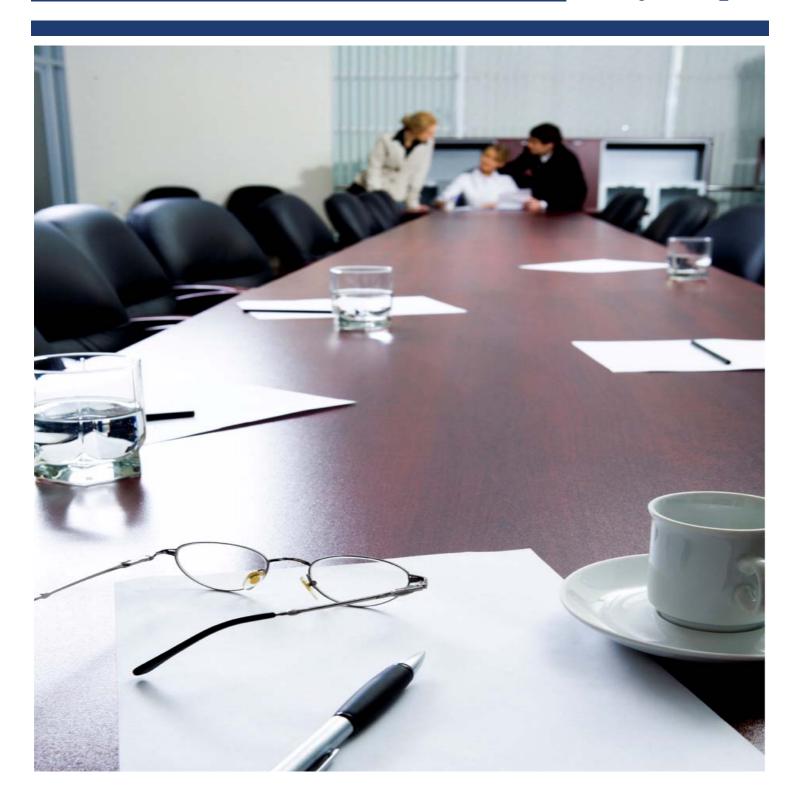
17th July 2009

Hay Group Submission to the Senate Economics References Committee Enquiry into Employee Share Schemes

HayGroup



Contents

Executive Summary		1
Introduction		2
About Hay Group		2
Hay Group interest	in the Senate Economics References Committee enquiry into	
Employee Share P	lans	2
Our approach to thi	s submission	3
General Employee	Plans	3
Executive Equity In	ncentive Plans	4
Benefits of employee	share schemes	5
General Employee	Plans (ie \$1,000 Plans)	5
Executive Equity In	ncentive Plans	5
Structure and operat	ion of employee share schemes	6
General Employee	Plans (ie \$1,000 Plans)	6
Executive Equity In	ncentive Plans	6
Taxation issues relat	ing to compliance of participants in employee	9
share schemes		7
Recently proposed c	hanges to the treatment of employee share	
schemes		8
General Employee	Plans (ie \$1,000 Plans)	
Executive Equity Incentive Plans		
Salary Sacrifice Pla	nns	9
Contact		. 11



Executive Summary

We endorse the general thrust of the proposed changes in the taxation of Employee and Executive Share Plans, however, we are concerned some of the detail may have unintended consequences. Specifically we support:

- Continued tax incentives for General Employee Plans
- Taxation of General Employee Plans in the year of grant
- Tax exemption for employees with income up to \$180,000 pa
- Taxation of participants in Executive Equity Incentive plans at the point they are first able to sell the shares, with a maximum deferral of 7 years
- Removal of taxation triggered by termination of employment
- Continued application of the income tax provisions at the initial tax point and application of Capital Gains Tax on share price growth from that point
- Removal of the proposed tax deferral limit of \$5,000 pa for salary sacrifice schemes
- Lifting the salary sacrifice limit if it is not removed

In our work with clients we take a strong stand that remuneration design should not be driven by tax minimisation but by the company's business and remuneration strategy to encourage desirable behaviours and business outcomes. We do believe however that it is important that the tax regime should not act in conflict with good reward strategy to achieve the desirable focus on performance and risk management.

