PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

Owning a Share of Your Work: Tax Treatment of Employee Share Schemes

House of Representatives Standing Committee on Tax and Revenue

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Chair's Foreword

Australia has an enviable record of innovation, invention and scientific inquiry, yet it has a deplorable record of translating these achievements into meaningful commercial outcomes. While scientific inquiry for the sake of inquiry is too often diminished, the lack of linkages between our world class research institutions and commercial communities is detrimental to our economic and social futures. It is doubly concerning when too often this research is commercialised in other nations.

Indeed, when you look at the 20 largest firms in the United States by capitalisation, the oldest was established in 1975, however, in Australia a similar exercise yields you with the result that the youngest of the top 20 listed on the ASX is Woolworths, which was established in the 1930s.

Why does any of this matter, and how do Employee Share Schemes (ESS) play a role in reversing the situation?

In short, it matters because new businesses, innovation and start-ups are the engine of higher productivity in our country. Higher productivity leads to sustainably higher wages, better products and services, more competition and more choice. All of these outcomes directly impact on the quality of life that hard working Australians enjoy. Productivity is what makes life better, more affordable and easier.

All successful, and indeed some unsuccessful, start-ups have ESS as a core feature. Whether here or in other parts of the world, innovative companies all have a large part of their companies owned by their workers.

And this is another point of principle that some of even the most ruthless corporate titans agree on: it is not fair for those people who are in large measure responsible for the success, or failure, of an organisation to not share in the spoils of what they are building. Yet in Australia our public policy has been designed to deny workers access to that entirely reasonable principle.

There are too many reports to cite that show alignment between a company's workforce and its owners has benefits not only to those two stakeholders but also to the nation at large. And yet, the institutions that have been empowered to promote productivity and rational policy making have for over a decade or more sought to stymie the introduction of these schemes.

This inquiry found what previous research has uncovered: that ESS are a public good, the benefit of which is far reaching. Secondly, that current policy settings have acted to discourage, inhibit and in most cases outright block the use of such schemes. In some extreme circumstances companies cited Australia's policy settings as reasons for listing in other jurisdictions and keeping operations out of Australia. Third, and most seriously, public institutions that are meant to be promoting the general welfare of our nation have instead shown little interest in this policy area.

As the research paper from the Office of the Chief Economist found:

> Firms with share based payments had on average a lower level of employee churn, higher wages per employee and higher labour productivity, compared to other firms of a similar size or age. This productivity difference was strongest for SMEs.[1]

The Report makes two groups of recommendations: Option A recommends that ESS be treated as capital for the purposes of taxation and dealt with under the capital gains tax regime. If this option is taken up then most of the challenges that Australian businesses face in implementing ESS fall away. The other significant recommendation of this option is the removal of most of the regulatory regime that was initially designed for retail consumers not employees working at the company. The reasons for this are that the regulatory regime is not useful, most start-ups cannot meaningfully value themselves and doing so costs valuable money that could otherwise be used on business development. And in any case the employee is unlikely to be contributing financially to the scheme.

Option B borrows from many of the recommendations made by the Nuttall review in the United Kingdom (UK). It reduces conflicts between the Tax System and the Corporations Law. It further seeks to encourage the use of ESS by reducing the cost and complexity of implementing a scheme.

[1] Department of Industry, Innovation and Science, 'The performance and characteristics of Australian firms with Employee Share Schemes', Research Paper 4/2017, June 2021.

Guerdon Associates made the point:

> Australia needs to step up and, at least, provide taxation that is comparable. Why relocate to Australia when our existing, entrepreneurial, high growth listed entities needing more scale can only offer equity taxed at a 49 per cent marginal rate when Singapore offers 20 per cent, the US 25 per cent, or the UK, under its various schemes, as low as 15 per cent.[2]

In other words, the benefits of having the correct policy settings in this area could lead to material economy-wide benefits.

This Report highlights the successes and failures in public policy settings in this area, but also what could be done to create better alignment between corporate purpose and public good. The changes announced by the Government in the budget are a significant step forward, removing some of the most egregious barriers to the use of ESS. The following chapters highlight some of the steps that could be taken to make Australia a global leader in this area.

Mr Jason Falinski MP

Chair

[2] Guerdon Associates, Submission 21, p. 2.

Contents

Abbreviations

AFSL	Australian Financial Services Licence
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
ESOP	Employee Share Ownership Plan
ESS	Employee Share Scheme
FBT	Fringe Benefits Tax
ISO	Incentive Stock Option
IPO	Initial Public Offering
PwC	Pricewaterhouse Coopers
PDS	Product Disclosure Statement
SME	Small to Medium sized business Entity
UK	United Kingdom
USA	United States of America

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Terms of Reference

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.

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.

List of Recommendations

Recommendation 1

2.43 The Committee recommends that the Australian Taxation Office obtains and publishes up-to-date data on Employee Share Scheme use.

Recommendation 2

2.45 The Committee recommends that the Australian Taxation Office establish a public awareness program to inform current and potential business owners of the existence and benefits of Employee Share Schemes, and where and how to access the available resources.

Recommendation 3

2.47 The Committee considers any changes to legislation resulting from this inquiry and the 2019 Treasury consultation referred to in Chapter 4 of this report should be reviewed by the Productivity Commission five years after the date of commencement of the changes.

Recommendation 4

2.50 The Committee recommends that the Productivity Commission investigate how the use of employee ownership trusts can be facilitated and encouraged.

Recommendation 5

2.51 The Committee recommends that the Productivity Commission explore the structure of Employee Share Schemes and their related taxation treatment in other countries, and how this could be adapted to the Australian taxation system to support productivity and innovation.

Recommendation 6

3.75 The Committee recommends that the following changes be made to the definition of a 'start-up' for tax concession purposes:

- The definition be extended to listed companies that otherwise fulfil the criteria to be considered a 'start-up'.

- The aggregated turnover test be removed to relate to wholly owned groups or entities that can be shown to be controlled by the entity as per the definitions of control under the *Corporations Act 2001*.

Recommendation 7

3.79 The Committee recommends that the definition of 'safe harbour' valuation contained in Legislative Instrument – *Income Tax Assessment* (ESS 2015/1) be extended to all unlisted companies.

Recommendation 8

3.82 The Committee recommends increasing the $1,000 limit in section 83A.35(2)(a) of the *Income Tax Assessment Act 1997* to $50,000.

Recommendation 9

3.84 The Committee recommends that the Government remove the taxation point on the cessation of employment by removing sections 83A-115(5) and 83A-120(5) of the *Income Tax Assessment Act 1997*.

Recommendation 10

4.70 The Committee recommends that the Government proceed with the proposals announced on 13 November 2018 and discussed in the Treasury Employee Share Schemes Consultation Paper dated April 2019.

Recommendation 11

4.72 The Committee recommends that the requirement for a maximum 15 per cent discount under the *Income Tax Assessment Act 1997* start-up regime be scrapped.

Recommendation 12

4.73 The Committee recommends that the Australian Taxation Office simplify its documentation to no more than two pages, and make recommendations to the Government of any legislative changes that could further simplify this process.

4.74 The Committee recommends that the Australian Taxation Office establish a one stop shop approach to ESS, including documentation, processes and Australian Securities and Investments Commission reliefs to enable start-ups in particular to find all they need in one place, combined with a help line to answer any questions specific to their circumstances.

Recommendation 13

4.75 The Committee recommends that the Australian Taxation Office re-instate the option for lodgement of the ESS annual report in a spreadsheet format.

Recommendation 14

4.79 The Committee recommends that a 'safe-harbour' methodology be introduced for ESS buy-backs for the purposes of determining the dividend / capital split and administrative treatment be allowed when no part of the purchase price paid under an ESS buy-back is deemed to be capital.

Recommendation 15

4.82 The Committee recommends that the Australian Taxation Office (ATO) clarify whether sections 109F(4) and 245-35(a) of the *Income Tax Assessment Act 1997* and ATO Interpretive Decision *Fringe Benefits Tax* (2003/317) mean that Fringe Benefits Tax is not in fact payable for discharged ESS loans.

Recommendation 16

4.85 The Committee recommends that the Australian Taxation Office include in its examples of 'merely incidental' activities in Taxation Determination Income tax: what is an 'employee share trust' (2019/13), actions that are taken in common corporate transactions such as rights issues, demergers and other capital raising transactions.

Recommendation 17

4.87 The Committee recommends removing the real risk of forfeiture requirement for shares and removing the 75 per cent offer requirement for shares.

Recommendation 18

4.88 The Committee recommends that the Australian Taxation Office expand its model documents to include documents similar to those produced by the United Kingdom Department for Business Innovation and Skills.

1. Introduction

Inquiry Overview

1.1 On 6 February 2020, the House of Representatives Standing Committee on Tax and Revenue (the Committee) adopted an inquiry referred by the Treasurer, the Hon Josh Frydenberg MP, to inquire into and report on the tax treatment of Employee Share Schemes (ESS) (the inquiry).

1.2 The Terms of Reference for the inquiry are set out in the front pages of this report.

1.3 On the same day the Committee announced the inquiry and called for written submissions from relevant individuals and organisations.

1.4 In total, 35 submissions were received. Four were confidential and two had the name withheld. Submissions are listed at Appendix A.

1.5 The Committee held three public hearings in Canberra. Details of public hearings are listed at Appendix B.

1.6 At the hearings on 4 and 19 June 2020, the Committee heard primarily from government agencies, and legal and tax experts about the effects of the policy and related rules.

1.7 At the hearing on 16 July 2020, the Committee heard from businesses with first-hand ESS experience about how the rules worked in practice.

1.8 Submissions and transcripts for all public hearings can be found on the Committee's website.

1.9 The Committee acknowledges the thoughtful and comprehensive contributions of witnesses. All the evidence brought to the attention of the Committee, both written and verbal, has been given careful consideration.

Report Outline

1.10 In undertaking this inquiry, the Committee was concerned as to what further reforms, if any, should be made to the taxation and administrative treatment of ESS to bolster productivity by encouraging entrepreneurship and supporting start-up companies in Australia.

1.11 The remainder of this chapter gives an overview of the evolution of the ESS regulatory framework. The following chapters in the report broadly mirror the inquiry's terms of reference.

1.12 The report highlights the benefits, but also the difficulties in measuring the usage of ESS in Australia (Chapter 2), before examining the effectiveness of the reforms brought about by the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Act 2015* (2015 Act) and its impact on the *Income Tax Assessment Act 1997* (Income Tax Assessment Act) (Chapter 3).

1.13 The report then examines whether any further reforms are appropriate to ensure the current taxation treatment of ESS remains relevant, in particular for start-up companies. The report focuses on the Income Tax Assessment Act and the *Corporations Act 2001* (Corporations Act), which both regulate the ESS regime in Australia, and the interaction between the Corporations Act and Australian Securities and Investments Commission (ASIC) class orders.

1.14 This report has adopted two roadmaps as recommendations. The first roadmap is contained in Recommendations A and B. In the event that the Government would prefer a more iterative approach the remaining recommendations present an alternative roadmap (see 'List of Recommendations' at page xvii).

Recommendation A

1.15 The Committee recommends that Employee Share Schemes be treated as capital for the purposes of taxation. That a tax liability would arise on the disposal of the assets granted through an Employee Share Scheme using the current capital gains tax regime.

