The Institute of Chartered Accountants in Australia

9 October 2009

Mr Dick Warburton
Chairman
Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Review into elements of the taxation of employee share scheme arrangements

Dear Dick,

We have pleasure in providing this submission to the Board of Taxation's review into elements of the taxation of employee share scheme (ESS) arrangements (the review).

As the Board of Taxation (the Board) will be aware, the Institute of Chartered Accountants in Australia (the Institute) has been a leading contributor to the recent public debate surrounding the Government's proposed changes to the taxation of ESSs announced in the Federal Budget in May 2009.

As part of our contribution, the Institute has made numerous submissions over recent months to both the Government and Treasury in relation to the scope of the proposed Budget changes, and the potentially detrimental impact that would have arisen if the original proposed changes were adopted. Whilst the Institute believes that there still exist a limited number of residual concerns with the 1 July 2009 policy statement, it is generally supportive of the revised tax policy approach proposed by the Government in relation to the taxation of ESSs.

As has been pointed out by the Institute and other stakeholders over recent months, the broad use of ESSs in Australia is an integral component of effective remuneration planning and performance management for a wide spectrum of employees at all levels. All effort should therefore be expended to ensure that the use of ESSs continues to be supported by appropriate tax policy that seeks to tax employees, at an appropriate point in time, on a fair and reasonable value which is reflective of the benefit they receive.

In accordance with the terms of reference for this review, the Board has an opportunity to examine specific issues in relation to:

1. determining how best to ascertain the market value of ESS benefits; and

2. whether shares and rights under an ESS that are provided by start-up, research and development and speculative-type companies should be subject to separate tax deferral arrangements which differ from those proposed in the Government's 1 July 2009 policy statement.

In the following pages, the Institute has put forward its views in relation to both elements of this ESS review.

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We would be pleased to provide further information if required to assist as part of the Board's review process before reporting back to the Government in February 2010. If you have any questions, please contact me direct on 02 9290 5623.

Yours sincerely,

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia

PART 1

Valuation of ESS benefits – clarification of scope

The Terms of Reference for the Board of Taxation's review do not clearly indicate whether it is confined to the valuation of employee shares and options (specifically), or extends to the valuation of ESS benefits more generally. This is an important distinction.

Under the existing law of Division 13A (as well as the proposed new Division 83A) the value of an employee "share" or employee "option" must not take into account conditions and restrictions relating to the plan under which the share or option is provided to the employee. However, the value of an employee share scheme "benefit" normally would take into account such restrictions and conditions.

The Assistant Treasurer's Media Release of 24 July 2009 provides support for the view that the Board's review extends to employee share scheme benefits [**emphasis** added]:

> The issues before the Board are: … how to best determine the market value of employee share scheme **benefits** …

There is also support in the Board's Terms of Reference [**emphasis** added]:

> Two issues remained unresolved by the 1 July Policy Statement – how best to determine the market value of employee share scheme **benefits** and …

Our submission therefore covers the valuation of ESS benefits more generally, which would typically account for restrictions and conditions attached to shares and rights.

Taxation of employee remuneration

Non-business income is normally assessable on a 'cash receipts' basis.[1] The courts have therefore held,[2] and the Commissioner of Taxation has acknowledged,[3] that employee remuneration is assessable when it is received.

However, there is an apparent anomaly in relation to employee share scheme benefits. This anomaly arose because the leading UK and Australian cases on employee options (*Abbott v. Philbin*[4] and *Donaldson*[5], respectively) involved specific taxing provisions that assessed the value of employee benefits when they were granted, irrespective of whether they had been, or even could be, converted into cash.

