A speech by Dr Brendan Nelson MP, Chair, House of Representatives' Employment, Education and Workplace Relations Committee, to the IIR/AEOA Conference and Workshop on Employee Share Ownership Plans, Millennium Hotel, Sydney, 23 February 2000.

[Note: Mr Sean Conlon is the new president of the AEOA and, according to the program, Chair of this session.]

Thank you, Mr Conlon.

Ladies and Gentlemen, I welcome this opportunity to address your conference on employee share ownership plans. This conference provides a welcome opportunity to bring you up to date on the progress of the inquiry into employee share schemes currently being finalised by the House of Representatives Standing Committee on Employment, Education and Workplace Relations.

All members of this Committee realise the importance of maintaining contact with the stakeholders in an inquiry. Stakeholders must be able to see clearly that their concerns have been noted and examined at the highest levels of administration in our community. This is an essential element in the democratic process enjoyed by Australians. Opportunities for reporting on progress, such as provided at this conference are essential in discharging our duties, as representatives, to the community and, importantly, demonstrating that citizens have been heard and their concerns are being addressed.

While I am unable to announce any particular recommendations or conclusions that may emerge from this inquiry, I would like to indicate in general terms the direction taken. I can tell you that the drafting process

is well advanced and we anticipate tabling the report sometime in April or May this year.

As I am sure you will appreciate, this area of policy is exceedingly complex. It involves balancing competing issues. Some of these involve taxation, the integrity of the taxation system, equity both within companies and across the community, and promoting the development of the business sector. It is important that we are able to canvass the issues in detail and formulate sensible, workable recommendations that can be taken to the Executive, and ultimately to Parliament, for consideration.

At this point I would like to thank all those people and organisations who have provided information to the inquiry, and who continue to support it by providing additional information and answering specific questions. The Committee has received a considerable amount of very detailed evidence from many interested parties. The evidence has been most useful and the continued interest in the inquiry and support for it is deeply appreciated. Parliamentary inquiries are successful only if there is strong support from the community; and the comprehensiveness of the final report will be possible only because of the enthusiastic support of the stakeholders in this inquiry.

The evidence has pointed not only to the strengths of the existing legislative arrangements but also to the areas that need to be examined in order for employee share ownership schemes to be fostered. The general view of the Committee is that employee share ownership schemes should be promoted. This does not provide a *carte blanche*, however. Schemes open to high-level executives only—as evidence to the Committee and articles in the business press make clear—already seem to be flourishing.

The schemes that need to be actively promoted by way of clear policy initiatives are:

- Those targeted at general employees;
- Those for employees in unlisted companies; and,
- Those for employees, either executives or general employees, of small, so-called "sunrise" companies.

The Committee is focusing on ways to foster these sorts of schemes and promote access to employee share schemes for as many Australian employees as possible, within the policy limitations that I have already mentioned.

I should say at this point that employee share plans are supported by all the major parties in Parliament. For over a quarter of a century provision has been made for such schemes in the *Income Tax Assessment Act*, with clear legislative recognition being made in 1974. Division 13A was enacted in 1995. Prior to the 1996 general election, the Prime Minister committed any coalition administration to fostering still further employee share ownership schemes. This commitment was honoured in the 1996 budget, which saw amendments to Division 13A enacted.

In this respect, Australia is in step with the rest of the developed world. Our major trading partners, the United States, Japan, the European Union, and in particular, the United Kingdom, have extensive employee share plan arrangements. Perhaps the most comprehensive legislated approach is in the United Kingdom, and the Committee is examining that approach closely. While we are in step with other countries, it is clear to the Committee that there is work to be done in this

country to ensure that we have appropriate policy settings that foster the development of employee share plans of the kinds I have mentioned.

Commonwealth administrations, in dealing with employee share ownership schemes, face a number of difficult questions in public policy. The major problem has been to find a way that facilitates employee share plans but does not, at the same time, create a mechanism to facilitate aggressive tax planning or undermine corporate governance.

I have said on another occasion, and repeat it again now, that this inquiry will not make any recommendation that facilitates aggressive tax planning. Nor will it make any recommendation that weakens the high standards required in corporate governance that are required in order to ensure a dynamic, open and resilient market, such as we enjoy in Australia. Witnesses who have appeared before the Committee have fully supported this approach.

