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14 July 2020

Mr Jason Falinski MP
Chair
House of Representatives Standing Committee on Tax and Revenue
Parliament House
CANBERRA ACT 2600

Dear Chair

Inquiry into the Tax Treatment of Employee Share Schemes

The Inspector-General of Taxation and Taxation Ombudsman (IGTO) appeared before the Committee at a public hearing on 19 June 2020.

We provide our answers to three questions that were taken on notice at that hearing. The questions and answers are set out in the Annexures to this letter.

We trust this information is useful and of assistance.

The IGTO thanks the Committee again for the opportunity to participate in this inquiry and to appear at the public hearing. If we may be of any further assistance to the Committee, please don't hesitate to contact me on [redacted].

Kind regards,

[redacted]

Karen Payne
Inspector-General of Taxation and Taxation Ombudsman

Annexure A - Inquiry into the Tax Treatment of Employee Share Schemes

Mr THISTLETHWAITE: Yes, I basically want to know what the circumstances are on the deferred basis, where the tax liability then arises. As far as I can see in the legislation there are three circumstances: the employee leaves, is sacked or the 15-year period arises. Are there any others that I'm missing?

Mr Pengilley: Certainly not as far as I'm aware, but we'll probably have to take that on notice to be definitive.

The IGTO submission to the Committee, dated 23 April 2020, includes a Comparison Table [Before and After] taken from the Explanatory Memorandum to the Tax and Superannuation Laws (Employee Share Schemes) Amendment Bill 2015[1] – see the table on page 12 of the IGTO submission – and which notes in respect of the New Law (After):

> In ESS deferred schemes where income tax is deferred, the taxing point is the earliest of:
>
> ***For shares***
>
> - when there is no real risk of forfeiture of the shares and any restrictions on the sale are lifted;
> - when the employee ceases employment; or
> - 15 years after the shares were acquired.
>
> ***For rights***
>
> - when there is no real risk of forfeiture of the rights and any restrictions on the sale of the rights are lifted;
> - when the employee exercises the right, and after exercising the right there is no real risk of forfeiture of the underlying share and the restrictions on sale of the share are lifted;
> - when the employee ceases employment; or
> - 15 years after the rights were acquired.

Accordingly, we consider there are three (3) taxing points for shares and four (4) taxing points for rights to acquire shares as described above.

[1] Explanatory Memorandum to the Tax and Superannuation Laws (Employee Share Schemes) Amendment Bill 2015, p 14.

Annexure B - Inquiry into the Tax Treatment of Employee Share Schemes

Mr YOUNG: …

I'd like to ask Karen a question about these investigations. Of the businesses that are using employee share schemes at the moment, typically what size are they? How many employees do they have?

Ms Payne: I don't know that I have an answer for you on that.

Mr Pengilley: We haven't done investigations of employee share schemes for quite a number of years, certainly not since 2015. We've had a couple of complaints, which were more around providing information to the person and helping them to make sense of things, rather than taking a deep dive into how it has been administered and what the deeper experience has been in dealing with the ATO and the tax system.

Ms Payne: But if you would like for us to reach out to stakeholders, to the profession, and see whether we can get some information on that so that it can be de-identified, because it's coming back through us, we're more than happy to use our stakeholder network to try to find you that information.

Mr YOUNG: Sure, because I think, depending on the size of the business—if typically most businesses that are going to take it up are going to have fewer than 10 employees then we'll approach it in a different way to those that employ maybe over 50 people. I think we need to know that sort of information before we proceed.

Ms Payne: Okay. We will take that on notice, then, and we will come back to the committee with the information we can find from our contacts at the market. Would that be helpful?

Mr YOUNG: Yes, that would be great. Thank you.

We have been informed in our discussions with professional stakeholders (undertaken at the request of the Committee), that there is a broad spectrum of the business market accessing the concessions. One stakeholder estimated that about 50% were very small businesses with (say) less than 5 employees but the remaining 50% were larger businesses, with many more employees and some at the upper limit of the turnover eligibility criteria. The stakeholders that we spoke with did not believe there are any particular market segments which have a predilection for employee share schemes (ESS).