We have some concerns that the proposed changes to taxation of employee share plans is happening ahead of, and in isolation from, the Productivity Commission enquiry into executive pay and the broader review of the tax system. Because of this lack of integration, and based on past global experience with regulation of remuneration, we have some concerns about unintended consequences of changes to the taxation of employee share plans. Specifically:

- We believe the proposed limitation of tax deferral to \$5,000 pa for salary sacrifice arrangements may force the abolition of Non-Executive Director plans requiring NEDs to take a significant portion of their fees as shares. This requirement is strongly supported by shareholders and governance advisory groups and should not be discouraged by the application of tax penalties.
- We believe that continuing the triggering of taxation at termination of employment is contrary to good plan design and desirable investor and community outcomes.

Introduction

About Hay Group

Hay Group is a global management consulting firm that works with leaders to transform strategy into reality. We develop talent, organise people to be more effective and motivate them to perform at their best. Our focus is on making change happen and helping people and organisations realise their potential. We have over 2500 employees working in 86 offices in 47 countries.

Locally, we operate out of seven offices across Australia and New Zealand with over 100 employees. We consult to listed, private and public sector organisations as well as the not-for-profit sector.

Hay Group interest in the Senate Economics References Committee enquiry into Employee Share Plans

Hay Group's participation in the Economics References Committee enquiry stems from our belief that we will add value to the process because we:

- have proven expertise in remuneration, including employee share plans, based on vast experience;
- have deep insight into the issues that impact on executive remuneration in particular;
- maintain a significant database of remuneration globally, including many of the publicly listed companies on the world's major stock exchanges; and
- believe that reward, including employee share plans, is a powerful tool for company boards to use to improve company performance to the benefit of all in an economy.

Our global databases are broad and deep, representing more than 7 million employees from nearly 13,000 organisations in 63 countries worldwide. Our Australian database includes reward information on over 180,000 incumbents from 418 organisations.

In Australia our remuneration information is used by many of the top ASX listed organisations and we also advise Boards and management on director, executive and management remuneration in a number of ASX listed organisations.

Our approach to this submission

We have framed our submission around the six areas the inquiry will examine as outlined in the letter we received inviting our submission. We have provided comments on the first four areas.

We see significant differences between those employee share plans that are provided for a broad range of employees (General Employee Plans) and those designed for senior executives and key senior employees (Executive Equity Incentive Plans). The different objectives of the two types of plan lead to quite different design structures and warrant different tax treatment.

We have provided separate comments applicable to each type of plan under each section of this submission.

The information and views in this submission are current at time of submission. Our views have been informed by legislation and regulation (including those in draft form) current at the time of submission and need to be considered in the current regulatory context.

General Employee Plans

For publicly listed companies, the focus of General Employee Share Plans, which are typically eligible for the \$1,000 tax exemption, is to give a broad section of the employee population an ownership experience. This provides a modest exposure to share price movements and for many employees increases their understanding of, and identification with, the organisation and its objectives. The emphasis is on affiliation rather than financial reward and for many companies the share allocations are voluntary additions to normal pay arrangements.

To meet the typical objectives of general plans it is important to maximise employee participation. The design of these plans is generally aimed at encouraging this through features such as:

- little or no cost to the participant;
- low risk of financial loss through participation; and
- simple design to allow clear and effective communication.

International research indicates that general share plans, in conjunction with good people management practices, are associated with above industry sector average company performance. The encouragement of widespread shareholding may have social, as well as economic, benefits and a number of other westernised economies, notably the UK and USA, provide tax incentives to encourage general share plan participation.

This support for general plans was accepted by both sides of Australian politics with changes to tax arrangements made in the late 1990s to encourage wider employee participation. We believe the social and general economic benefits of these plans justify continuing modest levels of tax benefit and any changes made at this time should not discourage broad based plan offerings and employee participation.



