Australian Government

The Board of Taxation

REVIEW INTO ELEMENTS OF THE TAXATION OF EMPLOYEE SHARE SCHEME ARRANGEMENTS

A report to the Assistant Treasurer

the board of taxation

www.taxboard.gov.au

Board of Taxation

February 2010

Review into elements of the taxation of employee share scheme arrangements

A report to the Assistant Treasurer

Board of Taxation

February 2010

ISBN 978-0-642-74584-2

CONTENTS

FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its review into elements of the taxation of employee share scheme arrangements.

The Board established a Working Group chaired by Mr Richard Warburton AO to oversee the review. The Board conducted consultation with stakeholders and an appointed Expert Panel, in addition to assistance received from officials from the Treasury and the Australian Taxation Office. The Board would like to thank all those who so readily contributed to assist the Board in conducting the review.

The ***ex officio*** members of the Board — the Secretary to the Treasury, Dr Ken Henry AC, the Commissioner of Taxation, Mr Michael D'Ascenzo AO, and the First Parliamentary Counsel, Mr Peter Quiggin PSM — reserved their final views on the issues canvassed in this report for advice to Government.

On behalf of the Board, it is with great pleasure that we submit this report to the Assistant Treasurer.

Richard F E Warburton AO
Chairman, Board of Taxation

EXECUTIVE SUMMARY

The Board of Taxation has undertaken a review into elements of the taxation of employee share scheme arrangements. The two specific areas which the Board was asked to review are:

- how to best determine the market value of employee share scheme securities; and
- whether shares and rights under an employee share scheme that are provided by start-up, research and development (R&D) and speculative-type companies should be subject to separate tax deferral arrangements.

Market value of employee share scheme benefits

The prior legislation[1] that existed in this area adopted a prescriptive approach to attributing a value to employee share scheme interests, which resulted in claims that the legislation operated too onerously on employee share scheme participants, creating large compliance costs that often prohibited employers from being able to offer their employees access to such arrangements. These claims were particularly strong in respect of start-up, R&D and speculative-type companies, which can generally be characterised as 'cash strapped' and hence place greater reliance on offering their employees equity in addition to cash remuneration.

The new employee share scheme provisions[2] evidence a shift away from this prescriptive approach when valuing employee share scheme interests to a valuation in accordance with the ordinary meaning of market value approach. The rationale behind this shift was to offer taxpayers increased flexibility such that they are able to choose a valuation methodology that fits their circumstances and has the lowest compliance costs associated with it.

In reviewing how to best determine the market value of employee share scheme securities, the Board's key findings are as follows:

Listed securities

- For employee share scheme securities that are traded on a recognised market, the Board supports the move to require their valuation in accordance with the ordinary meaning of market value. The Board is of the view that such an approach provides

1 Division 13A of the ***Income Tax Assessment Act*** (ITAA) 1936

2 Division 83A of the ***Income Tax Assessment Act*** (ITAA) 1997

greater flexibility for taxpayers to adopt an appropriate valuation methodology to fit their particular circumstances.

- However, acknowledging the trade off between flexibility and certainty, and to reduce uncertainty and potential costs for taxpayers, the Board recommends that the ordinary meaning of market value approach be supplemented with specific guidance released by the Commissioner of Taxation on acceptable valuation methodologies for valuing listed securities.

Unlisted securities

- For employee share scheme securities that are not traded on a recognised market and hence do not have a readily ascertainable market value, the Board agrees that the valuation of the security in accordance with the ordinary meaning of market value offers participants the greatest flexibility to adopt a valuation method appropriate to their particular circumstances.

Unlisted shares

- The Board holds the view that the disparate nature of the types of companies that may offer their employees unlisted shares under employee share scheme arrangements prevents the introduction of a 'safe harbour' valuation methodology.
  - As is the case with listed securities, the Board believes that these participants would benefit from further guidance from the Commission of Taxation on acceptable valuation practices to value unlisted shares.

Unlisted rights

- Due to the complexity and compliance costs associated with attempting to value an unlisted right in accordance with the ordinary meaning of market value, the Board recommends the retention of a 'safe harbour' methodology of valuing unlisted rights at the greater of their intrinsic value or the value derived under the statutory valuation tables.
- In addition, the Board recommends that the basis and assumptions underpinning the statutory valuation tables be reviewed from time to time, and the reviewed assumptions be made publicly available.
  - To further assist taxpayers in using this 'safe harbour', the Board recommends the Australian Taxation Office develop and keep updated an online calculator tool in accordance with which taxpayers can calculate the market value for their unlisted right based on information which is available to them.