We are also informed that further information should exist and be available for the Committee. We have been informed that the number of ESSs operating in Australia and the number of ESS participants should be readily available through existing reporting that is made to the Australian Taxation Office (ATO) going back to 2010. ESS Annual Reports are required to be lodged with the ATO by 14 August of each year. These reports are required to include, *inter alia*, the number of ESS interests acquired.[2] The Committee may request this information directly from the ATO, as appropriate. As the IGTO has not undertaken a review investigation into the ATO's administration of ESS, we are not able to comment on how readily available this information would be to obtain from the ATO.

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[2] Australian Taxation Office, *ESS – Reporting Requirements for Employers* (12 June 2020) <www.ato.gov.au>.

It has also been suggested that data from the Australian Securities and Investments Commission (ASIC) on the use of Class Orders CO 14/1000 and CO14/1001 in relation to Employee Incentive Schemes for listed and unlisted bodies, respectively, may assist the Committee in augmenting data obtained from the ATO.

In addition to the information about ESS usage and data sources, a key point that emerged through the conversations, however, is that regardless of the size of the entity that is making use of an ESS, there are a range of complexities that need to be considered. In addition to taxation complexities, entities using ESS will also need to consider other reporting consequences - such as accounting rules[3] and financial reporting obligations. Although the taxation rules may introduce simplified valuation rules for example, this will not necessarily flow through to accounting and reporting rules. Accordingly, in these circumstances, the simplification outcome may not in fact be realised.

One of the challenges for the advisers is to ensure that their clients seek professional advice before ESSs are established. Where advisers are engaged at the outset, they are able to assist the clients through the development and implementation of the plan and address the complexities that arise up-front. Where clients have gone some way down the path to establishing the ESS without having been properly advised, it can be difficult to remedy or rectify any errors after the fact. We are aware of product offerings that seek to streamline the creation and implementation of share plans.[4]

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[3] See for example: Australian Accounting Standards Board, *Accounting Standard AASB 2 Share-Based Payment* <www.aasb.gov.au>.

[4] See for example: Deloitte, *Share Plan in a Box* ® <www2.deloitte.com.au>.

Annexure C - Inquiry into the Tax Treatment of Employee Share Schemes

Mr THISTLETHWAITE: I have a technical question. To access the deferred tax option, there are shares or rights. But there's a difference between shares and rights, as I understand it—that is, for shares you need this 75 per cent rule to be met, and three years. Why is there a difference? Why is it that that doesn't apply for rights?

Ms Payne: I don't know the answer to that.

Mr Pengilley: We might have to take that one on notice.

Ms Payne: Shall we take that on notice?

Mr THISTLETHWAITE: Yes, fine. Thanks.

For the purpose of providing our response, we understand the reference to the 75 per cent rule (the 'wide availability rule') and 3 year rule is a reference to the rules provided in subsection 83A-105(2) of the *Income Tax Assessment Act 1997* (ITAA 1997).

In relation to the 2015 amendments to Subdivision 83A of the ITAA 1997, we have been unable to locate in the extrinsic materials an explanation for the difference in the way the rules apply to shares versus rights to acquire shares. However, earlier enactments (in 2009 and 1995) relating to the taxation of ESSs may assist to explain the reason for this difference. Some background also suggests that whereas option schemes are typically only available to Executives, share schemes are more likely to be general in nature and widely available.

