This paper represents the initial part of a much larger project that is examining the way in which current legal regulation structures and constrains the use of employee share and ownership plans ("ESOPs"). The project is examining taxation law, corporate law and employment law. The starting point for the project is that employee share ownership plays a significant role in generating a culture of enterprise and innovation, building national wealth and savings and is now the subject of broad consensus across political parties, private sector peak bodies and the trade union movement. However, to date there has not been a thorough study of whether the current practice or the regulatory regimes surrounding the use of ESOPs in Australia are consistent with the social, economic and policy objectives of generating enterprising and innovative workplace cultures.

The first part of this paper deals with identifying existing and emerging policy objectives of ESOPs. The second part of the paper provides a brief overview of the current regulatory regime in the area of taxation. The third part of the paper considers current structures and trends in the area and the fourth part of the paper addresses some of the difficulties that can be identified with the existing tax regime. The fifth part of the paper details the next stages of the broader project.

1. Public policy and legislative developments*

An important part of our study is to identify the social, economic and other policy objectives in the area of employee share schemes in order to determine whether the current practice reflects those objectives. To this end we have been researching legislative developments, particularly in relation to tax, and identifying the express or implied policy objective behind that legislation.

Although legislation was not introduced until the 1970s, support for the idea of employee ownership goes back even further. In a wide-ranging inquiry into employee share ownership in 2000,¹ it was noted that Robert Menzies won the 1949 federal election on a platform that argued that the best foundation for full employment would be found in “the prosperity of the business undertaking in which the man works”. In order to achieve this objective he recommended “the

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* The author would like to acknowledge the work done on this section by Ingrid Landau, Research Fellow, University of Melbourne.

encouragement and introduction of profit sharing schemes wherever practicable".2

Since the mid-1970s, Australian Governments have sought to reform taxation laws so as to facilitate broad-based employee share ownership while also seeking to limit the scope for abuse of employee share plans for aggressive tax planning purposes. The concept of employee share ownership has generally enjoyed bipartisan support in Australia. This paper surveys, in chronological order, the principal legislative reforms to employee share ownership in Australia and the key rationales for the promotion of employee share ownership at the federal government level.

1.1 Employee share ownership under the Whitlam Government

The first legislative provision for employee share ownership in Australia was introduced in 1974 by the Whitlam Government.3 The Income Tax Assessment Act (No 2) 1974 inserted s 26AAC into the Income Tax Assessment Act 1936 (Cth) (‘ITAA’) to govern the taxation of employee benefits in the form of share issues or grants of rights to acquire shares. The ATO explained the purpose of the provision as follows:

“Section 26AAC and ESAS [employee share acquisition schemes] were intended to encourage employees to acquire an interest in their employer company and to allow employees some control. Employees would benefit from the increase in the value of shares if the employer were a successful company.”4

Section 26AAC provided for the taxation of benefits that arose from shares or rights that were acquired in a company under an employee share acquisition scheme where the shares or rights were a consequence of employment or services rendered by the taxpayer or a relative. The shares or rights acquired could be in the employing company or in another company. Section 26AAC provided for the value received under an option or share plan to be measured at the time of the exercise of the option or when restrictions relating to shares were lifted rather than, as had been held in Donaldson v FCT,5 when the rights were acquired. This meant that if the shares were subject to restrictions or conditions so that the employee was prohibited from disposing of the shares or the employee could be divested of ownership, then the employee was only taxed on the discount in the year when the restrictions or conditions were lifted. There was no limit on the period of deferral. The taxpayer could, however, elect to be taxed in the year that the shares or rights were acquired.

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2 Ibid, p vii.
3 Shared Endeavours, f/n 1, p 12.
4 ATO submission No 24, p 6.
5 1974 ATC 4192.
The legislation introduced was the first to provide concessions for employee share ownership in federal legislation, but the government of the day does not appear to have clearly articulated a public policy rationale for employee share ownership. The impetus for the legislation was the decision in *Donaldson*\(^6\) that had held that assessable income would include the value of an option even though the option could not be assigned and could not be exercised for a period of 3 years. The value was said to be whatever a willing but not anxious person would be prepared to pay for it. The legislative reforms were introduced as one of a raft of taxation law amendments and did not form the basis of extensive debate in the federal houses of parliament.

1.2 Employee share ownership under the Keating Government

The second significant stage in the regulation of employee share ownership schemes came in the mid-1990s. Reforms were inspired in large part by concerns that that s 26AAC of the ITAA was being misused to create plans specifically designed for aggressive tax planning.\(^7\) In its 1993 Budget, the Keating Government announced a review of employee share plans. In the 1994 – 95 Budget, the then treasurer, Ralph Willis MP announced significant reforms to employee share ownership in order to facilitate broad-based schemes whilst limiting the potential for misuse. During the period 1994 – 1995, the Government tried three times to implement legislative reforms to employee share schemes. It was only with the third attempt – in 1995 – that they were finally successful.

In 1995, the Keating Government introduced Division 13A into the ITAA.\(^8\) In his second reading speech, the Hon G Gear, then deputy treasurer, explained:

“The government is making these changes to reduce the exploitation of the existing legislation and to ensure that the tax concessions that are available under the new arrangements are directed at share schemes which encourage employees to own shares in the company in which they are employed or a holding company of the employer. The measures will increase the taxation benefits available to employees under these schemes.”\(^9\)

The Bill narrowed the concessions available to employee share schemes to those where the shares are issued in the employer or holding company of the employer and which were available to at least 75% of all permanent employees. The provisions provided that the amount to be included in a taxpayer’s assessable income in respect of shares or rights acquired under an employee share plan would be the difference between the value of the share or right and any amount paid by the taxpayer to acquire the share or right. Generally, the amount was to be included in assessable income in the year that the share or

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\(^6\) Ibid.
\(^7\) Shared Endeavours, f/n 1, p 12. See also ATO Submission, 30 April 1999, p 4.
\(^8\) *Taxation Laws Amendment Bill (No 2) 1995*.
right is acquired. However, providing the rights or shares satisfied certain criteria, an employee who acquired a share or right under an employee share scheme may have been eligible for the following:

- An exemption concession: an income tax exemption initially to a value of $500 per employee per year for qualifying shares that are issued to employees under a scheme operated on a non-discriminatory basis; or
- A deferral concession: a deferral of taxation initially for up to five years on qualifying shares and rights that are subject to conditions. To be qualifying shares or rights, they must be acquired under an employee share scheme; at the time the share or right is acquired, or at an earlier time, 75% of permanent employee should have been entitled to acquire shares or rights of the employer or holding company of the employer. The shares or rights should be ordinary shares or rights of the employer or holding company. The employee should also not hold more than five per cent of shares or voting rights of the employer company or holding company.

The reforms were supported by the Democrats and the Greens but opposed by the Liberal/National Party opposition. While supportive of employee share schemes and cognisant of the need for reform of the existing provisions in s 26AAC, the opposition criticised the reforms on the basis that the ‘complex set of income tax rules’ would ‘make employee share acquisition schemes less attractive and less available to the Australian work force.’ They would, according to numerous opposition members, both threaten the viability of existing schemes and restrict the proliferation of schemes in the future. In particular, the opposition criticised the qualifying conditions for obtaining the tax discount as too restrictive, including the requirement that the shares be ‘ordinary shares’, thus excluding from the concessional and deferral regime those types of companies that do not issue ordinary shares; the tax treatment of share options for taxing a potential gain that may never be realised; and the five-year maximum deferral period for being too short (thus resulting in many international share option plans attracting tax before employees acquire shares).

