21 May 2019

Nathania Nero
Senior Policy Adviser
Consumer and Corporations Division
The Treasury
Langton Crescent
Parkes ACT 2600

Via email: ESSreforms@treasury.gov.au

Dear Ms Nero,

Employee Share Schemes

Chartered Accountants Australia and New Zealand (CA ANZ) welcomes the opportunity to provide a submission to the Treasury on the Employee Share Schemes Consultation Paper (Consultation Paper). We appreciate the Treasury providing us with an extension to the submission deadline. This has enabled us to obtain wider feedback from our membership on the proposals. We have focused our feedback on key areas where we consider we can add the most value. Appendix A provides our detailed submission and Appendix B provides more information about CA ANZ.

Key Points:

- We support the policy objective to reduce the time and cost burden for small businesses offering an Employee Share Scheme (ESS) to help them attract, retain and motivate employees to grow their business. ESSs allow employers to provide flexible remuneration arrangements and financial incentives to key staff.
- Feedback from our members indicates that whilst the regulatory framework is complex and simplification would be welcome, it would only result in minor benefits to support small business.
- In our view, the primary barriers to small business using ESSs relate to the tax treatment of these schemes. In particular, the key issue with the tax treatment of ESSs is the default situation under Division 83A of the *Income Tax Assessment Act 1997* (ITAA 1997) where the employee is taxed upfront on the acquisition of the share or right to shares at a discount without having the benefit of receiving any money to fund the tax liability. The tax impediments to ESSs often result in employees preferring not to participate in the scheme or employers abandoning the schemes or adopting alternate arrangements such as loan-backed schemes.

Yours sincerely,

Simon Grant FCA
Group Executive – Advocacy & Professional Standing and International
Chartered Accountants Australia and New Zealand

Karen McWilliams FCA
Business Reform Leader
Advocacy & Professional Standing
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Appendix A

General comments

We support the underlying policy intent, to simplify the Employee Share Scheme (ESS) framework for small business. Some of our members have highlighted, that in their experience, small to medium sized businesses have not made use of the concessions due to their complexity and that the benefits gained do not warrant the expense involved. However, whilst simplification of the regulatory framework is welcomed, we consider this will only result in minor benefits. We understand that the major barrier to wider adoption of ESS by small business relates to the tax treatment of these schemes, as discussed in more detail below.

We have also heard the perspective that the current regulatory framework has been designed with listed entities in mind. Whilst there are some exemptions for small business in specific circumstances, these don’t address the fundamental differences of an ESS for small business compared to those for listed entities. Examples of these key differences include there being no readily available market value for a small business; no appropriate market for the sale of the shares after they vest; small businesses not wishing to offer the ESS to many employees or on an annual basis.

Tax impediments

The tax treatment of ESSs for both the employer and employee have a significant influence on the design of an ESS. Unfavourable tax treatment may often result in the employer opting not to pursue an ESS and hence utilise the available regulatory exemptions.

A key issue with the tax treatment of the ESSs is the taxing point for employees. Although there have been changes to the tax treatment of ESSs in previous years to broadly defer the taxing point for certain start-up companies and ESSs eligible for deferred taxation treatment, often small businesses will find it difficult to meet the eligibility criteria to access the benefit of these changes. To effectively encourage and support small businesses to use ESSs to attract and retain employees, further refinements to the tax law are required.

As the purpose of the Consultation Paper is to seek feedback on proposals to simplify and extend the current regulatory regime for employee share schemes, we have outlined below some key tax issues facing small businesses when considering implementing an ESS. A separate consultation should be undertaken to draw out the tax issues if Treasury decides to consider the tax barriers to small business using ESSs.

Taxing point for employees

Division 83A of the ITAA 1997 applies where an employee acquires a share or a right to acquire a share under an ESS (ESS interest) at discount. Under this Division, the default tax position is that the discount is included in the employee’s assessable income for the income year in which the ESS interest is acquired. Typically, this means the employee has to fund the tax liability at a time before they have received any related monetary amounts. This outcome can result in the employee deciding not to participate in the scheme based on their independent tax advice. There are some tax concessions available to ESSs in certain limited circumstances enabling the employee to obtain an upfront $1,000 reduction in the tax paid or to defer the taxing point.

To overcome the challenge of the upfront tax liability, we understand some businesses may give a bonus at the same time to provide the employee with the ability to finance their tax bill for the acquisition of their

ESS interest. However, this increases the employer's cost to implement the ESS and is not an attractive solution for small businesses.

Alternatively, some may offer a loan to employees to fund the ESS tax liability, which is repaid through the future dividends. However, whilst an initial loan to employees who are not already shareholders would not be covered, any loan to existing shareholders would be subject to Division 7A of the *Income Tax Assessment Act 1936* which treats a loan from a private company to a shareholder as a dividend for tax purposes (the employee shareholder would be subject to tax on the "dividend").

12 month holding rule for the capital gains tax (CGT) discount

With the exception of eligible start-up ESSs, where an employee exercises a share option under an ESS, the employee will be required to hold the shares for 12 months after the exercise date to be eligible for the 50% CGT discount. This is because the general acquisition rule for CGT assets (section 109-5 of the ITAA 1997) states that a person acquires the asset when they become the owner. Therefore, an employee will only become the owner of the shares when the share option is exercised, not when the share option is granted.

Where an employee is eligible for deferred taxation for its share option, this general acquisition timing rule is problematic if the employee needs to sell the shares to access funds to pay the tax liability under the ESS. There is a special acquisition rule (section 115-30(1) item 9A of the ITAA 1997) applicable to 'start-up' companies which basically treats the employee as acquiring the shares at the time the original share option was granted. A similar special acquisition rule for small businesses would go a long way to support them using ESSs.

