Employee Ownership
Australia *Making it your business*

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To Directors
Market Conduct Division and
Individual and Indirect Taxation Division
The Treasury
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Dear Directors

Submission on the proposed Employee Share Schemes draft legislation

1 Introduction

Employee Ownership Australia ("**EOA**") welcomes the opportunity to make a submission on Treasury's exposure draft legislation published on 29 July 2021, which proposes to amend the tax rules and regulatory requirements relating to employee share schemes ("**Proposed Amendments**").

EOA was formed in July 2011 to ensure ongoing advocacy for broad based employee ownership and dynamic workplace participation in Australian companies.

It engages with and assists companies that have or aim to implement employee ownership or employee share plans, whilst also being a key advocacy body for broad based employee ownership. EOA is independent and entirely member funded, and is the only independent, dedicated advocacy and education group in this space in Australia.

We advocate for tax and corporate regimes that promote, not prevent, the ability of business to engage in employee ownership.

The Proposed Amendments are a positive step towards achieving this. These submissions set out areas where the Proposed Amendments could be improved to facilitate this goal.

We would be happy to discuss if you have any questions regarding our submissions.

Summary of recommendations

The removal of the taxing point on cessation of employment should be brought forward so that it applies with retrospective application from the date of Royal Assent or from an earlier date when the Government announces a changed commencement date. It should also apply to both new and existing ESS interests.
The “no consideration” exemption should be extended to mean “no risk”.
The proposed liability regime should be removed.
Modify the $30,000 cap so that there is no “per employee cap”, but an overall cap on the amount of employee equity that can be issued in a given period. This should be in a similar form to the “20/12” rule that is currently in the Corporations Act.
The tax rules and Corporations Act provisions dealing with ESS should be made more consistent.
ASIC should also continue to have the power to relieve companies from ESS obligations on a case-by-case basis to deal with anomalies.

2 Tax arrangements for employee share schemes

Removing cessation of employment as a taxing point

Recommendation 1

The proposed changes should apply with retrospective application from the date of Royal Assent or from an earlier date when the Government announces a changed commencement date.
The proposed changes should apply to all ESS interests currently on-foot. Namely those for which a taxing point has not yet arisen.

The EOA welcome the proposed amendments to *the Income Tax Assessment Act 1997* to remove cessation of employment as a taxing point.

For many years the EOA has supported the removal of cessation of employment as a taxing point as it often triggered a taxing point when employees did not have access to the underlying shares to fund the respective taxes.

Taxing employee share scheme interests on cessation of employment was out-of-line with the rest of world, so removing cessation of employment as a taxing point will increase Australia's competitiveness in the global battle for talent.

EOA recommends changes to the proposed application and transitional provisions.

Currently, the removal of tax on cessation of employment will only apply on the first day of the first quarter following the Bill receiving Royal Assent, and will only apply to ESS interests issued on or after the beginning of the final year that follows Royal Assent.

Practically, this means that should the relevant Bill receive Royal Assent prior to 30 June 2022, the earliest application of the removal of cessation of employment as a taxing point will be for ESS interests issued on or after 1 July 2022.

Given this proposed change was foreshadowed in the Federal Budget released in May 2021, the EOA recommends that the proposed changes should apply from the either Royal Assent or from an earlier date when the Government announces a changed commencement date.

The proposed changes to all existing ESS interests currently on-foot, rather than the changes only applying to ESS interests granted on or after the financial year following Royal Assent.

3 Regulatory arrangements for employee share schemes

Background – the psychology and economics of employee shares schemes

During recent discussions between Treasury and the EOA, a question was raised as to why companies do not just offer awards that "do not require payment to participate" given the proposed changes provide broad relief for schemes provided to employees or directors that do not require payment to participate.

Although there are currently many schemes that do not require payment to participate, there are also many schemes that do require payment from employees and directors to participate.

The decision of whether or not a company will require payment from employees to participate depends on the objectives of the scheme.

These objectives can vary from seeking to retain employees to driving share price growth. Equally, the cost to the company of operating the scheme can vary significantly depending on whether or not the employee pays to participate.

For example, the award of free shares or rights to receive free shares in a company, subject to satisfying service and/or performance conditions, is highly valuable to employees.

As the award always has value (even if the share price declines), these types of awards are very retentive. From a company perspective, there is a high cost in providing employees with these types of awards.

Alternatively, consider a discounted share purchase plan where employees can acquire shares at a discount to the current share price (typically between 10%-20%). These schemes may require employees to contribute their own funds to participate.