Recommendation B

1.16 The Committee recommends that the Government grant regulatory relief to companies issuing shares under an Employee Share Scheme so that disclosure requirements are minimal unless employees are being asked to contribute financially.

Employee Share Schemes in Australia

1.17 ESS 'involve an employer offering shares, options or other financial products to employees as part of an employee's remuneration package.'[1]

1.18 There are three classes of ESS in Australia: taxed-upfront schemes; tax-deferred schemes and schemes focusing on start-ups.[2]

1.19 Compared to other economies, Australia has a relatively low uptake of ESS. The 2014 Industry Innovation and Competitiveness Agenda emphasised the need for Australia to remain competitive in the global economy, stating that:

> Other advanced countries are aggressively reforming their economies. They are reducing barriers to trade in goods and services, reining in inefficient public spending, reducing taxes, deregulating and improving competition, stimulating entrepreneurship, investing in infrastructure and giving research a greater commercial focus.[3]

1.20 In the past decade or so, several regulatory reforms have been implemented to bolster entrepreneurship in Australia and support start-up companies. This chapter provides an overview of these reforms.

The current regulatory environment

1.21 ESS are regulated by certain provisions of the Corporations Act. These provisions give rise to a number of obligations relating to disclosure, financial services licencing, advertising, hawking, managed investment schemes and the on-sale of financial products.[4] It is fair to say that these obligations provide no consumer or employee benefit, are costly, onerous and only serve to generate work for legal firms. They further interact with the Income Tax Assessment Act in contradictory ways that require ASIC to grant relief, which they do slowly and often arbitrarily, costing often hundreds of thousands of dollars.

1.22 To reduce the regulatory burden for companies offering ESS, ASIC created class orders CO 14/1000 (for companies listed on an eligible financial market)

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1 Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 3.

2 Mr Bede Fraser, Principal Adviser, Individuals and Indirect Tax Division, Revenue Group, Treasury, *Committee Hansard*, 4 June 2020, p. 1.

3 Australian Government, *Industry Innovation and Competitiveness Agenda*, 2014, p. IV.

4 Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 4.

and CO 14/1001 (for unlisted companies). However, these are limited and are not found to be useful by those attempting to establish ESS.

1.23 The class orders provide conditional relief from the following provisions of the Corporations Act:

- the requirement to lodge a disclosure document with ASIC for the offer;
- the requirement to hold an Australian Financial Services Licence (AFSL) for the incidental provision of financial services in connection with the scheme;
- the advertising and hawking provisions;
- the requirement to register a managed investment scheme for a contribution plan (listed bodies only); and
- the on-sale provisions.[5]

1.24 ESS are also currently subject to provisions in the Income Tax Assessment Act. Individuals and any related entities are taxed on any discount they receive on an issue of an ESS interest. The amount of tax payable depends upon the conditions of the relevant ESS and individual circumstances.

The 2009 regulatory reforms

1.25 In 2009, reforms were made to the taxation regime to 'better target eligibility for [ESS] tax concessions', 'reduce opportunities for tax avoidance' and 'protect Commonwealth revenues needed to support jobs and invest in vital nation-building in the face of the global recession.'[6]

1.26 The key features of the reforms were:

- the default position being upfront taxation for both shares and options;
- deferral of tax being limited to schemes where there is a risk of the employee forfeiting the shares or options, and schemes provided through salary sacrifice (up to $5,000, and subject to conditions);
- qualifying conditions being applied to access deferral arrangements; and
- for options, a deferred taxation point when there is no risk of forfeiture or when any restrictions on the sale or exercise of the options are lifted (vesting point).[7]

5 Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 7.

6 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, Income Tax (TFN Withholding Tax (ESS)) Bill 2009, p. 13.

7 Senate Standing Committee on Economics Legislation, Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 [Provisions], June 2015, p. 7.

1.27 The Law Council noted that 'prior to 2015 the regime had reached a point where the take-up, or the rollout, of employee equity, because of its complexity, had significantly reduced.'[8]

1.28 Between 2004 and 2009, the percentage of employees receiving shares as an employment benefit reportedly declined from 5.9 per cent to 3.4 per cent.[9] This coincided with the 2009 reforms, which were 'argued by the business sector to have discouraged the incidence of ESS.'[10]

1.29 However, despite this evidence government departments and agencies consistently argued that policy settings had not impacted the deployment of share schemes. The Department of Industry, Innovation and Science found that 'the incidence of ESS increased across almost all firm sizes, ages and sectors and showed little change in 2009–10.'[11]

1.30 The Department noted that ESS intensity (the proportion of ESS-based payments in relation to salaries) had the largest decline in 2008-2009, but attributed this to 'poor or uncertain economic conditions such as the global financial crisis [rather] than policy changes.'[12]

1.31 Throughout this Inquiry, the Committee noted that Treasury showed little interest in this policy area. Indeed, their submission to the Committee and evidence presented consistently stated that they had little to no data on the policy area, nor were they likely to gather any. It was therefore very surprising to see in the Budget Papers that Treasury had been able to cost the impact of removing the taxation point at the cessation of employment. Given the attention and interest that Treasury showed throughout this inquiry, it seemed curious that they were able to provide such detailed costings to the Government.

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8 Mr Andrew Clements, Member, Law Council, *Committee Hansard*, Canberra, 4 June 2020, p. 11.

9 Australian Bureau of Statistics (ABS), 'Australian Labour Market Statistics', July 2005, p. 1; ABS, 'Employee Earnings, benefits and trade union membership, Australia', 2010, p. 58.

10 Department of Industry, Innovation and Science, 'The performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 3.

11 Department of Industry, Innovation and Science, 'The performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 15.

12 Department of Industry, Innovation and Science, 'The performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 15.

1.32 Therefore, it was no surprise that a Treasury review in 2013 indicated that the 2009 measures were 'broadly meeting [their] objectives.'[13] The review also noted that 'concerns have been raised that the tax treatment of ESSs may have a negative impact on the ability of some sectors of the economy to attract employees, such as start-up companies.'[14]

The 2015 regulatory reforms

1.33 In 2014 the Government conducted public consultations on ESS taxation treatment and ESS administrative arrangements for start-ups in response to concerns raised across the business community. This resulted in the 2015 Act, which commenced on 1 July 2015.

1.34 These reforms were intended to 'help better realise the potential of ESS, and ensure Australian firms are able to remain internationally competitive in attracting and retaining talented employees,'[15] and align with the Industry Innovation and Competitiveness Agenda.[16]

1.35 The key features of the 2015 Act included that:

- all companies' employees who are issued options to be able to defer tax until the exercise of the options;
- extension of the maximum time for tax deferral to 15 years;
- increasing the limit on individual employee ownership from five per cent to 10 per cent;
- new ESS concessions for start-up companies, including no up-front taxation if shares or options are held for three years and exemption from tax where the discount on shares is 15 per cent or less;
- the Tax Commissioner be able to approve optional 'safe harbour' valuation methodologies; and
- employees to obtain a tax refund if rights lapse or are cancelled.[17]

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13 Treasury, 'Post Implementation Review – Better targeting the concessions for Employee Share Schemes', 21 November 2013, p. 5.

14 Treasury, 'Post Implementation Review – Better targeting the concessions for Employee Share Schemes', 21 November 2013, p. 3.

15 Senate Standing Committee on Economics Legislation, Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 [Provisions], June 2015, p. 14.

16 Treasury, 'Employee Share Schemes and Startups', <https://treasury.gov.au/consultation/employee-share-schemes-and-startups>, viewed 28 January 2021.

17 Senate Standing Committee on Economics Legislation, Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 [Provisions], June 2015, pp. 4-5.

1.36 The effectiveness of the legislation was designed to 'be measured by the change in take-up of ESS among small to medium sized business entities (SME)'. A five-year review, from the enactment date, was proposed in the draft legislation explanatory memorandum.[18]

1.37 In 2015, the Productivity Commission raised some concerns about these reforms and recommended a review by 30 June 2020. As a result, the Productivity Commission recommended reviewing the use of tax concessions for start-up companies and eligibility requirements for such concessions. The Productivity Commission also suggested removing the deferred taxation point at cessation of employment.

Recent regulatory reforms

1.38 Further to the 2015 reforms, on 13 November 2018 the Government announced a proposal to 'simplify and expand the current regulatory exemptions that apply to an employee share scheme,' including by:

- creating a dedicated exemption for disclosure, licensing, advertising and on-sale obligations under the *Corporations Act*;
- increasing the value limit of eligible financial products that can be offered in a 12-month period from $5,000 per employee to $10,000 per employee;
- expanding ESS to include contribution plans, where an employee can make a monetary contribution to acquire eligible financial products; and
- allowing small businesses to offer ESS without publicly disclosing commercially sensitive financial information unless they are otherwise obligated to do so.[19]

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18 Explanatory Memorandum, Tax and Superannuation Laws Amendment Employee Share Schemes) Bill 2015, p. 49.

19 Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 2.

2. Understanding Employee Share Schemes

2.1 In Australia, Employee Share Schemes (ESS) are considered to be 'an important mechanism to encourage start-up activity by enabling Australian employers to improve cash flows and attract and retain talented staff at lower rates of wage compensation.'[1]

2.2 A research paper from the Office of the Chief Economist found that:

> Firms with share based payments had on average a lower level of employee churn, higher wages per employee and higher labour productivity, compared to other firms of a similar size or age. This productivity difference was strongest for SMEs.[2]

2.3 This chapter examines the benefits of ESS to individuals, employers and the economy, and the limitations that prevent businesses and the community from benefiting from the full potential offered by ESS.

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1 Department of Industry, Innovation and Science, 'The performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 2.

2 Australian Government, 'The performance and characteristics of Australian firms with Employee Share Schemes', Research Paper 4/2017, July 2017, p. 1.

Employee Share Scheme benefits

Attraction and retention of talent

2.4 According to the Department of Industry, Innovation and Science, the attraction and retention of valuable employees has been cited by Australian firms as the main reason for introducing ESS.[3]

2.5 For example, Minter Ellison commented: 'for start-up companies, these concessions are pivotal in enabling the start-up company to attract and retain talent at a point when those start-ups lack credit and are "cash poor."'[4]

2.6 StartupAUS suggested that tech start-ups, in particular, stood to benefit from ESS when recruiting staff:

> In technology, where competition for talent is global and fierce, prospective employees are often able to choose from a range of high-potential employers, each of which will invariably offer a share of the company as part of the compensation package. Equity/options packages are ubiquitous in the global technology talent landscape - Australia's ability to compete on this score is fundamental to our ability to attract and retain world class talent.[5]

Support for jobs and businesses during crises

2.7 StartupAUS noted: 'fundamentally, employee share schemes are about jobs,'[6] and using ESS 'can help cash-strapped businesses employ more staff in difficult circumstances, driving employment growth.'[7]

2.8 The Committee heard that companies were seeking 'ways to defer cash remuneration payments,' such as implementing ESS, in response to the challenges posed by the COVID-19 pandemic.[8]

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3 Department of Industry, Innovation and Science, 'The performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 2.