Once the courts identified this anomaly in *Donaldson's case*, the Whitlam government moved to correct it by amending the law to reinstate a tax treatment that was more like the 'cash receipts' basis.[6] The explanatory memorandum to the amending legislation clearly articulated a policy of taxing the employee shares, rather than the employee share scheme benefits, upon receipt [**emphasis** added]:[7]

> Broadly stated, the new provision will include a benefit received under an employees' share acquisition scheme, measured by reference to the amount by which the value of the shares acquired exceeds the consideration given for them, as assessable income of the year in which the shares are transferred to the employee-recipient. The effect of paragraph (e) of section 26 of the Principal Act (the operation of which is now to be

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1 Refer to the judgements of Dixon J in *Carden's case* [*The Commissioner of Taxes (South Australia) v. The Executor Trustee and Agency Company of South Australia Limited* (1938) 63 CLR 108], Barwick CJ in *Henderson v. F.C. of T.* (1970) 119 CLR 612 and Gibbs J in *Brent v. F.C. of T.* (1971) 125 CLR 418.

2 Refer to the judgement of McInerney J in *F.C. of T. v. Firstenberg* 76 ATC 4141 (at p.4154) and see also *Case 29* 1 TBRD 88; 1 CTBR (NS) 225 *Case 57*; and *Case B53* 2 TBRD 223; 2 CTBR (NS) 125 *Case 27*.

3 Refer to TR 98/1 *Income tax: determination of income; receipts versus earnings* [at paras.8 & 42].

4 In the UK, *Abbott v. Philbin (Inspector of Taxes)* [1961] A.C. 352 concerned Schedule E to the *Income Tax Act 1952* (UK).

5 In Australia, *Donaldson v. F.C. of T.* 74 ATC 4192 concerned s.26(e) of the ITAA 1936.

6 The decision in *Donaldson* was handed down on 31 July 1974. On 17 September 1974 the Whitlam Government announced that it would amend the law (the *Income Tax Assessment Act (No. 2) 1974* inserted s.26AAC with effect from the date of the announcement).

7 Refer to the introduction to Clause 8 of the explanatory memorandum to the *Income Tax Assessment Act (No. 2) 1974*.

> displaced in relation to benefits arising in future under these schemes) is to measure the value of the benefit in the year in which the employee acquires rights under the scheme and include any value as assessable income of that year. **The amount of the benefit assessable in terms of paragraph 26(e) may, in practice, turn out to be either more or less than the amount that eventually becomes available to the employee when rights to acquire shares have been exercised**.

Absent such statutory over-rides, the courts have consistently held that the taxable value of an employee benefit (of any kind) is its value **to the employee**:

- **Ordinary income**

In *Lambe*[8] Finlay J. said (at pp.182-3):

> Income may be of various sorts..., but nonetheless the tax is a tax on income. It is a tax on what in one form or another goes into a man's pocket. That is the general principle.

In *Tennant v. Smith*[9] Lord MacNaghten concluded that (at p.164):

> Take, for example, the 6th case of Schedule D, which sweeps in all profits or gains not otherwise chargeable. What the person liable to be assessed is required to do under Schedule G is to return "the full amount" of annual profits "received" (5 & 6 Vict. c. 35, s. 190, Schedule G, XII.). No doubt if the appellant had to find lodgings for himself he might have to pay for them. His income goes further because he is relieved from that expense. But a person is chargeable for income tax under Schedule D, as well as under Schedule E, not on what saves his pocket, but on what goes into his pocket. And the benefit which the appellant derives from having a rent-free house provided for him by the bank, brings in nothing which can be reckoned up as a receipt or properly described as income.

Other cases have even more explicitly recognised that the relevant value is not the cost of the benefit to the employer, but the amount of money for which the employee could turn the benefit to account. So, in *Wilkins v. Rogerson* [1961] Ch. 133 the taxable value of a new suit was the value for which the employee could sell it as second-hand goods.

- **Non-cash employee benefits**

In *Donaldson* Bowen CJ expressed the preferred approach in terms of what a prudent person would be prepared to pay for the actual employee share scheme benefit (at p.4207):

> Section 26(e) speaks of “value to the taxpayer”. This is a notion familiar in valuing to determine compensation for resumption purposes. In a case such as the present under sec. 26(e) I consider it is appropriate in ascertaining value to the taxpayer to determine what a prudent person in his position would be willing to give for the rights rather than fail to obtain them. (cf. *Pastoral Finance Association Limited v. The Minister*, (1914) A.C. 1083 at p.1088).

