



Law Council
OF AUSTRALIA

Business Law Section

General Manager
Law Design Practice
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: taxlawdesign@treasury.gov.au

6 February 2015

Dear General Manager,

**TAX AND SUPERANNUATION LAWS AMENDMENT (2015 MEASURES No. #) BILL
2015: IMPROVEMENTS TO THE TAXATION OF EMPLOYEE SHARE SCHEMES**

**INCOME TAX ASSESSMENT AMENDMENT (EMPLOYEE SHARE SCHEMES)
REGULATIONS 2015**

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to provide comments and submissions in response to the Exposure Draft of the *Tax and Superannuation Laws Amendment (2015 Measures No. #) Bill 2015: Improvements to the Taxation of Employee Share Schemes* released on 14 January 2015.

Whilst the Committee welcomes the changes set out in the Exposure Draft, it is concerned the changes do not go far enough to achieve the aims outlined in the Industry Innovation and Competitiveness Agenda to bring the Australian taxing regime in line with the rest of the developed world (and attract and retain talent).

In the Committee's view the following aspects of the exposure draft require further consideration:

1. The position that in most cases ESS interests are to be taxed on revenue account;
2. The lack of choice for employees to be taxed upfront on any ESS interest;
3. The retention of a taxing point at the cessation of employment, even where vesting or disposal restrictions may still apply to an ESS interest; and
4. The limitations on entities that can access the 'start-up' concessions and on the benefits that can be provided.

The Committee also include comments on the transitional rules and on a drafting matter.

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone +61 2 6246 3788
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

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1. Revenue account

The amendments contemplate that, in most cases, the gain relating to the ESS interest will be brought to tax on revenue account. This means that even though the ESS interests are acquired by the employees as an investment, the disposal of the interest will not be eligible for the CGT Discount. Both the United Kingdom (**UK**) and the United States (**US**) provide for either total exemption of the gains relating to ESS interests or at least allow capital gains tax treatment. In both countries capital gains are brought to tax at a lower rate than revenue gains.

2. Election to be taxed upfront

The amendments contemplate that the ESS scheme will either be eligible for deferral or will be taxed upfront, possibly with the amount included in assessable income reduced by \$1,000. Prior to the amendments in 2009 an employee who was eligible for deferral could elect to be taxed upfront i.e. on receipt of the ESS interests. This had the advantage for the employee that any subsequent gain on disposal would be on capital account.

This also provides a benefit to the revenue as tax is potentially received earlier than might otherwise be the case. The Committee also notes that in both the UK and the US, taxpayers have the option of electing to be taxed at the outset. We suggest that such an election be introduced.

The Committee also notes that the \$1,000 reduction amount has been unchanged since 1997 and is well below the level of benefit provided in other jurisdictions.

3. Taxing point on cessation of employment

In relation to tax deferred schemes, the exposure draft has retained a taxing point at the time that an employee ceases employment with the issuing employer. This can result in tax becoming payable on ESS interest before the interest is able to be realised by an ex-employee.

In particular, sale or exercise restrictions may still apply to an ESS interest such that an ex-employee is unable to sell the ESS interest for a period after employment has ceased. However, the ex-employee will be faced with a taxing point at the time of ceasing employment. The Committee considers this to be a highly unfair scenario, especially where an employee is terminated, but is classed as a 'good leaver' under a company's plan. The Committee also notes that other jurisdictions with which Australia must compete for talent, such as the UK and the US (that have significant employee ownership) do not treat cessation of employment as a taxing point. The Committee suggests that this taxing point be abolished.

4. Start-up companies

In many start-up companies, employee share schemes are a vital component of the strategy to recruit and retain the best talent, which is critical to the success of the company. This has been recognised by the inclusion of special tax concessions for employees of 'start-up' companies.

However, to qualify as a 'start-up' company, the company must certain eligibility criteria, including:

- Having 'aggregated turnover' of less than \$50M;
- Each company in the corporate group having been incorporated for less than 10 years; and
- Not be listed on a stock exchange.

