16 October 2009

Mr Dick Warburton
The Chairman - Review of Employee Share Schemes
The Board of Taxation
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Warburton

REVIEW INTO THE TAXATION OF EMPLOYEE SHARE SCHEME ARRANGEMENTS

Origin Energy appreciates the opportunity to make this submission to the Board of Taxation in its review into elements of the taxation of employee share scheme arrangements (the review).

In making this submission we note that Origin has made a submission to the Treasury in relation to taxation of employee schemes on 12 June 2009.

This submission is focussed on the valuation of employee share scheme securities, in particular in relation to options and rights issuances.

Objectives of Equity Plans

In making this submission, we commence by stating that employee share schemes are an integral part of effective remuneration planning, talent management and retention strategy for many companies. Origin has an employee share plan and Options and Performance Share Rights Plans. The objectives of these plans are essentially threefold:

1. to provide a long term performance and retention incentive to employees;

2. to encourage and facilitate greater ownership of company shares by employees; and

3. to align the employees' interests with that of shareholders.

An equity incentive plan that uses well structured performance hurdles is well placed to achieve the above objectives.

It is important to appreciate that options and rights plans are a means by which employees' interests are aligned with shareholders and they are most effective if the employee is encouraged to not only exercise the right, but hold the share so acquired. Option plans in particular provide a means by which employees can be incentivised to perform to ensure that the options vest and become exerciseable, but also are encouraged to invest their own funds through the exercise price and retain the shares so acquired. In this way employees' interests are most closely aligned with shareholders.

Vesting conditions, such as those based on a comparison of the company's Total Shareholder Returns (TSR) against other companies ensure that the exercise of the option is aligned with shareholders' interests and are generally favoured by investor groups and corporate governance advisors.

The use of options not only provides an incentive to the employee recipient, but has the added benefit of facilitating the raising of equity as part of the incentive plan. Rights, (zero price options) although they do not raise equity, are issued in smaller numbers for the same value and are therefore less dilutive than options. A combination of options and rights provides, therefore, an incentive which also balances shareholder interests.

The changes to taxation legislation as it relates to deferred tax benefits, has had significant implications for the remuneration and incentive value of options and rights plans, with the result that employee incentives are reduced and shareholder interests are less advanced.

Notably, taxation of options at the point of vesting imposes a tax upon a benefit that may not or cannot be realised by the employee. This will have the effect of:

1. exposing the employee to a tax liability that may not be matched by a realisable benefit at that time; and

2. encouraging an employee to exercise options and sell all shares immediately upon vesting to manage a tax liability, thereby discouraging long term ownership of shares and creating potential share market disruption.

These consequences are the result of the change to the taxing point of options and rights and the current valuation methodology adopted in the Tax Act.

Scenarios

The problems with the valuation methodology can be best demonstrated through several scenarios.

An option may vest and become exercisable in circumstances where the share market price is equal to or below the exercise price. This may occur where a plan uses relative TSR as the performance hurdle. Under the current proposed reforms and the existing valuation methodology, the tax on vesting would be determined on the value of the option as determined by the valuation tables (s139FM). Notwithstanding that the intrinsic value is nil (as the exercise price is equal to or higher than the market price of the underlying security) the tax value of the option would be positive. Under the proposed legislation, the employee would be taxed on the greater of the tax value of the option or the market value of the share less the exercise price unless the employee exercises and sells within 30 days of vesting. (Market Value being the volume weighted average price over the five days up to and including the relevant day)

The result would be, therefore, that the employee is forced to effectively close out the option by exercising and immediately selling the shares in no later than 30 days.

These problems are demonstrated in the scenarios below:

Scenario 1
Option vesting when exercise price less than market price

Assumptions:

a. *Options issued with an exercise price equal to the market price at the date of issue. Options have a 3 year vesting period and expire after 5 years.*
b. *Options vest on third anniversary - based on relative TSR hurdle.*
c. *The market price at the vesting date is less than the exercise price.*

	Issue Date	Vesting Date Year 3
Market Price	15.00	14.75
Exercise Price	15.00	15.00
Option Face Value		-0.25
Tax Value		1.07

In the above scenario the employee has an option for which he is subject to tax on the value of the option at the vesting date, which is determined by the s.139FM valuation tables at $1.07 (tax value). The employee is taxed on the greater of this value or the market value of the share less the exercise price unless the employee exercises and sells within 30 days of vesting. The exercise of the option and sale of the share would generate a loss of 25 cents per share. Should the employee decide not to exercise the option and the share price does not recover or worsens, the employee will have a significant tax liability without an asset to match - and for which a refund of the tax would not be available. Consequently, employees would be forced to exercise and sell at a loss to avoid a greater tax liability.

Scenario 2
Option vesting when exercise price equal to market price

Assumptions:

a. *Options issued with an exercise price equal to the market price at the date of issue. Options have a 3 year vesting period and expire after 5 years.*
b. *Options vest on the third anniversary - based on relative TSR hurdle.*
c. *The market price at the vesting date is equal to the exercise price.*

	Issue Date	Vesting Date Year 3
Market Price	15.00	15.00
Exercise Price	15.00	15.00
Option Face Value		0.00
Tax Value		1.30

In the above scenario the employee has an option for which he is subject to tax on the value of the option at the vesting date, which is determined by the s.139FM valuation tables at $1.30. The employee is taxed on the greater of this value or the market value of the share less the exercise price unless the employee exercises and sells within 30 days of vesting. Should the employee decide not to exercise the option and the share price falls, the employee will have a significant tax liability without an asset to match - and for which a refund of the tax would not be available. The exercise of the option and sale of the share would generate a nil return as against a tax liability on $1.30 per share. Consequently the employee would be forced to exercise and sell to avoid a tax liability on $1.30 per share.