1.3 Employee Share Ownership under the Howard Government

Even before his election to office in 1996, John Howard expressed his commitment to the promotion of employee share plans. His policy statement, Employee Share Ownership Plan Initiatives, emphasised the importance of employee share ownership plans in increasing the voluntary savings of Australian households; building a sense of participation in Australian business through giving employees a direct stake in the enterprise in which they work; and providing incentives to achieve high levels of productivity. Employee share

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12 John Howard, Employee Share Plans Initiatives, cited in Peter Reith MP, Minister for Employment, Workplace Relations and Small Business, ‘The Role of Employee Share Ownership in the New Workplace’ (Speech to the Australian Employee Ownership Association
ownership also featured in the Liberal/National Party Coalition’s 1996 Industrial Relations Policy, *Better Pay for Better Work.*

The potential contribution of employee share ownership plans to national savings was identified as a rationale for employee share schemes at least as early as the mid-1990s. The Federal Treasurer Peter Costello emphasised this rationale in 1996:

“We think that blue-collar Australians who have a stake in the business of Australia will not only have incentives to see them profitable, not only incentives to see Australian industry perform and improve, but also the opportunity to secure for themselves the kind of financial independence this government would like to see.”

The potential for employee share ownership to contribute to nationals savings is identified in Shared Endeavours. Yet, as the inquiry noted, ‘their place in a national savings program has not been fully considered by Parliament nor been the subject of clear policy.’

In the 1996-7 Budget, the newly-elected Coalition government provided for the amendment of the taxation concessions for employee share schemes to ‘build a greater sense of employee participation in the success of Australia businesses’. This would be achieved through doubling the value of shares or rights that were eligible for the tax concession under a share scheme from $500 to $1000 a year per employee, with a corresponding increase in the deduction available to employers; and reducing the participation conditions for the concessional arrangements from three quarters to two thirds of permanent employees.

The Coalition Government’s election commitments were included in one of a litany of proposed, and largely unrelated, amendments embodied in the *Taxation Laws Amendment Bill (No 4) 1996* and debate surrounding these other amendments appeared to overshadow those relating to employee share schemes.

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schemes. Nevertheless, there appeared a broad consensus in both Houses of Parliament that broad-based employee share plans should be promoted and thus that the increase in the value of shares that could be exempt from $500 to $1000 was desirable. Debate over the proposed amendments to employee share plans in the Senate, however, focused on the proposed reduction of the required threshold for employee share schemes from 75% to 66% and a change from ‘employees’ to ‘permanent employees’. Both of these proposed changes were opposed by the Labor opposition and the Democrats on the basis that it was restrictive of the development of employee share schemes that were open to as many employees as possible and on a fair basis. The proposal to reduce the threshold from 75% to two-thirds was rejected in the Senate.

The Coalition Government also amended the corporate law requirements for employee share schemes. The Corporate Law Economic Reform Act 1999 relaxed the prospectus requirements for companies initiating employee share plans, subject to a number of conditions. According to the Coalition government, its commitment to employee share ownership is also reflected in the provision of an employee share scheme in the sale of the first third of Telstra.

In 1999, the then Minister for Employment, Workplace Relations and Small Business, Peter Reith MP, directed the House of Representatives Committee on Education, Employment and Workplace Relations to ‘inquire into and report on the extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on: workplace relations and productivity in enterprises; and the economy.’ Even before the Committee’s report was handed down in September 2000, Peter Reith, in an address to the Australian Employee Ownership Association (AEOA) espoused the virtues of employee share ownership. He explained,

“Providing employees with a financial interest in the organisation for which they work is a particularly effective way of increasing employee motivation and commitment and developing a more productive workplace culture. Employees hare schemes can promote the commonality of interests between employers and employees and assist in breaking down any remaining vestiges of adversarial relationships. When you have shares in

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18 This Bill originated in the House of Representatives as the Taxation Laws Amendment Bill (No 4) 1996 on 12 December 1996, and into the Senate as Taxation Laws Amendment Bill (No 1) 1997 on 17 March 1997.
19 See Senate Hansard, 27 June 1997, p 5444.
21 Mr Leahy, Department of Employment, Workplace Relations and Small business, Transcript of Evidence, 13 July 1999, 82.
the organisation for which you work the old destructive ‘us’ and ‘them’ mentality is eroded, with a renewed focus on mutuality of interests.”

Mr Reith supported his observations by pointing to ‘a substantial body of international research available which supports the proposition that employee share schemes can lead to improvements in organisational productivity, growth, profitability, absenteeism, labour turnover, employee commitment and satisfaction and a range of other variables.’ He proceeded to note, however, that there was ‘some evidence’ to suggest that the impact of employee share schemes can probably not be viewed in isolation from other organisational factors, such as their interaction with broader employee participation measures.

The Nelson Committee’s majority report, tabled in September 2000, was overwhelmingly in favour of the promotion of broad-based employee share ownership plans in Australia. The Shared Endeavours Majority Report recommended that, from a public policy perspective, the rationale for promoting employee share plans should be expanded to include promoting national savings, especially for retirement purposes.23 The Majority Report observed that, while businesses in Australia use employee share plans for a variety of purposes, legislation in Australia has focused on one purpose only. The committee concluded that public policy should be formulated so as to promote employee share plans for four purposes:

• to better align the interests of employees and employers;
• to develop national savings;
• to facilitate the development of sunrise enterprises; and
• to facilitate employee buyouts and succession planning.24

The Dissenting Report by the Labor members of the Committee concurred with the Majority Report that broad-based employee share ownership schemes should be encouraged. Moreover, the Labor members supported a number of the Majority Report’s recommendations for the promotion of these sorts of plans. They were cautious to note, however, that while the conclusion that broad-based employee share plans better aligned employer and employee interests and fostered increased productivity and workplace harmony, seemed logical, there was no clear and objective evidence to support these rationales.25 Their report focused largely on their concerns with the capacity of employee share plans, as currently regulated, to facilitate tax avoidance by company executives.

22 Peter Reith MP, ‘The Role of employee Share Ownership in the New Workplace’, Address to the Australian Employee Ownership Association Breakfast Briefing, Canberra, 29 June 2000.
23 Shared Endeavours, fn 1, see Recommendations 5 and 6. The Committee was careful to emphasise that employee share plans should not be considered as alternatives to compulsory superannuation (recommendation 4).
24 Ibid, Recommendation 5.
In response to this recommendation, the Coalition Government noted blandly that ‘The Government broadly supports the development of policy on employee share ownership to better align the interests of employers and employees.’ The report identified a range of legislative and institutional reforms that would facilitate the public policy objectives identified. Of the 45 policy recommendations, however, the Government rejected close to 30.

Since 2001, employee share ownership has also featured within the Australian Government’s initiative to promote science and innovation. The initial strategy document - *Backing Australia’s Ability: An Innovation Action Plan for the Future* - published in 2001, noted that a high-level Ministerial Committee responsible for overseeing the implementation of *Backing Australia’s Ability* would, examine a number of areas in order to ‘ensure that relevant policies provide the most effective support for R&D, its commercial application and skills development. The document identified as one of these specific areas:

“To enhance the incentives for employees to drive stronger business productivity and to encourage start-up business activity, employee share ownership arrangements will be examined. This responds to the *Shared Endeavours: Inquiry into employee share ownership in Australian enterprises* report of by the House of Representatives Standing Committee on Employment, Education and Workplace Relations, which advocated extending employee share ownership schemes in small and medium unlisted companies, and companies in sunrise and new industries.”

Despite this pronouncement in 2001, there does not appear to have been any further developments in this regard.

During his time as Federal Minister for Employment Services, Workplace Relations and Small Businesses from 2001 to 2003, Tony Abbot proved to be a passionate supporter of employee share ownership. In 2001, he identified the promotion of employee share ownership as one of the key areas of workplace reform on his agenda in the following year. In his own words, “... if we are ever going to have workplaces which are more like partnerships and less like battlefields, we need to have a situation where workers and managers have a better perspective on each others situation.

