



**The Institute of
Chartered Accountants
in Australia**

17 July 2009

Mr John Hawkins
Secretary
Senate Economics References Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear John

Inquiry into employee share schemes

Thank you for the invitation to put forward our submission to this Senate Economics References Committee Inquiry. As you will be aware, the Institute of Chartered Accountants in Australia (the Institute) has been an active and lead contributor to the recent debate around the changes to the taxation of employee share schemes announced by the Federal Government as part of the 2009-10 Budget.

By way of background, it is useful to point out that the Institute represents more than 62,000 Chartered Accountants in Australia, and that its members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 140 countries around the world. Owing to the diversity of its membership, the Institute considers itself to be well positioned to make a valuable and impartial contribution to issues being examined in this Senate Economics References Committee Inquiry into Employee Share Schemes (the Inquiry).

In this submission, the Institute focuses on its:

1. overall remarks about the employee share schemes tax policy announcement made by the Government on 1 July 2009; and
2. residual concerns in respect of specific elements of the revised proposed policy position.

In this submission:

- A reference to the "12 May policy announcement" is a reference to the Federal Government's Budget night announcement in respect of employee share schemes;
- A reference to "Consultation Paper" is a reference to the Department of the Treasury's Consultation Paper titled 'Reform of the Taxation of Employee Share Schemes' issued on 5 June 2009; and
- A reference to the "1 July policy announcement" is a reference to the Assistant Treasurer's Press Release and accompanying Policy Statement issued on 1 July 2009.

GPO Box 9985
in your capital city

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000
Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601
Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street
Brisbane Qld 4000
Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L11, 1 King William Street
Adelaide SA 5000
Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000
Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
Ground, 28 The Esplanade
Perth WA 6000
Phone 61 8 9420 0400
Fax 61 8 9321 5141

Overall comments

The Institute is supportive of the Government's 1 July announcement.

From the time of the 12 May announcement, the Institute had expressed its concerns that the introduction of compulsory up-front taxation along with the introduction of a \$60,000 means-tested threshold for tax exempt shares would effectively spell the end of employee share schemes for many Australian companies.

This view was built on the basis that some Australian companies provided direct advice to the Institute that they would find it difficult to justify offering their employees access to employee share schemes (ESSs) if doing so would result in their employees being obligated to pay tax on an up-front basis, even though no absolute certainty may exist that the employee would in fact ever become entitled to the shares or rights.

Secondly, many Australian companies also made it clear that in their view introducing a \$60,000 income threshold for tax-exempt share plans (TESPs) would be unworkable and carry with it a significant, and unnecessary, compliance burden. For many employees of Australian companies, the introduction of the income threshold at this level would result in many of their employees missing out on the \$1,000 tax-exempt shares concession, and as a result, companies would not be able to continue to offer access to those plans to all of their staff without an unacceptable level of risk of disrupting workplace unity and engagement.

From a broader corporate governance, economic and community perspective, the Institute also expressed concerns that the 12 May policy announcement would:

1. be incongruous with best practice corporate governance principles which seek to encourage employees and senior executives to participate in long-term incentive arrangements that align their interests in the company with those of its shareholders;
2. discourage companies and their employees from seeking to build long-term individual wealth through equity-based savings initiatives such as employee share ownership; this also presented a risk that employees would seek other [short-term incentive] forms of remuneration such as increased wages and bonus payments which could result in undesirably rapid growth in real wages across the economy; and
3. in the longer-term, potentially result in increased demands being placed on government-funded social welfare (such as age pensions) as a result of lower levels of individual self-funded retirement incomes derived from a reduction in working life savings.

For all of these reasons, the Institute took an active and lead role in the debate which followed the Government's 12 May announcement. During the course of the weeks following that announcement, the Institute provided written submissions and held meetings with representatives from the Treasurer and Assistant Treasurer's Offices, as well as Government officials from the Department of the Treasury to convey its concerns in relation to the 12 May announcement. At all times in those discussions the Institute's focus was on identifying solutions that delivered to the Government its stated policy objectives of improving integrity, whilst at the same, allowing Australian companies to continue to offer ESSs as a fundamental component of their employee remuneration and retention strategies.

