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Tax White Paper Task Force

Tax White Paper

Employee Ownership Australia and New Zealand's (EOA) Expert Panel commend the Government for undertaking an examination of the current Australian Tax system. The Tax White Paper is both timely and needed.

Some of the key themes in the Tax White Paper are:

- The need to create a tax system that supports the modern economy;
- The need to create a tax system that helps innovation and productivity to sustain and improve economic growth;
- A tax system that simplifies the process for companies to reduce unnecessary red tape and to allow them to focus on economic growth; and
- An underlying it all tax system that is fair.

EOA's experts panel would like to put forward one key proposition that is important for all of the points above.

EOA has suggested some specific initiatives for Red Tape Reduction for Small Business and a single initiative to enhance savings in Australia for lower income tax earners.

EOA has also responded specifically to the question raised in the Tax White Paper -

What other taxation incentives, including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?

Taxation of Employee Share Schemes at Cessation of Employment

Request

Our request is to remove tax at cessation of employment for ESS schemes completely. Alternatively to remove it where the circumstances of cessation are considered to be good leaver situations.

If protection of tax revenue requires more than employer reporting, a better solution than tax on cessation would be employer withholding at the point of sale of vesting/shares. The proposed 10% withholding addition to the foreign resident CGT regime (i.e., to apply to real estate sales from 1 July 2016) is a precedent for such a rule.

Key Points

1. Cessation of employment as a taxation point creates significant complexity and cost for companies and employees:

Under the current reporting regime companies need to report when an employee leaves the company as a taxation point (if the equity is not lost or lapsed at this point). This event is usually not when the employee realises their equity. The company then needs to track what happens when the equity eventually vests (due to performance conditions etc). At that point if the equity lapses in full or part then the company needs to send the employee an amended statement. The employee then needs to amend their tax return and in most cases this results in a tax refund. This tracking of employees, out of cycle reporting and employee administration is costly, complex and unnecessarily burdensome.

2. **Australia is out of line with the rest of world:**

In no other jurisdiction is there a taxation point at cessation of employment. In no other jurisdiction is this seen as an issue for the revenue authorities. At the moment tax at cessation acts as a disincentive for employees to join Australian companies. For global talent this particular taxation issue can be a significant point when remuneration is discussed.

3. **The current workings of the taxation point are unfair:**

Changes in Corporations Laws and corporate governance standards have significantly changed share plan practices at cessation of employment. Cessation of employment no longer necessarily triggers vesting of awards.

Generally if an employee is classified as a good leaver[1], i.e. if they leave due to death, total and permanent disability, retirement or redundancy, their equity would remain in the plan until the testing/vesting date and then vest based on the performance/time testing at that time.

[1] Good leaver always includes death, TPD and redundancy. It can include retirement as well, 70% of the plans that were considered included.

In other situations commonly they lose the equity and no tax is payable, i.e. if they resign or are dismissed with cause.

In the current financial climate there are a growing number of employees that are being made redundant and are facing a tax liability on their equity. In most instances they may not have sufficient funds to meet the tax liability (if the share price has shifted) and rarely get the full equity grant later, i.e. when it is tested 1 –3 years later[2]. This results in individuals in already difficult situations facing large tax liabilities at a time when they can least afford to pay for the taxation. Employees are required to fund significant tax liabilities for equity that they may never realise and often the time between cessation of employment and performance measurement can be significant, 2 years or more.

4. **The reporting system removes concerns in relation to integrity:**

Cessation of employment was originally introduced as a taxation point prior to the reporting regime being introduced and was partly introduced in relation to concerns about employees leaving the jurisdiction post - employment and this creating potential collection issues. The reporting system that is now in place provides complete transparency around employees ESS interests and also the tax payable. If the employer does not have a TFN at the point of reporting they have an obligation to pay any tax due so the integrity issues are unlikely to occur.