In 2009, Subdivision 83A of the ITAA 1997 was enacted. It replaced Division 13A of the *Income Tax Assessment Act 1936* (ITAA 1936). Subdivision 83A like Division 13A applied ESS rules differently between shares and rights to acquire shares. The difference is stated in the Explanatory Memorandum (EM) to Tax Laws Amendment (Budget Measures No. 2) 2009 Bill was to be 'consistent with the current law' (refer – para 1.166 of the Explanatory Memorandum to Tax Laws Amendment (Budget Measures No. 2) 2009 Bill). Accordingly, it may be necessary for the Committee to consider the reasons for the difference in treatment between shares and rights when laws were first enacted to tax these transactions (i.e., examining extrinsic and Parliamentary materials around the original enactment of Division 13A in 1995).

We note that the wide availability rule which now exists in section 83A-105(2) of the ITAA 1997 is similar to a rule in subsection 139CD(5) in Division 13A of the ITAA 1936, which it replaced in 2009. Division 13A was originally enacted in 1995 (refer *Taxation Laws Amendment Act (No. 2) 1995*). Some insight into the differences between shares and rights to acquire shares for the purpose of the wide availability rule may date back to 1995. That is, the enactment of Taxation Laws Amendment Bill (No. 2) 1995 – specifically, clause 139CD of Item 1 of Schedule 2 of that 1995 Bill.

To assist the Committee in its consideration, we have set out extracts of materials we believe may be relevant below.

The introduction of Division 13A of the ITAA 1936 (in 1995)

We have been unable to obtain a copy of Taxation Laws Amendment Bill (No. 2) 1995 (the 1995 bill which introduced Division 13A of ITAA 1936). However, when comparing the EM to that Bill (refer in particular to the extracts below) with amendments that were agreed during the Bill's consideration by Parliament and the resulting enacted legislation, it appears that the wide availability rule for both shares and rights to acquire shares was originally the same but seems to have been revised in the final enacted legislation so that it applied only to shares – that is, only at the time the shares are acquired (including shares acquired by exercising rights to acquire shares) – please see extracts below.

Extract from the EM to Taxation Laws Amendment Bill (No. 2) 1995

Qualifying shares or rights
2.30 Under the new provisions a share or right obtained under an employee share scheme could be a *qualifying* share or right. Concessional taxation treatment (ie. the discount can be assessed in a later year – see paragraph 2.31 below) is available for *qualifying* shares or rights. These are **shares or rights** issued under a scheme where:
- the shares or rights are acquired under an employee share scheme;
- the shares or rights are shares or rights in the employer company or in the holding company of the employer company;
- at the time the share **or right** is acquired each permanent employee is entitled to or has been entitled to acquire shares or rights under the employee share scheme. A transitional provision will apply so that an employee will be taken to have been entitled to acquire shares or rights under an employee share scheme if the shares or rights were offered under an employee share scheme operated by the employer or a holding company of the employer before this Division commenced ***[item 11];***
- the shares are 'ordinary shares' or the rights to acquire shares are rights to acquire 'ordinary shares';
- the employee does not directly or indirectly hold - and after receiving the shares would not hold - more than 5% of the shares of the employer company or a holding company;
- the employee is not in a position, after receiving the shares or rights, to cast or control the casting of more than *5%* of the maximum number of votes at a general meeting of the company. *[New section 139CD/*

Extract from the Senate Hansard, when Taxation Laws Amendment Bill (No. 2) 1995 was considered in Committee (1 December 1995, pages 4572-4573)

Senator MARGETTS (10.54 a.m.)
—by leave—I move:

1.Schedule 2, page 22, proposed subsection 139CD(1), omit the subsection, substitute the following subsection:

"139CD(1) For the purposes of this Division:

(a)a share in a company is a qualifying share if the 6 conditions below are satisfied; and

(b)a right to acquire a share in a company is a qualifying right if the first, second, third, fifth and sixth of the 6 conditions below are satisfied.

Note: Section 139DP excludes certain shares from being qualifying shares.".

2.Schedule 2, page 23, proposed subsection 139CD(5), omit "the share or right", substitute "the share".

Our amendments seek to address the inequity where something that is clearly not income is taxed as unrealised gain. The effect of the government amendment would be to force employees to pay tax when they are given options through executive schemes, including broad executive schemes which provide options which are restricted and in cases where the company does not supply a general scheme.