The participation rate in these types of schemes is much lower (as employees have to pay to participate), and for those that choose to participate, these types of schemes incentivize employees to drive share price growth. If the share price falls below their purchase price, the employee will incur a loss.

This means employees have "skin in the game". These types of schemes also significantly cost companies less as they are only partially funding the scheme (e.g. the discount), with employees contributing the bulk of the cost of the shares.

Accordingly, the decision of whether or not to have employees pay to participate is driven by a number of different factors and there are valid reasons and drivers for requiring employees to pay to participate in some schemes.

It should not be inferred there is fund raising aspect to plans under which employees may make a payment to participate.

"No Consideration" exclusion

Recommendation 2:

To ensure the "no consideration" exclusion is better aligned with the tax rules, and to allow for employee equity to be provided more efficiently, the exclusion should mean 'no risk'.

The "no consideration" exclusion contained in the Proposed Amendments is a welcome reform.

The relevant test for the exclusion should not be 'no consideration', but instead 'no risk'. Our suggestion is that there should be a general exclusion for securities which are provided at no cost to the employee.

Most SMEs currently use a loan plan as their desired employee contribution method, especially when succession planning. Loan plans are not currently covered by CO 14/1001.

These arrangements are also critical to satisfying the relevant tax rules. If they are not captured in the new Corporations Act relief this will present a barrier for SMEs offering ESSs going forward.

When considering the exemption, a distinction should be made between:

(a) *a plan where at risk monetary consideration is provided in relation to the relevant shares*.

An example of a scheme of this type might include where an employee contributes an amount of cash for the acquisition of the relevant securities or directs an amount of their after-tax salary to acquire shares; and

(b) *where no at risk monetary consideration is provided in relation to the acquisition of the securities*.

An important example of the provision of securities of this type is the acquisition of securities which has been funded through the provision of a limited recourse loan arrangement.

In this case, the employee is not at risk in relation to the monetary consideration which has been provided in relation to the acquisition of the securities. On this basis, these should be treated differently from plans were at risk monetary consideration is provided.

Further alignment of the “no consideration” exemptions

Recommendation 3:

> The “no consideration” exclusion should also extend to:
>
> - salary sacrifice arrangements;
> - provision of options ‘for free’ where they would otherwise have a market value; and
> - schemes where shares are provided to an employee who has no choice in relation to the receipt of the shares.

Again, a distinction needs to be drawn where the acquisition of security is through a salary sacrifice arrangement. In all cases of an effective salary sacrifice, monetary consideration is not provided. This is the critical element of effective salary sacrifice arrangements.

The essence of these arrangements is that an amount of the total remuneration of the employee is provided in the form of shares. They are provided at no cost to the employee and without any monetary consideration by the employee.

A distinction should also be made between those contribution plans where the employee may elect to receive a form of the remuneration by the provision of shares for no consideration.

This should be contrasted with an instance where the shares are simply provided to the employee for no consideration and the employee has no choice or right in relation to the receipt of the securities.

An example of an arrangement of this type is where the employer decides to provide a bonus to the employee and that a bonus is provided at the election of the employer in the form of shares. In that case, the employee has no choice in relation to the form in which a bonus may or may not be provided.

A further distinction should be made where options would otherwise have a market value but are provided ‘for free’. In these circumstances the option should be treated as being provided for no consideration.

The critical issue is that an appropriate distinction is made up between the different categories of employee contribution plans: between those that require the employee to be ‘at risk’ for the provision of the shares and those that do not. Those that do not should be subject to the exemption.

No expansion of the liability regime for ESS offering documents

Recommendation 4:

> The elevated liability regime should be reconsidered.

The elevation of the liability regime in respect of ESS offering documents may operate as a strong disincentive against employers offering ESS.

The proposed amendments to the Corporations Act will impose on ESS documents the same level of liability as that which currently applies to fundraising documents.

Due to the nature of restrictions of offers of ESSs in terms of quantum, these offers are not considered to be 'fundraising' under the Corporations Act.

It is inappropriate to apply rules that are applicable to fundraising documents to ESS documents.

As the provision of employee equity serves different purposes to fundraising it should not attract the same liability regime. Employers are seeking to provide their employees with a benefit, rather than trying to raise funds for their company.

The elevated liability regime may disincentivise employers from providing this benefit.

$30,000 cap

Recommendation 5:

Either remove the $30,000 limit entirely or adopt the "20/12" exemption.

