

27 May 2020

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CANBERRA  
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Dear Sir/Madam

**Submission on the tax treatment of Employee Share Schemes**

1. This submission concerning the tax treatment of Employee Share Schemes (**ESS**) and the effectiveness of the 2015 ESS reforms is made by the Taxation Law Committee of the Business Law Section of the Law Council of Australia (**the Committee**).

***Terms of Reference***

2. The terms of reference for this inquiry are extracted in full below:

“An Employee Share Scheme (ESS) is a scheme where employers offer shares or options to an employee in relation to their employment. ESS are designed to align employees’ interests to those of the company.

In 2015 the Government made a number of changes aimed at improving the taxation treatment and administrative arrangements for ESS.

The Committee will inquire into the effectiveness of the 2015 Employee Share Scheme changes and examine:

- how effective the changes in 2015 have been in their goal of bolstering entrepreneurship in Australia and supporting start-up companies;
- the costs and benefits of these concessional taxation treatments, and deferred taxing points for options, to the broader community;
- whether the current tax treatment of ESS remains relevant to start-up companies and whether any changes are appropriate to ensure the taxation treatment remains relevant;
- how companies currently structure their ESS arrangements and how taxation treatment affects these decisions; and
- the challenges faced by companies in setting up an ESS arrangement and how the standard documents by the Australian Taxation Office, and introduced in 2015, assist this process and whether additional improvements should be made.”

### **Key Points**

3. The Committee wishes to raise the following key matters:
  - a. **Barriers to implementing ESS:** there is considerable room to simplify the regulation of ESS to provide coordinated outcomes and remove the unnecessary cost and complexity created by the current regime.
  - b. **ESS and start-ups:** the ESS start-up tax concession is a sensible idea. However, the definition of start-up should be broadened to further facilitate business access to this concession.
  - c. **ESS and business succession:** to address the complexities in using ESS as a means of business succession, the financial assistance regime should be reviewed, and the tax rules should be reformed to allow for the UK model of an employee share trust to be used in Australia.

### **Executive Summary**

4. The simplification of the law associated with the 2015 reforms together with the introduction of the concessional treatment of employee ownership has been a significant improvement to the law dealing with employee ownership.
5. However, the law dealing with employee ownership remains unduly complicated and continues to produce considerable cost for many businesses seeking to implement ESS arrangements. This complexity has developed from its disjointed development over an extended period.
6. A number of complexities exist where there are significantly different taxation treatments for transactions which are broadly economically equivalent.
7. This creates uncertainty and, in many instances, unintended outcomes. The problem is amplified by the lack of coordination of the preconditions for concessional tax treatment and the rules applicable under both the Corporations law and the relevant ASIC relief to the offer of securities under ESS. This is particularly the case in relation to an offer of securities in an unlisted company.
8. The Committee believe there is considerable room for further reform to take place.
9. The Committee have had the opportunity to review the submission by the Tax Institute of Australia (dated 18 March 2020) (**the Tax Institute Submission**) and have included references to it in this submission.

### **General barriers to setting up An employee share scheme**

10. There are a number of general barriers to setting up ESS, particularly for unlisted companies.
11. The Committee believes the key barriers are:
  - a. the lack of alignment between issues of shares compared to rights;
  - b. the need for specific valuations;

- c. the issue with cessation of employment as a tax trigger point;
- d. the limit imposed by the \$1,000 tax free threshold for the acquisition of shares; and
- e. the difficulties in implementing a share buyback for ESS.

***Lack of alignment between issues of shares compared to rights***

- 12. The lack of alignment between the conditions for an offer of shares compared to an offer of rights occurs for a number of reasons.
- 13. The tax legislation allows tax to be deferred on rights and shares, however the conditions for deferral differ. There is no rationale for the difference and companies use workarounds to overcome the legislative provisions. This adds unnecessary cost and complexity.
- 14. For example, shares must have been offered to 75% of a particular category of employees, rather than only a limited set (as is the case for rights), in order to access a deferred taxing point.<sup>1</sup> This condition is unnecessary and confusing – namely, the need to identify employees who have been with the business for in excess of 3 years in order to be treated as permanent employees.<sup>2</sup>
- 15. There must also be a real risk of forfeiture for an offer of shares, but not rights.<sup>3</sup> Given the benefits of receiving shares – the employee becomes a shareholder and can receive dividends; annual reports; and vote in company meetings – these conditions should be aligned to make an offer of shares as attractive for companies as an offer of rights.
- 16. The Committee would suggest there should be a consistency for the tax deferral conditions on rights and shares via:
  - a. removing the real risk of forfeiture requirement for shares; and
  - b. removing the 75% offer requirement for shares.
- 17. The Committee considers this consistency in tax treatment should reduce cost and complexity and remove unintended and arbitrary tax consequences.
- 18. Potential concerns have been raised in relation to revenue leakage. The Committee considers the potential for revenue leakage is, again, overstated. This is because of the impact of workarounds and offers simply not being made. In many instances the tax deferral conditions for shares are being achieved through the introduction of short-term forfeiture conditions or, alternatively, the addition of so-called cash out options.