I do not particularly like executive schemes and strongly support general schemes, which is why I am supporting this proposed section. I hope it will be amended. I don't believe it is right to penalise anyone, even an executive, when they are in a company that does not offer a general scheme. The taxing of unrealised gains is certainly a penalty. I feel there are strong provisions that support general schemes.

I do not see the intention of this as wiping out non-general schemes through penalising employees. The issue here is that many junior executives are eligible for options but the options are restricted and employees are not allowed to exercise them or sell them for seven years. To then consider the options as income and tax people on a benefit they cannot use or sell is to impose a significant cost on people that they must meet from their own pockets.

I do not like tax on unrealised gains. An unrealised gain is not income. Someone has acquired an asset. They may have paid for that asset, but if that asset is no use and it cannot be sold, it is fundamentally wrong to make those people pay up-front on some eventual benefit they may derive. I do not like the attitude that an asset that increases in value or is acquired at less than value should be taxed as income when the likely consequence is that this forces the person to sell the asset. Such law becomes a measure against owning assets. If you want to strip people of certain assets, I would suggest you be more honest and not call them tax cheats, and not try to do it through the tax system.

In this case you are saying that employees in share schemes, who are being tied to the company through options, where benefits are tied to productivity gains through placing a restriction on exercising or selling those options, should be penalised by making them find the money they cannot get from selling their options somewhere else. It seems basically unfair and to go far beyond the intent of supporting general share schemes or eliminating rorts.

The effect of my amendment would be to say that those schemes which offer options in a company will be considered as qualifying even when they do not meet the 75 per cent rule. This applies only where it is an option in the employer company. It would mean that an employee has a deferment before they have to pay tax—a 10-year deferment. I point out that at the moment if they do exercise an option to sell it or if they leave the company, they must pay tax—as they should.

The Corporations Law states that an option must be realised within five years. It is not a massive problem; it just allows the tax to be deferred effectively until the employee can sell it to pay the tax. I note that this entire thing is to get the formula for valuing unlisted options into law so that the options taxed up front will not be taxed at underlying value. This has ramifications far beyond this bill.

Senator SCHACHT (Minister for Small Business, Customs and Construction) (10.57 a.m.)
—The government does not agree with this amendment in principle because we believe it will water down the proposal to require employee share schemes to be offered to most employees of a company. However, to ensure that the general package is passed, the government will not oppose this amendment.

Extract from the *Taxation Laws Amendment Act (No. 2)* 1995

Section 139CD For the purposes of this Division:

*(5) The fourth condition is that, **at the time the share was acquired**, at least 75% of the employees of the employer were, or at some earlier time had been, entitled to acquire:*
(a) shares or rights under the scheme; or
(b) shares or rights in the employer, or a holding company of the employer, under another employee share scheme.

Subsequent changes to the regime for taxation of ESSs have retained this difference between shares and rights to acquire shares for the purpose of this rule. For example, the Explanatory Memorandum to Tax Laws Amendment (Budget Measures No. 2) 2009 Bill states:

> *…To encourage the wide availability of employee share schemes and the associated productivity benefits, the scheme must be operated on a non discriminatory basis. This means that the scheme must be available to at least 75 per cent of Australian resident permanent employees of the employer with three years service (whether continuous or non-continuous service)*
>
> *… Schemes must be broadly available (in respect of shares)*
>
> *1.165 The employer must offer a scheme or schemes that are available to at least 75 per cent of the Australian resident permanent employees of the company with three or more years service (whether continuous or non continuous). This means over all the schemes that the employer offers, more than 75 per cent of Australian resident permanent employees with three or more years service must be able* ***to access shares*** *under at least one of those schemes. [Schedule 1, item 1, subsection 83A-105(2)]*
>
> *1.166 Consistent with the current law, this requirement does not apply to schemes that offer only rights to acquire a share, rather than shares.*