Market valuation requirement for EES interests

As there is no liquid secondary market for shares/rights in unlisted companies, these companies have to obtain an independent valuation of the market value of its ESS interests at various times so that employees can determine the amount of tax they need to pay for income tax and CGT. This is a significant expense, particularly for smaller businesses. We also note that such valuations include significant assumptions, in particular relating to the impact the ESS itself has on the valuation, such as the rights employee shareholders have to dividends and to sell their shares.

Whilst the ATO has approved two safe harbour valuation methodologies (under legislative instrument ESS 2015/1), these can only be used by eligible 'start-ups'. Consideration should be given to expanding these safe harbour methodologies to all small businesses to encourage them to use ESSs.

Appendix A

Responses to the Consultation Paper questions

1. Consolidating and simplifying existing exemptions and ASIC relief

As noted above, whilst the regulatory framework is complex and simplification would be welcome, it would only result in minor benefits to support small business.

1.1 Do you support consolidating and simplifying the statutory exemptions and ASIC Class Order [CO14/1001] in the Corporations Act?

Broadly, we support the consolidation and simplification of ESS statutory exemptions and ASIC Class Order [CO14/1001] in the Corporations Act. Consolidating the ESS obligations into the Corporations Act will make it simpler to find the rules, however, this will not necessarily make compliance simpler or more attractive. Further, we note that there is insufficient information in the Consultation Paper on the specific simplification aspects of this proposal. We will consider these simplification proposals on a case by case basis once further detail is available.

1.5 Are there significant advantages or disadvantages in using ASIC class orders as opposed to primary legislation to regulate ESSs?

We note that ASIC Class Orders, now referred to as legislative instruments, usually apply to a class of persons who carry out a particular activity in certain circumstances.

Typically, primary legislation can be more difficult to pass and amend in the future. For example, we note that there are currently several existing technical changes to the Corporations Act which have not yet been passed. Therefore, if primary legislation is used, identification of the appropriate thresholds that will have long term application will be important to ensure the regulatory framework does not become a barrier to ESS adoption in the future.

Further, we note that our support of the consolidation of ESS exemptions and CO14/1001 into primary legislation does not extend to us being supportive of consolidating all Class Orders and legislative instruments into primary legislation.

2. Increasing the offer cap per employee

2.1 Do you support increasing the offer cap per employee?

Yes.

However, we understand smaller businesses may wish to incentivise only a few employees through the ESS in one year and the same employees are unlikely to receive grants on an annual basis. Therefore, we don't consider an annual monetary cap to be the most appropriate threshold mechanism. Alternative limitation mechanisms for consideration include a proportion of an employee's non-equity remuneration or a value based on an average over a period of time (eg 3-5 years).

2.3 Is a $10,000 limit per employee per year appropriate or is a greater increase appropriate?

We support the increase of the cap, however our members have noted that $10,000 may still be too low to make this worthwhile. Some members have suggested an even higher cap whilst others suggest alternative thresholds as noted in 2.1 above.

2.5 Is the level of disclosure currently required by the ASIC class order sufficient?

We note that the consultation paper indicates that the disclosure requirements required by the ASIC class order are similar to those under Crowd Sourced Equity Funding (CSEF) offers. We consider this to be appropriate.

Appendix A

3. Facilitating the use of contribution plans

We note that for some proposals the Consultation Paper has drawn comparisons with the CSEF regime. However, there are no comparisons included in relation to contribution plans. We consider that such comparisons would be helpful in answering the questions posed in the paper.

3.1 Do you support contribution plans being able to be used to fund the acquisition of financial products for an ESS of unlisted companies?

We support the use of contribution plans for employees to acquire an interest in an unlisted company. The Consultation Paper notes: 'currently unlisted companies seeking to make ESS offers without a disclosure document, in reliance on ASIC class order relief, cannot utilise contribution plans in connection with these offers.' Our understanding is that unlisted entities can use contribution plans in connection with an ESS, but there would be no exemptions so full product disclosure statement or prospectus would be required.

We would support the extension of the ESS exemptions to cover contribution plans subject to additional protections noted under 3.3 as we consider the risk to be more substantial.

3.3 Are any additional protections necessary for employees participating in contribution plans?

We support appropriate safeguards for contributions scheme to protect employee investors. These additional protections could include a cap on the monetary contribution or an independent valuation. However, we note there may be some alternatives to an independent valuation, which could also be considered such as the ATO's safe harbour methodologies noted above or a different fixed and clearly defined valuation metric or formula in the plan rules. A further consideration should be the length of time served with the employer. Employees who have been employed for several years will have a stronger understanding of how the business performs (financially and operationally).

4. Expanding the exemption from public access to disclosure documents

We support expanding the exemptions from public access to disclosure documents from start-ups to all small business.

Appendix B

About Chartered Accountants Australia and New Zealand

Chartered Accountants Australia and New Zealand is a professional body comprised of over 120,000 diverse, talented and financially astute members who utilise their skills every day to make a difference for businesses the world over.

Members are known for their professional integrity, principled judgment, financial discipline and a forward-looking approach to business which contributes to the prosperity of our nations.

We focus on the education and lifelong learning of our members, and engage in advocacy and thought leadership in areas of public interest that impact the economy and domestic and international markets.

We are a member of the International Federation of Accountants, and are connected globally through the 800,000-strong Global Accounting Alliance and Chartered Accountants Worldwide which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries.

We also have a strategic alliance with the Association of Chartered Certified Accountants. The alliance represents 788,000 current and next generation professional accountants across 181 countries and is one of the largest accounting alliances in the world providing the full range of accounting qualifications to students and business.