In the Institute's view, the Government's 1 July policy announcement is a significant improvement on the original 12 May policy announcement. The revised policy position put forward is considered to deliver outcomes which will allow many Australian companies to re-instate TESPs and ESSs that they had previously suspended immediately following the 12 May announcement. The revised position is considered by the Institute to be a reasonable compromised outcome for all key stakeholders such as Treasury, the Australian Taxation Office, Australian companies and their employees. The willingness of the Government to take on-board the concerns raised by the Institute and the business community more broadly should be commended.

Residual areas of concern

Notwithstanding the overall comments set out above, the Institute believes that there are some residual issues where further changes to the 1 July policy announcement could be made to further improve the overall outcome for all stakeholder groups. The Institute is mindful of the revenue constraints faced by the Government in formulating not only its 1 July policy announcement, but also in considering further changes in the areas set out below.

Taxation of rights at time of vesting

The 1 July announcement proposes a policy position that the deferred taxing point for rights will be triggered at the time when the rights are no longer subject to a 'real risk of forfeiture', or a time based restriction which prevents the employee from being able to dispose of, or exercise, those rights.

Whilst this deferred taxing point test is consistent with the equivalent test proposed to apply to shares [with which we do not have any significant concerns at this point], in our view the underlying difference between the natures of rights as opposed to shares does not appear to be adequately taken into account in proposing this policy position.

Fundamentally, rights held by employees are typically subject to either, or both, a real risk of forfeiture in relation to the employee and company's overall performance against pre-agreed key specific measurements (such as profitability or total shareholder return), or perhaps a time-based restriction. It would not usually be the case that an employee would be subject to further real risk of forfeiture once the rights are able to be exercised over the underlying shares in the company; it may however be the case that further time-based restrictions may apply to the underlying shares once the rights are exercised.

It is for this reason that the proposed policy position of triggering a deferred taxing point at the time that the rights are vested will likely result in situations whereby some employees will effectively be compelled to either:

- dispose of the rights for cash consideration; or
- exercise the rights and immediately dispose of the acquired shares,

in order to generate sufficient cash funds to be able to meet their tax liability. In a practical sense, in most cases employees will be likely to exercise the rights and immediately dispose of the acquired shares as an employee's ability to dispose of the rights alone may be limited for legal reasons.

An implicit compulsion on employees to dispose of the rights or exercise the rights and dispose of the underlying shares is not considered to be an appropriate reflection of sound corporate governance as it allows taxation policy outcomes to unduly influence the behaviour of employees to take decisions that are not necessarily in the longer-term best interests of themselves or their employer company.

Where an employee elects not to dispose of the rights, or exercise the rights and dispose of the underlying shares, the outcome will be that employees will be required to pay tax at a point well before they have the means with which to fund their liability. As a fundamental principle, individuals should not be required to pay tax at a point in time before they have realised the cash gain which may be generated from disposal of the rights and/or underlying shares.

In our view, it would seem appropriate to revise this element of the 1 July policy announcement so that the deferred taxing point for rights is moved to the point at which the rights are actually exercised by the employee, rather than the point at which the rights are vested in the employee. Making this change would remove the undue influence that the proposed tax policy position may have on undesirably influencing employee decision making in a way that does not demonstrate a genuine alignment between employee, the company and its shareholders' interests.

Salary sacrifice schemes

Many Australian companies offer their employees access to share ownership through the use of salary sacrifice arrangements. Under these types of plans, employees are provided the opportunity to direct a portion of their pre-tax income towards the acquisition of shares in their employer company. It is also commonplace for directors of companies and other management and executive-level employees to be required in some cases to direct a portion of their short-term bonus incentives towards the acquisition of shares in their employer company.

The Institute's concern with the 1 July policy announcement in this area is that despite the Government announcing a \$5,000 per annum threshold in respect of the maximum amount of salary sacrifice shares that will be eligible for tax deferral under the proposed new rules, the introduction of threshold at this level will, in practice, be considered too low for many employees. For management and executive-level staff, a threshold limit of \$5,000 per annum will only represent a relatively small proportion of their, on-average, higher salaries.

