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Dear Tim

Employee Share Schemes Consultation Paper

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) is pleased to provide this submission on the consultation paper concerning the operation of Division 83A of the *Income Tax Assessment Act 1997* (**ITAA 1997**), released in April 2017 (**Consultation Paper**).

1 Introduction

1.1 You are seeking input from the community on two primary questions:

(a) *what issues should ATO public guidance cover?* and

(b) what form should the ATO public guidance take?

1.2 We have set out below ten areas that we believe should be the subject of further guidance from the ATO. In each case we believe that well-considered guidance, properly consulted upon, would reduce complexity and therefore the compliance costs to both participants and employers when dealing with employee share schemes.

1.3 The ten areas are as follows:

(a) the application of Division 16K and the franking regime in the context of employee share scheme buy-backs;

(b) the meaning of "ESS interest" and related issues;

(c) indeterminate rights;

(d) deferral conditions;

(e) the start-up concession;

(f) employee share trusts;

(g) employee remuneration trusts;

(h) ESS valuations;

(i) ESS reporting obligations; and

(j) cross-border schemes.

1.4 Given the complexities associated with some of the issues we have identified above, our preferred approach would be to have the above issues addressed in separate guidance products. Such an approach would enable each of the issues to be dealt with in a timely manner and would allow for more targeted consultation. We comment further below on issues associated with the preferred form of guidance and our priorities in this respect.

2 Employee share scheme buy-backs

2.1 One of the key initiatives under the Australian government's Industry Innovation and Competitiveness Agenda is to encourage employee ownership in Australia. The Government is to be commended for this initiative and for the measures it has introduced, in conjunction with the ATO, to make employee equity arrangement more accessible for start-up entities.

2.2 Despite the implementation of positive reforms in this area, including broader tax concessions for eligible start up entities and access to a cost-effective safe harbour valuation methodology (discussed further in section 9 below), the absence of a market for the shares of departing employees remains a key obstacle to start-up entities, and all unlisted companies more generally, implementing employee share schemes.

2.3 More specifically, for a variety of reasons it is generally undesirable for a former employee who has departed a private company to remain a shareholder in that company. For this reason, the plan rules will generally require an ESS participant that ceases employment to sell their shares at the time of cessation of employment. To achieve this, it is necessary for the company to create a market for the shares. In an unlisted environment, the following potential markets may be considered:

(a) an existing shareholder may purchase the shares;

(b) an employee share trust may be set up to administer the acquisition and grants of shares under the plan; or

(c) the company may acquire the shares under the Corporations law buy-back regime.

2.4 The first two options at paragraphs (a) and (b) above are generally not realistic in an unlisted context. Other than in exceptional circumstances, it will not be possible to rely upon existing shareholders to fund the acquisition of shares from departing

employees. The cost and complexity of establishing and administering an employee share trust is substantial and therefore will generally only be feasible for a large company with extensive employee share ownership plans.

2.5 The most obvious market is the company itself and the employee share scheme buy-back provisions in the *Corporations Act 2001* facilitate this option. However, the tax treatment of off-market buy-backs remains a barrier to private companies utilising the Corporation's law ESS buy-back regime.

2.6 Very broadly, under Division 16K so much of the purchase price as exceeds the part of that price that is debited against the company's share capital account is treated as a dividend paid to the shareholder by the company. Franking credits may be available in respect of this dividend. The balance of the purchase price for the share will be treated as consideration for capital gains tax (**CGT**) purposes.

2.7 By contrast, if the former employee sold their ESS shares to a third party the entire purchase price would be consideration for CGT purposes. Accordingly, disposal of shares to the company under an ESS buy-back may lead to a significantly different tax outcome for a participant than if the shares were disposed of to an employee share trust or other third party. Whether, and the extent to which, a participant may be disadvantaged having their shares assessed under the off-market buy-back provisions will depend upon a number of factors, including: the dividend/capital split, whether the dividend component is unfranked, whether the market value of the shares at the time of disposal is more or less than the participant's cost base, whether the shares qualify for the CGT discount and the participant's marginal tax rate.

2.8 In light of the above, it would be helpful if ATO guidance could address the application of Division 16K to an ESS buy-back in respect of the following:

(a) What is the ATO's preferred methodology for determining the dividend/capital split in an ESS buy-back? Will the same methodology apply in all circumstances, including where the relevant shares are issued to employees for nil consideration?

(b) Are there circumstances where the Commissioner would seek to apply the following anti-avoidance rules in respect of a ESS buy-back?: 45A (dividend and capital benefit streaming); 45B (schemes to provide certain benefits); s 177EA (franking credit trading and dividend streaming rules) and s 204-30 (streaming distributions)?

2.9 Would the ATO consider allowing an administrative treatment whereby no part of the purchase price paid to an ESS participant under an "employee share scheme buy-back" within the meaning of the *Corporations Act* is deemed to be a dividend?

