The Changing ESS Landscape since 1 July 2009

Employee Ownership Australia and New Zealand (EOA) Report

April 2013

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Acknowledgements

The *Changing ESS Landscape since 1 July 2009* Report was prepared by the **EOA Experts Panel** which is comprised of:

- Adrian O'Shannessy – Greenwoods & Freehills
- Andrew Clements – King & Wood Mallesons
- Angela Perry – Link Market Services
- Karen Quinsey – PwC
- Matthew Garvan – Computershare
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About EOA

Employee Ownership Australia and New Zealand (EOA) was formed in July 2011 to ensure ongoing advocacy for broad based employee ownership and dynamic workplace participation in Australian and New Zealand 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.

EOA is a member-focused, not for profit association and replaced the Australian Employee Ownership Association which was formed by 20 companies in 1986. EOA is the only independent, dedicated advocacy and education group in this space in Australia and New Zealand.

About the Experts Panel

Members of the EOA Experts Panel are selected by EOA based on their combined experience of consulting in the employee share plan space over several decades. To be invited to be a member of the Experts Panel the individuals must have over ten years' recognised experience in designing, managing and implementing employee ownership plans. In addition, the individuals selected by EOA are recognised by their peers as practitioners of excellence in this area. The Experts Panel members have been selected from the leading tax and legal professional firms and share plan administrators and registry providers in Australia.

The Experts Panel's philosophy regarding broad based employee share ownership is aligned with that of the EOA.

EOA'S CORE OBJECTIVES

Since its incorporation in July 2011 the EOA's core objectives have been:

- to be the centre of excellence for companies seeking to implement or support employee ownership;
- to be the principal voice for the advocacy of employee ownership in Australia and New Zealand;
- to increase employee involvement, engagement and participation in workplaces through broad based employee ownership;
- to encourage research into the productivity impacts of employee ownership;
- to encourage Governments at all levels to develop taxation and other incentives to promote broad based employee ownership; and
- to provide exceptional services to our members.

EOA'S POLICY RECOMMENDATIONS

The EOA recommends that public policy should be formulated so as to promote broad based employee share ownership based on the following key objectives:

- to better align the interests of employees and employers so as to promote employee engagement and productivity;
- to enhance national savings;
- to facilitate and encourage the development of small to medium, privately owned enterprises including start up companies; and
- to facilitate employee buyouts and business succession.

Introduction

This Report addresses the adverse impact on participation in employee ownership plans following the introduction of Division 83A of the *Income Tax Assessment Act 1997 (Cth)* effective from 1 July 2009. The Report has been based on the professional experience of the EOA Experts Panel comprised of Computershare Limited, E&Y (Ernst & Young), Greenwood & Freehills, King & Wood Mallesons, Link Market Services Limited and PwC (PricewaterhouseCoopers).

The conclusions in the Report are supported by statistical information collated from client data provided by Computershare Limited and Link Market Services Limited. Additional statistical information could also be collated from the Australian Taxation Office ESS reporting regime, however this has not been made available to the public.

The aim of this report is to promote debate. The Experts Panel believe that this may stimulate greater employee equity participation levels for Australian employees, and at least restore participation rates to the pre 1 July 2009 levels.

The statistics on which this report is based

The statistics on which this report is based and to which this Report refers have been compiled from across Link Market Services Limited's and Computershare Limited's joint client group of 500 listed clients and approximately 1,000,000 Australian employees. The statistics have been collated from client's ranging from two employees to 100,000 employees and encompassing all industry types within the ASX All Ordinaries Index.

Executive Summary

The EOA Experts Panel has concluded that the following are the key outcomes of the introduction of Division 83A in 2009:

1. Employee Share Scheme (ESS) Reporting alone could have achieved the desired outcomes

Division 83A was introduced in a period where there was a focus on rising Executive pay levels and a key reason given for implementing Division 83A was to reduce opportunities for tax evasion and avoidance[1] in a period of global recession. The Experts Panel believes that this concern could have been addressed effectively through the implementation of the ESS Reporting regime. ESS Reporting provides certainty and transparency to both ESS participants and to the Australian Taxation Office in relation to the timing and quantum of taxable events, and it has helped employees understand the taxation impacts of ESS awards. Due to the complexity of the employee share scheme tax rules many employees have struggled to understand when their ESS awards were taxed and how to calculate that taxable discount. The ESS Reporting regime has added much needed clarity in this area.

The Experts Panel believes that this concern could have been addressed effectively through the implementation of the ESS Reporting regime.

2. Division 83A has increased companies' compliance costs and added an additional level of complexity to plan administration

Outside of the ESS Reporting regime, the changes introduced in Division 83A have added complexity for most companies in administering employee share plans rather than simplifying the process. Division 83A has also diminished the level of equity participation levels for employees, particularly at a broad based level. In many instances it has required companies to increase the number of plans. It has, at the same time, reduced the rates of participation by employees and offers being made by employers.

Importantly in many cases, the need to comply with the requirements of Division 83A has added additional and inappropriate complexity, whilst at the same time in some cases providing a similar economic outcome for employees. It is this complexity, which in many instances adds to the compliance costs, reduced participation rates for employees and, most importantly, undermines many of the key motivational objectives in offering employee equity to employees.