- **Non-cash business benefits**

In *Cooke and Sherden*[10] the Federal Court concluded that non-transferable airline tickets were not "income" because the recipient could not convert them into cash.

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8 *Lambe v. Inland Revenue Commissioners* [1934] 1 K.B. 178. Jordan CJ. approved *Lambe* in *Scott v. C. of T. (NSW)* (1935) 3 ATD 142 (at pp.144-5).

9 *Tennant v. Smith (Surveyor of Taxes)* [1892] A.C. 150

10 *F.C. of T. v. Cooke and Sherden* 80 ATC 4140.

It may be noted that s.21A of the ITAA 1936 now deems such benefits to be convertible into cash, and brings them into assessable income at their "arm's length value" (as defined). However, this provision does not apply to employee remuneration.

- **Fringe benefits**

In 1986 the (then) Treasurer noted the subjectivity of the courts' approach in his second reading speech on the new Fringe Benefits Tax [**emphasis** added]:[11]

> Before turning to the main features of the fringe benefits tax, I remind honourable members of the background. There has over the years been a very strong movement towards the remuneration of employees – especially higher income earners – by fringe benefits packages which allowed income tax to be avoided on substantial parts of the overall remuneration. So-called tax-free perks came to dominate salary package negotiations and packages were openly advertised in the market place. Increasingly innovative deals were emerging particularly after the demise of the paper tax avoidance schemes in the early 1980s. All of this was aggravated by the inability of the existing income tax system to exact tax effectively from recipients of fringe benefits. Several factors contributed to this.
>
> First there were deficiencies in the income tax law itself. **A major one was that it called for case by case subjective judgments to be made as to the value of fringe benefits in the hands of individual employees. That kind of requirement is simply incompatible with the efficient assessment and collection of tax on a mass scale and invites disputation.** There were also technical defects creating gaps in coverage, for example, when benefits were given to family members and associates rather than to employees directly. A decided lack of enthusiasm to tackle such problems over the years by previous governments inhibited administrative initiatives in this area, encouraged the growth of fringe benefits and heightened perceptions that there was a right to enjoy perks tax-free once they were negotiated. This was a situation that the Government could not leave unchallenged if tax reform was to have any meaning.
>
> The Bill also contains all the rules necessary to identify and value the wide range of fringe benefits it deals with.

The valuation of employee share scheme benefits

It follows from the above that, according to fundamental principles of income tax law, an employee should be taxed on the value of an employee share scheme benefit when the benefit is received. The taxable value of such a benefit should be the amount that a prudent person, in the employee's position, would be willing to give rather than fail to obtain it. This value should reflect any conditions and restrictions attaching to the benefit that are outside the employee's control.

The legislature is, of course, free to impose tax on an employee share scheme benefit at a different time (such as when an employee share or option is received). However, the taxable value of the benefit should still be the amount that a prudent person would be willing to give, at the new taxing point, rather than fail to obtain it. This value should reflect any conditions and restrictions attaching to the share or option that are outside the employee's control.

The Institute’s submission on valuation of employee share scheme benefits therefore proceeds on the basis that an appropriate valuation should require a comprehensive valuation of the benefit, rather than a narrower valuation of the underlying share or right (such as an option).

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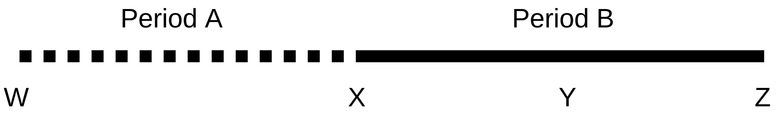
[11] Second reading speech on the *Fringe Benefits Tax Assessment Bill 1986* by the Hon. Paul Keating (Treasurer) on 2 May 1986 (interjections and responses omitted).