5. **The Current Taxation Point is contrary to normal taxation rules:**

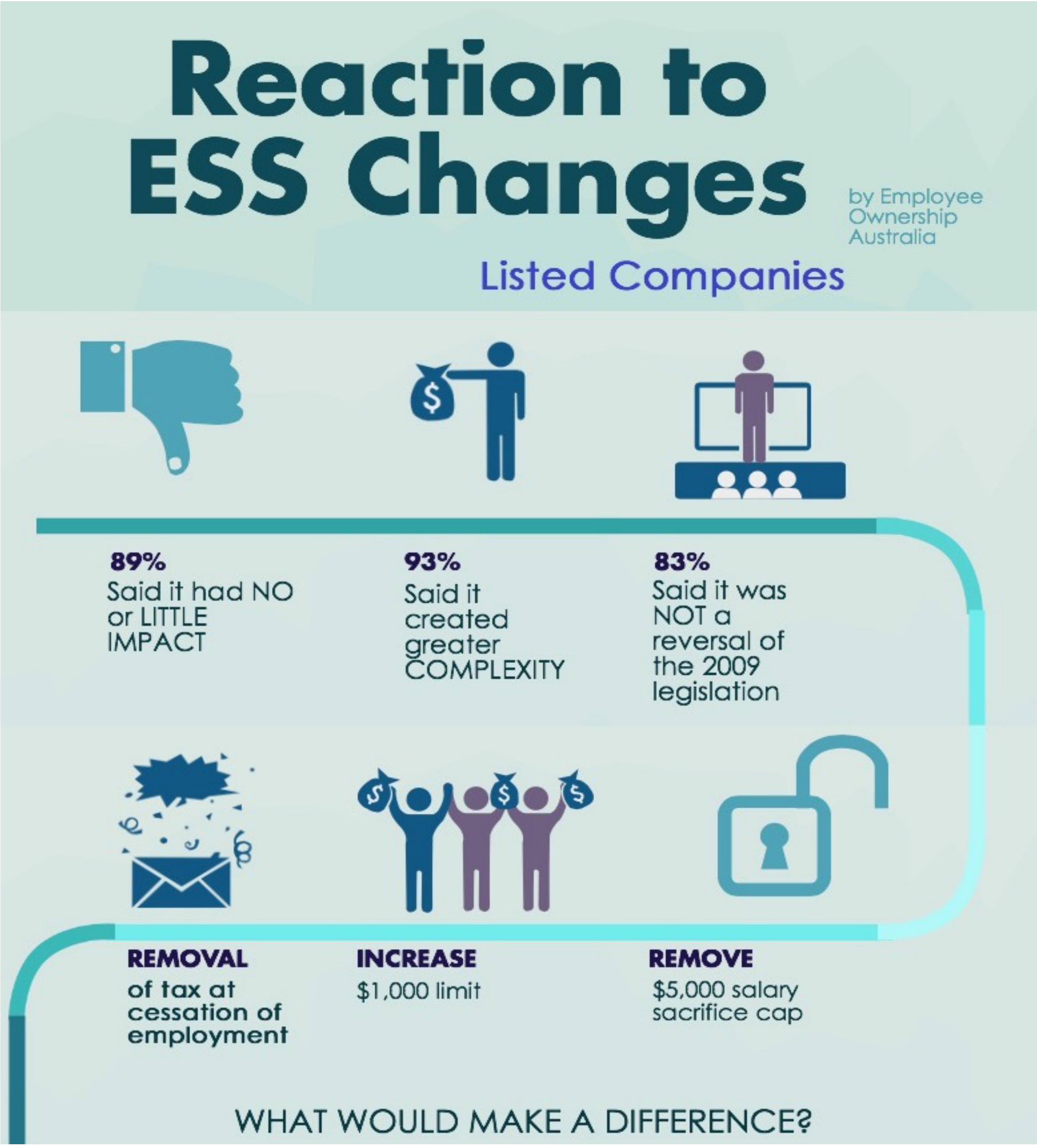
This income taxing point overrides all other possible taxation points, such as the lifting of a real risk of forfeiture or the ending of disposal restrictions on the ESS interest. This income taxing point at termination of employment applies irrespective of whether performance conditions or holding requirements still apply to the ESS interest and whether or not the employee can access the equity.

For any other asset an individual is only taxed when they are able to realise the asset. Commonly on termination of employment an employee is unable to dispose of the securities because they can not access or sell anything. Conversely they are required to pay tax on something they **may never** realise.

[2] Approximately 90% of plans do not vest fully when they are tested according to data provided by Computershare and Link Market Services Limited.