As a result of the introduction of Division 83A most companies needed to review or amend their existing ESS awards. Additionally, Plan Administrators and their clients were required to make significant investment in time and capital to implement the ESS Reporting in the short time frames that were required by the legislative changes. In particular the time frame provided, under the amending legislation, to introduce the ESS Reporting was limited to a period of less than six month following Royal Assent of Division 83A, whereas such a transition typically would have required at least an 18 month implementation period.

[1] See paragraph 1.14 and 1.15 of the Explanatory Memorandum to Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009

3. Broad based employee share plans have been impacted the greatest by the changes

The greatest impact of Division 83A has been at the broad based employee participation level with the impact being as follows:

a. Over 90% of plans were suspended during the first year and 30% of plans were suspended for up to two years. Of the 30% of plans suspended for two years many have not been reinstated.

b. The $5,000 salary sacrifice limit imposed under Division 83A has had the greatest impact on broad based employee groups, middle management and employee savings plans. There has been a noticeable decline in the amounts that are contributed to salary sacrifice employee share ownership plans as a direct result of the provisions in Division 83A and, in particular, the $5,000cap.

c. Overall, the number of employees participating in, and the amount invested by employees in, employee share ownership plans has substantially reduced since the introduction or Division 83A.

Over 90% of plans were suspended during the first year and 30% of plans were suspended for up to two years.

4. Employee Share Option Plans have also been significantly impacted by the changes

The use of employee share option plans has significantly declined. This is largely because of the introduction in Division 83A of taxation at vesting. In addition, the elimination of tax refunds for vested but "out of the money" options has also exacerbated the situation.

These plan where formerly used in executive remuneration. However, employee share option plans were also widely used in small to medium, privately owned enterprises including start up companies, because of the potential for upside that such plans deliver. From a practical perspective, more options are typically awarded than shares or performance rights (because the option plan has an exercise price and hence a lower intrinsic value). This could lead to larger gains for employees in start-ups who rely on this type of plan to offset the lower initial salary and higher risks inherent in a start-up company. The change in taxation of option plans has severely impacted the ability of many such companies to effectively remunerate their employees through employee share options and retain key talent in their businesses during the early period of growth.

Further, the change to the time of taxation of employee share options from exercise to vesting is one of a number of reasons that has forced listed Australian companies to expend considerable time and financial costs in restructuring employee equity plans.

5. Division 83A has led to a decline in International Plans offered in Australia

Division 83A, especially as it applies to option plans, has added complexity and cost for companies offering Australian employees shares in an overseas listed parent company. Plans typically implemented by an overseas listed parent company, include market value option plans for more senior executives and periodic distribution type savings plans and these now have significant issues as a result of the provisions in Division 83A.

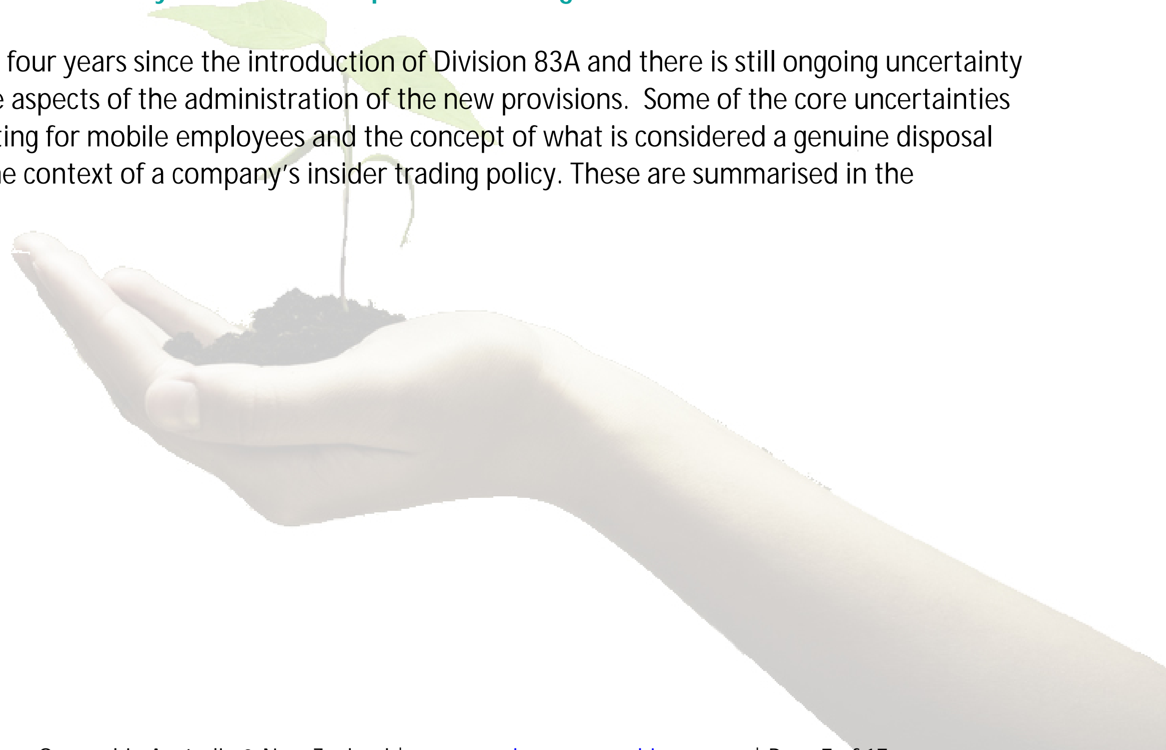
This has resulted in a decline in international plans being offered to Australian employees. This has prejudiced the ability of Australians employed by international companies to participate in employee share plans as well as impacting the ability of such employers to offer competitive remuneration packages to employees in Australia.