4 Minter Ellison, *Submission 26*, p. 5.

5 StartupAUS, *Submission 30*, p. 3.

6 StartupAUS, *Submission 30*, p. 3.

7 StartupAUS, *Submission 30*, p. 3.

8 Pricewaterhouse Coopers, The Group of 100 Incorporated (G100), Corporate Tax Association (CTA), Business Council of Australia (BCA), *Submission 28*, p. 1.

2.9 Palantir Technologies suggested that the COVID-19 pandemic 'has definitely highlighted the need to strengthen ties between employer and employees to endure the economic impact of the virus...[and] strengthening that relationship can be done through a simple and manageable ESS regime.'[9]

Higher productivity

2.10 Evidence to this inquiry suggests that ESS may increase productivity. For example, StartupAUS said that 'widespread employee ownership generates higher productivity, with workers' incentives strongly aligned with employers.'[10]

2.11 Employee Ownership Australia noted that 'consistently, those companies which have got whole-of-employee ownership have outperformed the ASX 200...there are productivity gains which are greater and, indeed, greater for small firms.'[11]

2.12 The Department of Industry, Innovation and Science's review of the performance and characteristics of Australian firms with ESS referred to a Melbourne University study, which found 75 per cent of surveyed businesses agreed that having an ESS encouraged increased productivity.[12]

Greater entrepreneurship

2.13 The ESS deferred tax rules are largely targeted at start-up companies, in an effort 'to encourage greater entrepreneurship and so that good ideas can be commercialised in Australia.'[13]

2.14 ESS are particularly important for encouraging the development of technology firms, as 'globally, technology firms heavily utilise equity-based

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9 Mr Timothy Hamilton, Legal Counsel, Palantir Technologies, *Committee Hansard*, 16 July 2020, Canberra, p. 1.

10 StartupAUS, *Submission 30*, p. 3.

11 Mr Andrew Clements, Deputy Chair, Employee Ownership Australia, *Committee Hansard*, 16 July 2020, Canberra, p. 11.

12 Department of Industry, Innovation and Science, 'The Performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 4. See also Ingrid Landau, Ann O'Connell and Ian Ramsay, *Incentivising Employees: The theory, policy and practice of employee share ownership plans in Australia*, February 2013.

13 Australian Government, *Industry Innovation and Competitiveness Agenda*, 2014, p. XX.

compensation, so it is no surprise that this is an issue of importance to Australian companies in this sector.'[14]

Fairer distribution of economic gains

2.15 It was suggested during the inquiry that ESS could assist with sharing the financial benefits of a successful business.

2.16 StartupAUS noted that 'in an era where successful high-growth private businesses regularly deliver polarised wealth to founders, sharing company ownership broadly among the employee base can distribute the gains more evenly and spread the economic value much more quickly through the system.'[15]

Measuring usage of Employee Share Schemes in Australia

2.17 Despites the apparent benefits generated by ESS for businesses, their employees and the economy, 'the incidence of ESS in Australian firms is growing but appears low relative to European and US firms.[16]

2.18 In 2014-15, 'ESS payments grew to just over $2 billion in 2014–15 accounting for approximately 0.4 per cent of total wages and salaries in Australia.'[17]

2.19 In comparison, in the 2014 – 2016 period, 3.6 per cent of the United Kingdom (UK) population held some form of employee shares. However, the uptake in the UK is still considered to be relatively low with just over 13,000 companies operating some form of tax-incentivised ESOP [Employee Share Ownership Plan].[18]

2.20 The Committee was interested in hearing about the usage level in Australia and the possible hurdles that prevented a higher uptake of ESSs and limit the effectiveness of the *Tax and Superannuation Laws Amendment (Employee*

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14 StartupAUS, *Submission 30*, p. 1.

15 StartupAUS, *Submission 30*, p. 3.

16 Australian Government, 'The performance and characteristics of Australian firms with Employee Share Schemes', Research Paper 4/2017, July 2017, p. 14.

17 Australian Government, 'The performance and characteristics of Australian firms with Employee Share Schemes', Research Paper 4/2017, July 2017, p. 1.

18 Scott Corfe, James Kirkup, *Strengthening employee share ownership in the UK*, February 2020

Share Schemes) Act 2015 (2015 Act). However, the lack of up-to-date data made it a difficult picture to paint.

Lack of up-to-date data

2.21 One of the difficulties with determining the extent of ESS use in Australia was said to be the lack of published data on the subject. Professor Andrew Pendleton advised:

> Unfortunately, there is very little hard information available to assess either the take-up of the start-up concessions or whether the use of options/shares granted under the concession contribute to the achievement of broader policy goals. The ATO do not routinely publish statistics on the take-up of share schemes by companies or individuals. Nor, to date, has there been any government-conducted or sponsored research on the start-up concession and its outcomes.[19]

2.22 Treasury advised that taxation statistics for ESS use by number of employees were updated annually, but that tax data was produced on a delayed basis to allow individuals enough time to lodge their returns and for the Australian Taxation Office (ATO) to quality assure the data.[20] Yet, they were able to provide up-to-date data to inform ESS changes in the 2021 Budget. The Committee was surprised and found Treasury's costing of the changes to ESS in the budget curious.

2.23 According to Treasury, access to the ESS tax exemptions and deferrals are 'up from 2015':

> In 2015-16, there were 182,000; that's gone up to 187,000 in relation to the upfront schemes. For the deferred schemes, there were around 72,000 in 2015-16 and 74,800 in 2016-17.'[21]

2.24 Treasury acknowledged that as there was 'only two years of data to identify what's happened since 2015' and that they 'haven't got a great sense of the take-up.'[22]

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19 Professor Andrew Pendleton, *Submission 22*, p. 2.

20 Treasury, *Submission 31*, p. 1.

21 Treasury, *Submission 31: 4*, p. 1.

22 Mr Bede Fraser, Principal Adviser, Individuals and Indirect Tax Division, Revenue Group, Treasury, *Committee Hansard*, Canberra, 4 June 2020, p. 4.

Awareness of Employee Share Schemes

2.25 Evidence presented during this inquiry suggests that the uptake of ESS could be improved by assisting businesses and employees to access relevant information and resources.

2.26 The Taxation Law Committee of the Law Council of Australia (Law Council) emphasised the need to promote employee ownership and the need for a 'better understanding of what's available in the market, better understanding by business, more targeted development of programs that business can use and a coordinated body which promotes employee equity.'[23]

2.27 Succession Plus told the Committee:

> Unfortunately, in Australia, ESOP is not widely known, understood or utilised…business owners generally are unaware of ESOP as a strategy, believe it is expensive and/or complicated and perceived to be mainly for listed companies/larger corporates.[24]

2.28 The Department of Industry, Innovation and Science similarly reported that large and very large firms (with more than 200 employees) are three to five times more likely to have an ESS than smaller businesses.[25]

2.29 However, Treasury reported that 'the ESS component of total remuneration is on average 4.5 times higher for small and medium enterprises'[26], indicating that while larger firms use ESS more frequently, they are more important for small and medium firms.

2.30 By contrast, the Inspector-General of Taxation and Taxation Ombudsman reported:

> 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

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23 Mr Andrew Clements, Member, Taxation Law Committee of the Law Council of Australia (Law Council), *Committee Hansard*, Canberra, 4 June 2020, p. 10.

24 Succession Plus, *Submission 15*, p. 1.

25 Department of Industry, Innovation and Science, 'The performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 5.

26 Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 3.

> spoke with did not believe there are any particular market segments which have a predilection for employee share schemes.[27]

How does Australia's usage of Employee Share Schemes compare to other countries?

2.31 According to Guerdon Associates:

> Australia needs to step up and, at least, provide taxation that is comparable. Why relocate to Australia when our existing, entrepreneurial, high growth listed entities needing more scale can only offer equity taxed at a 49 per cent marginal rate when Singapore offers 20 per cent, the US 25 per cent, or the UK, under its various schemes, as low as 15 per cent.[28]

2.32 However, the Committee felt that Treasury continued to cast doubt on the benefits of ESS by noting that it is 'hard to compare specific elements of different countries' tax systems as 'tax systems across countries vary in fundamental ways, including the rates and thresholds of the personal income tax system, retirement income schemes and concessions, and the taxation of capital gains.'[29]

2.33 However, as ESS usage in Australia remains below that of the United States of America (USA) and the UK, it is helpful to examine the taxation and regulatory systems of these jurisdictions, which reportedly have substantially stronger tax incentives and more conducive regulatory frameworks to encourage ESS.[30]

2.34 Stripe, a global technology company told the Committee that in their view the current tax rules in Australia are 'not as attractive for [their] company to grow its footprint in Australia as they are in other jurisdictions around the world.[31]

2.35 Whereas in the USA, the National Centre for Employee Ownership reported that in 2018 there were 6,416 companies using an ESOP, with 14 million

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27 The Inspector-General of Taxation and Taxation Ombudsman, *Submission 13.1*, p. 3.

28 Guerdon Associates, *Submission 21*, p. 2.

29 Treasury, *Submission 31: 6*, p. 1.

30 Succession Plus, *Submission 15a*, p. 32.

31 Stripe, *Submission 35*, p. 2.

participants and total assets of over $1.4 trillion. An average of 263 new ESOPs are created each year.[32]

2.36 Succession Plus noted that 'the US is seen as the leader of employee ownership with ESOPs emerging as early as the 1920's.'[33]

2.37 The USA has two types of stock options: statutory stock options and non-statutory stock options. Each type is provided under either an incentive stock option (ISO), or an employee stock purchase plan.

2.38 Statutory stock options must be provided to employees of the company. There are rules that prevent the transfer of the option and determine how long the option must be held for. Where the requirements of a statutory stock option are not met, then the rules relating to non-statutory stock options apply.[34]

2.39 The UK's approach to ESOPs typically involves the implementation of a discretionary trust structure, with the trustee being a company limited by guarantee. There are no allocated shares held in the trust, and no beneficiary has a specific interest in any of the trust cash or shares. Periodic voluntary contributions from the company to the trust are not liable to tax.[35]

Committee comment

2.40 The Committee heard that ESS have several important benefits for the business community, employees and the economy in general, hence successive Australian Governments have encouraged their use.

2.41 Legislation and policy regarding ESS continues to be strengthened and refined, with the most recent changes being well received. However, the Australian Government's ability to measure the effectiveness of recent measures is hampered by a lack of up-to-date data.

2.42 The Committee is concerned that the ability to review the recent effects of changes to ESS policy is impeded by a lag in the data produced by the ATO. The Committee is of the view that more up-to-date data is needed to ensure

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32 National Center for Employee Ownership, 'Employee Ownership by the Numbers', September 2020, <https://www.nceo.org/articles/employee-ownership-by-the-numbers>, viewed 15 February 2021.

33 Succession Plus, *Submission 15a,* p. 17.

34 Treasury, *Submission 31: 6*, p. 2.

35 Employee Ownership Australia, *Submission 19*, p. 9.

policy changes are having the intended effects, and to allow the government to enact timely reforms if needed.

Recommendation 1

2.43 The Committee recommends that the Australian Taxation Office obtains and publishes up-to-date data on Employee Share Scheme use.

2.44 Discussions during the public hearings indicated that the use of ESS in Australia is being hampered by a lack of awareness within the business community of the existence and benefits of ESS.