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28 The initial 2001 package *Backing Australia’s Ability* which comprised a $3 billion over five years to 2005 – 06, was extended on 6 May 2004. Together, the two packages constitute a ten year, $8.3 billion funding commitment, stretching from 2001 – 02 to 2010 – 11. See [http://backingaus.innovation.gov.au](http://backingaus.innovation.gov.au)
And I think the best way to do that is through greater employee share ownership.”

In the same year, John Howard spoke of the importance of encouraging employee share ownership, in order to encourage ‘asset acquisition…[and] foster a more balanced approach to retirement planning’.

In 2003, at the launch of the Government’s Employee Share Ownership Development Unit (ESODU), Tony Abbott, identified a number of rationales for employee share ownership. He spoke of the potential for employee share ownership to ‘encourage savings’, ‘boost wealth’ and to ‘promote a sense of ownership’. Employee share ownership, according to Abbott, ‘while not a cure all, can help turn wage earners into stakeholders, proletarians into capitalists and antagonists into collaborators’. Abbott went on to describe employee share ownership as a means of ‘humanising capitalism’ and of strengthening the social fabric. He explained:

“For workers, employee share ownership is another chance to get ahead. For business, it’s a means of motivating the workforce. For government, it’s a way of empowering people how might otherwise feel disenfranchised and alienated.”

The ESODU itself appears to promote employee share ownership to employers and employees principally as a means of improving enterprise productivity and industrial harmony. ESODU promotional material emphasises the potential for employee share ownership to improve the productive performance of enterprises and to create a ‘win-win’ situation, as employees benefit directly when their business does well, while employers benefit through a more committed workforce.

It is important to note that, for the current Government, employee share ownership fits into their broader agenda for industrial relations reform and for share ownership. As Peter Costello explained to the Nelson Committee, employee share ownership was ‘consistent with Government policy of allowing employees and employers greater flexibility and choice in their working

32 The ESODU provides information and raises awareness about the potential benefits of ESO through information materials and seminars; assists employers and employees with the design and implementation of schemes; and carried out research to identify barriers to the diffusion of employee share ownership.
33 Australian Government, Department of Employment and Workplace Relations, ‘Employee Share Plans: Getting Started’.
arrangements.' The Howard Government is also committed to encouraging share ownership among the broader community.

One of the most controversial justifications for employee share ownership which has been consistently identified by the Coalition Government is the capacity of businesses to use employee share ownership as a substitute for wages and other benefits. This was identified as a rationale in the Department of Workplace Relations’ submission to the Nelson Inquiry but rejected by the Majority and Dissenting Reports. Nonetheless, it appears to be a recurring theme among Government politicians.

In 2004, the subject of employee share ownership featured briefly in parliamentary debates when Mr Hunt MP from the Liberal Party put forward a nine part motion in the House of Representatives for stronger support for employee share ownership programs in Australia. Mr Hunt noted that employee share ownership was about three things. Firstly, it was about the democratisation of wealth. Second it was about productivity and finally, it was about improving social and industrial harmony. In response to a number of adamant supports for the motion, the then Shadow Minister for Workplace Relations, Craig Emerson MP, argued that ‘there is nothing wrong with employee share ownership. It is a good idea and a good concept. But why do taxpayers have to foot the bill all the time?’ Mr Emerson proceeded to note that, as a member of the Nelson Committee, he had discovered that, subject to parliamentary scrutiny, the links between employee share ownership and productivity were elusive. He was also sceptical of the potential for employee share ownership to contribute to industrial harmony. These comments produced ire in several other MPs. This debate was adjourned shortly afterwards. According to Mr Hunt’s office, it remains, two years later, ‘a work in progress.’

The current Minister for Employment and Workplace Relations, Kevin Andrews MP, does not appear to be as passionate or vocal a supporter of employee share ownership as his predecessors. Nonetheless, he has on various occasions made comments on continuing government support. In 2005, for example, he reiterated the rationales for Government support of employee share ownership:

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34 Cited in Shared Endeavours, f/n 1, p 33.
35 See, eg, DEWRS submission to the Shared Endeavours Inquiry, June 1999.
36 See, eg, the comments on employee share ownership by Peter Reith MP, Minister for Employment, Workplace Relations and Small Business, ‘Impediments to Prosperity – Labour Market Reform and Beyond’ (Speech to the Centre for Independent Studies, 22 July 1999) and those made by Senator Humphries, Liberal Party, in the Senate: Senate Hansard, 27 October 2003, 12857; and Peter Reith MP, Minister for Employment, Workplace Relations and Small Business, ‘Impediments to Prosperity – Labour Market Reform and Beyond’ (Speech to the Centre for Independent Studies, 22 July 1999).
38 Ibid.
39 Mr Hunt’s response to inquiry, 30 October 2006.
• employee share ownership reinforces that responsibility for workplace relations must be at the workplace as employee share plans provide a framework conducive to employee participation;
• employee share ownership fosters cooperative and productive workplaces, creating a sharing workplace environment that is beneficial to both employers and employees;
• employee share ownership aligns employee and employer interests, improving the productive performance of enterprises, resulting in a motivated workforce and increased staff loyalty.
• employee share ownership is consistent with the Howard Government’s policy of encouraging a higher level of share ownership in the broader Australian community, as well as boosting national savings.40

1.4 Employee share ownership and the Australian Labor Party

In opposition, the Australian Labor Party (ALP) has continuously emphasised its support for broad-based employee share ownership. Employee share ownership was briefly in the limelight in 2002, following the launch of an ALP discussion by Mark Latham promoting an ‘ownership revolution’, including facilitating employee share ownership. Employee share ownership, like increased asset ownership more broadly, would ‘contribute to the social democratisation of the Australian economy.’41

The promotion of employee share ownership features twice in the current ALP National Platform. First, under the sub-heading ‘Promoting Industrial Democracy and Cooperative Workplaces’, the ALP identifies the promotion of employee share ownership as a key principle to be pursued.42 Second, the Platform identifies ‘enhanced measures to facilitate and promote employee share ownership will be an important part of a successful information industry development strategy.’43 In September 2006, Wayne Swan, Shadow Treasurer, announced that the ALP will explore ways to promote employee share ownership. Mr Swan conceded that employee share ownership was ‘an area where Labor has not talked much about in the past’. He proceeded to note that

“We need to make as many people as possible as stakeholders in the economy. We need people to see that they are sharing in the capital creating side of the economy and not just competing in global labour markets. We need as many workers as possible to become stakeholders and share a slice of the pie. Just as we strived for homeownership in the

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41 Mark Latham, Address to the Pluto Institute and NSW Fabians Society, Sydney 3 July 2002.
43 Ibid, Chapter 12, [97].
last century, workers should strive for share ownership in the new
century.”

The productivity rationale is recognised and supported by the ALP, though the
ALP seems to be more cautious to emphasise the link found within the empirical
research on the relationship between employee share ownership and productivity
between employee share ownership and participative management. In referring
to international studies suggesting that employee share ownership can contribute
to increased productivity, Mr Swan appeared cognisant of the fact that these
studies found that employee share ownership only increased productivity when
coupled with participative management practices. The Shadow Treasurer
identified the existence of a number of barriers which stood in the way of wider
employee share ownership and expressed his belief that there was a ‘compelling
case for change’. He foreshadowed an examination of specific measures to
facilitate employee share ownership over the following twelve months.