Nevertheless, the Committee has identified a number of areas that warrant detailed and extensive examination. Before turning to those I wish to make a few remarks about the purpose of employee share plans.

The nature of employee share plans

Witnesses ascribed to employee share plans a range of purposes. Some advised the Committee that employee share plans are a means of aligning the interests of businesses and employees so as to achieve better business results. Others suggested that employee share plans are mechanisms whereby employees can be rewarded for the success of a business beyond simply collecting a pay packet. Some witnesses suggested that employee share plans are designed, at least in part, to provide tax-effective remuneration benefits to employees. Others

considered employee share plans could function as medium and long-term savings schemes, in effect a form of supplementary superannuation or a savings "pot" for significant life-cycle events. A further argument submitted was that employee share plans should be seen as a means of "democratising" capital; that is, spreading capital ownership and access to capital more widely within the community.

Depending upon the way employee share plans are viewed they may be a savings vehicle, a reward for services performed, an inducement to perform to a certain, higher standard, or they may have a "political" purpose.

The purposes that employee share plans are thought to serve will affect the way that employee share plans are dealt with in legislation and the way that they are taxed. For example, should the increase in value of shares or options in employee share plans be taxed as income or as a capital gain, or in some combination of both rates? The answer to that will be justified by the answer to the question: What is the purpose of an employee share plan?

This question highlights one purpose of employee share plans that did not receive a great amount of attention in submissions or evidence. It is a purpose that, it seems to me, should not be over looked.

While we live at present in economically prosperous times, this has not been translated into tangible benefits for all of our fellow citizens. One result is that suicide, depression, substance abuse, and family breakdown are far too common. The corrosive effects upon our community of unemployment, educational failure, and marginalisation are evident: they produce a raft of social problems that require urgent action.

Ours in not a minimalist, safety-net society; nor do our fellow citizens want it to be that limited. Australians want a pro-active, imaginative, decent society, actively grappling with problems and seeking creative solutions and implementing them. What is required is creative public policy that helps build an inclusive and caring society.

Where do employee share plans fit into this? My point is that the creative public policy of which I speak is not going to be merely one policy, one law or one program. It will be a cocktail of different, but coordinated, approaches. Employee share plans are part of that cocktail.

Specifically, employee share plans bind people more closely to the activities of their fellow citizens who work within a particular organisation. They are one initiative, a simple initiative, that many businesses can make to create a more inclusive workplace.

Employee share plans provide employers with an opportunity to do their part in discharging their obligation to the community. There is not merely an obligation on the community to provide, subject to other considerations, the opportunity for business to succeed. Business must do its part in fostering a healthy community. The business sector has obligations to the community in virtue of the benefits the community confers upon business: social stability and harmony; a peaceful society that provides a strong foundation for business to prosper.

Not only will employee share plans promote productivity and democratise capital, but they can help engage people in the lives of their workplaces, attach people to groups and communities, and in that way enrich their lives. Employee share plans are part of the host of measures responsible members of the business community can implement to go

some way to discharging their responsibilities to the community; that is, meeting their side of the mutual obligation equation.

We can see that employee share plans are part of a larger picture and that the reasons for establishing them extend beyond merely serving the bottom line or rewarding employees. Seeing them in this way also provides a stronger set of reasons to do as much as we can to ensure that as many employees in Australia have access to these schemes; or if they do not have access, then access to some comparable benefit.

There is one final issue I would like to discuss before talking about some specific matters. Unlike the United States, where employee share plans are a central element in retirement planning, in Australia employee share plans are at best regarded as adjuncts to superannuation and other forms of retirement planning.

The primary way that Australians make provision for their retirement is by way of compulsory superannuation contributions. This policy is supported by the overwhelming majority of the Australian community. Unfortunately, evidence is emerging that the amount being saved will not meet the needs of Australia's rapidly ageing population.

This is exacerbated by the fact that, historically, Australians have not been enthusiastic savers.

All this is now beginning to have an effect. The population is ageing; the demands of an ageing population upon the tax dollar is increasing; the level and rate of taxation is not. That there will be a shortfall is clear. What should and can be done about it is one of the major public policy questions that face our community and the Parliament.