Separate tax deferral arrangements

In respect of whether it is necessary or appropriate to offer start-up, R&D and speculative-type companies access to additional deferral concessions outside of those proposed by the Policy Statement i.e. despite the interests not being subject to a real risk of forfeiture, the Board's findings are as follows:

- The Board acknowledges the claims that generally start-up, R&D and speculative type companies tend to place a particular reliance on offering their key employees equity remuneration due to their cash-strapped status.
- Further, the Board acknowledges the statistical findings which evidence that the take up of employee share scheme arrangements in Australian unlisted companies (which would generally include start-up, R&D and speculative-type companies) is much lower than the take up of employee share scheme arrangements by listed companies.
- The Board agrees that there is some merit to the argument that the existing restrictions[3] that operate to limit access to the existing employee share scheme tax concessions tend to operate particularly onerously on these types of companies.
- However, the Board considers that due to the largely disparate nature of these types of companies there is a fundamental difficulty in attempting to define which entities should be eligible to access any relaxed restrictions. The Board considers that in light of the significant integrity concerns to the operation of the employee share scheme provisions created by the inability to adequately ring-fence eligibility, any relaxation of the current restrictions is not a viable alternative.
- Therefore, it is the Board's view that any additional support for start-up, R&D and speculative-type companies would be better provided by Government through support mechanisms such as programs administered by Commercialisation Australia and the new R&D tax incentive which can be better targeted than any further tax concession.

3 These restrictions include: the 'broad availability of scheme' (i.e. available to 75 per cent of permanent employees) restriction, the 'employment' restriction, the 'ordinary share' restriction, certain integrity rules, the 5 per cent limit of shareholding restriction and the 'real risk of forfeiture' restriction.

CHAPTER 1: INTRODUCTION

1.1 On 24 July 2009, the Assistant Treasurer, Senator the Hon Nick Sherry, asked the Board of Taxation to undertake a review into elements of the taxation of employee share scheme arrangements and to report its findings and recommendations to the Government by the end of February 2010. As part of that request, the below terms of reference were provided to the Board.

1.2 The Treasurer announced as part of the 2009 Budget that the Government was looking to introduce certain reforms to the taxation of employee share scheme arrangements that better target eligibility for the employee share scheme tax concessions and reduce opportunities for tax avoidance. Following the Budget announcement, the Government issued a public consultation paper which sought to better understand the concerns of industry and canvas a number of options to improve the taxation of employee share schemes.

1.3 On 1 July 2009, the Government issued a Policy Statement setting out the taxation of employee share schemes. This Policy Statement contained changes to the Budget announcement which took account of industry concerns expressed in consultation, while still addressing the acknowledged problems of tax evasion and tax avoidance.

TERMS OF REFERENCE

Background

1.4 Two issues remained unresolved by the 1 July Policy Statement - how best to determine the market value of employee share scheme benefits and whether employees of start-up, R&D and speculative-type companies should benefit from a tax deferral arrangement despite not being subject to a real risk of forfeiture.

Market valuation of employee share scheme benefits

1.5 The Government has announced that the general principles of market value will apply in determining the market value of listed and unlisted securities. It also announced scope for regulations to be made to provide for a 'rule-of-thumb', where necessary, and, as an interim measure, for the existing valuation rules for unlisted rights will be replicated in the regulations. The issues were outlined in the Consultation Paper issued in June 2009.

Start-up, R&D and speculative-type companies

1.6 The Government received a number of submissions that raised concerns that the proposed changes would disproportionately affect start-up, R&D and speculative-type companies because they have limited capital and cash flows, and rely on employee share schemes to attract skilled labour.

Scope of the review

1.7 The Board of Taxation was requested to examine:

- how best to determine the market value of employee share scheme securities; and
- whether shares and rights under an employee share scheme 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 Policy Statement.