1.5 Observations

A number of observations can be made based on the above brief survey. First,
several key rationales for facilitating the practice of employee share ownership
recur regularly in public rhetoric. These include the potential for employee share
ownership to lead to better enterprise performance and, related to this, to
contribute to greater industrial harmony. Rationales that have recurred less
commonly but nonetheless been flagged by the current Government include the
potential for employee share ownership to contribute to national savings and to
be used as a substitute for wages when business is doing poorly. Rationales
which are notably absent from public rhetoric but identified by the Shared
Endeavours inquiry include those relating to facilitation of employee buyouts and
succession planning. Second, while the federal ALP appears to be supportive of
employee share ownership, it does not appear to have a coherent policy on the
issue. Third, there continues to be a gulf between public policy rhetoric on
employee share ownership, particularly by members of the current Australian
Government, and academic research in this area. While this gulf was bridged
to some degree by Shared Endeavours, the Report’s findings appear to have
been largely ignored. Finally, the above survey highlights a paradox between the
apparent strength of support for employee share ownership in the federal political
arena and the persistent dearth of legislative reform.

44 Wayne Swan MP, Shadow Treasurer, ‘Australia’s Economic Future’, Keynote Address to the
45 Ibid.
46 For academic scholarship on employee share ownership, see the literature review done earlier
for the project.
2 The current tax treatment of ESOPs

In researching current practice in relation to employee share schemes it appears that the structuring of such schemes is heavily influenced by the tax treatment that applies to these arrangements. It is therefore useful to consider the nature of the current tax rules. Basically, the tax rules treat the issuing of shares or rights as a substitute for cash income for services and impose tax, at marginal rates, at the time the share or right is acquired, subject to some concessions.

The relevant provisions are in Division 13A, Part III Income Tax Assessment Act 1936 (Division 13A). The amount to be included in assessable income is basically the difference between the market value of the share or right and any consideration provided, that is, the amount of the discount provided to the employee or service provider. Rules are provided for calculating the market value of the share or right. This means that where shares or rights are provided to an employee in respect of employment (or to an associate of the employee) at a discount to market value, an amount will generally be included in the assessable income of the employee. This also applies in a non-employment situation where shares or rights are provided in respect of services rendered.

Division 13A also provides for concessional treatment provided certain conditions are satisfied. The first type of concession allows for discounts of up to $1000 to be provided tax free to an employee or service provider per income year (the exemption concession). The second type of concession allows for tax on the discount to be deferred for up to 10 years (the deferral concession). Critics argue that the exemption concession provides insignificant benefits while the conditions for both concessions are difficult to satisfy.

There are a number of different plans or arrangements which potentially fall within Division 13A. They include:

- the provision of shares or rights (the latter sometimes referred to as option plans);
- the provision of shares or rights accompanied by a low interest or interest-free loan;
- the provision of shares or rights through an employee share trust; and
- the provision of rights that are not within Division 13A.

The tax treatment of the different types of plans needs to be considered.

2.1 Div 13A and the provision of shares or rights

In the basic type of share plan an employer will provide shares at a discount to employees. The employee may be required to pay the full discount price for shares (the shares are “fully paid”) or may only have to pay a small amount of it (the shares are “partly paid”). In the latter case the employee will not usually be required to pay any calls on the shares, if at all, until disposal.
Alternatively, an employer may provide options to acquire shares. The option is usually issued for no consideration with a right to acquire shares at a nominated price (the exercise price) in the future. The exercise price is usually the market price of the shares at the time the option is granted or some variant of that price. In some cases, the exercise price is nil.

Unless concessions are available, the effect of Division 13A is to include an amount in assessable income at the time the shares or rights are acquired. The Division applies if any shares or rights (see below) are acquired under an “employee share scheme”. Shares or rights are acquired under an employee share scheme if the shares or rights are acquired in respect of, directly or indirectly, employment or services rendered (see below). The shares or rights may be acquired by an employee or a service provider or by an associate of the employee or service provider (see below). The Division contains rules for determining the amount to be included in assessable income (see below).

2.1.1 Any shares or rights

The Division applies when an employee or service provider acquires any shares or rights under an employee share scheme, whether they are shares or rights in the employer company, a related company or any unrelated company. However, in order to obtain access to the concessions it is necessary for the shares or rights to be in the employer company or a holding company of the employer.

The term “rights” is not defined but is commonly taken to mean rights to acquire shares ie options. An option involves the right, but not the obligation, to acquire shares in the future at a fixed price (the exercise price). In some cases the person acquiring the option pays to acquire that right but commonly in the employment case the option is acquired for no consideration. The term “rights” could also encompass other sorts of rights such as those rights that replicate shares eg “phantom shares” (see below). However, in order to access the concessions, the rights must be rights to acquire ordinary shares.

The acquisition of a share as a result of exercising a right acquired under an employee share scheme is not treated as the acquisition of a share (presumably to avoid double counting).

A point to note is that the shares or rights must be acquired at a discount. The acquisition of shares for a consideration equal to or greater than market value will not be within the Division even if accompanied by some other benefit such as a low or interest-free loan (see below).

2.1.2 Acquired under an “employee share scheme”

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47 Section 139B ITAA 1936.
48 Section 139CD(3) ITAA 1936.
49 Section 139CD(4) ITAA 1936.
50 Section 139C(4) ITAA 1936.
Shares or rights will be acquired under an employee share scheme if they are acquired directly or indirectly in respect of employment, or if the parties are not in an employment relationship, in respect of services rendered. That is, there does not need to be any particular form of scheme but rather there must be some connection between the acquisition of the shares and the employment or services provided. If the acquisition falls within Division 13A it will be taxed under that Division rather than the other provisions of the income tax legislation. Furthermore, the acquisition will not give rise to fringe benefits tax (see below).

Shares will not be taken to be provided under an employee share scheme (and therefore not subject to Division 13A) if they are acquired for market value (see below).

2.1.3 Acquired by an employee or service provider (or an associate)

A person acquires a share when it is transferred or allotted to that person or when a person acquires a legal or beneficial interest in the share from another person. Division 13A applies to both employees and independent contractors acquiring shares. Division 13A also applies if an associate of the employee or service provider acquires shares as a result of the employment or provision of services. An associate in this context includes a relative, a partner, a trustee of a trust under which the taxpayer or an associate is capable of benefiting and related companies. In such a case the employee or service provider will be subject to tax on the discount received by the associate. Although shares or rights provided to an associate will be subject to tax under Division 13A, only shares or rights provided to an employee will be eligible for the concessions.

2.1.4 Calculating the amount to be included in assessable income

The rules for determining the amount to be included in assessable income vary according to whether the discount is assessable immediately or is deferred.

When the discount is included in assessable income in the year the share or right is acquired, the amount is the market value of the share or right less any consideration paid or given.
When the taxing time is able to be deferred (see below) and the taxpayer disposes of the share or right within 30 days of the relevant “cessation time” in an arm’s length transaction, the amount to be included is the amount received on disposal less any consideration given, including any amount paid to exercise a right to acquire a share.\(^\text{62}\)

When the taxing time is able to be deferred and the taxpayer does not dispose of the share or right within 30 days in an arm’s length transaction, the amount to be included is the market value of the share or right at cessation time less any consideration given, including any amount paid to exercise a right to acquire a share.\(^\text{63}\)

Where a right to acquire a share is lost without having been exercised (whatever the reason), the right will be taken never to have been acquired and any tax paid will become refundable through an amended assessment if necessary.\(^\text{64}\)

2.1.5 Complex valuations of shares or rights required

Division 13A contains rules for determining the market value of both listed and unlisted shares and rights on a particular day.\(^\text{65}\) This includes quite complex rules for determining the market value of unlisted rights depending on whether the right must be exercised within 10 years or not.\(^\text{66}\) For example, a 10 year option with an exercise price equal to current market value of the underlying share will have a taxable value of 18.5% of the exercise price/current market value.\(^\text{67}\) In the case of both unlisted shares and unlisted rights, the issuing company will often need to have valuations done by qualified valuers at the time shares or rights are being provided which could give rise to significant cost issues.