Scenario 3
Option vesting when market price is slightly above the share price

Assumptions:

a. *Options issued with an exercise price equal to the market price at the date of issue. Options have a 3 year vesting period and expire after 5 years.*
b. *Options vest on the third anniversary - based on relative TSR hurdle.*
c. *The market price at the vesting date is slightly above the exercise price.*

	Issue Date	Vesting Date Year 3
Market Price	15.00	15.50
Exercise Price	15.00	15.00
Option Face Value		.50
Tax Value		1.56

In the above scenario the employee has an option for which he is subject to tax on the value of the option at the vesting date, which is determined by the s.139FM valuation tables at $1.56. The employee is taxed on the greater of this value or the market value of the share less the exercise price unless the employee exercises and sells within 30 days of vesting. The exercise of the option and sale of the share would generate a 50 cent return per share as against a tax liability on $1.56 per share. Should the employee decide not to exercise the option and the share price falls, the employee will have a significant tax liability without an asset to match - and for which a refund of the tax would not be available. Consequently the employee would be forced to exercise and sell to make a small gain to avoid a significantly greater tax liability on $1.56 per share.

It can be seen by the above examples that the tax amendments, which impose tax at vesting and use the current valuation methodology, will actively encourage employees to exercise their options and immediately sell the shares acquired and do so within 30 days of vesting.

The effect of this will be:

a. Long term ownership of shares is discouraged.

b. Market distortions will be caused by many employees seeking to exercise options and sell shares within a short period. This could result in market disruption and a highly volatile share price resulting in a lottery of returns.

The objectives of the employee equity plans are thereby not being achieved and both employees and shareholders are disadvantaged by the reforms.

The Problems

The problems with the proposed tax regime are therefore:

1. Tax being imposed at vesting without the ability to obtain a refund if the option is not exercised, will actively encourage employees to immediately exercise options and sell their shares.

2. Imposing a taxing point at time of vesting will result in a common taxing point for all option holders. Consequently, a large number of employees seeking to mitigate their exposures by exercising and selling shares at the same time will result in market disruption and significant administrative difficulties.

3. Tax valuation of vested options are determined by the greater of the tax market value or the market value of the shares value of the shares less the exercise price unless the options are exercised and the shares sold within 30 days of vesting. This provides only a small window for employees to determine their tax position and act. Consequently they will adopt a risk mitigation approach and close out their exposures by exercising and selling.

4. A taxing point at cessation of employment also requires the employee to pre-pay tax on the tax value of an unvested right or option. The tax value as determined by the tables in s139FM does not take into consideration the restrictions and vesting conditions that may be attached to the option. Consequently, an employee who may be made redundant will need to pre-pay tax on a right or option that may never be exercisable.

Suggested alternatives

The solutions to the above problems are suggested as follows:

1. The taxing point for options, where the employee is required to pay a consideration in order to exercise that option (i.e. distinct from a right or zero priced option), should be at the point where the option is exercised, not at the point of vesting. In this regard there should be a clear distinction made between options where a consideration must be paid by the employee in the form of an exercise price and rights (or zero priced options) where no consideration is payable. That is, the employee does not have a clear and unfettered right to the underlying share on vesting as he/she is required to pay a consideration in order to exercise the option and acquire the share. A taxing point that is forcing an employee to make a choice to acquire a share in order to manage a tax liability is unfair and bad policy.

2. If the taxation at vesting is to be retained, an alternative but a less satisfactory solution would be to adopt an alternative valuation method. That is, the tax liability should be determined as the difference between the market value of the share at the date of vesting, less the exercise price. This would be consistent with current methodology under Division 13A that applies upon exercise of an option.

3. An alternative but similar approach would be for taxation to be determined according to the lesser of the tax value of the option at the time of vesting and the market value of the option less the exercise price at the time of the exercise of the option if that occurs within the same tax period.

It is appreciated that the issue of the timing of the deferred taxing point in respect of employee share options may be outside the terms of reference of the Board of Taxation's current review. Nevertheless, our objection to this proposal needs to be restated. It is unreasonable to impose tax on an option notwithstanding the employee may never realise the value of the option. Further, it is unjust to subsequently deny a refund where tax has been paid and the option is never exercised because it is out of the money.

We note that the Productivity Commission has recommended that the cessation of employment should not trigger taxation of equity-based payments. We support the Productivity Commission's recommendation on this matter and seek the concurrence and recommendation of the Board of Taxation that cessation of employment should be removed as a point of taxation.

Therefore, we strongly recommend that the Board advise the Government to reconsider its proposal to impose tax on options prior to exercise; and, pending or in the absence of such reconsideration, that the valuation principles in Alternatives 2 and/or 3 be adopted.

Yours faithfully

Bill Hundy
Company Secretary