Executive Equity Incentive Plans

Executive equity plans have grown in importance in Australian executive pay programs over the past 20 years and particularly over the past decade. For listed companies they are now a key strategic remuneration tool to provide a significant portion of the overall remuneration in a form that is directly linked to company performance.

Our survey data indicates that in 1997 senior executives received about 75% of their remuneration as fixed pay with 25% subject to short and long term performance criteria.

In 2008 the proportions had changed to 54% fixed pay with 46% subject to performance. Roughly two thirds of the "at risk" component is short term and one third (17% of the total) long term. The long term incentive is virtually all delivered through share or option plans.

For CEOs the proportions are now 45% fixed pay, 24% short term and 31 % long term (share based) incentive pay.

Executive plans take several forms, with performance linked shares the most common approach. The vesting of these shares or options under Long Term Incentive plans is virtually always subject to the achievement of rigorous performance hurdles and continued employment over the performance test period.

The company objectives for these plans include:

- balancing the attention on short term issues with a medium to long term focus;
- aligning the interests of management with those of shareholders;
- ensuring a significant proportion of executive pay is subject to performance outcomes;
- linking the level of executive reward with returns to shareholders; and
- encouraging the retention of key executives.

Plan designs are varied but are usually limited to a relatively small number of participants who can have direct impact on corporate results. To be effective, the size of the financial opportunity must be meaningful to the incumbent as a proportion of their overall remuneration. Recent community debate across the globe has emphasised a preference for a large proportion of executive pay to be dependent on medium to long term performance and for levels of pay to vary in line with shareholder rewards.

It is appropriate that the taxation of Executive Equity Incentive Plans should be neutral, providing no community support through tax benefits but also ensuring that the tax system does not create barriers to the effective use of these plans which have considerable benefits in assisting with good governance structures for executive reward.



Benefits of employee share schemes

General Employee Plans (ie \$1,000 Plans)

- Mechanism for increasing the identification of employees with the business.
- Opportunity for employees to share in the success of the company.
- Assist in communicating, and giving focus to, company performance.
- Part of a Total Reward strategy using more than just financial rewards.
- Opportunity for employees to build wealth as a supplement to superannuation.

Executive Equity Incentive Plans

- Important tool for the company to provide a balanced remuneration framework.
- Mechanism for putting part of the executive remuneration package at risk subject to medium term company performance.
- Provides a focus on medium to long term company performance for employees most able to influence the strategic direction and longer term achievements of the company.
- Reduces the risk of executives taking short term actions at the expense of the long term health of the company.
- Mechanism to align rewards to executives with rewards to shareholders.
- Mechanism to support the retention of key employees.
- Opportunity for executives to build wealth outside the tax supported superannuation environment.
- Important alternative to cash rewards for start-up companies with limited cash reserves.

Structure and operation of employee share schemes

General Employee Plans (ie \$1,000 Plans)

- Generally provided to increase affiliation and involvement rather than as a major remuneration tool.
- Key issues are to maximise participation:
 - little or no cost of participation;
 - simple design to assist clear communication to employees;
 - no risk of loss (unlike executive plans); and
 - limited level of share allocations to keep company costs manageable.
- Tax Exempt (\$1000) plans generally meet these requirements.
- Tax concession makes those plans more attractive to employees (no tax cost for participation) and so more likely to be effective for employer.
- Tax exemption requirements (no risk of forfeiture & hold for 3 years) also assist in meeting the employee engagement objectives.
- The restrictive requirements of the Tax Exempt plans ensure they do not play a significant role in executive remuneration. Many companies exclude executives from these plans. Others include them, based on a universal participation philosophy, but the \$1000 annual limit makes them irrelevant in the overall remuneration structure for executives.

Executive Equity Incentive Plans

Executive plans are always (for substantial listed companies) part of a structured incentive pay program. There are typically three main forms of equity plans.