How best to determine the market value of employee share scheme benefits

(a) Features of ESS benefits

In order to understand the issues with valuing the employee share scheme benefits, it is worthwhile understanding the typical features of the benefits. Figure 1 shows the generic timeline of an ESS benefit.

Figure 1



The employee and the employer enter into an agreement at time W whereby the employee will receive a share, or the right to acquire a share, provided certain conditions are satisfied during Period A. Some of the performance conditions include:

- Employment with the company for a specified period
- Internal company metric such as earnings per share growth, and
- External metric such as share price growth

If the performance conditions are satisfied then the employee receives the share or the right to acquire the share at time X. For a right to acquire a share, the employee usually has a period of time in which to exercise that right. The right to acquire the share lapses at time Y. The share may be subject to a 'holding lock' which restricts the disposal of the share. The end of the holding lock occurs at point Z. Y may be the same as Z. The time from when the performance conditions are achieved to the end of the holding lock is Period B.

For income tax purposes, a valuation may be required in Period A or B. The fundamental techniques to value shares or rights to acquire shares are well established in valuation practice. The main difficulty comes from establishing the appropriate basis of valuation. This affects whether certain performance conditions or restrictions should form part of the valuation.

Under the assumption that 'value' for income tax purposes should be determined on the basis of the benefit the employee receives, all performance conditions and restrictions that the employee is subject to should be considered in the valuation. As long as valuation methodologies are applied in accordance with fair market value principles, prescriptive guidance is unnecessary. However, where employee conditions exist, it would appear fair and just that the valuation is suitably discounted to reflect the employment conditions and restrictions attached to the award. In Period A, the valuation is more difficult because there are performance conditions to consider. In Period B, the only concern from a valuation perspective is the restriction on disposal.

(b) Existing rules

- **Traded securities**

With existing rules, if the share or the right to acquire the share underlying the benefit is traded, the traded price is deemed to be the market value. A prudent person, taking into account the presence of conditions and restrictions, would not pay the same price as the underlying unrestricted traded security for the benefit. The existing rules, which focus on the underlying security and not the benefit, over-value the benefit when conditions are in place. The existing rules are more suitable for Period B where the discount to the traded value may be quite small depending on the ease with which disposal restrictions can be lifted.

Another area where the existing rules over-value arises in respect of a right with a nil exercise price (s139FE(1)). The valuation under existing rules in this situation is the same as the value of the underlying share. Usually, the right does not have entitlement to dividends and as such must forgo any dividends until the share is received. The share price reflects the present value of all future dividends so for a share that receives regular dividends, the current method of using the full value of the share price for a nil priced right over-states the value of the right.

- **Unlisted securities**

For unlisted shares, the existing rules require a valuation of the underlying shares disregarding any conditions and restrictions (s139FD). For a valuation in Period A in Figure 1 above, once conditions and restrictions are disregarded, the valuation will be higher than the fair value a prudent person would be willing to pay for the share.

For unlisted rights, deemed valuation tables are used to calculate the value of the rights (s139FJ to 139FN). There has been some criticism that these valuation tables under-value the rights. This criticism stems from the observation that the values in the tables may be less than that calculated using the Black-Scholes option pricing formula. The valuation tables were introduced around 1995 and it is likely the relevant valuation percentages incorporated within the tables were determined using a set of assumptions that reflected market conditions at the time.

The valuation tables must serve the purpose of catering for all different types of companies. It is therefore not feasible or possible for a single table to satisfactorily cater for all different types of companies. The current tables are probably not suitable for valuations in Period A because performance conditions are not incorporated. For Period B, the veracity of criticism that the tables may result in under-valuation should be examined by the Board in this review. However, the Institute is of the view that the existing tables deliver an appropriate outcome when relevant factors such as high levels of accuracy, complexity and compliance costs are traded-off against simplicity and certainty for taxpayers. It is likely that any differences in valuations, and therefore tax collected, are unlikely to be material and therefore would not appear to justify the significantly higher compliance costs that would likely arise.