2.1.6 Qualifying for concessions

In addition to setting out that the acquisition of shares at a discount will give rise to assessable income, Division 13A also provides two concessions if certain conditions are met. In order to be eligible for either concession the shares (or rights) must be “qualifying shares or rights”.\(^\text{68}\) There are six conditions relevant to determining whether a share is a “qualifying share” but only five of those conditions apply in determining whether a right is a “qualifying right”:

1. the share or right must be acquired under an employee share scheme;
2. the shares must be in the company which is the employer of the taxpayer or in the holding company of the employer company. (This means the concessions are not available if the recipient is not in an employment

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\(^{62}\) Section 139CC(3) ITAA 1936.
\(^{63}\) Section 139CC(4) ITAA 1936.
\(^{64}\) Section 139DD ITAA 1936.
\(^{65}\) Subdivision F of Div 13A, ITAA 1936.
\(^{66}\) Sections 139FC and 139FJ to FN ITAA 1936.
\(^{67}\) Section 139FM ITAA 1936.
\(^{68}\) Section 139CD ITAA 1936.
relationship or if shares or rights are acquired by an associate of an employee or if the shares are shares in an unrelated company); (3) all the shares must be ordinary shares and the rights must be rights to acquire ordinary shares; (4) in the case of shares, at least 75% of permanent employees must be entitled (or have been entitled) to participate in this or another employee share scheme. This condition does not apply to rights; (5) the taxpayer’s legal or beneficial interest in shares of the company does not exceed 5%; and (6) the taxpayer is not in a position to control more than 5% of the votes that could be cast at a general meeting of the company.

Several of these conditions make it difficult for the concessions to be accessed by unlisted companies generally and new companies in particular. For example, the requirement that the scheme or another scheme be available to 75% of permanent employees means that new companies are effectively unable to satisfy the requirement. This is because the term “permanent employees” is defined as full-time or permanent part-time employees with at least 36 months service.\(^69\) It should be noted that the Commissioner does have discretion to determine that the condition has been satisfied\(^70\) and it may be that in the case of a new company the Commissioner would do so if the scheme was open to 75% of current employees. Although the condition does not apply to option plans, some of the other conditions may mean that the concessions are unsuitable for start-up companies. For example, the restrictions relating to ordinary shares and the 5% limit may make the schemes unattractive to providers of intellectual property who wish to receive preferential share rights or to take a larger stake in the company. Shared Endeavours made a number of recommendations to ease some of the requirements for qualifying shares and rights, particularly to facilitate the use of employee share schemes in “sunrise enterprises”.\(^71\) The Government, however, did not support any of those recommendations.\(^72\)

If the shares or rights are qualifying shares or rights, the taxpayer may be able to claim the exemption concession or the deferral concession but not both as the taxpayer must make an election.\(^73\)

(a) The exemption concession

A taxpayer who acquires “qualifying shares or rights” may elect to have the discount included in assessable income in the year in which the shares or rights are acquired and receive $1000 worth of discount tax-free\(^74\) if three additional conditions are satisfied:

\(^69\) Section 139GB ITAA 1936.
\(^70\) Section 139CD(5) ITAA 1936.
\(^71\) Shared Endeavours, f/n 1, Recs 32-39.
\(^72\) Treasurer’s Press Release 14/03, 27 March 2003.
\(^73\) Sections 139BA and 139E ITAA 1936.
\(^74\) Section 139BA(2) ITAA 1936.
(1) there are no forfeiture of ownership conditions;
(2) shares or rights may not be disposed of for a minimum of three years
    (unless employment ceases earlier); and
(3) the scheme and any related scheme for the provision of finance must be
    operated on a non-discriminatory basis.\textsuperscript{75}

An employee share scheme or a related scheme for the provision of finance will
be non-discriminatory if it is open to at least 75\% of permanent employees and
the essential features of the scheme are the same.\textsuperscript{76} Again the reference to
permanent employees as full or part-time employees with at least 36 months
service makes this condition impossible to satisfy for start-up companies. It may,
however, be possible to obtain the deferral concession which is often seen as a
more attractive option for providing executive remuneration.

\textit{(b) The deferral concession}

If the shares or rights are qualifying shares or rights and the taxpayer does not
make an election to be taxed up-front, the discount amount will be included in
assessable income at a future time (referred to as the “cessation time”).\textsuperscript{77}
However, if there are no restrictions preventing the taxpayer from disposing of
the shares or conditions that could result in forfeiture, the cessation time will be
the time at which the shares are acquired.\textsuperscript{78}

Where \textit{shares} are not subject to tax at the time of acquisition, the cessation time
is the earliest of when the restrictions on disposal or possibility of forfeiture end,
the shares are disposed of, when employment ceases or 10 years.\textsuperscript{79}

Where \textit{rights} are not subject to tax at the time of acquisition, the cessation time
is the earliest of when the rights are exercised, when the rights are disposed of,
when employment ceases or 10 years.\textsuperscript{80} If the right is exercised to acquire
shares and restrictions apply or the shares are subject to forfeiture, cessation
time is when the restrictions end (to a maximum of 10 years).\textsuperscript{81}

\textit{2.1.7 Position of employer}

In relation to deductibility, the issue of shares or rights by a company will not
generally involve any cost to the employer, compared with the situation where
shares or rights are acquired on-market.\textsuperscript{82} However, the company providing the

\textsuperscript{75} Section 139CE ITAA 1936.
\textsuperscript{76} Section 139GF ITAA 1936.
\textsuperscript{77} Section 139B(3) ITAA 1936.
\textsuperscript{78} Section 139CA(1) ITAA 1936.
\textsuperscript{79} Section 139CA ITAA 1936.
\textsuperscript{80} Section 139CB ITAA 1936.
\textsuperscript{81} Section 139CB(1)(c) ITAA 1936.
\textsuperscript{82} The Treasurer in Press Release 26/04 (30 April 2004) announced that there would be no
change to the deductibility provisions despite changes to the Accounting Standards relating to
expensing options granted to employees.
shares or rights under an employee share scheme (either the employer or the holding company of the employer company) may be entitled to claim a deduction for some of the costs associated with the scheme. For example, it should be possible to claim a deduction under the general deduction provision for the costs associated with setting up and administering scheme. Where a deduction would not otherwise be available, Division 13A provides a deduction to a maximum of $1000 for shares or rights that are qualifying and also satisfy the exemption concessions. Contributions of money or property to an employee share trust may also be deductible but only at the time the employee or associate acquires the shares or rights (see below).

A final issue for employers is whether the provision of shares or rights under an employee share scheme will give rise to a fringe benefits tax liability – this is discussed below.

2.1.8 Other taxing provisions

On general principles it is possible that the provision of shares or rights as remuneration could give rise to tax either as a non-cash benefit or as a fringe benefit. It is also possible that any subsequent disposal of the shares or rights could give rise to capital gains tax liability.

The provisions of Division 13A are an example of statutory income and as such an amount determined under the Division is included in assessable income. If Division 13A applies then a number of other taxing provisions such as section 26(e) (employment benefits) and section 21A (business benefits) are expressly excluded from applying. However, those provisions may need to be considered if Division 13A does not apply (see below).

Prima facie, the provision of shares or rights would give rise to a liability for the employer to pay fringe benefits tax. However, the definition of “fringe benefit” expressly excludes a benefit constituted by the acquisition of a share or right that falls within Division 13A or the acquisition of money or property by certain employee benefit trusts (see below). It should be noted though that the provision of other benefits, such as the provision of financial assistance to acquire the shares or rights, could give rise to fringe benefits tax liability for the employer (see below).