1.8 In undertaking the review, the Board was to consider:

- whether the existing rules for valuing unlisted rights to acquire shares properly reflect market value;
- whether special rules are appropriate or necessary to determine the market value of employee share scheme shares and rights (listed and unlisted);
- whether there are suitable alternative mechanisms for determining market value;
- whether it is appropriate or necessary to provide separate deferral arrangements for employees of start-up, research and development and speculative-type companies receiving shares or rights under employee share schemes; and
- possible options to provide assistance to start-up, research and development and speculative-type companies.

1.9 In conducting the review, the Board was to:

- have regard to the Government's taxation review headed by Dr Ken Henry;
- seek public submissions and consult widely (including with representatives of the previous Consultative Group); and
- produce a final report by 28 February 2010.

THE REVIEW TEAM

1.10 The Board appointed a Working Group of its members comprising Mr Richard Warburton AO (Chairman), Ms Annabelle Chaplain and Mr John Emerson AM to oversee this review.

REVIEW PROCESS

1.11 As requested by the terms of reference, the Board sought public submissions addressing the terms of reference and consulted widely with interested stakeholders.

1.12 The Board invited submissions by 9 October 2009. In total the Board received 21 submissions from individuals and organisations. Submissions have been published on the Board's website and a list of individuals and organisations that provided public submissions to the review is at Appendix C.

1.13 In addition, the Board had access to the submissions received by Treasury commenting on the Exposure Draft for the Taxation of Employee Share Schemes legislation (which was released for comment on 14 August 2009[4]), as well as the 'Executive Remuneration in Australia' Productivity Commission Inquiry Report, released on 4 January 2010[5] (the Productivity Commission Remuneration Report).

1.14 To supplement the feedback obtained from submissions, the Board formed an Expert Panel chosen for their expertise to assist with the review. They are:

- Ms Sarah Bernhardt (Allens Arthur Robinson);
- Ms Sandra Buth (Deloitte Touche Tohmatsu);
- Mr John Egan (Egan Associates);
- Mr Martin Morrow (KPMG); and
- Ms R'chelle Wakely (Westpac Banking Corporation).

1.15 The Expert Panel members assisted the Board with technical and practical advice on the key issues and recommendations and the technical content of this report. The Board appreciates their valuable contribution.

---

4 A copy of the public submissions received by Treasury can be found at http://www.treasury.gov.au/contentitem.asp?ContentID=1658&NavID=037

5 ***Executive Remuneration in Australia***, Productivity Commission Inquiry Report, No. 49 19 December 2009. A copy of the Report can be found at http://www.pc.gov.au/projects/inquiry/executive-remuneration/report

1.16 In addition, the Board consulted extensively with the Treasury, the Australian Government Actuary and the Australian Taxation Office.

1.17 As requested by the terms of reference, the Board had regard to the general principles underlying the Government's taxation review headed by Dr Ken Henry in compiling this Report.

BOARD'S REPORT

1.18 The Board has considered the issues raised by stakeholders in their submissions and at consultation meetings. However, the Board's recommendations reflect its independent judgment.

CHAPTER 2: BACKGROUND TO THE OPERATION OF THE EMPLOYEE SHARE SCHEME RULES

2.1 The basic principle of the employee share scheme (ESS) rules, contained in Division 83A of the ***Income Tax Assessment Act*** (ITAA) 1997, is that any discount given in relation to a share or right acquired by a taxpayer under an ESS arrangement is included in the taxpayer's assessable income in the income year in which the share or right is acquired, to ensure taxpayers are taxed consistently regardless of the forms of remuneration they receive.[6]

2.2 However, tax concessions are available to certain ESS arrangements, which allow either a reduced amount to be assessable to the taxpayer, or a deferral of the taxing point in relation to the discount.[7] In order to access these tax concessions, the shares or rights issued under the ESS arrangement must satisfy a list of requirements which aim to ensure, among other things, that participation in the scheme is widely available to employees, and that the concessions cannot be accessed by shareholders who are effectively able to exert control over the company's operations.[8]

2.3 The discount in relation to a share or right issued under an ESS arrangement is generally taken to be the difference between the market value of the share or right and any consideration paid by the employee to acquire the share or right. Division 83A contains provisions which detail how the market value of the share or right issued under the ESS arrangement is to be calculated. In most circumstances, these provisions mandate that the market value be calculated in accordance with the ordinary meaning of market value.[9]

2.4 The term 'right' as used in Australia's income tax legislation in connection with employee share schemes is not specifically defined in either the ITAA 1936 or the ITAA 1997. It is generally taken to refer to an option or performance right issued by a company to its employee. An option in the context of employee share schemes is the right, but not the obligation, to buy a share, at a specified price (the 'exercise' or 'strike price') on, or before, a specified date.[10] The term 'performance right', again while not specifically defined in legislation is generally taken to mean a right issued by a company to an employee with a nil exercise price attached.