Recommendation 2

2.45 The Committee recommends that the Australian Taxation Office establish a public awareness program to inform current and potential business owners of the existence and benefits of Employee Share Schemes, and where and how to access the available resources.

2.46 Although the 2015 reforms to the taxation of ESS have been reviewed, it remains unclear whether these changes have increased ESS usage due to a lack of relevant and up-to-date data.

Recommendation 3

2.47 The Committee considers any changes to legislation resulting from this inquiry and the 2019 Treasury consultation referred to in Chapter 4 of this report should be reviewed by the Productivity Commission five years after the date of commencement of the changes.

2.48 When considering measures to improve the use of ESS in Australia, it is helpful to consider what arrangements are in place in the US and the UK, where ESS use is readily accepted and part of the early start-up architecture of the top companies.

2.49 The evidence received by the Committee indicates that every regime has its own complexities and issues, but there are beneficial practices in other jurisdictions that Australia should consider adopting to improve the take-up of ESS and remain internationally competitive.

Recommendation 4

2.50 **The Committee recommends that the Productivity Commission investigate how the use of employee ownership trusts can be facilitated and encouraged.**

Recommendation 5

2.51 **The Committee recommends that the Productivity Commission explore the structure of Employee Share Schemes and their related taxation treatment in other countries, and how this could be adapted to the Australian taxation system to support productivity and innovation.**

3. Effectiveness of the 2015 reforms

3.1 This chapter examines the effectiveness of the *Tax and Superannuation Laws Amendment Employee Share Schemes)* Act 2015 (2015 Act), also referred to in this report as the '2015 reforms', and the impact on the *Income Tax Act Assessment Act 1997* (Income Tax Assessment Act).

3.2 The 2015 Act was designed to provide tax incentives to support start-up companies and bolster innovation, competitiveness and entrepreneurship. The Committee heard evidence that the 2015 reforms were welcome, but suggestions were received to further refine the tax treatment of ESS.

3.3 The Law Council told the Committee that 'the start-up concession is certainly in terms of tax an outcome that works' and explained further that:

> it deals with two fundamental problems. The first is taxation at cessation of employment […] The second is the taxation gain as a capital gain rather than ordinary income. In terms of the market that it is seeking to develop, the essence of that structure is well designed. […] The take-up of it has not been as strong as it should have been.[1]

3.4 Atlassian noted that despite the disadvantages of the Australian treatment of ESS interests, 'the tax treatment of options granted under the start-up concession is more favourable than the non-statutory scheme in the US that is broadly available to employees. As such, it can be considered a point of advantage for Australian start-ups.'[2]

3.5 To assist the Committee to explore any limits of the 2015 reforms to ESS tax treatment and/or explain the limited uptake of ESS, witnesses provided

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1 Mr Andrew Clements, Member, Law Council, *Committee Hansard*, 4 June 2020, Canberra, p. 10.

2 Atlassian, *Submission 33*, p. 2.

evidence about the difficulties encountered with current provisions of the Income Tax Assessment Act particularly to do with:

- the definition of a start-up;
- the valuation rules;
- the limits on concessions and employee ownership; and
- the cessation of employment as a taxation point.

Definition of a 'start-up'

3.6 The Law Council commented that despite the 2015 reforms being considered to be 'a welcome and very helpful reform', the use of the concession has been limited by the restrictive definition of 'start-up' in the Income Tax Assessment Act.[3]

3.7 As noted by KPMG Australia, to be considered a start-up for tax concession purposes, a company must:

- have no equity interests listed on a stock exchange;
- have an aggregated turnover of less than $50 million;
- have been incorporated for less than 10 years; and
- be an Australian resident company.[4]

No equity interests listed on a stock exchange

3.8 Section 83A.33 of the Income Tax Assessment Act provides that the start-up concession is not available if a company, or any of its subsidiaries or holding companies, have equity interests listed on any approved stock exchange. This means that any company that has shares listed on the ASX, for example, will not be eligible for the concession.

3.9 Some stakeholders consulted during the development of the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 (2015 Bill) suggested the start-up concession should not exclude listed companies. This measure was not retained as 'these policy issues would likely come at an additional cost to Government revenue, which may be difficult to achieve in the current budget environment.'[5]

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3 Taxation Law Committee of the Law Council of Australia (Law Council), *Submission 18*, pp. 7-8.

4 KPMG Australia, *Submission 9*, p. 2.

5 Explanatory Memorandum, Tax and Superannuation Laws Amendment Employee Share Schemes) Bill 2015, p. 47.

3.10 Evidence to this inquiry indicates that such support continues. For example, Employee Ownership Australia suggested that 'listed companies that are otherwise able to meet the definition of a "start-up" company should be able to apply these concessions.'[6]

3.11 Guerdon Associates noted that there is a false assumption that 'a listed company is in a more advanced stage of development than an unlisted company,' and explained:

> It is true that companies are often listed to access capital, but often this is because there are no private sources of capital available after the house has been mortgaged twice, and family and friends are in as deep as they care to go, and the start-up needs more capital as it has outgrown the garage. The Australian private capital market is small compared to sophisticated, deep and wide private capital markets in the US and to an extent the UK, leaving little choice but to turn to listed company markets.[7]

Aggregated turnover of less than $50 million

3.12 The 2015 Act limits access to tax concessions to businesses that have a turnover of no more than $50 million per year.

3.13 Concerns were raised that the current requirement to have an aggregated turnover of less than $50 million to be considered a start-up for tax purposes was too restrictive.

3.14 Guerdon Associates suggested that this 'arbitrary $50 million limit will encompass most start-ups' but excludes entrepreneurial, high growth companies that may have high turnover but 'a long gestational period', such as Xero, NearMap, Afterpay, and Zip Co.[8]

3.15 Right Click Capital noted that the aggregated turnover limit restricted the participation of e-commerce or marketplace businesses, which can post high turnovers but have high cost of goods sold.[9] It advocated for increasing this limit to $100 million or $150 million to 'encourage our fast-growing companies to accelerate their growth [and provide] a greater contribution to our economy through employment, exports and company tax.'[10]

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6 Employee Ownership Australia, *Submission 19*, p. 11.

7 Guerdon Associates, *Submission 21*, p. 2.

8 Guerdon Associates, *Submission 21*, p. 3.

9 Right Click Capital, *Submission 14*, p. 2.

10 Right Click Capital, *Submission 14*, p. 2.

3.16 PricewaterhouseCoopers (PwC) was concerned that:

> the qualifying conditions around the aggregated turnover test can make it difficult to assess whether a company is a start-up. The test should only relate to wholly owned groups or entities that can be shown to be controlled by the entity as per the definitions of control under the Corporations Laws.[11]

Exclusion of established companies

3.17 The 2015 Act provides that companies that are 10 or more years old cannot be considered a start-up for tax concession purposes.

3.18 Minter Ellison suggested that this 10-year limit be removed as 'there do not appear to be good policy reasons for imposing this requirement.' They recommended the Committee consider alternative requirements such as a maximum number of employees.[12]

3.19 KPMG Australia also suggested that the limit be removed as 'companies have different trajectories for growth. The fact that some companies take longer to achieve growth compared to others should not disqualify them from benefiting from this regime.'[13]

3.20 King & Wood Mallesons advised that this requirement could prevent genuine start-ups from accessing this concession if, for example, a participant wanted to use a previously dormant company to start a new business.[14]

3.21 Stripe, a global technology company, stated that the 10-year limit 'put a damper on high growth start-ups.'[15]

3.22 In the second reading speech for the 2015 Bill, the then Minister for Small Business, the Hon Bruce Billson MP, commented on the start-up eligibility criteria:

> These eligibility criteria mean that the concession is targeted towards small and start-up firms. The innovators we are committed to encouraging are those who often face additional liquidity and valuation obstacles that larger firms do

11 PricewaterhouseCoopers (PwC), *Submission 27*, p. 4.

12 Minter Ellison, *Submission 26*, p. 6.

13 KPMG Australia, *Submission 9*, pp. 2-3.

14 King & Wood Mallesons, *Submission 25*, p. 8.

15 Stripe, *Submission 35,* p. 2.

not. The eligibility criteria will also limit and manage the cost to revenue at a time of fiscal repair.[16]

Valuation rules

3.23 To offer an ESS, companies need to determine the market value of the ESS interests they want to provide.

3.24 The Australian Taxation Office (ATO) provides approved market valuation methods for start-ups. Using one of these methods increases the certainty for start-ups that the valuation will be accepted. This is referred to as a 'safe-harbour' valuation.[17]

3.25 As advised by the ATO, the approved market valuation methods can be used for:

- ESS interests that are in the form of shares and where the discount does not exceed 15 per cent of the market value of the share at the time it is acquired; and
- ESS interests that are in the form of options where the exercise price of the options is at least equal to the market value of the underlying shares.[18]

3.26 The Law Council described these 'safe harbour valuation rules' as 'very helpful', but expressed concern that 'they are limited in scope and apply only to start-ups.'[19]

3.27 Issues can arise for unlisted companies that don't qualify to use the safe-harbour valuation method (such as mature small or medium businesses), as the nature of such companies means their shares can be particularly difficult to value. For example, Pitcher Partners noted:

> Unlisted companies have no liquid secondary market for their shares and therefore do not have a simple means to determine their market value at any point in time. In order to determine the tax consequences of issuing ESS interests, a costly valuation needs to be obtained every time these are issued in

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16 The Hon Bruce Billson MP, Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015, Second Reading, *House of Representatives Hansard*, 25 March 2015p. 3360.

17 Legislative Instrument –*Income Tax Assessment* (ESS 2015/1)

18 Legislative Instrument –*Income Tax Assessment* (ESS 2015/1)

19 The Law Council, *Submission 18*, p. 4.

order to properly comply with the tax regime (e.g. to quantify what discount, if any, the ESS interests are issued at).[20]

3.28 Pitcher Partners suggested that the "safe harbour" contained in the Legislative Instrument –*Income Tax Assessment* (ESS 2015/1) be extended to companies that are unlisted with an aggregate turnover of less than $50 million, consistent with the requirements in subsection 83A-33(5) of the Income Tax Assessment Act.[21]

3.29 Further, the Committee found that it was not necessarily clear how the valuation rules that are designed for outside investors necessarily help protect employees. The shares or options are often granted without having to be paid for upfront. In start-ups, valuation processes are not meaningful especially in the early stages.

3.30 In listed entities, the valuation information is publicly available. And the very nature of being an employee presents opportunities to understand the financial health of a company that others do not have. In summary, the valuation requirements provide little meaningful protection, while costing much in time and money.

Limited tax incentives

3.31 The issue of limited tax incentives was another hindrance that was brought to the Committee's attention and that helps to explain the relatively low uptake of ESS in Australia.

The $1,000 upfront tax concession limit

3.32 If an employee receives shares or options at a discount pursuant to an ESS scheme, and they have an adjusted taxable income of $180,000 or less, they are eligible for a tax exemption on the first $1,000 of discounts received each year.

3.33 The amount of this concession was last changed around 1996, when it was increased from $500 to the current level of $1,000 for shares or rights acquired after 1 July 1996. It is not indexed, which Treasury notes 'is not uncommon for thresholds in the tax system.'[22]

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20 Pitcher Partners, *Submission 8*, p. 11.