Company Sentiment and Reaction

Cessation of employment is the number one issue for listed companies in this area, see below the following survey undertaken with top 100 listed companies:



Investor and Market Support

The Productivity Commission's Report in January 2010 endorsed the removal of the taxable event at termination of employment.

The Australian Prudential Regulation Authority (APRA) Prudential Practice Guide released in November 2009 concluded it is preferable for deferral and vesting arrangements to remain in place post termination of employment and that cessation of employment as a taxation point for the taxable event arising for deferred share schemes 'has the potential to cause conflict between prudent deferral and taxation requirements' [APRA 2009c, p. 13].

This issue has also been emphasised by the Financial Stability Forum in its Principles for Sound Compensation Practices , and subsequently by the G20 and European Union. For shareholder alignment, requiring employees to hold equity following termination of employment is considered to be best practice.

This view is also held in Australia. For example, the Australian Shareholders' Association (sub.54) supports executives holding equity for a period of at least two years after departure.

The Productivity Commission's aim to have employees tested post termination of employment, so as to encourage a long term, not short term outlook by employees, is diminished due to the need to administer awards through termination of employment.

SME Businesses – Red Tap Reduction Measures

The key issues for SME companies in the employee ownership space is very similar to those highlighted in the UK's **Sharing Success: The Nuttall Review of Employee Ownership**[3]**:**

1. **Lack of awareness around employee ownership in Australia, and misconceptions around what it is and what is creates.** Specifically among the local advisors that work with businesses in this area. Interestingly, despite this general perception more and more companies are contacting us about employee ownership and how they can implement it for succession planning (in the last year our enquiries in this area have doubled)**.**

2. **The cost of implementation, because there is no readily available resources that companies can access and general it is more complex in Australia to implement an employee equity plan.** The average cost for an unlisted company to implement a plan in this space is between $30 – 120,000. This is a significant cost to companies and it is exacerbated because they don't have any starting documents they can rely on to reduce this cost. In the global plan world, Australia is considered one of the harder jurisdictions to understand and implement plans in (by overseas companies).

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[3] In this report they characterise them as follows:

> **Firstly, a lack of awareness of the concept of employee ownership. In many respects this underpins all other barriers to employee ownership. The concept of employee ownership is not widely known, and is undermined by misperceptions.**
>
> **Secondly, a lack of resources available to support employee ownership. All businesses need information and guidance to support them. There is a lack of awareness of employee ownership amongst legal, tax, accountancy and other advisers, which means advice is hard to find.**
>
> Thirdly, the actual (or perceived) legal, tax and other regulatory complexities of employee ownership were cited as barriers to its adoption, or as burdens facing existing employee owned companies.

3. **A view that it is just too hard (real or perceived).** Companies that have a very strong desire to implement employee ownership don't know who to ask or where to go and often give up when they understand the legal, tax and corporate law hurdles that they need to jump through.

Key Points

1. **Provision of standard documentation:** Most companies in the unlisted space use loan plans (the company provides a loan to the employee and the only security is against the shares. The loan is used to purchase the shares at market value and is repaid through post tax dividends or profit share). Where there is a transfer of the business to employees this is usually the only way that this can be facilitated. It also ensures that the employee is not subject to tax until the shares are sold. **We would suggest that the ATO creates standard documentation for loan plans for SMEs to use, this would save most companies a significant amount of compliance time and legal costs.**

2. **$5,000 cap in the ASIC Class Order:** The current ASIC Class order has a cap for unlisted companies of $5,000 which means that most unlisted that want to issue shares under a plan need to file a Offer Information Statement if they can not fall within the exemptions in section 708. **EOA would recommend that the current cap in s708(1) be increased to 50 investors in 12 months up to a $4 million cap. This would assist companies with employee share schemes (most SMEs have less than 50 employees and would also assist with capital raising through crowd sourced equity.**

3. **Remove the need for a Trust (Removal of 50 non-employee shareholder cap and self acquisition):** Currently most unlisted companies need to operate a trust to hold employee shares. This adds additional cost and complexity. The reasons behind this are twofold. When shares are forfeited they need somewhere to hold the shares (they are prohibited from doing so via self acquisition rules in the Corporations Act or they would need to use the share buyback provisions rather than simply cancelling shares) and also they need to ensure that they do not inadvertently exceed the 50 non-employee cap and fall into public company territory. **There are a number of provisions of the Corporations Act that could be reviewed to exclude employee share schemes from them, where the general provisions have inadvertently not considered the impact on employee share plans.**

4. **Exemption from Part Division 7A:** Companies in the unlisted sector have to go through a tax review of this particular part of the tax legislation (because they use loan plans). It is a cumbersome and costly exercise that could be overcome by ATO direction about when these types of ESS plans are outside this Division.