***Need for specific valuations***

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<sup>1</sup> Section 83A-105 of the *Income Tax Assessment Act 1997* (Cth) (**the 1997 Act**).

<sup>2</sup> See subsection 83A-105(2) of the 1997 Act.

<sup>3</sup> Section 83A-105 of the 1997 Act.

19. Another key impediment in relation to granting employee equity remains the need to obtain valuations.
20. The ESS rules work by reference to the market value of the relevant security at a particular point in time.<sup>4</sup> This is further complicated by the specific exclusion of considering the various contingencies which may exist in relation to the security.
21. This is an impediment for unlisted securities where a ready valuation of the security is not easily and cheaply obtained.
22. The problem of requiring a valuation is exacerbated as it may be necessary to determine the valuation at a number of points in time. For example, at the time of grant of the relevant security, at a relevant cessation of employment or, alternatively, at the end of a restriction period.<sup>5</sup>
23. The need to obtain a valuation in this case is an expensive impediment to many companies proceeding with an employee offer. The safe harbours contained in Legislative Instrument ESS 2015/1 in relation to valuation are very helpful. However, they are limited in scope and apply only to “start-ups”.
24. The Committee supports the recommendations of the Tax Institute of Australia to extend the safe harbour contained in the Legislative Instrument to companies which are unlisted with an aggregate turnover of less than \$50 million. (See page 4 of the Tax Institute Submission).
25. In addition, the need to obtain a valuation can raise different tax considerations (for example, when categorising whether the relevant securities are issued at a discount). This can create difficulties which results in securities being issued at a one cent discount being taxed on a significantly different basis to those issued at market value. (See, for example, the discussion of the operation of the deemed dividend rules under Division 7A in relation to ESS in paragraphs 52 – 54 below).

### ***Cessation of employment taxing point***

26. The Committee believes the most significant area for potential reform and the most important industry issue is the removal of the current taxing point on the cessation of employment, particularly for rights.<sup>6</sup>
27. The rules currently allow taxation of ESS awards to be deferred (rather than taxed at grant) under certain conditions. One of these deferred taxing points is at cessation of employment. However, these rules can lead to a mismatch between when the participant is taxed and when the participant is able to access the value from their ESS shares.
28. One of the most significant benefits accorded by the start-up regime is the removal of this taxing point.<sup>7</sup> It removes the impact of the employee being taxed

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<sup>4</sup> For example, under section 83A-110 of the 1997 Act, when calculating the amount to be included in the taxpayer’s assessable income where deferred taxing points are used.

<sup>5</sup> This is due to the mechanism in 83A-110 of the 1997 Act for including the market value of the ESS interest as at the deferred taxing point in the taxpayer’s assessable income.

<sup>6</sup> Contained in subsections 83A-115(5) and 83A-120(5) of the 1997 Act, for shares and rights respectively.

<sup>7</sup> As provided in section 83A-105 of the 1997 Act.

on cessation of employment for employees of companies that can take advantage of the start-up regime.

29. However, the taxation point on cessation of employment continues outside the start-up regime. It creates considerable inequity both for employees for listed and unlisted issuers.
30. It can significantly reduce the attractiveness of equity offers to employees. It can also reduce the competitiveness of Australian entities seeking to employ or retain employees in Australia, particularly for highly skilled employees in the technology area. These potential inequities have been exacerbated by the recent volatility in the market.
31. Tax currently arises when an employee ceases employment; however, many schemes do not allow employees to receive their rights at this point (for example, if they are not capable of being exercised). This creates:
  - a. potential anomalies associated with valuation mismatch; and
  - b. issues associated with tax funding, as a tax liability may arise without the ability to access the value from the right.
32. This can cause financial hardship and diminish the value of schemes.
33. This may cause financial issues for participants paying tax at cessation of employment, as they will not have effectively accessed the value of the shares to do so. It may also require participants to go through the additional cost and expense of amending their tax returns.
34. The Committee believes removing cessation of employment as a taxing point and only taxing participants when they can effectively access the value of those shares would be prudent to further encourage the use of ESS.
35. The removal of cessation of employment as a taxing point does not necessarily need to change the character of the income which the employee ultimately receives on disposal. The Committee is not proposing to alter the tax character of the amount to be taxed.
36. A concern has been expressed in relation to the collection of tax if the taxing point is deferred. To address any such concerns, consideration could be given to a withholding obligation on employers to ensure tax is collected.
37. Potential concerns have also been raised in relation to revenue leakage. The Committee considers the concern over revenue leakage is overstated. This is because of, amongst other things, the impact of workarounds under the current rules (for example, the reliance on the indeterminate right provisions).<sup>8</sup> There is also potential for the amount which may ultimately be assessed to be greater. However, importantly, it should reflect the real value of the security when it is accessed.