It would therefore be appropriate in our view for the Government to consider removing the proposed \$5,000 threshold limit for salary sacrifice arrangements, so as to encourage as many employees as possible (at both junior and senior levels) to acquire shares in their employer company and build their own individual wealth over time.

Also, the policy in this area should appropriately recognise that salary sacrifice arrangements would not typically be subject to any substantive 'real risk of forfeiture' conditions as it would be unreasonable to expect that employees who direct a portion of their earned salary or short-term bonus remuneration towards the acquisition of shares in their employer company would be exposed to a risk of losing those shares. It would however be commonplace for such salary sacrifice arrangements to be subject to some time-based restrictions.

Cessation of employment

The Institute is of the view that the cessation of employment alone should not cause an employee to be subject to a taxing point. As has recently been observed by APRA in its recent guidance in respect of executive remuneration, employees' interests should be aligned to the long-term interests of the company and its shareholders, even if that extends beyond the period for which the employee is in the employ of the company.

This approach appears sound from a best practice corporate governance perspective, as it minimises any risks that employees would view the management of the company through the one-dimensional lens of their own period of employment in the organisation; instead, it would encourage employees to take a much broader and on-going view of the company's performance in the longer-term.

Ensuring that the tax rules that apply to the granting of shares or rights are aligned to this broader policy imperative is therefore vital. Structuring the tax rules in a manner that causes an employee to crystallise their deferred taxing point at the time that they cease their employment in the company does not, in our view, appear to align to the broader policy objectives of best practice corporate governance.

The Institute believes that the Government should consider removing cessation of employment as a deferred taxing point and instead rely on the other proposed rules relating to 'real risk of forfeiture' and time-based restrictions. Whilst the integrity concerns sighted by Treasury in their Consultation Paper as a justification for adopting the current policy position in this area are understood, the Institute is of the view that the implementation of the enhanced reporting obligation on companies already announced by the Government in relation to employee share scheme participation will adequately address any real or perceived integrity concerns.

Review of ESS tax policy in the future

As the Inquiry will be aware, there are currently two major reviews being undertaken by the Productivity Commission and the Future Tax System Panel which will, in either a direct or indirect way, have an impact on the future structure and use of long-term remuneration arrangements such as ESSs. It is imperative that the tax rules that apply to ESSs are considered to be consistent with, and supportive of, the broader best practice corporate governance principles already outlined by APRA, as well as those that will be articulated by the Productivity Commission late in 2009.

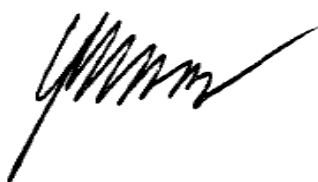
The Government has indicated a preparedness to re-consider the tax policy principles contained in their 1 July announcement after the final recommendations from these reviews are available. It may therefore be appropriate for some or all of the residual issues we have identified in this submission to be taken into account in reviewing the Government's ESSs tax policy in late 2009 or early 2010 after identification of any areas of 'misalignment' between broader policy and these proposed new tax rules.

At this point in time given that an exposure draft of the legislation which will give effect to the 1 July policy announcement is not available for our review and comment, this submission has not made any comments about the capacity of the draft legislation to deliver the 1 July policy announcement principles set out by the Government. Given the old tax rules ceased to apply on 30 June 2009, it is somewhat disappointing that draft legislation giving effect to the 1 July policy announcement is not yet available and no firm guidance has been issued by Treasury or the Government in relation to when that draft legislation will be available for review. The Institute will however make a separate submission to Treasury in respect of that draft legislation when it is ultimately made available for our review.

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We would be pleased to provide to the Inquiry further information in relation to any of the issues identified in this submission as well as attend any public hearings which may be held as part of the Inquiry's deliberations. Please do not hesitate to contact me direct on 02 9290 5623 if you would like to discuss any of these issues.

Yours sincerely



Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia