Australian Government

The Treasury

21 November, 2013

Mr Jason McNamara
Executive Director
Office of Best Practice Regulation
John Gorton Building
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Dear Mr McNamara

Post-implementation Review – Better targeting the concessions for Employee Share Schemes

I am writing to the Office of Best Practice Regulation (OBPR) regarding a Post-implementation Review (PIR) for the proposal 'Improving fairness and integrity in the tax system — better targeting the concessions for Employee Share Schemes' (ESS).

This measure was part of a package of measures in the 2009-10 Budget to improve fairness and integrity in the tax system and introduced limits on the tax concessions for ESS.

In developing the policy, the Department of the Treasury self-assessed the proposal as having a minor impact on business and/or the not-for-profit sector, in accordance with the Best Practice Regulation requirements that applied at the time. However, a Regulation Impact Statement exemption for this proposal was provided by the then Prime Minister. As the impacts of this policy have not been significant, the Department of the Treasury offers you the following assessment as our PIR.

Problem

If an employee is provided with shares or rights under an employee share scheme, any discount that the employee receives by acquiring the shares or rights below the market price was assessed as income under Division 13A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936). That provision of the ITAA 1936 sought to ensure that the concessions available were directed at ESS, given the role of ESSs in encouraging investment by employees in their employer company, or in their employer company's holding company, and which are broadly available to all permanent employees.

Under Division 13A of the ITAA 1936, an employee participating in an ESS could, subject to certain conditions, choose one of two tax concessions on the discount they received from an employer under a qualifying employee share acquisition scheme (also known as ESS). The two concessions were the tax-upfront concession or the tax-deferred concession.

- Under the tax-upfront concession, an employee could elect to pay no tax on the first $1,000 of discount received on shares or options, but were taxed on the remaining discount in the year the shares or options were received.
- Under the tax-deferred concession, an employee could defer paying tax on the discount received on shares or options until a cessation time. A cessation time occurs at the earliest of:
  - when restrictions on sale are lifted,
  - an employee sells the shares or exercises the options,
  - employment ceases, or
  - 10 years passes from the time the shares or rights were acquired.

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Employers who provided shares or rights under the tax-upfront concession were also eligible for a tax deduction of up to $1,000 in respect of the shares or rights provided to each employee in that income year. The deduction was available on condition that the share or rights meet certain qualifying conditions.

These provisions provided scope for losses to the Commonwealth revenue through evasion, avoidance or confusion as to the taxpayer's obligations and provided significant concessions to certain groups of employees. This had the unintended effect of treating different forms of employee remuneration unequally.

The legislation was also complex, and in conjunction with the complex and technical nature of existing employee share scheme arrangements, resulted in a significant amount of revenue lost through misapplication of the law and deliberate evasion. The ATO at the time estimated the amount of lost revenue to be up to $100 million per year. Additionally it has been acknowledged that there were integrity problems with the existing tax treatment, such as taxpayers artificially extending the taxing point.

Objectives

The objective of the 2009-10 Budget measure was to improve the fairness and integrity of the taxation rules, minimise the opportunity to avoid tax, better target the employee share scheme tax concessions to low- and middle-income earners and ensure that all forms of remuneration were treated equally for income tax purposes.

Impact analysis

The measure tightens the eligibility for tax concessions for ESS. Individuals with adjusted taxable income over $180,000 will no longer be able to receive a tax concession for discounts received on shares or options through an employee share scheme. The tax-deferred concession will now only be available if the shares are at real risk of forfeiture, or if the shares are acquired under a salary sacrifice arrangement and the employee receives no more than $5,000 worth of shares under those arrangements in an income year. An ESS interest acquired by an employee is at real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee may forfeit or lose the ESS interest, other than by intentionally taking no action to realise the benefit. Real risk of forfeiture in a scheme may include conditions where retention of the ESS interests is subject to performance hurdles, or a minimum term of employment. This risk justified the retention of the deferred-tax concession, because it may be some time before an employee passes the necessary condition, for example a minimum term of employment, and can therefore claim ownership of the ESS interest that they were granted.

Under the new rules, if tax on an employee share scheme is deferred, it is deferred until the earliest of the following: there is no real risk that the employee will forfeit or lose the share other than by disposing of it, the employee leaves the employment in respect of which they received the share, or seven years after the employee acquires the share.

The changes also introduced increased reporting requirements to improve the integrity of the tax system. As a result of the changes, employers are now required to report shares and rights acquired under an employee share scheme both at issue and at an employee's taxing point.

While the legislation allows for the collection of information via the employer statement, in practice, the Australian Taxation Office generally only seeks information which employers should already hold as part of the successful operation of an ESS, such as the employee's name, date of birth and address, the discount that was provided to the employee for taxed-upfront schemes or deferred taxing schemes, and the number of interests provided. Employers are only required to give a statement to the Commissioner of Taxation and to the employee if:

- Interests were provided to the employee during the year (either taxed upfront or deferred); or
- The employer has provided deferred tax interests to the employee and the ESS deferred taxing point for the interests occurred during the year.

In 2008-09, 5,740 taxpayers reported interests acquired an ESS with a value of $112 million. In 2009-10, following the commencement of the changes and with the availability of increased data through additional reporting requirements, 43,045 taxpayers reported interests acquired an ESS with a value of $1.4 billion.[1] This has risen to 73,403 taxpayers with a value of $2.2 billion in 2010-11.[2]

Those on incomes below $180,000 who elected to pay tax upfront still have access to the $1,000 exemption amount. Those on incomes above $180,000 are not eligible for the $1,000 exemption if they pay tax up front. Taxpayers who previously elected to defer taxation will no longer be able to make this election, but taxation may still be automatically deferred where there is a real risk of forfeiture of interests.