### ***Lack of flexibility in the use of share buybacks for Employee Share Schemes***

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<sup>8</sup> See section 83A-340 on the application of Division 83A to indeterminate rights.

38. There are a number of restrictions that apply to share buybacks for ESS, particularly in the unlisted environment. Employees of unlisted companies that operate an ESS have no ready way of realising value from the scheme. The employer must offer some form of opportunity to dispose of their shares where there is no ready third-party market.
39. It is important for private companies to create a facility for former employees to be able to sell their shares in the company when they cease to be employees. Many private companies also do not wish for employees to continue to hold shares after cessation of employment.
40. There is unnecessary ambiguity, cost and uncertainty for private companies to solve this problem and the existing employee buyback rules have unnecessary tax complexities.
41. Difficulties may arise under the existing rules with a buyback in the unlisted environment as it may engage the anti-avoidance rules in relation to capital streaming (if the total amount is debited to share capital). Alternatively, the part of the purchase price which exceeds the part debited against the share capital account is treated as a dividend paid to the shareholder.<sup>9</sup> As a result, the disposal of shares to the company under ESS buybacks may lead to a significantly different tax outcome for a participant than if the shares were disposed of to an employee share trust or an existing shareholder.
42. Facilitating the use of buyback rules for ESS to take advantage of the relief available under the Corporations law would be a significant benefit, particularly to unlisted issuers.
43. It is important there is flexibility for the buyback amounts for ESS to be assessed under the ESS provisions without a need to be franked or sourced from share capital for unlisted companies.
44. This will provide private companies with the ability to undertake share buybacks without the need to have a complex trust arrangement or matching purchases when employees leave the company, and removes the cost and complexity of existing buyback arrangements as:
  - a. the retiring employees are being taxed under the ESS provisions; and
  - b. the ambiguity regarding the sourcing of the buyback amount no longer exists.
45. This also ensures that there is no wastage of franking credits being provided to retiring employees.
46. The Committee recommends implementing a safe-harbour methodology for ESS buybacks for determining the dividend / capital split, or implementing administrative treatment where no part of the purchase price paid to an ESS participant under a buyback is deemed a dividend.

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<sup>9</sup> Under section 159GZZP of the *Income Tax Assessment Act 1936* (Cth) (**the 1936 Act**).

### ***More general concerns***

47. They are a number of areas in relation to the operation of ESS where unnecessary complexity arises simply as a result of the lack of coordination of some of the existing legislation.

#### *Access to franking credits.*

48. There are specific exclusions in the provisions dealing with the availability of franking credits for ESS held under ESS trusts.
49. Unfortunately, the legislation which seeks to provide this outcome is at best unclear. This is because the exclusion arises through references to the predecessor legislation in Division 1A of former Part IIIA of the 1936 Act. This has been repealed but it is still operative.
50. Unfortunately, the operative provisions rely on definitions of Division 13A, the predecessor ESS legislation to the current regime contained in Division 83A of the 1997 Act.
51. As a result, there is ambiguity as to whether or which legislation is to be applied in determining the availability of franking credits for shares held by employee share trusts. There is no basis for this ambiguity.

#### *Loans to acquire shares*

52. Again, there is a specific exclusion in the provisions of Division 7A which provides for certain loans to shareholders to be treated as deemed dividends. There is a specific exclusion which applies to loans for employee shares.<sup>10</sup>
53. This is a good example of the anomalies which can be created by the requirement for shares to be issued at a discount. It creates the anomaly that a loan made to an employee to acquire a share at a one cent discount is outside the provisions of Division 7A, whereas a loan made to another employee to acquire the shares at market value is not outside the scope of Division 7A.
54. This anomaly should not exist. The exclusion for employee loans in Division 7A should not require a discount to the market value to operate.

### ***Barriers for start-ups***

55. The start-up ESS concession in the 2015 legislation was a welcome and very helpful reform. Unfortunately, the use of the concession has been limited by several factors.