6. A key concern in the former legislation has not been addressed – being tax at termination of employment

The impact of tax at termination of employment continues to be a troublesome issue for companies. This, combined with the overlay of other concerns such as the termination payments cap under the Corporations Act and the Productivity Commission's recommendation of continued performance testing of employee share plans for senior employees following termination of employment (to overcome the perceived short term views of executives that was in part blamed for the Global Financial Crisis) makes the taxation point at termination of employment unreasonable and inequitable. Taxation at termination of employment can trigger a taxable event for unvested awards as well as for "out of the money" awards and, as far as the Experts Panel is aware, sets Australia apart from the rest of the world as a jurisdiction taxing unrealised awards. However, in spite of previous lobbying on this matter, Division 83A has retained termination of employment as an ESS taxable event with harsher consequences than under the previous rules due to the now limited tax refund provisions.

7. There is still uncertainty about some aspects of the legislation

It is now nearly four years since the introduction of Division 83A and there is still ongoing uncertainty regarding some aspects of the administration of the new provisions. Some of the core uncertainties relate to reporting for mobile employees and the concept of what is considered a genuine disposal restriction in the context of a company's insider trading policy. These are summarised in the Appendix.



Immediate Recommendations

The Experts Panel has considered the statistics and has made some immediate recommendations to make the current legislation more amenable to broad based employee ownership:

1. Remove or increase the $5,000 salary sacrifice limit

The $5,000 salary sacrifice limit has inhibited the ability of employees to make meaningful savings through employee salary sacrifice employee share plans. The data referred to in this Report shows that the average salary sacrifice amounts before 1 July 2009 were above $5,000 per participating employee per year.

Interestingly the Experts Panel's considered view is that the tax deferred salary sacrifice plans are likely to provide greater income tax revenue in a rising market. Under Division 83A an employee is taxed at the deferred taxation point, which can be up to seven years after their share scheme interests are acquired. At the deferred taxation point the full value of the share scheme interests is taxed as ordinary income. If the employee had paid income tax on the salary initially they then would have been able to have any gain taxed in the more favourable CGT regime, and would have paid less tax. So by having brought forward the initial taxing point for plans which do not meet the $5,000 limit, Division 83A is just as likely to have reduced the overall tax collection.

Rather than impose a salary sacrifice dollar limit, the Experts Panel recommends that the previous position be reinstated, i.e. by removal of $5,000 cap and no limit on salary sacrifice contributions to employee share plans or for the cap to be significantly increased.

2. Reinstate tax at exercise for options

The impact of the change in timing of the taxation point, for options in particular, has been highlighted above and figure 5 in this Report evidences the impact. The marked decline in the use of option plans has largely been a direct result of the changes, which apply from 1 July 2009. Further, this change has had a significant impact in the small to medium, privately owned enterprises including start up companies where it is anticipated that a future event for the company may lead to a significant share price increase. For example in the resources sectors, biotech or and IT sectors [2].

3. $1,000 tax reduction limit needs to be increased

The $1,000 tax free amount for plans (formerly known as "exemption") plans has not been increased or indexed since its inception in 1997. In real terms the value of $1,000 has significantly decreased.

[2] See also AVCAL's submission to the review of the National Innovation System.

ADDITIONAL MID TO LONG TERM RECOMMENDATIONS

There are some additional recommendations that the Experts Panel suggests need attention in the mid to long term if employee ownership is to be competitive with our international counterparts and if employee ownership is to assist productivity, growth and help increase national savings. These include:

1. Termination of employment needs to be removed as a deferred taxing point.

2. The operation of Division 83A generally should be reviewed more broadly against the objectives of national savings and productivity policy, and alternative share plan tax regimes considered for small to medium, privately owned enterprises including new start up companies.

3. There should be greater flexibility in the interpretation of the term Genuine Disposal Restriction to reflect commercially applicable disposal restrictions.

Background to the 1 July 2009 tax reform introducing Division 83A

In summary, Division 83A very much duplicated its predecessor being Division 13A of the *Income Tax Assessment Act 1936 (Cth)* (now repealed) but, in addition, introduced some significant changes. An overview of Division 83A is summarised below.

As explained in the Explanatory Memorandum to the *Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*, Division 83A "was designed to improve the horizontal equity in the tax system by treating all forms of remuneration more consistently, to target employee share scheme tax concessions more closely to low and middle income earners, and to reduce the scope for losses to the Commonwealth revenue through tax evasion and avoidance[3]".

Division 83A was specifically targeted at generating additional revenue of $135 million[4] principally from the new ESS Reporting regime. It is unclear from the information available to date whether this objective has been achieved. As far as EOA is aware there has been no tracking against this target. EOA believes this additional revenue estimate could have been achieved by implementing an ESS Reporting regime alone. Thus creating transparency for all stakeholders, as opposed to rewriting the employee share scheme tax provisions in their entirety.

