THE TAX INSTITUTE

18 March 2020

Committee Secretariat
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Parliament House
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By email: TaxRev.reps@aph.gov.au

Dear Sir/Madam

Inquiry into the tax treatment of Employee Share Schemes

The Tax Institute welcomes the opportunity to make a submission to the House of Representatives Committee on Tax and Revenue in relation to the inquiry into the tax treatment of employee share schemes (**ESSs**).

Summary

The Tax Institute welcomed the start-up concessions implemented in 2015. However, there are still significant hurdles for the small to medium enterprises (**SME**) market in adopting ESSs which, in many cases, result in these schemes not proceeding despite the commercial desire to offer employees equity in the business. Major impediments include:

- The costs of advice and implementation;
- Privacy concerns; and
- Specific tax issues.

We have discussed these issues in detail below.

Terms of Reference

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.

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The Committee will inquire into the effectiveness of the 2015 Employee Share Scheme (ESS) 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."

Comments

The Tax Institute welcomed the start-up concessions implemented in 2015. However, there are still significant hurdles for the SME market in adopting ESSs which, in many cases, result in these schemes not proceeding despite the commercial desire to offer employees equity in the business.

These include:

- **Costs of advice and implementation** – Where the ATO template rules are not adopted (eg due to the existence of bespoke shareholders agreements) the advisory/legal fees will be a significant cost. Implementation costs coupled with the additional ongoing costs of administration are often prohibitive to these arrangements.
- **Privacy** – Employee shares are visible by a simple ASIC search. An employee share trust could be used to alleviate this lack of privacy. However, these are complex vehicles which are costly to manage and also require an AFSL. It is therefore difficult to maintain privacy for employees who receive share offers.
- **Exits** – SMEs do not typically want to retain shareholders after they exit the business. This requires the company undertaking a buy-back or some equivalent exit event which has its own tax issues and may create a liquidity issue for the company to fund the exit. These concerns limit the range of employees who may be offered shares in the SME market (ie to senior executives where staff turnover is likely to be less) and can undermine the potential benefits of an ESS that is taken up more broadly.

Some specific tax issues:

- **Taxing point** - The taxing point for employees under Division 83A often results in funding pressures that discourages SMEs from implementing ESSs. Employees may be taxed before they have the cash to fund the tax liability. Forcing them to sell their employee shares is both impractical in an unlisted environment and undermines the purpose of the ESS in the first place. A sale to the company itself (eg a buy-back) may create funding issues for the company. This results in a prevalence of "loan plans" that are not caught by Division 83A to align the taxing point to the receipt of cash by the employee. A deferred taxing point for unlisted companies could alleviate these difficulties.

- The taxing point in every case regardless of size or terms or identity of the employer or employee should be deferred until the equity is monetised. For example, US entities that issue restricted stock options are designed around US tax rules that defer the taxing point until the options are sold. The Australian rules often have the effect of taxing the options on exercise. In our opinion, this is not appropriate.

- 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.

- **Share buy-backs** – The market value rule in s 159GZZZQ(2) may result in an unfunded tax liability for employees in situations where the shares are funded by limited recourse loans and the loan is waived as consideration for the buy-back. An increase in market value creates a CGT liability for employees. Further the need to value the shares for unlisted companies to comply with the buy-back rules is costly itself. A carve-out for certain employee shares in the buy-back rules would assist with employee exits for SMEs. The Institute considers that such a carve-out should be implemented.

- **Debt forgiveness** – Further to the above example, if the market value of the share has fallen below the face value of the loan, the waiver of the loan may result in a debt forgiveness in respect of the difference (and a deemed dividend under section 109F). ATO ID 2003/317 concludes that a discharge of a loan in such circumstances does not give rise to a debt waiver fringe benefit due to the loan being satisfied in full by way of a transfer of property not being considered a release or waiver. However, the income tax treatment of this is not entirely clear.