3 Meaning of "ESS interest" and related issues

3.1 We believe that there are a number of 'gateway' interpretational issues that would benefit from some clear guidance. Some of the issues are dealt with by existing guidance albeit in relation to different legislative provisions, and so it would be useful if it could be collected and refreshed in the context of a single Division 83A product.

3.2 A number of issues, some of which are identified in Attachment A to the Consultation Paper, arise. A few of these specific issues include:

(a) What is an ordinary share vs a preferred share in the context of Division 83A?

(b) Do voting restrictions on ordinary shares exclude them from qualifying?

(c) What is an 'ordinary share' in relation to foreign entities such as LLCs and other hybrid entities?

(d) If more exotic interests, such as a profits interest in a LLC,1 are not ordinary shares, does that mean they will be taxed to the employee up-front or will the employer be subject to FBT implications (possibly depending on whether the employer or employee make a foreign hybrid election)?

4 Indeterminate rights

4.1 There is a need for clear guidance on a range of issues that goes beyond what is presently included in the ATO's online guidance and Taxation Determination TD 2016/17.[2]

4.2 Specific issues to do with indeterminate rights include the treatment of rights to shares which may be cash settled, and in particular:

(a) Are there any income tax and FBT consequences on the grant of such a right if they are ultimately cash settled?

(b) How is the cash settlement amount taxed?

(c) When is the cash settled amount taxed?

5 Deferral conditions

5.1 It would be useful to have some refreshed guidance as to the current approach of the ATO to the requirements regarding a real risk of forfeiture and to have that approach documented in a form readily accessible to all taxpayers and advisers.

5.2 Eight years have passed since the introduction of Division 83A and practice regarding what is considered to be a real risk of forfeiture has inevitably shifted around the very basic guidance that was given on the concept of "real risk of forfeiture" in the explanatory materials to the legislation.

5.3 Taxpayers and advisers would also greatly benefit from guidance on what constitutes a genuine restriction from disposing of ESS interests. Public guidance on this issue will assist employers and employees to have certainty and apply a

[1] See the following website for an explanation of profits interests - http://www.hutchlaw.com/blog/what-is-a-profits-interest

[2] https://www.ato.gov.au/General/Employee-share-schemes/In-detail/Indeterminate-rights/ESS---Indeterminate-rights/#Example_11:_Creation_of_indeterminate_right_at_beginning_of_performance_period,_employee_receives_cash_or_shares

consistent approach to reporting of the deferred taxing point for ESS interests which are subject to disposal restrictions.

5.4 There is presumably a body of knowledge, reflected in rulings and other non-published sources, that represents the ATO's current views and approaches to these issues. It would be useful if that was made public.

5.5 For example:

(i) What is the position regarding general board discretions?

(ii) Is it possible to have a genuine restriction on disposal if the board has a residual discretion to lift it?

(iii) In what circumstances would the ATO accept such a discretion e.g. financial hardship, sickness?

(iv) In what circumstances does the ATO accept that approval requirements constitute a genuine disposal restriction on disposal (eg, where a share trading policy mandates prior approval to dispose of shares)?

(v) How many times can such a discretion be exercised before it becomes problematic?

5.6 It would also be desirable to include confirmation that the alternative deferral requirements of s.83A-105(6)(b)(ii) can be met in a variety of ways, such as in the body of the main plan document, in a sub-plan or addendum for Australian participants in the case of a foreign plan or in an individual agreement with each Australian participant.

6 The start-up concession

6.1 There is a need for guidance on a range of issues concerning the start-up concession. These issues arise from the specific requirements imposed by section 83A-33. The valuation issues referred to below also extend to start-ups who will in most cases be reluctant, or unable, to pay for external valuations on an ad-hoc basis. Flexibility remains the key for such businesses and so the adaptability of these rules is an important yardstick by which their effectiveness can be measured.

6.2 The issues identified in Attachment A to the Consultation Paper would provide a good starting point for further specific consultation with taxpayers directly concerned with these schemes.

6.3 We believe that most of the issues concerning start-ups would be better dealt with in a separate product, with any cross-over with issues of a broader application to Division 83A dealt with as necessary.

6.4 One issue that is worth being examined in this context is whether the minimum holding period restriction still needs to be applied to new issues after the relevant company fails to meet the threshold conditions in section 83A-33 (eg. if it is more

than 10 years' old), but there are still ESS interests on issue that are covered by the start-up concession.

7 Employee Share Trusts

7.1 It is our strong view that it is appropriate to exclude from draft Taxation Ruling 2014/D1 (the **Draft ERT Ruling**) those matters specifically relating to employee share trusts (whether complying or non-complying). It is recommended that:

(a) A separate ruling or tax office product should be created to deal with matters relating to employee share trusts.