(c) Determining fair market value

- **Independent valuation**

Ideally, to determine fair market value, an independent valuation should be performed taking into account appropriate performance conditions and restrictions. However this may be impractical due to the cost involved for many taxpayers, and ‘short cut’ methods, such as providing valuation tables, should be available. With the complexities of performance conditions in Period A, short cut methods can never provide a reasonable degree of precision compared to an independent valuation and so trade-offs are required. The simpler the short cut method, the more imprecise the valuation is relative to fair market value. In Period B where the main condition is a disposal restriction, short cut methods can provide a reasonable estimate of fair value. Nevertheless, the taxpayer should be able to commission an independent valuation if they so choose.

- **Short cuts – valuation in Period A**

Accounting valuation

If a valuation is required at time W of Figure 1 above, accounting standard AASB 2 *Share-based Payments* can provide a useful reference point in certain circumstances because the valuation date is the same.

The perspective that AASB 2 takes is “for accounting purposes, the objective is to estimate the fair value of the share option, not the value from the employee’s perspective”[12]. Notwithstanding this, AASB 2 incorporates the impact of conditions and restrictions in estimating the accounting

[12] *IFRS 2 Basis for Conclusions,* International Accounting Standards Board, February 2004, BC168

expense. Under AASB 2, performance conditions are classified into two groups, market based and non-market based. Market-based performance conditions are share price performance conditions, such as total shareholder return, and are incorporated in the fair value estimate using sophisticated techniques such as Monte Carlo simulation analysis.

Non-market based performance conditions are any conditions which are not market based and are incorporated through a subjective estimate of the number of instruments expected to vest rather than through the fair value estimate. This estimate is trued-up during the course of Period A. Given the approach and the different treatment of performance conditions, AASB 2 is appropriate to use for an income tax valuation when the valuation is required at time W and when there are share price performance conditions or no performance conditions except for employment during the course of Period A.

Generic discounts for performance conditions

For a benefit where the underlying security is traded, the traded price is used as the starting point and then a discount should be applied to account for the performance conditions. The appropriate discount varies for different performance conditions and in order to provide a simple solution, a generic discount (such as 20 percent to 40 percent) could be applied. Further analyses are required to determine an appropriate discount or range of discounts but in reality the discount would be less than 50 percent given the nature of the arrangement is such that employees are unlikely to sign up for arrangements where they feel they have less than a 50 percent chance of achieving the performance conditions.

For a benefit where the underlying security is an unlisted right, the current tables of value can be used to provide a valuation as the starting point. The current tables can be updated to reflect current market conditions. The generic discount for the performance conditions is then applied to determine the fair value. If the underlying security is an unlisted share, a valuation of the underlying share is required. Unfortunately, this cannot be avoided.

A possible solution to increase the level of valuation precision is to have more than one valuation table as the starting point and different generic discounts for different categories of performance conditions. There could be, for example, a table for each industry group. However, it is not easy to classify some companies within a distinct industry group. Having multiple tables and multiple discount factors can lead to confusion, as well as add significantly complexity to taxpayer's compliance obligations. The Institute's view is that having one table with one generic discount would be preferable.

- **Short cuts – valuation in Period B**

In Period B of Figure 1 above, the main condition to consider is disposal restrictions which may or may not be onerous. In most cases, the discount to the value of the underlying security would be small. If the underlying security is traded, the traded price would be the market value.

If the underlying security is not traded, the current tables or updated tables could be used for a right to acquire a share. If the generic discount approach described above is appropriate, the same table used as the starting point for a valuation in Period A should be used to value a right in Period B. For an unlisted share, a valuation of the share is required.

Conclusion

In conclusion, we believe the appropriate basis of valuation of ESS benefits for income tax purposes is the value of the benefit from the employee's perspective. On this basis, performance conditions and restrictions that exist at the taxing point should be taken into account when estimating an appropriate fair value. The only modification is that for the purpose of the valuation, it is assumed that the employee will comply with employment conditions.