---

6 Section 83A-5 of the ITAA 1997.

7 Section 83A-1 of the ITAA 1997.

8 Section 83A-35 and section 83A-105 of the ITAA 1997.

9 Section 83A-315 of the ITAA 1997.

10 An option is 'in the money' (or 'out of the money') when the exercise price for the share is below (or above) the market price of the share. An option is 'at the money' where the exercise price for the share is equal to the market price of the share.

POLICY INTENT

2.5 Tax concessions are provided in respect of employees' interests in qualifying ESS arrangements on the grounds they can contribute to aligning the interests of employees and employers, encourage positive working relationships, boost productivity through greater employee involvement in the business, reduce staff turnover and encourage good corporate governance.

2.6 The Treasurer announced in the 2009-10 Budget that the Government would amend the legislative provisions to better target eligibility for the employee share scheme tax concessions and reduce opportunities for tax avoidance to protect Commonwealth revenues.

2.7 The 2009-10 Budget measures were designed to improve horizontal equity in the tax system by treating all forms of remuneration more consistently, to target employee share scheme tax concessions more closely to low and middle income earners, and to reduce the scope for losses to the Commonwealth revenue through tax evasion and avoidance.[11]

OPERATION OF THE DIVISION 83A RULES

2.8 Following the 2009-10 Budget announcement of proposed amendments to the ESS provisions, the Parliament approved a new set of legislative provisions. This followed targeted consultation undertaken by the Government including releasing an exposure draft of the legislation and Regulations.

2.9 The main body of the new ESS taxation regime is contained in Division 83A of the ITAA 1997.

2.10 Division 83A of the ITAA 1997 received Royal Assent on 14 December 2009, replacing the previous rules contained in Division 13A of the ITAA 1936. Division 83A applies to ESS interests acquired for a discount on or after 1 July 2009.

Taxing point

2.11 Under the Division 83A provisions, any discount to the market value of an interest in a share or right provided to an employee under an ESS is taxed in the income year of acquisition. Deferral of taxation is provided where the ESS interest meets certain specified criteria, one of which is the existence of a real risk of forfeiture in relation to the interest.[12]

---

11 Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009*** at paragraph 1.15.

12 Section 83A-105 of the ITAA 1997. Other criteria which apply to restrict access into the Division 83A measures include: the broad availability of scheme (i.e. available to 75 per cent of permanent

2.12 Under the real risk of forfeiture test, 'real' is regarded as more than a mere possibility of forfeiture occurring. Accordingly, contrived schemes, where the risk is highly unlikely to arise, will not qualify for the tax deferral.

2.13 Where tax deferral occurs, the deferred taxing point for the shares is the earliest of:

- the earliest time when:
  - there is no longer a real risk of forfeiture; and
  - if, at the time you acquired the interest the scheme genuinely restricted you from immediately disposing of the interest, there are no longer restrictions preventing disposal.
- when the employee ceases the employment in respect of which they acquired the share; or
- 7 years after they acquired the share.[13]

2.14 The deferred taxing point for rights is based on similar principles, with some additional conditions to account for situations which would only arise in relation to rights (for example, because they can be exercised as well as disposed of).[14]

Valuation of the employee share scheme interest

2.15 Division 83A provides that the discounted ESS interest is taken to have been acquired by the employee for its market value (rather than its discounted value), to be calculated in accordance with the ordinary meaning of market value.[15] The accompanying Regulations allow a taxpayer to substitute a different amount for the market value of the ESS interest where the interest is an unlisted right and the taxpayer elects to value the right in accordance with the greater of the right's intrinsic value or the amount determined under the statutory valuation tables.[16]

2.16 Paragraph 1.107 of the Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** (the Explanatory Memorandum) states:

> The new employee share scheme rules use the ordinary meaning of market value as this meaning is used for almost all other tax purposes, and the increased flexibility that this provides means that taxpayers are able to choose a valuation methodology that fits their circumstances and has the lowest compliance costs associated with it.