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83 Section 8-1 ITAA 1997.
84 Section 139DC ITAA 1936.
85 Section 139DB ITAA 1936.
86 Section 6-10 ITAA 1997.
87 Section 139DE ITAA 1936.
88 Section 136(1) Fringe Benefits Tax Assessment Act 1986 (FBTAA 1986), definition of “fringe benefit”, para (ha). There is also an equivalent provision for benefits provided under a previous legislative scheme applying to employee share schemes in existence before 1995 (para (h))
89 Ibid, para (hb)
A final point to note is that the subsequent disposal of shares or rights may give rise to capital gains tax liability. The interaction between Division 13A and the capital gains tax provisions is considered below.

2.1.9 Interaction with CGT

The general position is that the discount on market value received on acquisition of the shares will be taxed on acquisition under Division 13A (subject to the concessions) but the difference between market value and consideration on disposal will be taxed as a capital gain.90 As a general rule the disposal of a share or right will give rise to a capital gain if the consideration on disposal (or in certain cases the market value at disposal) is greater than the cost base of the share or right.91 A capital loss will arise if the capital proceeds are less than the reduced cost base.92 The cost base of a share or right acquired under an employee share scheme depends on whether the discount is subject to tax at the time the shares or rights are acquired or whether liability to tax is deferred.

If the discount on shares or rights is subject to tax on acquisition, the cost base of the share or right will be market value at the time of acquisition.93 This means that the discount will be taxed under Division 13A and the taxpayer will then be able to use the market value at the time of acquisition to determine the capital gain or loss.

If tax is deferred and the share or right is disposed of within 30 days of cessation time, the capital gains tax provisions do not apply.94 This means that the difference between market value of the share or right and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A.

If tax is deferred and the share is disposed of more than 30 days after cessation time, the cost base of the share is market value at cessation time.95 This means that the difference between market value of the share or right at cessation time and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A. Any subsequent increase in the value of the share or right will be subject to tax as a capital gain.

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90 Net capital gains and net capital losses are calculated under Parts 3-1 and 3-3 ITAA 1997. A net capital gain is included in assessable income (s 102-5). A net capital loss can be carried forward and offset against future capital gains (s 102-15).
92 Section 104-10(4) ITAA 1997. The reduced cost base is a modified cost base used to calculate a capital loss. It does not include certain costs that can be included to determine a gain (Subdiv 110-B).
93 Section 130-80(2) ITAA 1997.
94 Section 130-83(2) ITAA 1997.
95 Section 130-83(3) ITAA 1997.
An important point to note is that since September 1999, certain capital gains have been eligible for the “CGT discount” which means that only 50% of the nominal gain is included in assessable income.⁹⁶ This may mean that it is advantageous to bring forward the taxing time under Division 13A and receive less of any relevant gain in the value of shares or rights as an “income” gain subject to tax under Division 13A and more of any relevant gain as a “capital” gain.

### 2.2 The provision of shares or rights accompanied by a low or interest-free loan

The provision of a loan by an employer (or associate or a third party under an arrangement) to an employee (or an associate) will attract the operation of the *Fringe Benefits Tax Assessment Act* as a benefit provided in respect of employment.⁹⁷ The value of the benefit is the difference between a benchmark rate of interest and the rate of interest actually paid.⁹⁸ If the loan is provided interest-free or at an interest rate below the benchmark rate, the difference will be subject to fringe benefits tax and tax will prima facie be payable by the employer at 48.5%. However, as the loan is used to acquire income producing assets (the shares or rights), the value of the benefit will be reduced to zero under a rule known as the “otherwise deductible” rule.⁹⁹ The employer will not be subject to tax with respect to the loan benefit provided. Furthermore, the employee will not be subject to tax with respect to the loan.¹⁰⁰

If the loan is used to acquire shares or rights at a discount, Division 13A will apply to the discount and if the conditions discussed above apply the employee will be able to access the concessions.

If the loan is used to acquire shares or rights at full market value, the shares themselves will not be subject to Division 13A (see below) and the employee will not be able to access the concessions.

A point for private (ie non-listed) companies is that the making of a loan to an employee who is a shareholder in the company (or an associate of a shareholder) could be treated as a deemed dividend from the company and therefore included in the assessable income of the recipient.¹⁰¹ There is however an exception if the loan is made solely for the purpose of enabling a shareholder or associate to acquire shares or options under an employee share scheme but only if the shares or rights are qualifying shares or rights within Division 13A.¹⁰²

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⁹⁶ Division 115 ITAA 1997. A number of conditions must be satisfied to take advantage of the discount eg the shares must have been held for at least 12 months.
⁹⁷ Section 136(1) definition of “fringe benefit” FBTAA 1986.
⁹⁸ Section 18 FBTAA 1986. The “benchmark interest rate” is determined by the Reserve Bank. For the FBT year ending 31 March 2006 the rate was 7.05%.
⁹⁹ Section 19 FBTAA 1986.
¹⁰⁰ Sections 23L and 26(e)(iv) ITAA 1936.
¹⁰¹ Section 108 and Div 7A (ss 109B to 109X) ITAA 1936.
¹⁰² Section 109NB ITAA 1936.
An alternative way in which to finance the acquisition of shares may be to enter into a salary sacrifice arrangement with the employee (see below).

2.3 The provision of shares or rights using an employee share trust

The provision of shares or rights through an employee share trust involves transferring shares or right or money or other property to a trustee to enable the trustee to acquire shares on-market and subsequently provide those shares or rights to employees or their associates. The use of such a trust can provide a number of benefits to an employer. For example, according to Shared Endeavours one benefit is that it reduces the number of entities subject to taxation and focuses taxation liability on the beneficiaries of the plan.103

The provision of shares or rights to a trust, or the transfer of money or property to enable shares or rights to be acquired, will have no immediate tax consequences for the employee. This is because the employee will only acquire the share or right when they acquire the legal or beneficial interest in the share or right from the trustee. This is implicitly recognised in Division 13A which provides for deductibility in respect of the provision of money or property to a person for the purpose of enabling another person (the ultimate beneficiary) to acquire a share or right under an employee share scheme, but not until the ultimate beneficiary acquires the share or right.104 This suggests that the acquisition by the trust will not be treated as an acquisition by an associate of the employee even if the employee is “capable of benefiting under the trust”.105 Furthermore, the section dealing with acquisition of a share or right merely refers to acquisition from another person (not necessarily from the employer).106 For capital gains tax purposes, the first element of the cost base (or reduced cost base) is market value when the employee first acquired a beneficial interest in the share or right.107

The trustee of the employee share trust does not acquire a share or right under an employee share scheme if it is "the trustee of a trust whose sole activities are obtaining of shares, or rights to acquire shares, and providing those shares or rights to employees of a company or to associates of those employees".108 This is consistent with the general tax treatment of trusts. For capital gains tax purposes, where a beneficiary of an employee share trust becomes absolutely entitled to a share or right, any capital gain or loss the trustee (or beneficiary) makes is disregarded if the beneficiary is an employee of a company; the terms of the trust require or authorise the trustee to transfer shares or rights; the rights

103 Shared Endeavours, f/n 1, pp 124-8.
104 Section 139DB ITAA 1936.
105 See definition of “associate” in s 26AAB ITAA 1936.
106 Section 139G(d) and (e).
107 Section 130-85(3) ITAA 1997.
108 Section 139C(5)
where acquired under an employee scheme and the employee did not acquire the shares for more than the trustee's cost base.\textsuperscript{109}

An important consideration for the employer proposing to provide shares or rights at a discount is the issue of deductibility.\textsuperscript{110} This is because the issue of shares or options by a company does not generally involve a deductible outgoing, even though it clearly involves some sort of "cost" to shareholders of the issuing company. However, it is generally accepted that an employer will be entitled to a tax deduction under the general deduction provision\textsuperscript{111} in respect of a non-refundable contribution made to an employee share trust for the purpose of the trust using those funds to provide shares to employees of the contributor (by way of subscription or on-market acquisition) as part of an employee's remuneration package. This is implicitly recognised by a provision that allows a deduction where money or property is provided under a trust arrangement (although not until the employee actually acquires the shares or rights).\textsuperscript{112}

Another advantage of establishing an employee share trust is that the provision of money or property to a trust will not attract fringe benefits tax where "the sole activities of the trust are obtaining shares, or rights to acquire shares in the employer company or its holding company and providing those shares or rights to employees or associates of the employees".\textsuperscript{113} As noted below, the provision of other benefits, such as financial assistance, may give rise to fringe benefits tax liability for the employer.