(b) It is not necessary for this separate ruling or tax office product to be at the same level of detail as contained in the current Draft ERT Ruling. However, it should recognise the issues raised in Attachment A to the Consultation Paper and in particular:

(i) the differences (as applicable to employee share trusts) from the Draft ERT Ruling;

(ii) the importance of the existence of the sole purpose test; and

(iii) the scope of activities that are considered to be 'merely incidental' to the activities listed in the definition of an employee share trust in subsection 130-85(4) of the ITAA 1997.

8 Employment remuneration trusts

8.1 Having regard to the above comments regarding employee share trusts, we would like to see the ATO continue to progress the Draft ERT Ruling in respect of employee remuneration trust arrangements.

8.2 Again, we believe these issues can be appropriately covered in a separate guidance product and it would be useful to understand the current status of TR 2014/D1. The Committee has already made detailed submissions with respect to the issues covered in the draft ruling.

9 ESS valuations

9.1 It would be useful to have more practical guidance in the form of safe harbours or rules as to the valuation requirements in Division 83A. Limited guidance of this nature is available for example in the unlisted options and start-up space, but more general guidance is required and could significantly reduce compliance costs for taxpayers, while any risks to the revenue are managed. For instance, if a company has recently raised equity capital from independent parties, why could the company not be given an option to issue ESS interests based on the same price, subject to there being no material change in the company's circumstances since the equity raising?

10 ESS reporting obligations

10.1 A clear statement of the ATO's expectations around the ESS reporting requirements would be useful.

10.2 One issue that we would like to raise is the difficulty created by imposing reporting obligations on a non-resident issuer of ESS interests where the actual employer was (but is no longer) an Australian subsidiary of the issuer. In practice these requirements give rise to compliance burdens and difficulties that are disproportionate to the integrity aims of the provisions.

10.3 Guidance on the circumstances in which the ATO might accept alternative reporting arrangements which are consistent with the integrity aims of the provision (such as allowing the Australian employer to agree to report on behalf of the non-resident issuer) would be useful.

11 Cross-border schemes

11.1 Practical guidance on how the ATO approaches employee share schemes in a cross-border context would be useful.

11.2 There are numerous issues that arise where employees receive interests under a scheme and either change jurisdiction or the interests are awarded in respect of services performed across a number of different jurisdictions.

Some of the issues on which publication of the ATO's position would be helpful (backed up by practical and realistic examples) include:

(a) Confirmation of how the ATO will approach scenarios where options and shares are issued and/or vest whilst the employee is overseas. In particular, how does the ATO approach the issue of where and when the relative "employment" of the individual is?

(b) Does the ATO distinguish between a vesting period and what can be referred to in foreign plans as a "blocking period"?

(c) How does the ATO approach the application of Australia's network of double taxation agreements in terms of allocating taxing rights and the potential double taxation issues that may arise in cross-border share schemes?

(d) Confirmation of how the temporary resident rules may apply in the context of Division 83A.

12 What form should the guidance take?

12.1 As already noted, given the complexity of some of the issues identified above our preferred approach would be to deal with each of the above issues in a standalone piece of guidance.

12.2 We believe that this approach will allow for the effective prioritisation of the issues, effective consultation on an issue-by-issue basis and will enable effective guidance to be bought to market earlier than if the issues are dealt with collectively.

12.3 The alternative would be to request that all of the issues be dealt with in a single product but it was generally agreed that the risk was that such a product would not be able to be produced in a timely fashion. It was felt that to the extent that some issues could be dealt with faster than others then there was no reason to hold back the issuance of that guidance pending the resolution of the other issues.

12.4 It would also be preferable to provide any guidance in the form of a public ruling (to the extent possible) rather than a practical compliance guideline (**PCG**). This ensures greater certainty, which is critical given the generally long time frames applicable to, and wide availability of interests in, many employee share schemes. However, it is accepted that some issues, such as valuation, may be more suited to a PCG or similar product.

12.5 Our preferred approach would be to prioritise the above issues as either "core" or "non-core" issues and press to have the core issues dealt with as a priority. Of the ten issues identified above, we would categorise the following four issues as "core" issues that are concerned with fundamental and threshold parts of the legislation:

(a) the application of Division 16K and the franking regime in the context of employee share scheme buy-backs;

(b) the meaning of "ESS interest" and related issues;

(c) indeterminate rights; and

(d) deferral conditions.

13 Other matters

13.1 For completeness, there are a number of issues that go beyond the kind of guidance envisaged, but which warrant examination in terms of law reform or by exercise of the Commissioner's remedial power including the interaction between the ESS rules and other regimes such as value shifting, fringe benefits tax and Division 7A.

If you have any questions in relation to this submission, in the first instance please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or via email: adrian.varrasso@minterellison.com

Yours sincerely,

Teresa Dyson, Chair
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