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<sup>10</sup> See section 109NB of the 1936 Act.

*Restrictive definition of 'start-up'*

56. There is a restrictive definition of 'start-up' that must be satisfied,<sup>11</sup> particularly when compared to other jurisdictions.
57. The Committee proposes that:
- a. the limit for the turnover test be increased (or removed altogether);
  - b. the 10% limit for individual shareholders be removed;
  - c. the exclusion for companies 10 or more years old be removed or increased; and
  - d. the restrictions on listed companies that otherwise meet the criteria from accessing the start-up concessions be removed.

*Lack of functional Corporations law relief*

58. The corporate rules for the offer of shares for start-up companies is poorly aligned to the requirements of the tax rules. As a result, the number of schemes has been limited.
59. The start-up rules under the Tax Act and the relevant ASIC Class Order conflict such that it is impossible for a start-up to meet the requirements of both.<sup>12</sup> For example, there is a requirement for a maximum 15% discount for the tax concession for shares under the start-up regime.<sup>13</sup> This is compared with a minimum 100% discount under the terms of the ASIC Class Order relief. This limits the take up of the start-up concession for share offers.

*Temporal limit of the start-up concessions*

60. The Committee agrees with the Tax Institute Submission that the start-up concessions should not be limited to start ups and should extend to all entities or at least to entities where if they issued shares to employees during the start-up phase, they should continue to be able to do so post the start-up phase on substantially identical terms.

***Barriers to using an ESS as a means of business succession***

61. There is a growing interest in using ESS as a means of facilitating business succession plans. Without a viable succession plan, these businesses would either be sold or cease to operate. This is an area where many of the difficulties referred to above come together to cause significant difficulty in providing an effective business model with collective employee ownership.
62. Using an ESS poses problems in relation to the tax imposed on retiring owners, the limitations on providing financial assistance, and difficulties with the current Australian model of employee share trusts.

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<sup>11</sup> Under section 83A-33 of the 1997 Act.

<sup>12</sup> See ASIC Class Order 14/1001.

<sup>13</sup> Under subsection 83A-33(5) of the 1997 Act.



63. The Committee believes any tax imposed on retiring owners should be on a concessional basis. Under the current rules, retiring owners may be assessed based on deemed market value regardless of whether that represents the value they receive.
64. The Committee is of the view that the current regime involves overly onerous disclosure and regulatory obligations in relation to financial assistance.<sup>14</sup> Financial assistance may also be treated as a deemed dividend in some instances.<sup>15</sup> The Committee recommends that business succession via an ESS be facilitated through a less onerous regime and without treating financial assistance as a deemed dividend for tax purposes.

#### ***The \$1,000 tax exemption concession***

65. The current tax rules allow employees with taxable income of less than \$180,000 per annum to purchase or receive free shares of up to \$1,000 per year in their employer without paying income tax, provided certain conditions are met.<sup>16</sup>
66. This limit was set in 1997 and has not been increased or indexed since. Increasing this limit would encourage broad-based share ownership – without any increase in the real value of this threshold, the operation and compliance costs of implementing an ESS may outweigh the benefits.

#### ***Simplification of employee ownership offering***

67. The Committee has sought to address some of the general considerations which impede the provision of employee equity at worst or, at best, complicate the provision of employee equity.
68. The Committee considers the key to effective ESS is a proper coordination of the tax and corporate regulation of the offering of employee equity which is targeted at the areas where employee equity is to be promoted.
69. The provision of the draft documents in 2015 by the ATO was a significant and useful tool to facilitate the provision of employee equity.
70. An expanded range of draft documents prepared in conjunction with the simplification of the rules could be a real opportunity to promote employee ownership and economic growth.
71. Most importantly, to be effective the draft documents would need to be accompanied by the simplification of the rules. Without a simplification of the rules the creation of draft documents will be less successful.

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<sup>14</sup> See, generally, Part 2J.3 of the *Corporations Act 2001* (Cth) and in particular the requirements in section 260B.

<sup>15</sup> Under Division 7A of the 1936 Act.

<sup>16</sup> Under section 83A-35 of the 1997 Act. Further conditions for access to this concession are included in section 83A-45 of the 1997 Act.

**Conclusion and further contact**

72. The Committee would be pleased to discuss any aspect of this submission.
73. Please contact the chair of the Taxation Committee, Mr Clint Harding [REDACTED] or Committee member, Mr Andrew Clements [REDACTED] if you would like to do so.

Yours faithfully

[REDACTED]

**Greg Rodgers**  
**Chair, Business Law Section**