21 Pitcher Partners, *Submission 8*, p. 11.

22 Treasury, *Submission 31: 7*, p. 1.

3.34 Fortescue Metals Group commented that $1,000 'is now too small a value to represent a meaningful incentive to most employees.'[23] They also noted that as the discount is applied to employees earning $180,000 or less, this limit 'disadvantages the segment of the employee population who could most reasonably benefit from a higher level of incentive.'[24]

3.35 Fortescue Metals Group suggested that the limit be increased to $5,000, to match the tax-deferred salary sacrifice plan limit.[25]

The $5,000 tax-deferred salary sacrifice plan limit

3.36 Employees receiving shares at a discount that are acquired under a salary sacrifice arrangement can access deferred tax rules under the Income Tax Assessment Act, provided they receive no more than $5,000 worth of shares in an income year.

3.37 This limit was introduced in 2009 to ensure 'that deferral of tax under the salary sacrifice arrangements is limited, providing a relatively more attractive concession for low- and middle-income earners.'[26]

3.38 Shareworks by Morgan Stanley suggested that the $1,000 and $5,000 limits have led to decreasing popularity of these plans and do not 'strike true with regards to perceived value for individuals anymore.'[27] They recommended increasing the limits to 'further foster employee ownership and thus drive plan participation.'[28]

3.39 Employee Ownership Australia similarly noted:

> Unfortunately, the $5,000 salary sacrifice cap is too limiting…This has inhibited the ability of employees to make meaningful savings through employee salary sacrifice plans. As a result of those changes, there has been a marked decline in the broad-based participation in salary sacrifice plans with many companies closing down their plans.[29]

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23 Fortescue Metals Group, *Submission 10*, p. 4.

24 Fortescue Metals Group, *Submission 10*, p. 4.

25 Fortescue Metals Group, *Submission 10*, p. 5.

26 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, Income Tax (TFN Withholding Tax (ESS)) Bill 2009, p. 45.

27 Shareworks by Morgan Stanley, *Submission 4*, p. 5.

28 Shareworks by Morgan Stanley, *Submission 4*, p. 5.

29 Employee Ownership Australia, *Submission 19*, p. 5.

3.40 Guerdon Associates considered that the COVID-19 pandemic 'has brought a focus on the salary sacrifice arrangements that could be improved for the benefit of the economy' and that employees 'would be prepared to sacrifice more than $5,000 and even up to 100 per cent of their salary to assist their employer avoid layoffs.'[30]

3.41 Guerdon Associates suggested that the Government could support businesses during the COVID-19 crisis and its immediate aftermath by temporarily removing the $5,000 cap until 30 June 2023, adding that this would also allow the Government to test the impact of this measure on revenue and growth.[31]

3.42 In relation to concerns regarding potential revenue loss or leakage, the Law Council suggested that 'the potential for revenue leakage is…overstated,' adding that this was due to:

> the impact of workarounds and offers simply not being made. In many instances the tax deferral conditions for shares are being achieved through the introduction of short-term forfeiture conditions or, alternatively, the addition of so-called cash out options.[32]

Ten per cent limit on ownership through an Employee Share Scheme

3.43 The Explanatory Memorandum to the 2009 Bill noted that an interest provided to an employee via an ESS must not exceed five per cent for tax concessions to apply. It stated:

> The concession is intended to encourage employees with small or no ownership in their employer to take up an interest in the company. It is considered that if one employee owns more than five per cent of the voting rights, interests between the company and that shareholder are already aligned, and no tax concession is appropriate or warranted.[33]

3.44 One of the changes introduced by the 2015 reforms was an increase to the limit on individual employee ownership of a company through an ESS from

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30 Guerdon Associates, *Submission 21*, p. 5.

31 Guerdon Associates, *Submission 21*, p. 5.

32 Law Council, *Submission 18*, p. 3.

33 Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, Income Tax (TFN Withholding Tax (ESS)) Bill 2009, p. 31.

five per cent to 10 per cent. The change was designed to 'help some founders and provide a boost for critical workplace team members.'[34]

3.45 Succession Plus noted that the 10 per cent ownership limit 'can serve to prevent SMEs from accessing the taxation concessions' and 'prevents employee or management buyouts from occurring under Division 83AA.'[35] They suggested such prevention is problematic as 'despite the taxation limits, [ESS] do produce more viable succession outcomes.'[36]

3.46 The Committee notes that the Standing Committee on Employment, Education and Workplace Relations recommended in its 2000 Shared Endeavours report that public policy should be formulated so as to 'facilitate employee buyouts and succession planning.'[37]

Cessation of employment as a taxation point

3.47 Currently, ESS interests can become subject to the deferred tax rules in Division 83A of the Income Tax Assessment Act when the holder of the interest ceases employment with the relevant company. This rule was introduced in 1995, with the rationale being 'to provide some level of tax integrity to ensure that the discount for certain companies is taxed at some point, but also to achieve a balance in encouraging the take-up of employee share schemes.'[38]

3.48 Several witnesses suggested that Australia's taxation arrangements with respect to the point at which ESS interests are taxed were 'no longer best practice' and less favourable than arrangements overseas, resulting in Australian firms being at a disadvantage when competing for global talent.[39]

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34 The Hon Bruce Billson MP, Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015, Second Reading, *House of Representatives Hansard*, 25 March 2015, pp. 3359–3360.

35 Succession Plus, *Submission 15a*, p. 21.

36 Succession Plus, *Submission 15*, p. 2.

37 House of Representatives Standing Committee on Employment, Education and Workplace Relations, 'Shared Endeavours, Inquiry into employee share ownership in Australian enterprises', September 2000, p. 54.

38 Ms Shanyn Sparreboom, Individuals Tax Unit, Treasury, *Committee Hansard*, 4 June 2020, p. 2.

39 PwC, *Submission 27*, p. 9; KPMG Australia, *Submission 9*, p. 3; Shareworks by Morgan Stanley, *Submission 4*, p. 5; Guerdon Associates, *Submission 21*, p. 3; Stripe, *Submission 35*, p.1.

3.49 Stripe, a technology company operating a global equity stock plan in over 15 countries, pointed to the deferred taxation point at cessation of employment as a 'key hurdle' affecting their 'growth in Australia and ability to hire'.

3.50 Similarly, Atlassian commented that Australia had a 'comparative disadvantage' compared to the USA's tax system, and suggested removing the taxation event on cessation of employment, to prevent 'departing employees either desperately seeking means to fund the tax liability or entirely foregoing their interests due to inability to shoulder the tax consequences' or alternatively staying in 'a job that no longer suits them or their employer.'[40]

3.51 This issue was considered as part of the 2015 Bill inquiry, where the Committee noted that 'the present system of taxation on cessation of employment seems to be an anomaly internationally, and might provide an opportunity for further reform.'[41]

3.52 StartupAUS advised that tax 'treatment of options on terminating employment was the single biggest issue identified by respondents' to their survey, due to employees potentially having to pay tax on incentives before receiving any benefit from them.[42]

3.53 Succession Plus stated:

> The deferred taxation rules (Division 83A) serve to tax employees (on a deferred basis) without them having access to income/equity to fund the tax payment - we have several clients where this taxation impact will be far greater than the employees annual salary and may in fact force them to sell some shares to fund the taxation liability.[43]

3.54 The Australian Small Business and Family Enterprise Ombudsman concurred with these comments and noted that 'the cash payment triggered on leaving may discourage workers from joining a firm and encourage existing workers to stay with the firm for the wrong reason.'[44]

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40 Atlassian, *Submission 33*, p. 2.

41 Senate Standing Committee on Economics Legislation, Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 [Provisions], June 2015, p. 12.

42 StartupAUS, *Submission 30*, p. 5.

43 Succession Plus, *Submission 15*, p. 2.

44 Australian Small Business and Family Enterprise Ombudsman, *Submission 3*, p. 1.

3.55 Pitcher Partners said that such difficulties can result in companies limiting the range of employees to whom they are prepared to offer shares, undermining 'the potential benefits of broader participation in the ESS.'[45]

3.56 The effects of COVID-19 were also raised as a rationale for abandoning cessation of employment as a deferred taxation point, due to increased redundancies and decreased share values. For example, Employee Ownership Australia commented:

> …the current crisis has seen a significant number of employees made redundant. This has resulted in a large number of employees being considered "good leavers" and triggering a taxing event on their ESS awards due to cessation of employment. Therefore, there is an increased incidence of tax on cessation of employment in ESS. Secondly, the sharp fall in the share market means that employees who ceased employment prior to the crisis are likely to have triggered a taxing event on cessation of employment at a significantly higher share price.[46]

3.57 PwC commented that 'market volatility' was 'inevitable' and 'has been a major issue adversely affecting a significant number of taxpayers over a great number of years', adding that it was not strictly a COVID-19 problem [47]

3.58 In contrast, Treasury advised that 'the provisions are around ensuring that there's a connection between the employer and the employee, and then, if the employee does leave, that connection has gone.'[48]

Retirement

3.59 The American Chamber of Commerce in Australia (ACC) expressed particular concern about 'Australian retirees being taxed unfairly where unvested or not fully vested ESS interests are taxed upon termination of employment,'[49] whereas ongoing employees can defer tax until their interest is fully vested.

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45 Pitcher Partners, *Submission 8*, p. 5.

46 Employee Ownership Australia, *Submission 19*, p. 7.

47 PwC, *Submission 27*, p. 9.

48 Mr Bede Fraser, Principal Adviser, Individuals and Indirect Tax Division, Revenue Group, Treasury, *Committee Hansard*, 4 June 2020, Canberra, p. 8.

49 The American Chamber of Commerce in Australia, *Submission 6*, p. 1.

3.60 The ACC advised that in the USA retiring employees are permitted to retain ESS rights or shares and defer taxation until they become fully vested and the value can be determined.[50]

3.61 In their view, this taxing of unvested interests 'further marginalises older Australians by discouraging their participation in ESS arrangements as they get closer to retirement, or their ability to retire.'[51]

3.62 The taxation of unvested interests was also raised as an issue for retiring business owners. Employee Ownership Australia suggested that any tax imposed on retiring business owners, particularly when they are transferring the business to existing employees, should be on a concessional basis as the deemed market value of their interest may not represent the value that they receive.[52]

Income tax withholding

3.63 If cessation of employment is removed as a taxation point, it may affect employers' ability to fulfil reporting requirements for an ESS, as they may not necessarily know when employees dispose of their shares.

3.64 The introduction of a voluntary tax withholding mechanism could simplify arrangements for employers, ensure tax collection and make the tax rules more consistent with those of international trading partners.[53]

3.65 Minter Ellison noted:

> We have received feedback from our clients, both domestic and multinational, that they are struggling with the lack of withholding mechanism and believe that such a mechanism would materially improve the effectiveness of administering an ESS and (in the case of multinational companies) ensure a 'level playing field' with participants in other countries.[54]

3.66 Shareworks by Morgan Stanley advised that to manage associated withholding tax obligations, the USA captures federal and state tax utilising

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50 American Chamber of Commerce in Australia, *Submission 6*, p. 1.