> *Division 83A was specifically targeted at generating additional revenue of $135million principally from the new ESS Reporting regime…EOA believes this additional revenue estimate could have been achieved by implementing an ESS Reporting regime alone…*

Overview of Division 83A

Under Division 83A the default position is that ESS awards are taxed as ordinary income at the time of grant.

Tax can (as previously) only be deferred or exempted if the ESS interest meets further additional conditions. Below are the conditions in the current legislation:

- for a tax reduction plan it is that it meets the requirements to access the $1,000 reduction from income tax. This is only available if an employee's adjusted taxable income is less than $180,000 total taxable income;
- there is salary sacrifice arrangement of up to $5,000 and there is a genuine disposal restriction on rights or shares acquired under the plan; or
- there is a real risk of forfeiture of the share or right or option.

If these base conditions are satisfied then income tax on an ESS interest can be deferred for up to seven years (subject to the design and operation of the particular plan and awards made under the plan).

[3] Paragraph 1.15 of the Explanatory Memorandum to *Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009.*
[4] See page 7 of the Explanatory Memorandum

Impacts of the legislation generally

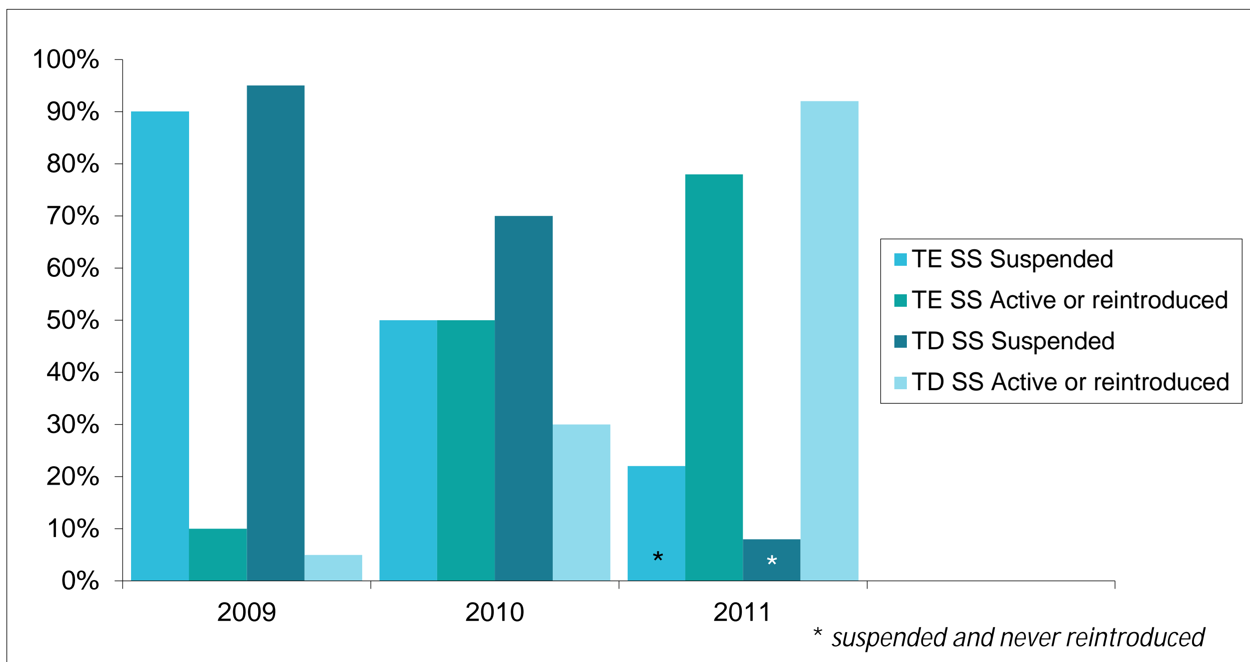
The following points are general observations regarding the practical impact noted since the introduction of Division 83A.

IMPACT OF THE CHANGES ON THE NUMBERS OF PLANS IN OPERATION

After the initial uncertainty and suspension of plans companies have largely reintroduced some of their plans. For example, the broad based $1,000 reduction employee plans were eventually re-introduced, however Salary Sacrifice Plans (both tax exempt and tax deferred) were also significantly impacted (according to the client data). For companies, which provided a matching company contribution, the dollar value of the contribution was, in most cases, reduced or ceased altogether, having a marked reduction in participation levels by employees.

Figure 1 below shows the plans that were in operation prior to the 1 July 2009 changes and how those plans were affected by the changes, specifically how many of the plans were suspended, either temporarily or permanently for at least one year. Figure 1 shows what happened from when the legislation was announced, to the time that the legislation was enacted and in operation, post the uncertainty of changes. The 2011 figures evidence the number of plans that were not reintroduced.

Figure 1: the Plans that were suspended as a result of the 1 July 2009 ESS legislation changes.

