper?
2. Do you have further suggestions for improving the expression of the eligibility criteria?

The Taxation Institute recommends the following amendments to the Bill:

- The concept of "real risk" (refer proposed sections @83A-25(2)(d) and @83A-100(1)(e)) should be reconsidered or clearly defined.
- The forfeiture and refund provisions relating to choices made by individuals (refer proposed section @83A-310) is too broad and should to be reconsidered and amended so that unintended consequences do not arise.
- The employee reporting requirements should be reconsidered. At a minimum the requirement in proposed section 392-5(4)(c)(iii) should be removed or revised.

\* \* \* \*

The Taxation Institute would be happy to meet to discuss these issues further. If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirks, on 02 8223 0011.

Yours sincerely



Joan Roberts  
President

Level 2  
95 Pitt Street Sydney, NSW 2000  
**Telephone** 02 8223 0000  
**Facsimile** 02 8223 0077  
**Email** [tia@taxinstitute.com.au](mailto:tia@taxinstitute.com.au)  
**Website** [www.taxinstitute.com.au](http://www.taxinstitute.com.au)  
**ABN** 45 008 392 372



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Sandra Roussel  
Business Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email [sandra.roussel@treasury.gov.au](mailto:sandra.roussel@treasury.gov.au)

Dear Madam

### **Employee Shares Schemes – Consultation**

The Taxation Institute of Australia (**Taxation Institute**) welcomes the Government's decision in the joint Media Release of 24 May 2009 (No. 074, Employee Share Schemes) (**Media Release**) to reconsider its policy approach to countering problems it perceives with employee share schemes, as outlined in the 12 May 2009 Budget.

Although the Taxation Institute understands from the joint Media Release that a 'policy options paper' will be released in the next fortnight, the Taxation Institute believes it is important to provide the following initial comments on the four options referred to in the Media Release.

#### **The reporting requirements which should be applied to address tax avoidance concerns, such as the application of withholding arrangements or enhanced Tax File Number (TFN) reporting**

The Taxation Institute submits that specific legislation is not required to address tax avoidance concerns in relation to employee share schemes. The Taxation Institute believes that the Commissioner of Taxation already has extensive powers to obtain the information required and to identify those individuals who have a vested interest under an employee share scheme (and hence a potential tax liability). Further, targeted information gathering powers would merely increase the length and complexity of the law without notable enhancement and could even fetter the Commissioner's existing powers. If the issue is one of lack priority under the Australian Taxation Office's (**ATO**) Annual Compliance Plan due to competing compliance activities with greater risks then the evasion problem could be addressed through targeted funding of the ATO thereby ensuring that this perceived risk is accorded a higher priority within the ATO Compliance Plan.

#### **The level of the income threshold for accessing the \$1,000 tax exemption for upfront taxation, which would ensure the continued availability of employee share schemes for low and middle income employees**

The Taxation Institute recommends that the Government abandon the announced \$60,000 income threshold for accessing the \$1,000 tax exemption as it is too low and is inconsistent with the income thresholds of a number of other recent tax measures such as the tax bonus and the proposed paid maternity leave. The Taxation Institute submits that the \$60,000 income threshold will discourage participation in employee share plans across the workforce. Further, the Taxation Institute believes that this cap may not affect high income earners who would typically be expected to receive shares or rights under employee share schemes with a discount in excess of \$1,000 and would be expected to defer their taxing point. Therefore, this measure does not appear to deal with the high income earners who appear to be the target of the proposed changes.



An alternative to the \$60,000 income threshold which could be considered is increasing the income threshold for accessing the \$1,000 tax exemption to an amount that is consistent with other recent tax measures such as the tax bonus and the proposed paid maternity leave (i.e. to at least \$150,000).

**Whether there are circumstances under which it may be appropriate to provide for the deferral of taxation, the period of deferral and what those limited circumstances would be (such as when there is a real risk of forfeiture)**

The Taxation Institute believes that the abolition of deferral of the taxing point will generally end the use of most employee share schemes providing genuine employee exposure to shareholdings in the employer due to the upfront costs and risks involved. In particular, this will adversely affect low and middle income earners without addressing the fundamental problems perceived by the Government of evasion and over use of the discount concession by high earning taxpayers.

In relation to the increased costs and risks of demanding upfront payment of tax, the Taxation Institute submits that without deferral of the taxing point:

- employees may not have the ability to pay the tax associated with the employee share scheme upfront. It is essential employees are in a position to their sell shares or have time in which to save to cover their tax liability otherwise the costs associated with investment will be untenable; and
- employees may not be willing to participate in an employee share scheme as they will incur upfront tax costs in relation to a gain that may never materialise.

Given the current volatile market conditions, the Taxation Institute believes that without deferral of the taxing point, low and middle income earners in particular will not be willing or able to participate in employee share schemes where there is an upfront tax cost. On the other hand, high income earners are likely to be better placed financially and be more sophisticated investors, and are more likely to still be willing and able to incur the upfront tax costs despite the fact that a gain is not assured.

For these reasons, the Taxation Institute submits that the abolition of deferral of the taxing point will affect low and middle income earners in particular rather than the high income earners, which appear to be the target of the proposed changes announced in the Budget. Therefore, the Taxation Institute believes that the deferral of the taxing point needs to be restored. If not, the underlying policy objective of employee share schemes (ie encouraging an alignment of the interests of companies and their employees through continuing share ownership by employees) will be significantly discouraged.

**Whether the tax law provisions which determine the market value of discounted and deferred shares or rights result in undervaluation**

The provisions which deal with the valuation of discounted and deferred shares and rights were considered as part of the revision of the tax treatment of employee shares and options in the mid 1990s. The Taxation Institute submits that, in the absence of empirical evidence establishing that the current approach results in over or undervaluations, the current approach should be retained. If it is established to the reasonable satisfaction of all concerned that the current approach results in over or undervaluations, then alternatives should be considered. In which case, the Taxation Institute would be pleased to comment at that time.

The Taxation Institute would be happy to meet to discuss these issues further. If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirks, on 02 8223 0011.

Yours sincerely



Joan Roberts  
President