An independent valuation of the benefit should be the starting point if the taxpayer chooses to commission one. In the absence of an independent valuation, 'short-cut' or proxy methods should continue to be available.

When the underlying security that the employee ultimately receives is traded, the traded value should be used as the starting point and then a prescribed generic discount should be applied for performance conditions if the taxing point is in Period A. For unlisted rights, a valuation table such as the one in the existing rules should be used as the starting point and then the generic discount should be applied to this value for performance conditions. If the taxing point is in Period B, the valuation table should provide an appropriate value.

When the underlying security is an unlisted share, a valuation under fair market value principles is required which is unavoidable.

PART 2

Alternative arrangements for certain types of companies

The Institute supports the work of the Board to examine whether shares and rights under an ESS that are provided by start-up, research and development and speculative-type companies should be subject to separate tax deferral arrangements outside of those proposed by the Government in their 1 July 2009 policy statement.

In respect of this aspect of the review, the Institute makes the following observations:

- Perhaps the broader question that should be examined by the Board is whether it is appropriate to provide alternative tax concessions for the types of companies identified; in the Institute's view, the answer to this proposition is that it is appropriate. Support should be provided to these companies in the same way that other, concessional, tax law are applied in the area of income tax, GST and research and development tax concession (credit).

- Only those entitlements that are granted in the form of remuneration should fall within the scope of any new regime recommended by the Board, so that equity interests that are proprietor-type interests are not inadvertently captured in the same way.

- The key reason why special concessions should be allowed for the types of companies referred to is that they are usually in start-up mode and often have limited access to cash facilities. Therefore, an important tool for attracting and retaining employees is the ability to offer deferred equity as compensation in-lieu of paying higher up-front cash remuneration. Such equity will therefore commonly display some or all of the following characteristics:

    - They will often be provided in the form of options, as the investors and owners usually don't want to give-up immediate equity and control over the start-up business;

    - Often there is no vesting period because the options are being provided in-lieu of lower cash remuneration, and therefore will not otherwise qualify for deferral under the new tax rules announced on 1 July 2009;

    - Options are often provided over alternative classes of shares (sometimes non-voting) with conversion to ordinary shares at a later defined point in time. Such options therefore will not qualify for deferral under the new tax rules even where there is a 'risk of forfeiture'.

    - The benefits often can't be crystallised until a defined event in the future such as an initial public offering, trade sale or similar event, because there is typically no cash liquidity until that point in time. Even if the deferral requirements are otherwise met, the event may not occur

- until long after a taxing point has otherwise arisen. Where the options have vested, they are not truly realisable and to tax them as if they are would yield an unreasonable result.

For these reasons set out above, many overseas jurisdictions provide alternative tax regimes for the taxation of ESS interests in respect of small, or start-up type entities such as those identified in this review.

Notable examples which should be more closely examined by the Board as part of this review can be found in the United Kingdom and Singapore. Typical features of the special rules in these jurisdictions are the existence of certain threshold restrictions relating to the size of the relevant company, as well as the total value of the options in the hands of the employee for which the concessional tax rules can be applied.

Defining the types of companies that can offer concessionally taxed equity will be critical to the success of any new regime recommended by the Board. The Institute believes that there should be tightly defined criteria around eligibility to access the concession to ensure it is appropriately targeted and not abused. Some key criteria and limits that should be taken into account by the Board in defining any new regime include prescriptions around:

- maximum value of the company
- maximum value of assets held by the company
- maximum number of employees
- maximum revenue and turnover
- type of activities that qualify, and
- the maximum number and value of options or shares that can be allocated to employees, at both an absolute total and per individual employee level.

The Institute re-affirms the importance of the Board working collaboratively with the Australia's Future Tax System Review in the area of small business taxation generally in order to ensure that any recommendations made are appropriately aligned to the longer-term design features of Australia's future tax system.