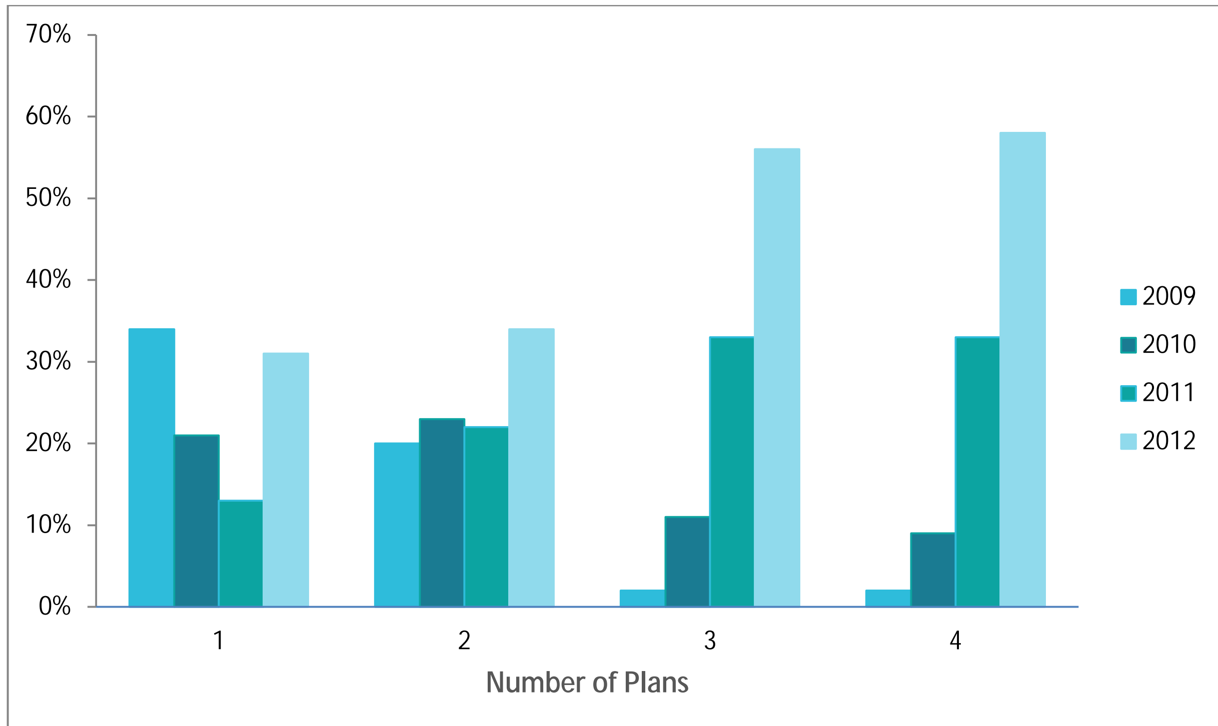


One of the key impacts of the legislation has been that virtually all companies have needed to review and revise their existing plan arrangements at a significant cost to those companies. This has led to companies introducing new plans and/or amending former plans with the outcome that they are now having to operate more plans than prior to 2009. This adds to complexity and cost. Most importantly, the increase in the number of plans being operated does not translate into greater employee participation.

Usually a listed company now operates at least two plans at the broad based employee level (low to middle income earner levels) and at least two plans at the Executive level. Indeed, many companies now operate three or more plans and smaller companies have needed to operate at least two plans since the legislation was implemented. This indicates that the new legislation has created greater cost and complexity. As

evidenced in the rest of the report this increase in the number of plans has not led to an increase in the number of employees that are participating in the plans. Participation rates by employees have in fact dropped even though there are now more employee share plans being operated.

Figure 2: the number of plans that companies operate Pre and Post the introduction of Division 83A.



Outside the ASX 200 the ability of companies to operate an employee share plan is still an issue. Many companies cannot afford the cost and complexity of implementing an employee share plan.