Again, I do not think that the solution is likely to be single-sided. Public policy, like truth, as Oscar Wilde said, is rarely pure and never simple. There will be no single policy or program. The most effective response will be a cocktail of policies that work in unison to procure the desired outcome. Employee share plans are part of this cocktail. And one of the matters we must examine is the extent to which encouragement should be given to employees to place part of their employee share plan entitlements into preserved superannuation arrangements.

I would like to turn now to the specific matters that the Committee has identified as restraining the development of employee share plans for general employees, unlisted companies and sunrise firms.

From the evidence available to the Committee there are seven major issues that affect the establishment of, and participation in, employee share plans. These are:

1. The $1,000 limit on the taxation concessions available to employees and employers on tax exempt employee share schemes that operate under Division 13A;

2. The requirement that only ordinary shares or rights to ordinary shares may be offered in an employee share plan operated under Division 13A;

3. The times when tax becomes payable under deferred benefit share schemes. These are the so called “cessation times”;

4. The 5% limit on the number of shares that an employee may hold, or votes the taxpayer may cast or control, in an employee share plan operating under Division 13A;

5. The information that the Government requires in order to monitor the effectiveness of employee share plans and encourage their use through appropriate public policy;

6. The information that employees require in order to make an informed decision and the exemptions that can be given from mandatory disclosure rules; and,

7. The clarity of the existing legislative arrangements.

I would like to make a few comments on each issue in turn.

The $1,000 limit.

A business can obtain a deduction up to $1,000 in respect of qualifying shares issued to an employee under an employee share plan. The deduction relates to the value of the discount.

The Committee was advised, however, that the costs of implementation, compliance, tax sign-off and administration would significantly erode the benefit, to the extent that it would be more cost beneficial to the company to award a similar benefit in cash, fully taxed. The Committee was advised that the $1,000 limit should be both increased and indexed. The figure of $2,000 has been mentioned.

This recommendation would seem to be supported by the results of a survey conducted by KPMG. This survey revealed that 35% of respondents stated that they would introduce a share scheme if the tax exemption currently available were increased to $2,000 per employee, per year.

It is clear that at least in the opinion of some employers, one clear way to increase the number of schemes, and also increase the level of

holdings, is to increase the tax exemption. The countervailing consideration is the cost to revenue and whether there are more effective ways to increase participation and the creation of employee share schemes.

Equities other than ordinary shares or options

At present, the only equities that can be allocated under a share scheme operating under Division 13A are ordinary shares or options. Many witnesses advised the committee to recommend that this restriction be removed. A number of reasons were given.

The Committee was advised that some employers may wish to allocate stapled securities as part of an employee share plan. However, such allocations are not available for the concessions provided under the provisions of Division 13A. In some cases, the company may decide not to allocate any equities at all, thereby depriving employees of any equity participation in their employer.

Other witnesses advised the Committee that ordinary shares confer voting rights upon the holders of the shares. As a result, the owners of small or medium companies may be deterred from offering employee share plans because they may fear losing control of the company to the employees or to a third party who purchases shares from employees.

Other witnesses suggested that equities other than ordinary shares or options should be permitted in order to diminish the risks. Some witnesses even suggested that employee share plans operating under Division 13A should be permitted to offer equities in companies other than the employer company.

These are complex issues. They involve balancing the purpose of an employee share plan against measures that may well foster the creation of schemes and promote an increase in the size of allocations. Also relevant are considerations concerning the integrity of the taxation system and the protection of employee share plan investors and ordinary investors.

Cessation issues

At present, tax must be paid on certain shares or options in employee share plans operating under Division 13A when certain events occur. These "cessation times" are specified in legislation. One such cessation time is set at 10 years after the taxpayer acquired the shares or the options. Other cessation times are when an employee ceases to be employed by the employer who issued the shares, or when the employee retires, resigns or dies. A cessation event may be triggered indirectly by a major lifecycle event such as parenthood.

Many submissions urged that these cessation points be removed. Witnesses testified that, under certain circumstances, the value of shares or options may be taxed, even though the taxpayer does not have access to any actual benefit. The taxpayer may be required to sell their shares or options in order to meet their taxation liabilities.

The argument was made that it is unfair to require a person to dispose of property in order to meet a taxation liability, when a useable benefit from the property has not accrued to that person. A forced sale of shares would dilute the employee's equity in their employer thereby defeating the very purpose for establishing the employee share plan. This acts as a disincentive to participation in

employee share plans, especially for young people who leave one employer for another as part of a natural career progression.