National Savings Agenda

With the findings from the Intergenerational Report and the declining levels of savings in Australia, employee ownership could be used to assist with long term savings and help ensure that older generations have sufficient money to fund their retirement. We would suggest that the Government creates a named employee share scheme similar to the SAYE (Save As You Earn) in the UK (which has been in existence since 1980).

The SAYE is a savings-related share scheme where you can buy shares with your savings for a fixed price which is a 15% discount on the share price at the start of the plan, when you enter the savings contract.

Employees can save up to £500 a month (post tax) under the scheme. At the end of the savings contract (3 or 5 years) the savings can be used to buy shares. The tax advantages are:

- the interest earnt and any bonus at the end of the scheme is tax-free
- you don't pay Income Tax or National Insurance on the difference between what you pay for the shares and what they're worth

Capital Gains Tax is only payable on the sale of the shares. It is a low risk plan in which employees can choose to buy the shares at a discount or take the cash at the end of the period. It is popular with low income tax earners who would not otherwise save. It is an easy vehicle as the money is automatically taken from the employees wages each pay cycle. The employee can leave at any time (but they lose the bonus at the end of the savings period).

EOA in conjunction with Andrew Pendleton from the UK is intending on publishing research in this area.

Innovation and Entrepreneurship

In Australia SMEs employ 70% of the workforce and 31.5% of small business owners are women[4]. They are a very significant part of the business sector. 60% of businesses do not intend to hand over the business to their family, which will leave a large number of companies faced with potential shut down unless they can find an alternative model.

In our experience there are three types of companies that approach EOA about employee ownership in the small business and unlisted space. Established companies that want to have the same benefits as their listed counterparts, family businesses and SMEs that want to transition into retirement by selling to their long standing work colleagues (who are often considered as a 2nd family) and start-ups who need employee equity to attract and retain talent as a top up to below average salaries.

The key area for reform in this area should be for family businesses looking to hand over ownership. This is an area where the UK CGT concession should be considered to encourage employee ownership as a succession planning mechanism that will ultimately help companies survive. In the UK if 50.1% of the company is handed to an employee benefit trust then this transaction is CGT free for the owner of the business. It was created to overcome the completely of tax planning for a retiring owner, help families owners transfer to their long standing employees and to ensure that all financial advisors actively had to discuss employee ownership as an option with business owners.

Small businesses are hubs for innovation because there are less layers of approval and employees are more connected. SMEs in conjunction with employee ownership are more

[4] SME Association of Australia, http://www.smea.org.au/newsmedia/official-launch/sme-infographic-illustrates-vital-role-of-sector-in-australian-economy

productive and less vulnerable to closure[5] so a specific policy and concession associated with this area is very important.

Creation of an Employee Ownership Panel

To continue improving employee ownership, innovation and productivity it is important that Key Government officials, experts and corporate stakeholders are engaged and consulted. The creation of a government lead initiative, which has a panel of individuals reviewing and considering potential areas for reform would maximise the value of the current start-up concession and any future initiatives. EOA endorses the creation of a panel of this kind.

Yours sincerely

Angela Perry

Chair

Employee Ownership Australia and New Zealand

[5] In the USA there are around 10,900 Employee Share Ownership Plans (ESOPs) employing more than 13 million US employees. In a joint project with the Employee Ownership Foundation, the NCEO found that employee ownership averts a substantial amount of unemployment and saved the US Federal Government over $23 billion in 2010. Data from the General Social Survey shows that in 2010, for instance, 12.1% of all working adults in the private sector reported having been laid off during the prior 12 months, compared to just 2.6% of those respondents who own stock in their company through a company-sponsored employee ownership plan. This dramatic difference remains even after adjusting for different conditions faced by employee-owners and non-employee-owners.