IMPACT OF THE CHANGES ON PARTICIPATION IN BROAD BASED EMPLOYEE SHARE PLANS

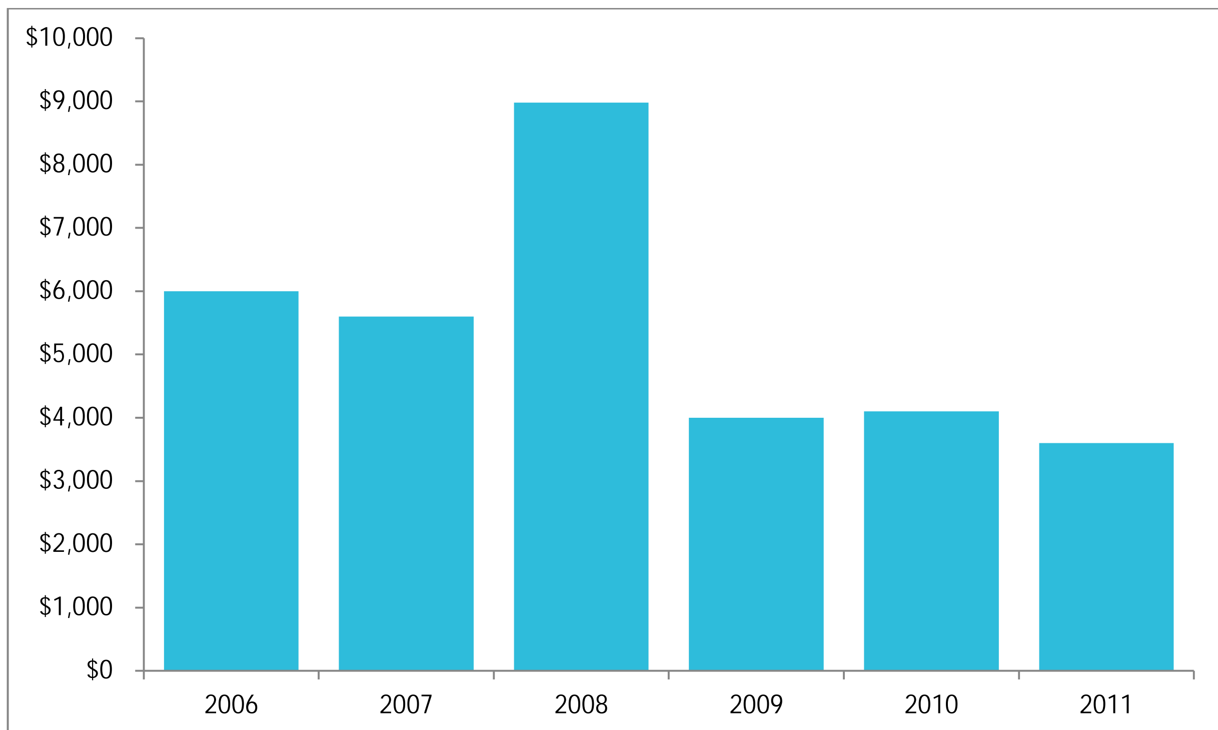
Division 83A has had the greatest impact at the broad based employee level, particularly on the tax deferred salary sacrifice plans and share option plans (see further discussion below). Whilst many executive plans offered prior to the change effective from 1 July 2009 were suspended, whilst the legislation was finalised, once the legislation was completed most executive plans recommenced and the actual changes in participation levels were marginal.

However, for both the tax deferred salary sacrifice plans and the share option plans, which are commonly used both for both employees and executives, there was a period of initial uncertainty and consequent suspension of these plans. The impact of Division 83A has resulted in these plans being the most affected by the changes. This is a result of the $5,000 salary sacrifice cap limit and, in the case of option plans, the taxable event now being vesting rather than exercise. So the reality of the situation is that whilst the individuals who the tax changes were aimed at were largely unaffected, it is the broad based employee salary sacrifice and option plans, which have been predominantly impacted. This is evidenced by the marked reduction in participation levels in these plans.

ADDITIONAL OBSERVATIONS REGARDING THE DECLINE IN PARTICIPATION IN TAX DEFERRED SALARY SACRIFICE PLANS

Salary sacrifice plans are most frequently used at the employee and middle management level to create a means for employees to accumulate company shares, save money for up to seven years (previously ten years) and for some employees this was used to supplement their retirement income. The imposition of a $5,000 salary sacrifice cap has significantly reduced the average salary sacrifice levels of employees and indeed many companies no longer use such plans.

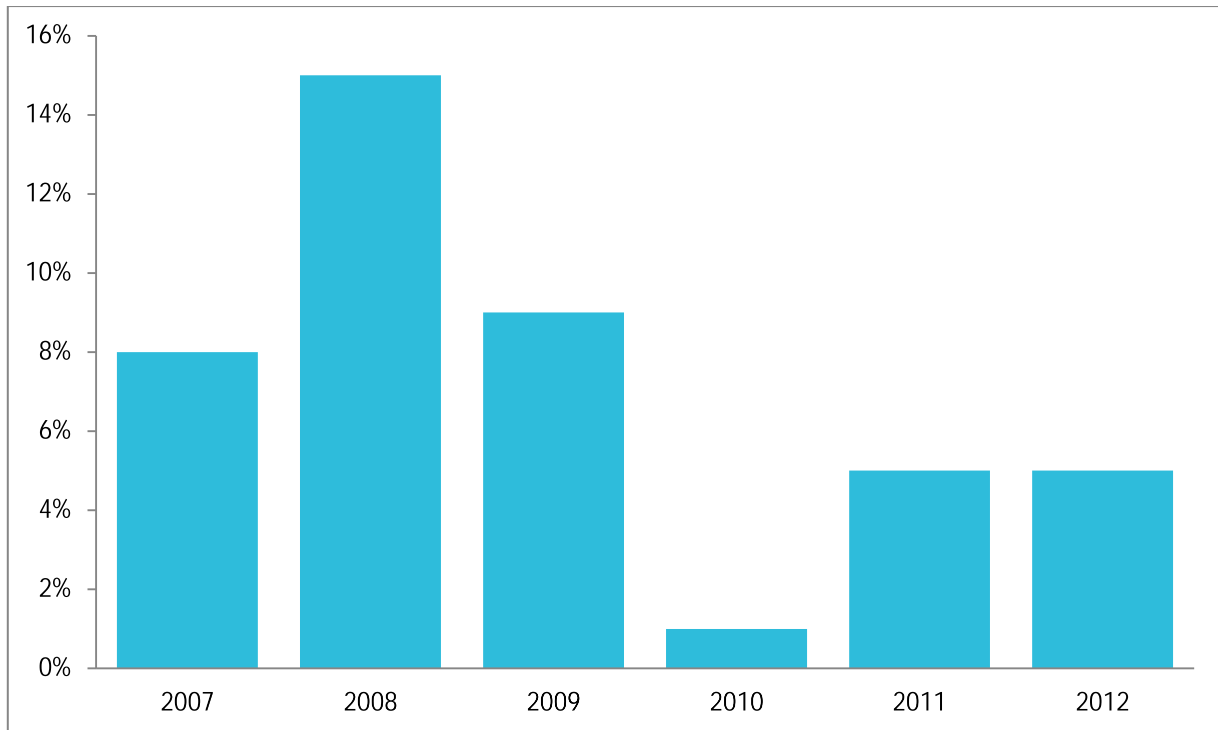
Figure 3: the impact of the $5,000 cap on average amount contributed to the Salary Sacrifice plan