51 The American Chamber of Commerce in Australia, *Submission 6*, p. 2.

52 Employee Ownership Australia, *Submission 19*, p. 8.

53 Ernst & Young, *Submission 17*, p. 6; Minter Ellison, *Submission 6*, p. 9; PwC, *Submission 27*, p. 3.

54 Minter Ellison, *Submission 26*, p. 9.

year-to-date income to determine individual tax obligations at the point of exercise or conversion of rights into shares.[55]

3.67 Ernst & Young noted that 'employers in the UK, US and New Zealand are entitled to tax deductions in relation to grants of ESS interests made to employees.'[56] Ernst & Young considered this to be 'appropriate tax policy as ESS interests are considered part of an employee's remuneration.' [57]

3.68 PwC suggested there should be 'further consultation on the benefits and disadvantages of the introduction of employer tax withholding for ESS awards which vest.'[58]

Committee comment

3.69 Evidence presented to the Committee indicated that the current taxation arrangements for ESS are too complicated and restrictive, despite the well-received 2015 reforms. Some adjustments were suggested to support Australian businesses in their uptake of ESS.

3.70 Based on available data and evidence received, the Committee has recommended a number of changes to the taxation treatment of ESS to increase its usage and decrease costs for Australian businesses, and in turn increase business support, especially for start-up companies, and general competitiveness, productivity and innovation. Improved data reporting, which has been identified as affecting the accurate measurement of ESS usage in Australia, may also highlight the need for further reforms.

3.71 The Committee acknowledges that some submissions called for more extensive changes to the definition of a 'start-up', for example, by removing the exclusion on companies that are more than 10 years old. However, the Committee came to the conclusion that the intent of the 2015 reforms should be preserved, to support start-ups in their first years of existence, when they are most fragile.

3.72 However, the Committee considers that given Australia's unique capital funding environment, it would be appropriate to extend the start-up tax concessions to all listed companies.

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55 Shareworks by Morgan Stanley, *Submission 4*, p. 5.

56 Ernst & Young, *Submission 17*, p. 6.

57 Ernst & Young, *Submission 17*, p. 6.

58 PwC, *Submission 27*, p. 3.

3.73 The Committee also considers it appropriate to reduce inconsistencies between taxation and corporations laws by removing the aggregated turnover test.

3.74 The Committee notes that some submissions to this inquiry called for an increase to the turnover limit of $50 million per year. The Committee considers that this cap is arbitrary and causes unintended consequences. As such, the Government should consider removing the cap.

Recommendation 6

3.75 The Committee recommends that the following changes be made to the definition of a 'start-up' for tax concession purposes:

- **The definition be extended to listed companies that otherwise fulfil the criteria to be considered a 'start-up'.**

- **The aggregated turnover test be removed to relate to wholly owned groups or entities that can be shown to be controlled by the entity as per the definitions of control under the *Corporations Act 2001*.**

3.76 The Committee notes there are concerns that obtaining valuations for the purpose of complying with ESS rules is time consuming, costly and overly complex, particularly for unlisted businesses.

3.77 It was suggested that the 'safe harbour' market valuation methods were helpful and could be used more widely to alleviate the difficulties of small and medium businesses in obtaining valuations.

3.78 The Committee considers that it would be appropriate to extend the 'safe harbour' valuation methods to small and medium unlisted companies that have a turnover of less than $50 million but do not otherwise come within the definition of a start-up.

Recommendation 7

3.79 The Committee recommends that the definition of 'safe harbour' valuation contained in Legislative Instrument – *Income Tax Assessment* (ESS 2015/1) be extended to all unlisted companies.

3.80 The Committee agrees that the $1,000 annual limit on shares that employees can receive without paying income tax is overdue for an increase, given this limit was set in in 1990s and its value is now out of date.

3.81 The Committee considers this limit should be increased to $50,000 to match the current salary sacrifice limit, and the wage requirements also be removed.

Recommendation 8

3.82 The Committee recommends increasing the $1,000 limit in section 83A.35(2)(a) of the *Income Tax Assessment Act 1997* to $50,000.

3.83 The Committee is concerned that tax becomes payable upon an employee receiving an ESS interest, although there may be no benefit realised at that point. The Committee is of the view that a system whereby tax is paid either as a dividend return to the employee or once the shares are sold would be a much simpler system that would encourage a greater uptake, particularly by employees.

Recommendation 9

3.84 The Committee recommends that the Government remove the taxation point on the cessation of employment by removing sections 83A-115(5) and 83A-120(5) of the *Income Tax Assessment Act 1997*.

4. Creating a conducive regulatory framework

4.1 The Australian Small Business and Family Enterprise Ombudsman described the current regulatory and taxation framework for Employee Share Schemes (ESS) as 'complex and fragmented.'[1]

4.2 The Committee heard that there remained 'inconsistences and limitations in the regulatory framework that reduce the attractiveness of ESS for Australian companies and employees'[2] despite the 2015 reforms to the taxation treatment of ESS having been well received.

4.3 The Taxation Law Committee of the Law Council of Australia (Law Council) noted that a coordinated body previously 'loosely' existed after the 2009 changes:

> There were meetings with Treasury, the tax office, ASIC and industry. That was one of the most effective bodies for actually understanding others' concerns and trying to develop a more cohesive framework to improve the regulation system that we had in Australia. If I could put an advertisement out for one thing, it would be for creating that kind of forum so that there's a better understanding so regulators can understand what we want better and we can understand what regulators want better.[3]

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1 Australian Small Business and Family Enterprise Ombudsman, *Submission 3*, p. 1.

2 Shareworks by Morgan Stanley, *Submission 4*, p. 4; Pitcher Partners, *Submission 8*, p. 3; KPMG Australia, *Submission 9*, p. 2; Inspector-General of Taxation and Taxation Ombudsman, *Submission 13*, p. 3, PricewaterhouseCoopers (PwC), *Submission 27*, p. 3.

3 Mr Andrew Clements, Member, Law Council, *Committee Hansard*, Canberra, 4 June 2020, p. 18.

4.4 This chapter includes a look at the following regulatory and compliance hurdles, and their attendant relief or exemption provisions, that currently exist in relation to ESS:

- the complexity of exemptions from the requirements of the *Corporations Act 2001* (Corporations Act);
- privacy issues arising from mandatory disclosure obligations;
- difficulties with the use of the Australian Taxation Office's (ATO) start-up documentation; and
- the inconsistencies with tax treatments of different types of interests, holding arrangements and disposals.

Regulatory hurdles and exemptions

Disclosure exemptions

4.5 The Corporations Act mandates that a company making an offer pursuant to an ESS must provide a disclosure document, such as a prospectus, offer information statement or Product Disclosure Statement (PDS).[4] The Corporations Act offers exemptions in certain circumstances.

4.6 The Australian Securities and Investments Commission (ASIC) class orders CO 14/1000 and CO 14/1001 provide further exemptions from the Corporations Act disclosure requirements. In place of the disclosure, these class orders provide that if certain conditions are satisfied, an offer document can be provided to eligible employees instead of the more detailed documents required under the Corporations Act.[5]

Small scale offer exemption

4.7 The Corporations Act states that if the offer is a 'small scale offer' or the proposed investor is a 'senior manager', the company making the offer will be exempt from the disclosure requirement.[6]

4.8 Further, ASIC provides case-by-case relief for employers who cannot meet all the conditions of the class orders, provided that the relevant ESS is

[4] Corporations Act, Chapter 6D and Chapter 7.

[5] Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 7.

[6] Corporations Act, sections 708, 1012E and 1012D.

otherwise consistent with ASIC's *Regulatory Guide 49: Employee incentive schemes*.[7]

Public access exemption

4.9 In 2017, the Government introduced provisions into the Corporations Act preventing public access to disclosure documents relating to eligible ESS offers by eligible start-ups.

4.10 This was part of the Government's National Innovation and Science Agenda and designed to protect commercially sensitive information that may be contained in the start-up's disclosure document.[8]

On-sale obligations conditional relief

4.11 The Corporations Act restricts the on-sale of financial products issued without disclosure within 12 months of their issue.[9]

4.12 ASIC class orders offer conditional relief from this restriction.

Licensing exemptions

4.13 Under the Corporations Act, an Australian Financial Services Licence (AFSL) may be required to conduct activities associated with implementing an ESS, such as circulating and explaining the conditions of the ESS, providing custodial services such as a professional trustee, or dealing in financial products.[10]

4.14 The Corporations Act provides an exemption from this requirement in relation to eligible ESS. ASIC class orders CO 14/1000 and CO 14/1001 also provide conditional relief from the requirement to hold an AFSL.

Advertising exemptions

4.15 There are restrictions on advertising an offer or intended offer of financial products in the Corporations Act.

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[7] ASIC, *Submission 34*, p. 2.

[8] Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 6.

[9] Corporations Act, Sections 707 and 1012C.

[10] Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, pp. 4-5.

4.16 Whereas the Corporations Act does not provide any exemption from the restrictions on advertising, ASIC class orders provide conditional relief on advertising restrictions.

Hawking exemptions

4.17 The Corporations Act has a prohibition on hawking:

> Under the Corporations Act, a person (the 'offeror') must not offer financial products for issue or sale in the course of, or because of, an unsolicited meeting or telephone call.[11]

4.18 However, there are limited exemptions from the hawking prohibition and ASIC class orders provide additional conditional relief from the hawking prohibition.

'Complex and fragmented' exemptions

4.19 The Committee heard that unlisted companies still struggle to comply with the disclosure requirements of the Corporations Act, despite these exemptions.

'Employee Share Scheme' definition

4.20 Treasury noted:

> While the current regulatory framework provides a range of exemptions that enable offers of financial products under an ESS, these exemptions are complex and fragmented across the Corporations Act and ASIC class orders. In addition the definition of ESS offers under the Corporations Act for the statutory exemptions does not align with the broader scope of ESSs covered by the ASIC class orders.[12]

4.21 To simplify the current exemption regime, it was suggested in Treasury's consultation paper that the definition of 'eligible ESS' under the statutory exemptions be simplified and expanded to align with the broader category of ESS eligible for relief under the ASIC class orders.[13]

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11 Australian Securities and Investments Commission, *Regulatory Guide 38 – The hawking prohibitions*, December 2019, p. 4.

12 Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 11.

13 Treasury, 'Employee Share Schemes', Consultation Paper, April 2019, p. 11.

Complex disclosure statements

4.22 KPMG suggested that unlisted companies in particular were likely to struggle with compliance:

> Ensuring compliance with disclosure and other requirements in the Corporations Act can be costly for unlisted companies (including start-ups) from both a monetary and time perspective. In addition, this disclosure regime restrict an unlisted company's ability to offer ESS awards where the relevant Corporation Act exemptions or ASIC class order relief is not available.[14]

4.23 Similarly, Right Click Capital provided evidence that some start-ups could find the disclosure requirements to be unnecessarily onerous. They suggested:

> Start-ups should be exempt from the requirement to prepare a product disclosure statement to employees; even ASIC has argued preparation of such statements to be disproportionately burdensome. If we want founders to focus on the growth of their business, the arduous task of a PDS will only serve as a distraction.[15]

4.24 Palantir Technologies criticised the requirement to file ‘expensive and public’ prospectus and financial report documents with ASIC as being ‘unique to Australia vis-à-vis similarly situated nations, such as the US, UK, France and Germany.’[16]

4.25 Stripe cited the ASIC disclosure filing requirement as one of the key hurdles.

4.26 The 2019 Treasury ESS Consultation Paper also suggested that:

- the ASIC class order relief for disclosure, licensing, advertising, hawking, managed investment scheme and on-sale obligations be moved into the Corporations Act and consolidated with the existing statutory exemptions for licensing and hawking;
- ASIC continue to have powers to grant individual relief from the disclosure, licensing and other obligations in the Corporations Act.[17]

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14 KPMG Australia, *Submission 9*, p. 4.