We support the extension of the $30,000 cap if a limitation per employee with any monetary cap is retained.

However, we do not consider that a financial cap per employee is an appropriate limit on arrangements. If the concern is with fundraising, then ESSs should be subject to overall caps which are outside the existing small scale offering exemption.

<u>Removing the monetary limit:</u>

The proposed $30,000 limit should be removed – or modified – for the following reasons.

(a) many foreign companies are not restricted by an equivalent limit in their own jurisdictions;

(b) the monetary limit has been a "roadblock" for unlisted Australian and foreign companies looking to implement ESSs in Australia;

(c) any monetary limit will be arbitrary and not tailored to the circumstances of the particular company, which will change over time. The monetary limit may also require regular updating to keep pace with Australian and international developments; and

(d) the monetary limit has introduced unintended complexity. For instance, different valuations for accounting and tax purposes have led to confusion around the application of the monetary limit.

In a succession planning context, the $30,000 cap may not be meaningful and may make it difficult to transition the business from the owner to employees.

The key benefit of modifying the monetary cap relates to the fact that primarily, at the moment, companies rely on sections 708(1) and 708(12) of the Corporations Act or tend not to proceed for all employees if they exceed those caps.

If the monetary limit is not removed then the "20/12" exemption in the Corporations Act should be adopted. That is, there is an exemption for 50 employees in 12 months up to $2 million. This overarching cap would effectively operate to restrict fundraising. It would also allow SMEs to offer a meaningful amount of employee equity, particularly in succession contexts.

Consistency between the tax and corporate rules

Recommendation 6:

The tax rules and Corporations Act provisions dealing with ESS should be made more consistent.

A significant issue with the current ESS regime is understanding how the different regulatory regimes interact: the tax legislation, the Corporations Act and ASIC Class Orders. This complexity is a deterrent to offering ESSs.

The proposed consolidation of regulatory relief will go a long way towards simplifying the overall regime, however, more should be done to ensure that relevant concepts are aligned between the tax rules and Corporations Act where possible.

Further areas that could be made consistent between the tax and corporate rules include:

- *the treatment of independent contractors:* the existing narrow definition of contractors (and casual employees) should be amended because it creates particular difficulties in the gig economy. The threshold in relation to the level of employment is too restrictive;
- *nature of shares offered:* relief from the prospectus rules only applies to ordinary shares that are offered under an ESS. There is no reason why this relief should not apply to other classes of shares (e.g. preference shares);
- *the scope of the loan exemptions*: there are specific exclusions from provisions that apply to ESS loans under the Corporations Act when those loans are made interest free. The provisions of Division 7A of Part III of the Income Tax Assessment Act 1936 (Cth) may require the charging of interest;
- *definition of an employee share trust*: the concept of an employee share trust is not consistent between regimes. If a trust is treated as an employee share trust for the purposes of the tax rules, this should be sufficient for the purposes of the Corporations Act; and
- *exclusion from the "20/12" rule for employee offers*: complying offers for the purposes of ESSs should be excluded from the "20/12" rule, as the rule may otherwise restrict the offering of equity to employees.

ASIC should continue to be able to provide regulatory relief

Recommendation 7:

ASIC should retain the power to provide relief on a case-by-case basis.

A risk of simply consolidating the current regulatory regime would be if it excluded the ability of ASIC to deal with case-by-case relief for anomalies which are outside the scope of the new regulatory regime.

This power should not extend to restricting the scope of statutory exemptions for ESSs.

There are advantages in using the ASIC Class Orders (CO 14/1001 and 14/1000) to regulate ESSs, particularly in areas where there may be differences in approach over time and between jurisdictions. The forms of employee equity which are offered across the world vary significantly. It is important that ASIC has the power to facilitate the offer of foreign schemes in Australia.

This is most likely to be achieved through a general class order rather than creating an overly complex legislative regime to facilitate offerings that are outside the normal scope of those currently offered in Australia.

The key is that the consolidation of the rules should not come at the expense of flexibility when dealing with offers which do not fall within the strict rules in the new regulation.

ASIC should continue to have the power to relieve companies from their obligation to comply with the primary or secondary restrictions in relation to securities offerings.

This is even in circumstances where the employer company might otherwise not be able to take advantage of the specific statutory exclusion for ESSs or any other general exclusions for equity offers.

We would welcome the opportunity to engage further with Treasury in relation to our above observations.

Yours faithfully

Andrew Clements

Employee Ownership Australia