In addition the creation of the genuine disposal restriction concept has made the salary sacrifice plans less attractive to employees. Previously there was a restriction and/or forfeiture condition that operated during the maximum ten year tax deferral period. Often an employee would be allowed to request a withdrawal prior to that period to access their shares. In practice 85% of employees did not access their shares prior to the end date. However, the previous legislation allowed greater flexibility and was perceived as more attractive to employees.

The current legislation requires the disposal restriction to apply from the date of the offer and can only be removed in extreme cases, such as financial hardship or special circumstances. This rule appears to have been administered very stringently by companies, in part due to the administration of the provision by the Australian Taxation Office. This change, when combined with increasing economic uncertainty in share price movements, has led to a decline in both the offer of, and the participation rates in this type of plan. In practice companies have tended to now use a restriction period of three years. The majority of participants in these plans now sell their ESS shares after the three year restriction period to enable them to fund their income tax liability, hence diminishing the returns they may have otherwise enjoyed from holding their salary sacrifice shares for up to 10 years.

Figure 4: Impact on participation rates in Tax Deferred Salary Sacrifice Plans



This figure shows the percentage of employees who accepted an offer to participate in a tax deferred salary sacrifice plan. As can clearly be seen, the participation rates dropped off sharply in the year ended 1 July 2009 and to date have not returned to the pre 1 July 2009 levels. This is due to the $5,000 salary sacrifice cap and the concept of genuine disposal restrictions, which are required for tax deferral.

The overall impact has been that employee savings through employee share plans have been significantly reduced.

ADDITIONAL OBSERVATIONS REGARDING THE DECLINE IN PARTICIPATION IN EMPLOYEE SHARE OPTION PLANS

Historically, option plans were the preferred vehicle with companies in specific sectors such as mining, biotech and information technology companies. They have been the most common type of plan for small to medium, privately owned enterprises including start up companies likely to have a significant growth phase.

This is because:

- The exercise price can be set at a time when the share price is low and the number of options granted can be significant. Usually there is a dollar value allocated as part of the employee's remuneration or as a top up to salary to make the employee's salary comparative to those companies that have the cash flow to offer market rate salaries. Because an option has a lower value than a share more options can be allocated than shares and there is potentially greater upside for employees;

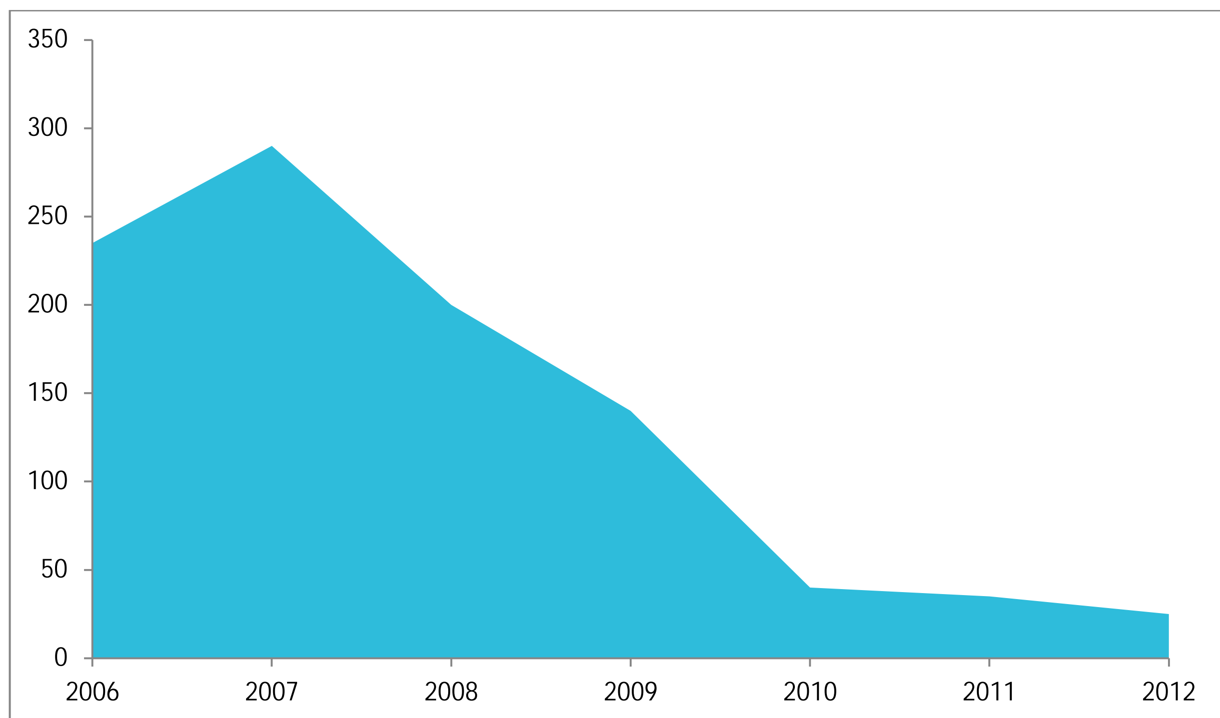
- The share price growth is likely to be substantive. Options focus employees on share price growth because the value of the option is dependent on share price growth. It was previously possible (prior to the 30 June 2009 changes) for an employee to choose to be taxed up-front on the value of the