15 Right Click Capital, *Submission 14*, p. 1.

16 Palantir Technologies, *Submission 16*, p. 13.

17 Treasury, ‘Employee Share Schemes’, Consultation Paper, April 2019.

Limited scope and application of the exemptions

4.27 PricewaterhouseCoopers noted that the existing exemptions will often not be available to start-up companies as 'the intended recipient population includes contractors, consultants or non-executive directors – all of whom often fulfil significant roles in start-up companies.'[18]

4.28 Palantir Technologies described existing exemptions as 'very limited' and noted that the disclosure requirements are unique to Australia. To protect company confidential information and company growth, they suggested the Government should:

- clarify and expand the statutory disclosure exemptions and/or ASIC employee equity class order relief; and
- expand the reporting exemptions for foreign controlled local proprietary companies.[19]

4.29 StartupAUS suggested 'changing the regime so that employees are not considered investors' as 'employees receiving these options are not making an arms-length investment decision in the traditional sense and (as employees) are naturally already well-informed about the business when they are offered stock.'[20]

Privacy concerns

4.30 It was also raised that despite the 2017 changes to the Corporations Act, privacy issues arise for most companies as employee shares remain publicly available via an ASIC search.

4.31 The Tax Institute noted that '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.'[21]

Laws versus regulatory frameworks

4.32 Income tax laws and the regulatory framework have different objectives that can result in inconsistences between the two systems. Income tax laws are

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18 PricewaterhouseCoopers, *Submission 27*, pp. 7-8.

19 Palantir Technologies, *Submission 16*, p. 2.

20 StartupAUS, *Submission 30*, p. 6.

21 The Tax Institute, *Submission 2*, p. 2.

'designed to maintain the equity and integrity of the tax system,'[22] whilst the purpose of the regulatory framework is 'to provide consumer protection for employees.'[23]

4.33 The Australian Small Business and Family Enterprise Ombudsman suggested that despite the inevitable differences between the systems, 'implementing the proposed changes flagged in the 2019 Treasury consultation paper would make significant inroads to achieving a closer alignment between corporate (ASIC) and taxation (ATO) requirements for ESSs.'[24]

4.34 Further changes may need to be made to ASIC's class order relief to improve alignment. For example, the Law Council noted that 'the start-up rules under the Income Tax Act and the relevant ASIC class order conflict such that it is impossible for a start-up to meet the requirements of both.'

4.35 The Law Council referred to the requirement for a maximum 15 per cent discount for the tax concession for shares under the start-up regime, compared with the minimum 100 per cent discount under the terms of the ASIC class order relief.[25]

The Australian Taxation Office's assistance for start-ups

4.36 The Australian Taxation Office (ATO) has developed some template documents that are 'designed to help eligible start-up companies to establish and operate an employee share scheme (ESS) of options to acquire newly issued ordinary shares.'[26]

4.37 These documents were described as 'very useful'[27] and 'have been welcomed by some as a positive step that should help to reduce start-up companies' compliance costs and address uncertainty.'[28]

22 Treasury, *Submission 31: 8*, p. 2.

23 Treasury, *Submission 31: 8*, p. 2.

24 Australian Small Business and Family Enterprise Ombudsman, *Submission 3*, p. 1.

25 Law Council, *Submission 18*, p. 8.

26 ATO, 'ESS – Standard documents for the start-up concession', <https://www.ato.gov.au/General/Employee-share-schemes/In-detail/ESS---Standard-documents-for-the-start-up-concession/>, viewed on 11 January 2021.

27 Employee Ownership Australia, *Submission 19*, p. 11.

28 Inspector-General of Taxation and Taxation Ombudsman, *Submission 13*, p. 3.

4.38 However, Ernst & Young suggested that additional guidance was needed, given the complexities associated with implementing an ESS. They recommended 'a more prominent disclaimer encouraging companies to seek legal advice prior to the implementation of the ESS arrangements' and indicated that 'the sample performance conditions in the standard documents need to be clearly flagged as being for illustrative purposes only to mitigate the risk that companies may adopt the sample performance conditions in the standard documents.'[29]

4.39 Pitcher Partners also expressed concern that the ATO's template Plan Rules have led to companies considering implementing an ESS without obtaining legal advice and they 'may not be appreciating the regulatory considerations when making offers to employees.'[30]

4.40 They recommended the inclusion of added guidance in the standard documents, such as key planning considerations a company should consider before adoption and simplification of the regulatory relief guidance in the documents. They also suggested that the 'current commentary in respect to the provisions of the Corporations Act, the ASIC class order, and other potential relief mechanisms, could be made clearer.'[31]

4.41 The Inspector-General of Taxation and Taxation Ombudsman noted the standard documents 'do not appear to include some of the more common clauses in ESS arrangements.' It was suggested that compliance costs could be reduced if the ATO provided 'a repertoire of standard clauses for the standard documents' that are commonly used in ESS arrangements as default provisions.[32]

4.42 In 2012, the United Kingdom (UK) Government commissioned an independent review into employee ownership - the Nuttall Review.[33] In response to the recommendations of this review, the UK Department for Business Innovation and Skills released a range of model documentation to facilitate businesses moving to employee ownership, including:

- a model articles of association of a company with employee ownership;

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29 Ernst & Young, *Submission 17*, p. 7.

30 Pitcher Partners, *Submission 8*, p. 4.

31 Pitcher Partners, *Submission 8*, p. 3.

32 Inspector-General of Taxation and Taxation Ombudsman, *Submission 13*, p. 14.

33 Graeme Nuttall, Sharing Success, 'The Nuttall Review of Employee Ownership', (the Nuttall Review), July 2012.

- a model trust deed of an employees' share trust; and
- a model articles of association of a trustee company limited by guarantee.[34]

4.43 Employee Ownership Australia considered that 'making similar documents available in Australia would be a most helpful addition to the current range of guidance and model documents the ATO provides.'[35]

4.44 The Law Council raised that 'there are good documents available and there's a good description there', but 'it's just that the tax office or ASIC are not obvious places to look for information about the best outcome to structure my business.'[36]

The Australian Taxation Office's reporting requirements

4.45 Companies that provide their employees with ESS interests have reporting obligations to both employees and the ATO.

4.46 Fortescue Metals Group noted that 'ESS reporting, though necessary, has undoubtedly increased compliance costs for employers. As such, where possible, reporting requirements should be simplified.' They suggested:

- the removal of the 30-day rule for employer reporting purposes, as this increases the complexity and requirement to perform additional calculations for the employer; and
- the simplification of the way the ATO receives the ESS annual reports. Fortescue Metals Group explained that:

> the online forms are cumbersome to complete and require manual entry of data, which increases the chance of error and is impractical for large employee populations. The historical option of being able to lodge in a spreadsheet format would be the most cost effective as it does not require employers to acquire a specific software only for the purposes of lodgement.[37]

[34] Employee Ownership Australia, *Submission 19*, p. 11.

[35] Employee Ownership Australia, *Submission 19*, p. 12

[36] Mr Andrew Clements, Member, Law Council, *Committee Hansard*, 4 June 2020, Canberra, p. 13.

[37] Fortescue Metals Group, *Submission 10*, pp. 5-6.

Inconsistencies in Employee Share Schemes' tax treatment

Share buy-backs

4.47 Share buy-backs are where an organisation repurchases its own shares from existing shareholders, often at a price higher than the current market value. There are five types of share buy-backs. One of them relates to ESS and is where:

> A company buys back shares held by or for employees or salaried directors of the company or a related company. This type of buy-back, referred to as an employee share scheme buy-back.[38]

4.48 Share buy-backs are a necessary part of ESS for unlisted companies as employers 'must offer some form of opportunity to dispose of their shares where there is no ready third party market such as an [Initial Public Offering] IPO or trade sale.'[39]

4.49 Currently, if the deemed market value of the shares exceeds the buy-back price, the difference in price is treated as a dividend paid by the company to the shareholder and the balance of the purchase price is treated as capital proceeds for Capital Gains Tax purposes.[40]

4.50 As noted by Employee Ownership Australia:

> [T]he disposal of shares to the company under an ESS buy-back may lead to a significantly different tax outcome for a participant than if the shares were disposed of via an employee share trust or an existing shareholder. It can also be administratively cumbersome for the company, for example, with a company needing to obtain a ruling from the ATO every time such a buy back occurs to determine the dividend/capital split.
>
> …[Employee Ownership Australia] recommends that a safe-harbour methodology be introduced for ESS buy-backs for the purposes of determining the dividend / capital split, or for the allowance of an

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38 ASIC, 'Share buy back', https://asic.gov.au/for-business/running-a-company/shares/share-buy-backs/#other viewed 11 February 2021.

39 Employee Ownership Australia, *Submission 19*, p. 6.

40 Employee Ownership Australia, *Submission 19*, p. 6.

administrative treatment where no part of the purchase price paid to an ESS participant under an ESS buy-back is deemed to be a dividend. [41]

4.51 The Tax Institute argued that 'most small and medium businesses do not want to retain departed employees on their equity register', but undertaking a share buy-back or equivalent on the exit of an employee in order to remove them from the equity register was said to be problematic under current arrangements as it can create funding and liquidity issues for companies.[42]

Employee Share Scheme loan plans

4.52 Currently a share buy-back can be complicated by changes in the market value of the shares if the shares were acquired by the employee using a loan from the employer. In the event the value of the shares to be bought back by the company has decreased to less than the loan value, if the company treats the loan as discharged this could be considered to be a debt forgiveness for tax purposes and therefore subject to Fringe Benefits Tax (FBT).[43]

4.53 Pitcher Partners stated:

> …ATO ID 2003/317 concludes that such a discharge of a loan in these circumstances does not give rise to a debt waiver for Fringe Benefits Tax ("FBT") purposes because the transfer of property in full and final satisfaction of a loan is not considered to be a release or waiver. However, a debt forgiveness for income tax purposes can also occur where a debt is extinguished other than by repaying the debt in full – see paragraph 245-35(a) of [*the Income Tax Assessment Act*] ITAA 1997.
>
> Some further clarity around this issue as well as whether subsection 109F(4) of ITAA 1936 applies as an exception for Division 7A purposes would provide further certainty to taxpayers who have entered into ESS loan plans.

Employee share trusts

4.54 A company may use an employee share trust to hold ESS interests on behalf of employees, for the purpose of obtaining commercial and tax benefits.

4.55 The ATO recently issued the Taxation Determination – *Income Tax: what is an employee share trust* (2019/13), which explains the Commissioner's views on the interpretation of subsection 130-85(4). The subsection sets out the

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41 Employee Ownership Australia, *Submission 19*, p. 6.