\textit{2.4 Plans that fall outside Division 13A}

If shares or rights are offered at a discount to employees but the shares or rights are non-qualifying, the benefit received will be subject to tax under Division 13A.

Examples include:

- Shares or rights in a company that is not the employer or the holding company of the employer;
- Where the recipient is not in an employment relationship but is an independent contractor;
- Where the recipient is an associate of an employee;
- Where the plan or another plan relating to shares is not open to at least 75% of permanent employees (ie employees with at least 3 years service with the company);
- Where the employee becomes entitled to more than 5% of the shares in the company; or

\textsuperscript{109} Section 130-90 ITAA 1997.
\textsuperscript{110} Other benefits of establishing an employee share trust include the fact that it facilitates forfeiture and disposal where necessary.
\textsuperscript{111} Section 8-1 ITAA 1997.
\textsuperscript{112} Section 139DB ITAA 1936.
\textsuperscript{113} Section 136(1) FBTAA 1986, definition on "fringe benefit" para (hb).
Where the shares are not ordinary shares or the rights are rights to acquire shares that are not ordinary shares.

However, if a scheme falls outside Division 13A it is necessary to consider other taxing provisions. There are two other situations that need to be considered. The first is a scheme that involves the provision of shares or rights at full market value and the second involves schemes that offer interests that are not "shares or rights".

2.4.1 Offering shares or rights at full market value

The acquisition of shares or rights for a consideration equal to the market value of the shares or rights when they are acquired is not an acquisition under an employee share scheme and therefore not covered by Division 13A. Generally, the provision of shares or rights to employees for market value would not give rise to a benefit and so would not attract any tax liability. An employer may, however, prefer to provide the benefit by other means. For example, the provision of an interest free loan will generally not attract fringe benefits tax liability where the loan funds are used to acquire income-producing assets such as shares (see above). However, the making of a loan in these circumstances may attract the deemed dividend provisions and the exclusion that applies where the loan relates to an employee share scheme within Division 13A will not be available (see above). Alternatively, the acquisition of shares or rights may be financed by a salary sacrifice arrangement. The main issue here will be to ensure that the salary sacrifice arrangement is “effective”. The Commissioner has indicated that such an arrangement will be effective if the arrangement is entered into before the amount to be sacrificed has been earned. If the arrangement is not effective, the Commissioner will treat the amount as having been derived by the employee and require the amount to be included in assessable income. The normal practice is to make these arrangements at the start of an income year to ensure that they are treated as effective. Regardless of how the acquisition is financed, the employee will be able to derive any capital gains on the shares as a discount capital gain and only pay tax on 50% of the nominal gain. This may be regarded as a preferable way to provide the benefit particularly as it means that the shares or rights do not have to try to fit within the restrictive conditions that must be satisfied to enable an employee to access the Division 13A concessions.

2.4.2 Schemes that offer interests that are not shares or rights.

Division 13A only applies when the interest being provided is a "share or right". Some employers have chosen to step outside the Division and offer benefits that replicate share ownership but do not involve the acquisition of shares or rights. These schemes are sometimes referred to as "replicator share plans" or "phantom", "synthetic" or "shadow" plans. Shared Endeavours noted that

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114 Section 139C(3) ITAA 1936.
replicator share plans are used "where the company cannot or is unwilling to issue equities in itself".\footnote{Shared Endeavours, f/n 1, p xxi} The plans provide benefits that "mimic the benefits they would have received had they held shares in the company".\footnote{Ibid.} Benefits provided under such plans will not be subject to tax under Division 13A and will not be eligible for concessions under that Division. Any non-cash benefit received by an employee in respect of employment will be subject to tax either under s 26(e) ITAA 1936 (which requires the recipient to include the value to the taxpayer of the benefit in assessable income) or as a fringe benefit (in which case the employer will pay tax on the value of the benefit as determined under the FBTAA 1986). Typically the plan will aim to provide the benefit at market value to avoid payment of tax and to provide the benefit either in the form of a low or interest-free loan or salary sacrifice to fund the acquisition of the interest. Alternatively, or in addition, the benefit may be derived if the shares when subsequently disposed of are eligible for discount treatment.

Although these types of schemes may avoid the operation of Division 13A, Shared Endeavours noted that they were not used very much in Australia.\footnote{Ibid.}

3 Current structures and trends

One of the difficulties we have encountered is that comprehensive information on the number, nature and extent of employee share plans in Australia, and the number of employees in plans is not collected by any government department such as the Australian Bureau of Statistics. Nor is data collected by bodies such as the ATO or the Australian Securities and Investment Commission (ASIC) despite both bodies having significant regulatory responsibilities in the area. In Shared Endeavours it was suggested that “over 5% of the Australian workforce...holds equities under employee share plans”.\footnote{“Shared Endeavours” f/n 1, p 20.} This contrasts with approximately 7% in the UK, 10% in the US and 23% in France.\footnote{Ibid, p 26.}

Despite the lack of official information, several private bodies have conducted surveys that provide some insights however. In 2003, KPMG released the results of a survey of 800 Australian companies entitled “Employee Share and Option Schemes Survey Report”.\footnote{J Lenne, R Mitchell and I Ramsay “Employee Share Ownership Schemes in Australia: A survey of key issues and themes”, Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law, University of Melbourne, 2005, p 16.} That report identified that employees of public listed companies are significantly more likely to be offered equity based compensation schemes as employees of other companies. Specifically, 80% of public listed companies that responded had some sort of scheme compared with 38% of public unlisted companies and 16% of private companies.

\footnote{Shared Endeavours, f/n 1, p xxi} \footnote{Ibid.} \footnote{“Shared Endeavours” f/n 1, p 20.} \footnote{Ibid, p 26.} \footnote{J Lenne, R Mitchell and I Ramsay “Employee Share Ownership Schemes in Australia: A survey of key issues and themes”, Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law, University of Melbourne, 2005, p 16.} \footnote{Another survey by Mercer Human Resources Consulting was released in 2002.}
In relation to the types of schemes being offered there would appear to be significant diversity as to the type of equity, the nature of the employee contribution (if any) and the conditions that must be satisfied. For example, the survey found that the most common types of schemes were option or option-based schemes as opposed to share plans (49% of schemes were in this category). The key differences relate to an entitlement to dividends (not available under an option plan) and downside risk protection (not generally available under a share plan). Under an option plan employees are offered options which can be exercised after a vesting period (usually 3 to 5 years) for a stated exercise price. The option itself (as opposed to the underlying share) is granted for nil or nominal payment. There is no commercial downside risk in holding options. That is, if the shares are ‘out of the money’ (ie the share price is less than the exercise price), the employee simply does not exercise the option. Rather the option is only exercised if and when the shares are ‘in the money’ (ie the share price exceeds the exercise price). If the shares remain out of the money, the options are simply allowed to lapse. Prior to the exercise of the option, the employee does not receive dividends and has no other shareholder rights. The survey found that the most common type of option plan set the exercise price at the market value at the time the options were granted (MEPO) but there were also plans with lower exercise prices (LEPO) as well as zero exercise price options (ZEPO). Plans with a zero exercise price have been becoming more common. Another significant feature is the development of Performance Rights Plans which generally involve the issue of options for no consideration with a nil exercise price but subject to the satisfaction of various performance criteria. This is particularly the case with executive remuneration as opposed to all-employee schemes. The most common performance hurdle was found to be Total Shareholder Return (TSR) but others included earnings per share (EPS) and share price performance.