The changes to the taxation of ESS will reduce complexity for taxpayers. The enhanced reporting requirements for employers mean that the Commissioner may be able to pre-fill employees' tax returns, which will reduce their compliance costs.

There may also be a compliance cost impact for tax agents in learning the new rules. However, the change was relatively simple and therefore would be a small part of a tax agent's regular process of updating their knowledge of recent law changes.

As part of the reforms to the tax treatment of ESS, the reporting requirements for employers were increased, which may result in additional compliance costs for employers in the short term. The legislation provided employers with guidance as to what information may be required by the Commissioner. These changes were made to improve the integrity of the taxation of share schemes and address concerns that the employee share scheme rules were not being complied with. The increase in the number of interests in ESS reported following the introduction of the changes demonstrates the increased reporting is meeting the objective of improving integrity.

Comments that were received in response to the introduction of the reporting requirement indicate conditional support[3].

Under the changes, employers were also required to withhold tax if they provided a discounted ESS to their employee and their employee has not provided their tax file number by the end of the relevant income year. Comments that were received in relation to this change were supportive.[4]

The changes to the tax concessions for ESS impact on the tax paid by individual employees, rather than businesses. However, the changes may have had an impact on business and the not-for-profit sector through the remuneration packages companies choose to provide to employees, as the changes to tax treatment of ESS may make them less attractive to employees, particularly those on higher incomes.

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. The former government had commenced consultation with industry on the most effective measures to address the barriers faced by start-up companies, including:

- developing guidance to reduce the administrative burden (meaning the cost of valuing shares and options) of establishing an ESS;
- adjusting the valuation methodology of options; and
- examining the point at which share options are taxed for start-up companies.

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[1] Australian Taxation Office, *Taxation Statistics 2009-10* (p14).

[2] Australian Taxation Office, *Taxation Statistics 2010-11*

[3] For example, Deloitte Submission, page 4, 12 June 2009 (available at: http://archive.treasury.gov.au/documents/1573/PDF/Deloitte_Touche_Tohmatsu_Ltd.pdf) and 'The Changing ESS Landscape since 1 July 2009', Employee Ownership Australia and New Zealand Report April 2013, p5 (available at: http://employeeownership.com.au/wp-content/uploads/2012/01/EOA-Div-83A-Report-April-2013.pdf)

[4] For example, Austock Group submission, page 4, 12 June 2009 (available at: http://archive.treasury.gov.au/documents/1573/PDF/AusStock.pdf)

These concerns are outlined in the former Government's discussion paper Employee Share Schemes and Start-up companies: Administrative and Taxation Arrangements which was released on 2 August 2013. This discussion paper sought comments on, among other things, the effect of the 2009-10 Budget change on start-ups.

The Treasury and the former Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education were undertaking the review of the administrative and taxation arrangements for ESS and start-up companies. The current Government has not made an announcement on the status of this review.

Other comments have also been made in relation to the Budget changes in other fora, such as the Board of Taxation's review (discussed in more detail below), and while in opposition, the current Treasurer made comments in relation to the ESS changes.[5]

Consultation

A comprehensive consultation process was undertaken during the development of these reforms. This included the release of a consultation paper and an exposure draft of the legislation, as well as a hearing at the Economic Reference Committee. Submissions were received in relation to the consultation paper and the exposure draft of the legislation, and changes were made to the reforms in response to stakeholder concerns.

On 5 June 2009 a consultation paper and exposure draft bill were jointly released by the Treasurer and the then Assistant Treasurer.

- 65 submissions were received in response to the consultation paper.

On 15 September 2009 exposure drafts of the application and transitional provisions were released for public comment

- Six submissions in response were received.

On 1 October 2009 Treasury officials met with the industry representatives who had participated in the confidential consultation.

In response to consultation, changes were made to the Budget announcement. This included increasing the income threshold for the $1,000 tax exemption to $180,000 or less (from $60,000), introducing a limited deferral of the taxing point for schemes where there is a genuine risk of forfeiture and increasing reporting requirements.

The Government also requested the Board of Taxation to consider and report to Government on how best to determine the market value of employee share scheme benefits, and whether employees of start-up, research and development and speculative-type companies should benefit from a tax deferral arrangement despite not being subject to a real risk of forfeiture.

The Board of Taxation reported to Government in February 2010. They acknowledged the claims that start-up, research and development and speculative-type companies place a particular reliance on offering employees equity remuneration due to their cash-strapped status. The Board found that there is some merit to the argument that the restrictions that operate to limit access to the existing ESS tax concessions tend to be particularly onerous for start-up, research and development and speculative-type companies[6].

However, the Board did not recommend the introduction of separate tax deferral arrangements for start-up, research and development and speculative-type companies. They did recommend that support for these companies would be better provided through support mechanisms such as programs administered by Commercialisation Australia and the new research and development tax incentive which can be better targeted than any further tax concession.

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[5] Business Review Weekly, July 4-10 2013, p20.

[6] Review into Elements of the Taxation of Employee Share Schemes Arrangements, Board of Taxation, February 2010, page ix.

Conclusion

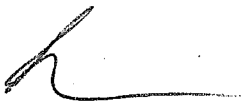
It is considered the measure is broadly meeting its objectives. The Government is continuing to consult with stakeholders on the impacts the measure may be having on some sectors of the economy.

Publication

The Treasury understands that this letter fulfils the Australian Government Best Practice Regulation requirements for a PIR, and as such will be published on the OBPR website.

If you have any queries about this advice, please contact Simone Abbot on 6263 3816 or simone.abbot@treasury.gov.au.

Yours sincerely



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