42 The Tax Institute, *Submission 2*, p. 2; Pitcher Partners, *Submission 8*, p. 5.

43 Pitcher Partners, *Submission 8*, p. 8.

permissible sole activities for a trust to meet the definition of an employee share trust under the *Income Tax Assessment Act 1997* (Income Tax Assessment Act), including activities that are allowable as 'merely incidental' to the permissible sole activities.[44]

4.56 Pitcher Partners noted that this definition adopted 'a fairly restrictive view of when an entity can qualify as an "employee share trust" with a single breach resulting in the trust forever being disqualified from obtaining this status.'[45]

4.57 King & Wood Mallesons expressed concern that the Taxation Determination 2019/13 did not 'clarify that actions taken in common corporate transactions, such as a rights issue or other capital raising transactions, are also merely incidental' and would not result in an employee share trust losing tax concessions.[46]

4.58 King & Wood Mallesons suggested that a discretionary trust structure model (discussed in Chapter 2) be used in Australia, given the benefits of providing a more stable structure for ownership, providing an effective means of financing employee ownership, and providing a straightforward tax position.[47]

Different tax treatment of shares and rights

4.59 An ESS can give employees a benefit such as shares in the company they work for at a discounted price, or the opportunity to buy shares in the company in the future, referred to as a right or option.[48]

4.60 Shares are treated differently to rights in the Income Tax Assessment Act. The Income Tax Assessment Act allows tax to be deferred on both, but the conditions for the deferral vary. For example to access a deferred taxing point for shares:

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44 Taxation Determination – *Income Tax: what is an employee share trust* (2019/13)

45 Pitcher Partners, *Submission 8*, p. 11.

46 King & Wood Mallesons, 'Will your employee share trust satisfy the "sole activities" test? – ATO finalises EST Tax Determination', < https://www.kwm.com/en/au/knowledge/insights/the-sole-activities-test-ato-finalises-est-20191218>, viewed 3 February 2021.

47 King & Wood Mallesons, *Submission 25*, p. 13.

48 ATO, 'Employee Share Schemes', <https://www.ato.gov.au/general/employee-share-schemes/#,> viewed 1 December 2020.

- they must have been offered to 75 per cent of a particular category of employees, rather than only a limited set as is the case for rights; and
- there must be a real risk of forfeiture of an offer of shares for a deferred taxing point to apply.

4.61 Whereas this condition does not apply to an offer of rights.[49]

4.62 Ernst & Young noted that 'there is no rationale for the difference'[50] and that 'different conditions to allow for tax deferral on grants of shares compared to awards of rights cause unnecessary complexities and discourage companies from awarding shares to employees.'[51]

4.63 Ernst & Young recommended that the tax deferral conditions for shares be made consistent with the conditions that apply for rights.[52]

4.64 The Law Council likewise suggested that there should be consistency in the tax deferral conditions on rights and shares, which could be achieved by removing the real risk of forfeiture requirement for shares and removing the 75 per cent offer requirement for shares.[53]

Committee comment

4.65 Evidence provided during this inquiry suggests that aspects of ESS legal reporting requirements and regulatory frameworks are complex and at times contradictory.

4.66 Some submissions referred to issues relating to the use of trusts in conjunction with ESS and it was suggested that the establishment of a system similar to that in the UK would resolve some of these issues.

4.67 The Committee has recommended changes that will benefit employers and employees, while ensuring that appropriate regulatory safeguards remain in place and that the Government can gather the information it needs to make effective policies.

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49 The Law Council, *Submission 18*, p. 3.

50 The Law Council, *Submission 18*, p. 3.

51 Ernst & Young, *Submission 17*, p. 2.

52 Ernst & Young, *Submission 17*, p. 2.

53 The Law Council, *Submission 18*, p. 3.

4.68 The Committee supports the findings of the Treasury ESS Consultation Paper, but notes that the changes proposed by the Government in 2018 and discussed in the consultation paper were positively received.

4.69 The evidence received by the Committee indicates that the inconsistencies between the Corporations Act framework and the ASIC class orders are especially problematic, and this issue should be resolved by consolidating the class orders into the Corporations Act.

Recommendation 10

4.70 The Committee recommends that the Government proceed with the proposals announced on 13 November 2018 and discussed in the Treasury Employee Share Schemes Consultation Paper dated April 2019.

4.71 The Committee notes that whereas the taxation and corporate regulatory regimes have different purposes, it is desirable for the relevant legislation and instruments to be consistent with each other whenever possible.

Recommendation 11

4.72 The Committee recommends that the requirement for a maximum 15 per cent discount under the *Income Tax Assessment Act 1997* start-up regime be scrapped.

Recommendation 12

4.73 The Committee recommends that the Australian Taxation Office simplify its documentation to no more than two pages, and make recommendations to the Government of any legislative changes that could further simplify this process.

4.74 The Committee recommends that the Australian Taxation Office establish a one stop shop approach to ESS, including documentation, processes and Australian Securities and Investments Commission reliefs to enable start-ups in particular to find all they need in one place, combined with a help line to answer any questions specific to their circumstances.

Recommendation 13

4.75 The Committee recommends that the Australian Taxation Office re-instate the option for lodgement of the ESS annual report in a spreadsheet format.

4.76 The Committee notes that share buy-backs are a necessary part of ESS scheme management. However, some stakeholders indicated that the process to determine the dividend / capital split when a buy-back occurs is overly cumbersome, largely due to the need to obtain binding ATO advice.

4.77 The Committee also notes that under the current arrangements, share buy-backs can produce inconsistent tax outcomes depending on the way in which the shares are disposed of.

4.78 The Committee therefore considers it would be appropriate to introduce a 'safe-harbour' methodology for ESS buy-backs for the purposes of determining the dividend / capital split and to allow for administrative treatment where no part of the purchase price paid to an ESS participant under an ESS buy-back is deemed to be capital.

Recommendation 14

4.79 The Committee recommends that a 'safe-harbour' methodology be introduced for ESS buy-backs for the purposes of determining the dividend / capital split and administrative treatment be allowed when no part of the purchase price paid under an ESS buy-back is deemed to be capital.

4.80 The Committee notes that the effect of the interaction between sections 109F(4) and 245-35(a) of the *Income Tax Assessment Act 1997* and ATO Interpretive Decision *Fringe Benefits Tax* (2003/317) is unclear with respect to the application of Fringe Benefits Tax.

4.81 The Committee acknowledges this lack of clarity could compromise tax professionals' ability to advise their clients and lead to unanticipated tax liabilities.

Recommendation 15

4.82 The Committee recommends that the Australian Taxation Office (ATO) clarify whether sections 109F(4) and 245-35(a) of the *Income Tax Assessment Act 1997* and ATO Interpretive Decision *Fringe Benefits Tax* (2003/317) mean that Fringe Benefits Tax is not in fact payable for discharged ESS loans.

4.83 The Committee notes that some submissions expressed concern that the definition of an employee share trust and permissible sole activities set out in the Income Tax Assessment Act were too narrow and any breach could result in a trust permanently losing its tax concession entitlement. The Committee considers these conditions are necessary to preserve the integrity of employee share trust concessions.

4.84 However, the Committee agrees that participation in common corporate transactions should not disqualify a trust from being considered an employee share trust.

Recommendation 16

4.85 The Committee recommends that the Australian Taxation Office include in its examples of 'merely incidental' activities in Taxation Determination Income tax: what is an 'employee share trust' (2019/13), actions that are taken in common corporate transactions such as rights issues, demergers and other capital raising transactions.

4.86 The Committee agrees that there is a need to reduce complexity by ensuring the rules apply equally to both shares and rights.

Recommendation 17

4.87 The Committee recommends removing the real risk of forfeiture requirement for shares and removing the 75 per cent offer requirement for shares.

Recommendation 18

4.88 The Committee recommends that the Australian Taxation Office expand its model documents to include documents similar to those produced by the United Kingdom Department for Business Innovation and Skills.

Mr Jason Falinski MP

Chair

23 August 2021

A. Submissions

1 Name Withheld

2 The Tax Institute

3 Australian Small Business and Family Enterprise Ombudsman

4 Shareworks by Morgan Stanley

5 Australian Institute of Company Directors

6 American Chamber of Commerce in Australia

7 Confidential

8 Pitcher Partners

9 KPMG Australia

10 Fortescue Metals Group Ltd

11 Confidential

12 Name Withheld

13 Inspector-General of Taxation and Taxation Ombudsman

13.1 Supplementary to submission 13

14 Right Click Capital

15 Succession Plus

16 Palantir Technologies

17 Ernst & Young

17.1 Supplementary to submission 17

18 Taxation Law Committee, Business Law Section, Law Council of Australia

19 Employee Ownership Australia

20 Confidential

21 Guerdon Associates

22 Professor Andrew Pendleton

23 National Australia Bank

24 Business Council of Co-operatives and Mutuals

25 King & Wood Mallesons

26 Minter Ellison

27 PricewaterhouseCoopers

28 PricewaterhouseCoopers, the Group of 100 Incorporated, Corporate Tax Association and Business Council of Australia

29 Australian Investment Council

30 StartupAUS

31 Treasury

31.1 Supplementary to submission 31

31.2 Supplementary to submission 31

31.3 Supplementary to submission 31

31.4 Supplementary to submission 31

31.5 Supplementary to submission 31

31.6 Supplementary to submission 31

31.7 Supplementary to submission 31

31.8 Supplementary to submission 31

32 Confidential

33 Atlassian

34 Australian Securities and Investments Commission

35 Stripe

B. List of Public Hearings and Witnesses

Thursday, 4 June 2020 - Canberra

(Video and Teleconference)

The Treasury

- Mr Bede Fraser, Principal Adviser, Individuals and Indirect Tax Division, Revenue Group
- Ms Ruth Moore, Principal Adviser (Acting), Market Conduct Division, Market Group
- Ms Shanyn Sparreboom, Manager, Individuals Tax Unit

Law Council of Australia

- Mr Andrew Clements, Taxation Law Committee member, Business Law Section

Friday, 19 June 2020 - Canberra

(Video and Teleconference)

Inspector-General of Taxation and Taxation Ombudsman

- Ms Karen Payne, Inspector-General of Taxation and Taxation Ombudsman
- Mr David Pengilley, General Manager
- Mr Duy Dam, Director, Review and Engagement

The Tax Institute

- Mr Mark Molesworth, Chair, SME and Tax Practitioner Technical Committee
- Mr Chris Wookey, Co-Chair, SME and Tax Practitioner Technical Committee

Employee Ownership Australia

- Mr Andrew Clements, Deputy Chair

StartupAUS

- Mr Alex McCauley, Chief Executive Officer

HWL Ebsworth Lawyers

- Mr Shaun Cartoon, Partner

EY Australia

- Mr Alfonso Capito, Executive Director
- Mr Christopher Galway, Partner

Private Capacity

- Professor Andrew Pendleton

Thursday, 16 July 2020 - Canberra

(Video and Teleconference)

Palantir Technologies

- Mr Timothy Hamilton, Legal Counsel

Atlassian

- Mr Patrick Zhan, Head of IP, Policy and Government Affairs
- Mr Toby Eggleston, Partner, Greenwoods and Herbert Smith Freehills

Macquarie Group

- Mr Ernest Chang, Head of Taxation
- Ms Nicole Sorbara, Chief Operating Officer

Culture Amp

- Ms Sarah Tinsley, General Counsel and Company Secretary
- Mr Adin Martin, Vice President, Finance