- Deferred Payment Short Term Incentive plans most commonly:
 - The size of the allocation is determined by an annual performance hurdle. Focus at the allocation point is on short term performance criteria
 - Once determined, the share allocation is held for a further period (often another two years) subject to continuing employment so provides a retention incentive
 - The value to the executive is subject to share price movements over the holding period. This
 provides an on-going link to company performance
 - If annual allocations are provided, the typical two year holding period ensures there is always two
 year's allocation at risk to medium term share price performance with clear alignment to
 shareholder interests
- Option Plans most commonly:
 - The executive is granted the right to acquire shares in the future (usually three years) at a fixed price, almost always the current market price
 - For listed Australian companies this is almost always subject to the achievement of defined performance targets and continued employment over the period
 - The most common performance hurdles are Total Shareholder Return (TSR), usually relative to a comparator group of companies and Earnings per Share (EPS)
 - There is a small but growing trend to utilise other performance hurdles, more specifically linked to individual company strategies and objectives
 - Subject to the hurdles, the executive receives the growth in the share price between issue and exercise. This provides a very clear link to shareholder interests small growth yields small rewards, large growth yields large rewards

- Because an option only provides the growth component they are less valuable than full shares that include the initial share value so grant sizes must be greater than for shares to deliver the same remuneration value
- Performance Share Plans most commonly:
 - The executive is granted the right to acquire shares in the future (usually three years) at no cost
 - For listed Australian companies this is almost always subject to the achievement of defined performance targets and continued employment over the period
 - Performance and service hurdles for share plans are similar to option plans
 - These plans can allocate shares at grant date or can use other administrative structures, such as Zero Exercise Priced Options (ZEPOs), to deliver the same outcome
- Because they are intrinsically more valuable and allocation sizes are smaller, shares are less leveraged to the share price than options and generally provide a less volatile payout pattern than options

Regulatory and advisory bodies are increasingly advocating a higher portion of executive pay should be subject to the achievement of medium to long term company performance. Executive Equity Incentive Plans are the most logical mechanism to deliver this outcome provided the plans are not subject to tax penalties compared to cash payments.

Long Term Equity Incentives (Performance Shares and Options) are almost always subject to the achievement of tough performance hurdles. Typical Australian plans deliver no benefit value to executives 50% of the time and partial benefits for another 25% of the time.

Taxation issues relating to compliance of participants in employee share schemes

- The existing tax arrangements which rely on employees having to decide when to be taxed are technically defensible but complex and difficult to explain to general employees and executives
- While some individual employees and executives may seek to avoid payment of the appropriate tax, it is clear from years of contact with plan participants that many are genuinely confused about their obligations
- Many companies attempt to provide basic advice to participants but they are constrained by legal exposure issues to keep the advice general and yet cover all possibilities. This makes the "simple" advice statements very complex
- Removing the employee election option will assist considerably in clarifying the taxation obligations
- Better reporting to the ATO of share plan grants will assist the ATO to monitor individual returns and this will also encourage better voluntary compliance

The general direction of the currently proposed changes specifically targeting compliance is appropriate and not unreasonably onerous for companies or participants.

Recently proposed changes to the treatment of employee share schemes

General Employee Plans (ie \$1,000 Plans)

We believe the proposed changes are appropriate because:

- The provision of tax exemption for these plans is an appropriate community support to encourage general share plan participation. The annual exemption limit ensures the community cost is kept within reasonable limits.
- The limitation of the tax exemption to those employees earning less than \$180,000 pa will allow these plans to remain an effective tool for the general employee population.
- The clarification that these plans will always be taxed in the year of grant will make compliance more practicable.

The implementation of the changes currently proposed by the Government will allow continuation of effective employee share plans for the benefit of individual companies and the Australian community.

