The issue

The are aware that certain employers operate employee share schemes where the employer company makes limited recourse loans to employees to acquire shares and charges interest on the loans.

As the loan provided to the employees is limited recourse, the capital protected borrowing (CPB) rules in Division 247 of the Income Tax Assessment Act 1997 could apply to restrict the deduction that the employees can claim for the interest paid on the loan.

An exclusion from Division 247 applies to shares acquired under an "employee share scheme". However, under Division 13A of the Income Tax Assessment Act 1936 ("ITAA 1936"), a share is only acquired under an employee share scheme if the share's acquisition price is less than the "market value" of the share as determined under the market value rules in section 139FA of Division 13A of the ITAA 1936.

Typically, under these types of plans, shares are acquired for market value, so the exclusion in Division 247 would not apply.

This is contrary to the stated intention of Division 247 (Explanatory Memorandum at paragraph 7.41 provides - "this measure is not to apply to CPB's under which a company provided limited recourse loans to employees to buy shares in their employer companies").

Why this issue is beyond the scope of TIES

This proposal is seeking an extension of the Employee Share Scheme (ESS) exclusion in the CPB measures. This is a policy change. This is not a mere technical correction.

The ESS exclusion was a concession that deliberately used the existing definition of ESS in the tax law that is, it only applied schemes are acquired for less that the market value of the share. Despite the claim by the in relation to the Explanatory Memorandum it was never the intention for the exclusion to apply beyond ESS as defined in the tax law. Employee Share Schemes as defined in the tax law are basically schemes were shares are provided at a discount.

This issue was raised by industry at the time the legislation was going through Parliament and the previous Government decided not to make the proposed amendment. It was considered that there was no compelling reason to extend the scope of the exclusion beyond ESS as defined in the tax law.

An arrangement under which a taxpayer pays consideration of market value or greater to acquire a share or right is not an ESS because the employee receives no discount on the share price. It is assumed that the benefit provided under such an arrangement to the employee will be in the form of a below market interest rate on a limited recourse loan. This arrangement is economically identical to other CPBs under which a discounted loan is made to a borrower. Such arrangements have not been excluded from the scope of the CPB measures.

The proposed extension would undermine the integrity of the measures because it would be easy to structure a CPB using an employer loan so that the CPB measures would not apply.

It would encourage the use of CPBs with employer loans compared to CPBs with non-employer loans.

- The cost of capital protection for CPBs with employer loans would be fully deductible and on revenue account in accordance with *Firth's case*.
- This is in contrast with other CPBs which are subject to the CPB measures where the cost of capital protection is on capital account and not immediately deductible.

This would result in fully deductibility for the cost of capital protection and create a different taxation treatment based on the form of the CPB.

> ***Example: Same CPB with non-employer loan and with employer loan***
>
> John Smith enters into a CPB with a bank under which he borrows $50000 for one year on a limited recourse basis. The loan is used to acquire $50,000 of shares at market value. Mr Smith pays the banks an amount of 20% per annum (ie $10000). This amount is for interest on the loan and for the cost of capital protection.
>
> Assume under the CPB measures the benchmark interest rate is 6% per annum. This means that 6% ($3000) is deductible as interest while 14% ($7000) is taken to be paid for the capital protection is treated as a put premium and subject to capital gains tax.
>
> Now assume the same facts except that the bank lends the money to the employer who lends it to Mr Smith. If such a CPB was excluded from the CPB measure the whole 20% per annum ($10,000) would be deductible

As demonstrated in the example this proposed change would create non-neutrality in that it would result in different tax treatment for CPBs using employer loans and CPBs using non-employer loans.

The proposed change would result in fully deductibility for the cost of capital protection and create a different taxation treatment based on who made the loan under the CPB. The more favourable tax treatment for CPBs with employer loans would encourage the use of such structures and undermine the integrity of the CPB measures and ultimately render the CPB measures obsolete.

Further points

- This proposed extension would be at a cost to the revenue and a costing request would need to be prepared and authority would need to be sought for any legislative amendment.
- It was made clear during consultation that the scope of the ESS was that in the tax law and that the CPB exclusion was not intended to provide leverage to amend the back of the ESS.
- The employer loans covered by the proposed extension would have to be at a discount otherwise it would be cheaper for the employee to extend their home loan to fund the purchase of shares at market prices.
- The main issuers of CPBs are banks. There would be no need for these rules if banks had agreed to provide the actual cost of capital protection something along the lines of companies providing information in relation to imputation credits on shares. The non-disclosure of the actual cost of capital protection allows CPB issuers to avoid competition in relation to the provision of the cost of capital protection.
- If the integrity of CPB measures are undermined by this proposed amendment the two main options will be to either:
  - (1) force banks and employers to disclose the actual cost of capital protection; or
  - (2) to use complex option pricing methodologies such as the modified Black-Scholes methodology, or a binomial or trinomial pricing methodology.