The Committee was advised that the cessation points disadvantage small and medium companies and employee buyouts. They also inhibit the development of share ownership as an adjunct to superannuation and retirement saving.

This raises a matter of general principle: Should shares and options in employee share plans be taxed only at the point of disposal, as many witnesses suggest? Should the present system be partially modified so as to lessen the burden of the present cessation events; and should the modification apply selectively, only to smaller firms and particular classes of employees?

The 5% limitation

Many submissions indicated that an impediment to the creation of employee share plans amongst unlisted, small and medium sized businesses is that, in order for the share or option to be a "qualifying" share, and so attract various taxation concessions, there is a 5% limitation on share or option ownership by an individual employee. There is also a limitation of 5% on the votes at a general meeting over which one individual can exercise control.

In small, unlisted firms of under twenty employees, a single shareholder can exceed these limits.

Moreover, in the case of "sunrise" industries, an executive may be offered a considerable parcel of shares or options, often exceeding 5%, in return for his or her services. Such shares would be unqualifying and, therefore, they would not attract the various taxation concessions.

The Committee has been urged to increase this limit.

There is no doubt that a relaxation of this limit would assist sunrise companies along with other small and medium companies of twenty people or less. The consideration that must be weighed against this is the exposure that other shareholders may have to aggressive takeovers or to executive employees receiving excessively generous grants of shares. Another consideration is that relaxation of this limit may take an employee share plan away from its central purpose and turn it into a scheme to raise capital or provide income by other means.

Monitoring and encouraging employee share plans through public policy

One of the impediments faced by the Committee has been to obtain accurate information about employee share plans operating in Australia. We have not been able to obtain accurate figures on the number of plans, the number of employees involved in employee share plans, the nature of the plans on offer, and the value of the plans.

There have been surveys carried out in this country, by private sector organisations. These, however, lack the comprehensive access to data that is necessary in order to build an accurate picture of employee share plans and properly develop public policy.

The lack of information creates difficulties for the Committee in formulating recommendations. It is difficult for us to estimate the potential revenue effects of various proposed changes when we don't even know the revenue effects of existing share plans.

This is quite unlike the situation in the United States and United Kingdom. In the United States, information about employee share plans is collected by various Federal agencies.

In the United Kingdom, the Inland Revenue collects information about plans and provides clear advice on whether a particular plan meets taxation law requirements. As a result, reliable information is available upon which to base developments in public policy.

The absence of this information is having an effect on other areas of policy. Evidence is emerging that employee share plans are elements in the bargaining process in which employers and employees are now engaging. It is important to know what elements of a bargaining process are important to its success, in order to facilitate the process.

As well, evidence is also emerging that employee share plans are also being used to attract employees. This is tending to create a still more competitive labour market.

The issue is whether some sort of agency ought to be established to monitor the effectiveness of employee share plans and ensure that public policy continues to foster the development of these plans and participation in them.

Related to this is the issue of information about designing and implementing share plans. At present employers can approach a specialist company to design and implement a plan. Or an employer can construct one themselves. In each case, where a plan deviates from a standard arrangement, an employer may have to obtain a private binding ruling from the Taxation Commissioner. This can be time consuming

and, as the Committee heard, the Commissioner may decide to suspend the granting of such rulings until some point of public policy is clarified.

There has to be a better way. One option we are examining is the approach taken in the United Kingdom. Not only does the Inland Revenue monitor the operation of employee share plans and issue taxation compliance certificates, but it actively provides advice on the formulation of employee share plans to companies constructing them, and also actively promotes the idea of employee share plans. This still leaves room for private operators to do what they do now: design specific plans, but they can do so with the assurance that their efforts will comply with the taxation laws.

This reduces implementation costs, which, the Committee has been advised, is a disincentive to some small and medium sized companies.

Disclosure issues

As you would be aware, employee share plans will be popular only if employees understand the risks involved and the way a plan operates. Non-employee shareholders or potential investors require information so that they can obtain an accurate picture of the financial health of a company. In both cases, companies should disclose information about their finances and the details of a scheme in order for employees and other investors to make prudent investment decisions. In this area, some issues that the Committee was urged to consider included:

- What level of disclosure about the nature and size of employee share plans should be mandatory in annual reports?