These restrictions appear to be arbitrary and difficult to understand in the context of the broader objectives of the reforms. The Committee believes that the overly restrictive criteria will prevent many genuine start-up companies from accessing the concessions.

\$50 million aggregated turnover

It is unclear why a turnover of \$50M has been chosen or whether turnover is the best way to measure a company's eligibility for the rules. The use of aggregated turnover may unduly restrict a company's ability to qualify as a 'start-up' where it receives seed funding from a large investor that results in that investor being grouped for aggregation purposes.

In addition, requiring the application of the grouping provisions in Division 328 of the *Income Tax Assessment Act 1997* may result in significant compliance costs for start-ups, particularly where there are a number of key investors.

Unlisted entities and 10 year rule

It is unclear why, having satisfied the aggregated turnover and 10 year incorporation threshold, which a company that is listed on a stock exchange is excluded from the start-up tax concessions. In addition, the requirement that **all** companies in the corporate group be incorporated for less than 10 years will limit the application of these concessions in industries that require a longer lead time to commercialise products. The restriction may also prevent companies from qualifying where they have acquired an older company to further their business (e.g. to acquire specific software).

Additional valuations

An ESS interest must also satisfy the conditions relating to market value in proposed subsection 83A-33(5). Whether the ESS interest is a share or right, the company will be required to undertake a valuation in order to ensure the market value conditions are complied with. The Committee notes that if the maximum discount on shares or minimum exercise price of rights is not complied with, the whole discount will become taxable to the employee. Given the nature of the start-up companies that this measure is target towards, requiring valuations in order to comply with these conditions is likely to be administratively and financially prohibitive to the company taking advantage of the tax concessions.

Inability to reward/provide benefits

The combination of the \$50 million aggregated turnover threshold, conditions relating to market value (e.g. the 15% discount rule) and the 10% ownership limit imposed on individual employees will restrict the value that can be provided to key employees through an ESS that qualifies under the 'start-up' rules.

For example, a start-up with a market value of \$10,000,000 could issue interests of up to 10% to a single employee, with the benefit being provided to the employee being a maximum of \$150,000 (15% of \$1,000,000). If that benefit is spread over a five year period then, ignoring the time value of money, the benefit would be worth only \$30,000 per year to the employee. The Committee would query whether the quantum of such a benefit would be significant to retain or attract top talent in a global marketplace.

75% rule applicability to rights

The ability to target specific employees will be further restricted by subsection 83A-33(1)(c), which requires that the scheme be available to 75% of full time employees with 3 years' service to the company. Previously this requirement was imposed on share schemes but did not apply to schemes that provided rights to employees. It is unclear why this requirement should apply to rights for a start up scheme.

3 year holding period

Subsection 83A-45(4) requires that ESS interest acquired under a start-up plan be held for 3 years from when a taxpayer acquires the interest (unless the taxpayer's employment ceases). If the start-up company was to be sold and the ESS interests were sold as part of that (whether by agreement of the employee or by reasons of a drag along provision), this provision may not ultimately be satisfied. As a result, employees may enter into the scheme on the basis that any discount would be subject to the start up tax concessions and ultimately through unforeseen circumstances, that discount is subject to income tax.

The Committee recommends an exception be made where, for example, an employee's ESS interest is disposed of as a result of the sale of the company.

10% Ownership limit

While the ownership limit has been increased from 5% to 10%, the Exposure Draft includes deeming provisions that require a taxpayer to assume that shares that can be acquired by exercising rights are included in the ownership test (sections 83A-45(5) and (6) and 83A-130(9) and (10)).

Firstly, it is unclear whether rights that have not yet vested and may be forfeited by a taxpayer are required to be taken into account under these provisions. If this is the case, such a condition would unduly restrict the application of the rules as many of these rights may not ultimately be exercised. It is common place for option schemes to include a number of different exercise prices that represent increasing hurdles to be achieved, as a result, many options are never exercised.