options with the balance of any gain taxed as a capital gain which can be attractive for employees (note that, tax at grant only applies post the 1 July 2009 changes to awards where there is no real risk of forfeiture or the option is premium priced);

- The option plan is recognised as high risk but with a potential high return because of the growth cycle of the company; and
- Dividend income is unlikely to be a factor because cash flow is used for development, so shares are less attractive.

Division 83A has significantly reduced participation in ESS option plans.

Figure 5: Decline in Option Plan Usage after the 1 July 2009 changes



Note: Employer population based on 500 employers.

In addition to the decline in the number of ESS option plans in operation there has been an adaptation of the way that the option plans operate. Division 83A has created an unusual anomaly that has made Australia out of step with the rest of the world. As far as we are aware Australia is the only jurisdiction where ESS options are taxed at vesting; the rest of the world typically taxes ESS options at exercise hence matching the derivation of a benefit with the timing of the taxable event.

This has led to plan changes that make them artificially fit into the, perceived international norm. These changes include:

- Restrictions on the exercise of options to shift the taxation time from vesting to exercise;

- Restriction on shares acquired at exercise, which means employees need to fund the exercise costs without the ability to sell some of their shares to meet the exercise cost;

- An increase in the use of the premium priced options, where the exercise price exceeds the market value of the underlying shares at grant. Heavily premium priced options have no ESS tax value and are therefore outside of Division 83A. Typically these types of options only have any value if the share price grows significantly; the employee is only able to benefit from significant share price growth to which they have contributed. Note: the employer has a potential fringe benefits tax liability when the option is granted.

Further, the new tax refund rules unfairly impact option awards. For options awarded since 1 July 2009 the income tax liability typically arises at vesting, and this is the case even if the options are "out of the money" (i.e. the option exercise price exceeds the market value of the underlying shares at the vesting date). Further, this income tax liability cannot be refunded under the new rules even if the options lapse unexercised. The reasoning behind it is that the employee "chooses" not to exercise their options and therefore should not be allowed to access the tax refund provisions.

There has also been an impact on international companies offering share options in Australia because of the taxation of options at vesting (previously option plans were treated on a comparable basis globally and were typically taxed at exercise). This has meant that global companies (typically US listed companies), which have commonly operated this type of plan globally now may not offer ESS options to Australian employees. In summary, the tax complexity has led to a decrease in offers in Australia, and those offers have been made to fewer employees.

Appendix

ONGOING AREAS OF UNCERTAINTY

There are several areas of ongoing uncertainty in the application of Division 83A. Some examples have been summarised below:

1. Taxation of rights at vesting rather than exercise works against a national savings and productivity policy. Rather than promoting continuing equity ownership by employees, it encourages sale of shares to (a) fund the tax payable on the vesting event and to (b) eliminate the risk for employees of being taxed on a higher value than the amount for which the shares may later be realised. Further, in the case of employee share options, tax may be payable at vesting even if the options are "out of the money".

2. What constitutes a genuine disposal restriction, and how this is administered by the Australian Taxation Office is uncertain, particularly in situations where an employee possesses insider information or where a company insider trading disposal restriction policy is in place.

3. Taxation of the Market Value of shares for unlisted companies requires an independent valuation at grant and at any possible taxing event, the costs of which can be prohibitive for such companies.

4. There is some confusion regarding the interaction between s.83A-325 and awards granted to a non-individual. The ATO has issued a Fact Sheet indicating a view that ESS awards granted to, say, a company associated with an employee are outside Division 83A.

5. Simple after tax contribution plans previously common in Australia and still used internationally (e.g. plans for purchase of shares at a small discount, for example 5%) are no longer feasible in Australia because they satisfy neither the real risk of forfeiture test nor the salary sacrifice requirements. Further, the indeterminate rights provision now adds additional complexity to such plans where tax deferral cannot be accessed.

6. Unnecessary complexity arises in complex reconstructions and de-mergers. For example, de-mergers can give rise to a termination of employment for ESS purposes under Division 83A, for example, where a subsidiary company is sold, employees transfer with the de-merged company. Commonly, in a de-merger situation the ESS award will continue in place through a de-merger event. Division 83A should be amended to provide that de-mergers do not cause an ESS taxing event.

   The interaction between de-mergers and termination of employment can cause significant administrative problems for awards under reduction plans during the three year disposal restriction period and reform of the existing provisions is needed to address these unintended consequences.

7. The operation of the "indeterminate right" rules can also be uncertain and, as a result, problematic in many scenarios.