The survey also identified that 12% of companies with a scheme had a $1000 tax-exempt plan. As already notified to access this exemption the employee must elect to be taxed upfront. The view was expressed in the survey that the decline in the use of such plans could be linked to the state of the share market generally in the period covered by the survey and that companies are less likely to offer free or discounted shares to employees during periods of slow profit performance.

If the acquisition of shares or rights requires some contribution by the employees there are various methods available to achieve this other than requiring the employee to provide cash. For example, the acquisition may occur as a result of a salary sacrifice so that the employee elects to receive part of their remuneration as shares, rather than as cash (ie the employee’s cash salary is reduced). Provided the requirements of Div 13A are met, the employee will be entitled to tax deferral. One high profile salary sacrifice arrangement is that of the CEO of ANZ who was reported to have earned only $49 in cash salary last year (i.e. less than $1 per week), receiving the rest of his remuneration in shares and performance rights in ANZ. Loan plans, discussed above are also a common way
of financing acquisitions. Typically the loan will be limited in recourse to the value of the shares so that there is no downside risk.

There has also been a trend by employers to have plans operated through a trust (discussed above) or to use a third party ‘plan company’. This is seen as providing flexibility as to the source of shares to be provided under the plan, that is, either existing shares acquired on market or new shares issued by the company. The use of a third party can also address the issue of deductibility which is discussed above. The introduction of accounting standards in 2004 which require companies to expense the value of share and option grants has highlighted the fact that such companies will generally not be entitled to claim a deduction despite the accounting requirement.

Another trend identified in the press has been the practice of executive employees hedging shareholdings, that is, locking in profits but still holding shares in order to seek concessional CGT treatment and/or to limit disclosure to shareholders. For example, the CEO of Channel Seven recently exercised 500,000 options and immediately entered into put and call options over the resulting shares. CEO of Westpac recently exercised 677,886 options and immediately entered into cap and collar arrangements with CBA. This hedging trend appears to replace the sale of vested option arrangements which were common a couple of years ago. The Australian Council of Super Investors found that 34 companies were engaging in hedging even though many companies did not respond to its call for information.

What does appear to be the case is that ESOPs are strongly based on Australian income tax law and changes to it. For example, in the early-mid 1990’s ESOPs were put on hold for 2 years between the period starting when the Government announced that the old tax regime (section 26AAC) would be replaced and ending when the Government announced the rules now comprising Divisions 13A. Similarly, a current trend is to implement plans for stapled securities in light of the 2006 Federal Budget announcement. This is a very major development given the prevalence of listed property trusts and infrastructure funds in the market.

4 Difficulties with the current tax regime

My preliminary research has identified a number of problems in the use of the tax concessions as a regulatory tool. The problems that have been identified so far include:

- The complexity of the tax and regulatory requirements;
- The inflexibility of the tax provisions; and

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122 Australian, 12 June 2006.
• The potential for abuse.

4.1 Complexity

If an employer wishes to offer shares to employees it must comply with regulatory requirements in the Corporations Act designed to provide information to investors. The requirements are onerous and often ill-suited to a decision by an employee to obtain free or discounted shares in the enterprise where they work. Although there are concessions for employee share schemes, they can also be quite difficult to satisfy. In addition, in order to access the concessions or to ensure that the plan has the appropriate tax consequences, employers need to consider the taxation requirements. As already noted there are different consequences depending on what is offered, on what terms the offer is made and a range of other structural issues. For these reasons start up costs for employers can be very high. Legal drafting of documents is expensive as they must be precise (for tax purposes) and helpful for employees (plain English) drafting. There are also costs of educating administrators – eg HR, tax group, legal group, payroll etc. Standard or “off the shelf” plans invariably fall foul of the tax rules with serious consequences. There are added costs if binding tax rulings are sought, which is common but often unnecessary. On-going costs can be high especially if an external administrator (eg Computershare) is used. Also, there may be costs associated with obtaining external advice for unique employee circumstances that continually arise. Educating employees (both administrators of the plans and participants) and responding to queries especially if they are not commercially literate can also be costly. Furthermore there is a need to review plans and documents each time an offer is made given the rapid and numerous changes in tax law.

4.2 Inflexibility

Work done to date suggests that a “one-size fits all” approach to the concessions is increasingly less appropriate to meet the emerging diversity and flexibility of the workplace and work practices across the spectrum from small start-up companies in sunrise industries to large listed companies with transnational workforces. For example, the author has been involved in a study that highlighted the difficulty faced by a start-up company in meeting the conditions for the available tax concessions. 124 Rider has also argued that there are conceptual problems in treating an individual involved in an intellectual property commercialisation who receives shares in exchange for their labour in the same way as an employee who receives fixed cash salary regardless of the fortunes of

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the enterprise.\textsuperscript{125} In his view such persons are more like at-risk investors and should receive the tax treatment available to investors.\textsuperscript{126}

The limited terms on which ESOP benefits may be provided and the limited component of overall remuneration which they can provide, also reflect an outdated view of the appropriate taxation treatment of labour income.

43. Potential for abuse

In its Dissenting Report to Shared Endeavours, the minority argued that although the original intention of the tax concessions for ESOPs was to encourage the ownership of shares in companies by the employees of those companies, over a number of years such plans had “become vehicles for aggressive tax planning for the benefit of company executives”.\textsuperscript{127}

The lack of published information relating to the number, structure and incidence of ESOPs makes it difficult to identify particular types of abuses but this is an area that certainly requires more attention.

The Dissenting Report made the point that the government should encourage the growth of what it termed “genuine” or bona fide employee share plans and should develop anti-avoidance measures to deal with the abuse of plans “that are available only to executive, high income employees and have as their real purpose the tax effective or tax free provision of remuneration”.\textsuperscript{128}

5 Where to now?

There is clearly much more work to be done. The next stage of our project is looking to gather information on the number, incidence and structure of ESOPs in Australia. We are also looking to gather data from the point of view of the potential employee beneficiaries. While there is a considerable body of international literature on employee share ownership, and much of this literature suggests that high levels of employee participation in an ESOP is necessary to achieve any of the purported benefits, very little attention has been paid to the motivations of employees in participating or declining to participate in such plans. Why do employees take up shares in their own organisations when it is possible to buy shares in other, perhaps better performing, organisations through the share market? Do employees take up shares for financial returns or because of a desire to participate more in the decision-making processes of the organisation? What other factors influence the decision to take up shares? We plan to identify and examine these issues through two research methodologies. The first stage

\begin{footnotesize}
\begin{enumerate}
\item[126] Ibid.
\item[127] Shared Endeavours, fn 1, p 280.
\item[128] Ibid, p 277.
\end{enumerate}
\end{footnotesize}
involves interviews with a number of HR managers/ESOP administrators and trade union officials. The second stage involves administering a large-scale survey to employees in companies that offer broad-based employee share schemes. Once we have collected data we hope to carry out an analysis of the regulatory ‘fit’ between regulatory framework and social & economic objectives.

Any suggestions for the project will be gratefully received.