Secondly, the 10% limit applies to the ownership of the company and not the ownership conferred as a result of an ESS. Where ESS interests are provided under a 'start-up' scheme and later a general ESS plan is adopted, an employee who received ESS interest under the 'start-up' rules may be prevented from also participating in a scheme which allows deferred taxation, due to the ownership limits. This is particularly the case due to the interaction of the market value conditions discussed above.

For these reasons, the Committee recommends:

- Rights be excluded from the ownership limit, or at a minimum only rights that are capable of exercise at that time be included; and
- Consider whether the ownership limit could be separated for 'start-up' and general ESS plans.

5. Substance over form - 83A-105(6)(b)(ii)

Proposed paragraph 83A-105(6)(b)(ii) provides:

"the governing rules of the scheme expressly stated that this Subdivision applies to the scheme (subject to the requirements of this Act)"

The inclusion of such a requirement appears to be unnecessary and takes a substance over form approach to the application of the rules.

Further, it is common for scheme rules to be broadly drafted to allow various employee incentive scheme to be operated under a single plan under which the Board, a committee or similar is able to determine the actual awards given to participants. A corporate groups' plan may also cover jurisdictions other than Australia. As a result, it may not be possible to include in the overarching rules that it is intended to be subject to the rules in Subdivision 83A-C, as not all offers made under the rules may be eligible for such treatment.

The Committee recommends that this requirement be removed and the application of the Subdivision be based on satisfying the disposal restriction in proposed paragraph 83A-105(6)(b)(i).

6. Transitional rules

The changes to the circumstances in which a taxpayer may obtain a refund in relation to an ESS interest have been expanded in the Exposure Draft. However, these changes are proposed to apply only to ESS interests acquired after the commencement of the legislation. As the circumstances which this particular amendment is aimed at are largely being removed by the amendments (i.e. tax paid on a right where the option can't be exercised).

The Committee also highlights that as a result of successive law changes, a company may have ESS plans being operated under 3 different taxing regimes. This is obviously a compliance burden on the company and may lead to companies being hesitant to implement new schemes to take advantage of the new laws where it will result in an increased compliance burden. This also highlights the need to optimise the current changes (i.e. so that additional adjustments and amendments are not required).

7. **Drafting clarification**

Proposed sections 83A-33(1) and 83A-35(1) provide that the requirements of proposed section 83A-45 must be satisfied for there to be non-assessability of the discount in relation to both “start-up” companies, as well as in other cases.

Section 83A-45 provides for a number of conditions that must be satisfied in relation to an employee share scheme. Subparagraph (4)(d) provides that “Everyone else who acquires ESS interests under **the scheme** is subject to a corresponding restriction.” [emphasis added]

Where a number of schemes may be operating at the same time within or relating to the one company, potential ambiguity arises regarding the identification of the relevant scheme to which subparagraph (4)(d) is referring. Although the reference in that paragraph to “the scheme”, in the context in which it appears, should logically relate to the scheme in which the interest is being acquired, this is not abundantly clear within the terms of the subparagraph.

An alternative construction would be that subparagraph (4)(d) requires “everyone else” who acquires an ESS interest under another scheme operated by the same company, to be subject to the restrictions contained in subsection (4). This would lead to the conclusion that where there is at least one scheme being operated that does not contain the restrictions required by subsection (4), the holder of an ESS interest in a scheme that does contain such a restriction would not satisfy subparagraph (4)(d).

In order to clarify the position, it is recommended that subparagraph (4)(d) is amended to read as follows:

“Everyone else who acquires ESS interests under the same scheme is subject to a corresponding restriction.”

The Committee would be happy to provide further assistance, or discuss any of the above proposals, if that would assist Treasury. In the first instance, please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or via email: adrian.varrasso@minterellison.com.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'John Keeves', with a long horizontal flourish extending to the right.

John Keeves
Chairman, Business Law Section