- **Division 7A issues** – Some practitioners take the view that there is a "one-off" opportunity to fund an employee share acquisition without a complying loan because the loan is made immediately prior to the employee becoming a shareholder. Further acquisitions would need to comply with Division 7A which creates large funding issues where annual minimum repayments must be made. Even if funded by company dividends, the employee is left with a tax liability on the dividends without any cash (as it is applied to repay the loan). The existing exemption in Division 7A for employee shares in section 109NB only applies where Division 83A applies. For example, this could be where the share is acquired for a discount to market value (including a small 1% discount) but not where it is acquired for full value funded by a loan. A broad ESS exemption for Division 7A would prevent these inconsistencies.

- **CGT discount** – Where employee shares are acquired pursuant to the exercise of options, the special acquisition rule in Item 9A of the table in s 115-30(1) (to deem the acquisition date of the share as the date the option was acquired) only applies to "start-ups". For those not eligible for the concession, this requires the shares to be held for an extra 12 months after acquisition before the CGT discount is available which creates funding pressures when the share is required to be sold to fund the tax liability. A broader application of this item to all employee shares would assist other SMEs and more broadly align the holding period to the time under which the underlying economic gain is made (ie from acquisition of the option to ultimate sale of the share).

- **Imputation benefits** – The application of the 45-day rule to dividends paid on employee shares is unclear given the outdated legislative references in Division 1A of former Part IIIA of ITAA 1936 (repealed but still operative). These repealed rules refer to Division 13A rather than its successor Division 83A. Additionally, for employee shares funded by non-recourse loans there may be a "short" position which creates uncertainty and complexity in determining the "delta" of such a position.

- **Employee share trust CGT concessions** – Subdivision 130-D only applies to ESSs where Division 83A has applied but not where the ESS interests where fully funded by a loan for value. As such, the complexities of dealing with CGT events E5 and E7 apply to such loan schemes. A broader

application of Subdivision 130-D to all ESS schemes involving unlisted companies would reduce compliance costs and the risk of unfunded tax liabilities for SMEs.

- The "sole activity" test described by the ATO in TD 2019/13 effectively makes it impossible to use an employee share trust to facilitate a loan funded share plan without there being a CGT consequence as the ATO state that the provision of financial assistance to allow an employee to acquire the shares would breach the "sole activity" test.

- **Valuations** – The safe harbours contained in legislative instrument ESS 2015/1 are limited in scope and apply only to "start-ups". Extending this to SMEs more broadly (eg aggregated turnover of less than $50m) may assist in removing a key impediment to the take up of ESSs being the requirement to conduct formal valuations.

- **Rights and Options** - The start-up concession is unduly restrictive in the case of rights/options in comparison to shares. The start-up concession may apply to shares issued to eligible employees at a discount of up to 15% to market value. However, deferring tax on rights is only possible if the rights' exercise price is greater than or equal to the market value of the company's ordinary shares at the time the rights were acquired. The Institute considers that the administration of these provisions and the rate of discount should be reviewed.

- Given a number of the ancillary issues with issuing ESS shares such as numerous ASIC updates to the Company for the new members and the difficulties associated with removing an employee who ceases employment via a share buy-back, options are often preferable. However, due to the requirement for the exercise price to be at least equal to market value, they are often not as attractive as shares (which may be issued at a 15% discount).

- **The $1,000 tax exemption concession** - The $1,000 tax exemption should be increased or indexed and increased annually. An appropriate amount may be determined through consultation. The starting amount for consultation could be around $5,000.

In conclusion, for the start-up concessions to be truly beneficial and offer employees a real opportunity to participate in the relevant business, the hurdles and issues outlined above need to be addressed. As the concessions stand, the complexity and compliance issues are acting as a deterrent to implementing ESSs.

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If you would like to discuss any of the above, please contact either Tax Counsel, Angie Ananda, on 02 8223 0050 or me.

Yours faithfully,

Peter Godber
President