Executive Equity Incentive Plans

General comments

- Executive plans are provided as part of balanced remuneration programs and are aimed at improving the performance of the executive team in delivering results for shareholders. As a remuneration element delivered in a different form to cash there is no social policy rationale for tax advantage or penalty to the executive.
- Because these plans often deliver no benefit to the participants, and if any is received the benefit is delayed, it is appropriate to have specific tax provisions for share/option grants.
- Tax should not be payable until the executive has the capacity to sell the shares and standard income tax should be paid on the value of the shares at that point.
- Our understanding of global approaches to taxation of executive equity plans is that taxation is almost universally imposed at vesting or sale of the shares.
- We do not see tax deferral to vesting point as a material tax benefit. If a company provided a cash plan that promised payment in three year's time, subject to some performance hurdle, the tax point would clearly be at the time of payment. Deferring the taxation of share plans to the vesting point is consistent with the taxation of cash.
- The "benefit" of deferral (if any exists) is further minimised by the fact that while the tax is deferred it remains in the income tax regime and the executive does not have the opportunity of halving the tax liability on share price growth that will apply once income tax is paid and the share moves into the CGT environment.
- We regard the reduction in the maximum deferral period to seven years as reasonable.

Tax at Termination

- We do not believe that termination of employment with the issuing company should trigger the tax point unless it also triggers the vesting of the shares.
- Investors and other commentators/advisors are encouraging executive plans to avoid early vesting because of cessation of employment. This ensures that executives remain exposed to the market price for the full term of the plan and reduces the risk of short term manipulation of results prior to termination.
- Triggering tax at termination is inconsistent with this broader remuneration policy position.
- Taxing prior to vesting creates a real possibility that tax may have to be refunded. This creates administrative and compliance complexity for no clear policy benefit.
- Taxing prior to vesting does not remove a benefit it imposes a penalty.

We see no reason why tax should be payable before the shares/options vest and can be sold.

Application of Capital Gains Tax

Although not proposed by the Government, there has been some suggestion that the application of the CGT rules to shares acquired under an Executive Incentive plan is an unreasonable benefit for earned income. We strongly disagree with this view.

- A requirement that tax is paid at income tax rates at the time of vesting largely invalidates this concern
- If executives retain shares beyond the vesting and initial tax point, that is essentially a personal investment decision and no longer related to the source of the shares
- Once the shares have vested it is impractical to differentiate the tax treatment of those shares from other shares. If they remained subject to income tax, executives who wanted to retain the shares could sell those shares at vesting and immediately purchase new ones which would clearly be subject to CGT provisions

Salary Sacrifice Plans

- Salary sacrifice plans are used by some companies for executives and general employees but are widely used for Non-Executive Directors
- It is common practice for companies to require Directors to salary sacrifice a portion (often 20%) of their fees into shares and hold them while they remain on the Board. This is an alignment of interest device and is well regarded by shareholder and governance groups. The \$5,000 limit is far too low for these arrangements
- In the absence of a change to this limit we expect most companies will remove the salary sacrifice requirement as the tax requirement will be prohibitive
- The limit should be removed since the Directors are unable to deal with the shares and have no resultant cash flow to meet the tax liability at grant. They should be taxed once they are able to deal with the shares.
- The deferral is not a benefit, as the tax liability will grow during the holding period in line with share price growth with no CGT discount available



- If a limit is retained it should be increased to cover a meaningful proportion (for example 25%) of typical fees for major corporations
- Removal of the limit or an appropriate increase would allow companies to retain a significant salary sacrifice requirement and impose a seven year holding obligation
- Imposing performance hurdles on Director shareholdings, to qualify for tax deferral, would be unacceptable under good corporate governance guidelines
- There is also a suggestion in the current community debate about executive pay, that executives should be required to hold a defined number or value of company shares
- Removing the limit would allow salary sacrifice to be used by executives and facilitate the adoption of such requirements



Contact

Trevor Warden
Executive Reward Practice Leader
Level 27
360 Collins Street
Melbourne 3000
Phone 03 9667 2628
trevor_warden@haygroup.com

Submitted by

Karyn Johnson State Manager - Victoria

On behalf of Hay Group