- Do Australian Accounting Standards require an appropriate level of disclosure, particularly in relation to the issuing of options?

- What level of disclosure is required for employee-investors in unlisted, small and medium sized companies?

Parliament has provided for the protection of investors by way of the Corporations Law. It requires certain sorts of disclosure, by way of prospectus, in certain circumstances.

Witnesses told the committee that constructing a prospectus could be a daunting and excessively expensive business. As such it acts as a barrier to small and medium sized companies, whether they are listed or unlisted. As a result, according to witnesses, the need to issue a prospectus has become the single greatest obstacle in the way of expanding employee ownership in the unlisted company sector of the economy.

Some relief from the prospectus requirements of the Corporations Law is provided in the law itself. For example, no prospectus is required if shares are offered free of charge, or if the offer is made to executive officers or senior managers of a corporation, or the offer is made personally to no more than twenty persons in a twelve month period.

Further relief can be obtained, for listed companies, by way of an exemption provided by the Australian Securities and Investment Commission under Policy Statement 49, subject to certain conditions.

The recently enacted CLERP legislation will simplify and liberalise the disclosure requirements that employee share plan proposals must satisfy. CLERP will do this in two ways. It provides that,

1. an unlimited number of personal offers may be made (as opposed to a limit of twenty under the former legislation); however, only twenty acceptances will be permitted in any twelve month period, subject to a ceiling of $2 million in funds raised;

2. where no more than $5 million dollars is raised through a securities offer, a simplified disclosure document will be permitted, called an "Offer Information Statement", rather than the more expensive and more detailed prospectus.

This goes some way to addressing the suggestion made by a number of witnesses that the prospectus requirements be relaxed when the level of risk associated with an employee share plan is low. There are, however, a number of other disclosure issues that affect small and medium size unlisted companies, which some submissions suggest, will not be adequately addressed either by the CLERP enactment or the operation of Policy Statement 49. These are:

- Companies that do not meet either of the disclosure exemptions contained in the CLERP legislation may fail to be eligible for relief under Policy Statement 49 if they have not been listed for over 12 months on the Australian Stock Exchange. This acts, the Committee has been advised, as a constraint upon large private companies and unlisted sunrise companies offering employee share plans;

- Policy Statement 49 will provide relief only for fully-paid shares and not for partly-paid shares or options, for which payment, other than a nominal one, is required;

- Policy Statement 49 will not provide class order relief from disclosure requirements when more than 5% of a company's capital is being used for an employee share plan. This may inhibit employee buyouts and the offer of shares to employees in sunrise companies.

- The CLERP legislation provides that an offer to grant an option is taken to be an offer to issue the security constituted by the option. Unless an exemption is granted, such an offer requires a disclosure document. In the case of unlisted securities, or offers by unlisted companies, if other disclosure exemptions do not apply, obtaining a value for these securities could be difficult or expensive. Again, these provisions may inhibit the development of employee share plans in unlisted, small and medium sized enterprises.

The Committee is examining these apparent anomalies and the likely impact upon the development of employee share plans in small and medium companies. We are concerned, as I have already mentioned, that the law should assist the creation of, and participation in, employee share plans, while also protecting the revenue base and investors.

Clarity of, and anomalies in, Division 13A of the Income Tax Assessment Act.

A number of witnesses pointed to other anomalies and a lack of clarity in the relevant legislation. Some suggested detailed amendments. I can assure you that the Committee will examine those suggestions in detail. If the matter is a simple technical amendment that would remove uncertainty while not at the same time encouraging aggressive tax planning, then the Committee will look favourably upon them. We have

sought detailed comments from the Treasurer on the problems raised by witnesses.

Although we will finish this report and table it within the next three months, it is likely to take some time for executive government to evaluate the recommendations and transform any response into policy that Parliament can consider.

What we have all learnt from the evolution of the taxation system and especially the past twelve months, is that in an area such as this, designing appropriate legislative initiatives is as much an art as a science. And being an Art, we would do well to recall the words of Hippocrates, the patron of my own profession before entering Parliament:

“Life is short and the Art long; opportunity fleeting; experiments dangerous and judgement difficult.”

There are always solutions. With your support, I am confident we will identify them.

Thank you. I am happy now to take questions.