---

employees) restriction, the employment restriction, the ordinary share restriction, certain integrity rules and the 5 per cent limit of shareholding restriction (section 83A-35 of the ITAA 1997).

13 Section 83A-115(1) of the ITAA 1997.

14 Section 83A-115(3) of the ITAA 1997.

15 Section 83A-30 of the ITAA 1997.

16 Regulation 83A-315.02 of the ***Income Tax Assessment Amendment Regulations 2009 (No.)***

Listed securities (including both listed shares and listed rights)

2.17 Listed securities are to be valued in accordance with the ordinary meaning of market value. The Explanatory Memorandum refers to the Australian Taxation Office (ATO) published guide ***Market value for tax purposes*** as an additional source to provide further assistance in determining market value.

Unlisted shares

2.18 Unlisted shares are also to be valued in accordance with the ordinary meaning of market value. The Explanatory Memorandum refers to the ATO published guide, ***Market value for tax purposes***, as an additional source to provide further assistance in determining market value. The use of the ordinary meaning of market value for valuing unlisted shares means that taxpayers will no longer be obliged to use an auditor if they can determine (and sufficiently justify) the market value of the unlisted share appropriately without one.

Unlisted rights

2.19 Unlisted rights can be valued in accordance with the ordinary meaning of market value, or alternatively, the taxpayer may elect to value the unlisted right at the greater of its intrinsic value or the value determined by the valuation tables contained in the Regulations.[17] The 'intrinsic value' of the right is the market value of the share that may be acquired by exercising the right less the lowest amount that must be paid to exercise the right. The valuation tables reproduce those contained in Division 13A of the ITAA 1936. These tables have been inserted as an interim measure pending the Board's recommendations contained in this Report.

Impact of conditions and restrictions on valuation

2.20 Subdivision 960-S of the ITAA 1997 provides that any conditions and restrictions that prevent a taxpayer from converting a non-cash benefit (including an ESS interest) into money are ignored in calculating the market value of the interest. This rule has general application across the ITAA 1997 and the ***Taxation Administration Act 1953***.

---

17 Regulation 83A-315.01 to 83A-319.09 of the ***Income Tax Assessment Amendment Regulations 2009(No.)***

CHAPTER 3: HOW BEST TO DETERMINE THE MARKET VALUE OF LISTED SECURITIES

3.1 Division 83A evidences a deliberate shift away from dictating a specific valuation methodology when valuing listed securities issued under ESS arrangements, as was the case in the previous Division 13A, to an approach based on the ordinary meaning of market value. The term listed security refers to both listed shares and listed rights issued under qualifying ESS arrangements.

3.2 The Explanatory Memorandum states this shift in valuation principles attempts to align the market value of the listed security with the market value used for almost all other tax purposes, while also serving to increase flexibility, as taxpayers are able to choose a valuation methodology that fits their individual circumstances and has the lowest compliance costs associated with it.[18]

VIEWS IN SUBMISSIONS

3.3 All written submissions received by the Board which addressed the issue of valuing listed securities acknowledged that the shift to valuation in accordance with the ordinary meaning of market value would offer increased flexibility to those companies who undertake, or are looking to undertake, ESS arrangements.

3.4 Numerous written submissions also acknowledged however that the increased flexibility offered through allowing valuations in accordance with the ordinary meaning of market value created increased uncertainty that could result in those employers and employees who participate in these ESS arrangements not complying with their taxation obligations.

3.5 This increased uncertainty was seen by some as additionally problematic in light of the increased reporting requirements placed on employers under the Division 83A provisions.[19]

3.6 To address this issue of increased uncertainty, multiple submissions suggested the introduction of a legislative 'safe harbour' valuation methodology, in addition to

---

18 Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** at paragraph 1.107.

19 The legislation subjects employers to annual reporting requirements as well as requiring employers to withhold and remit tax where an employee fails to provide the employer with a TFN or ABN at the taxing point.

valuation of listed securities in accordance with the ordinary meaning of market value. Suggested 'safe harbour' valuation methodologies included the re-inclusion of a volume weighted average price (VWAP) approach to calculating market value, a 'point-in-time' approach to determine market value, or alternatively the taxpayer being allowed to adopt the value expensed in the company's accounts under ***AASB 2: Share-based payments*** in relation to listed securities issued under the ESS arrangement.

3.7 In discussing the re-introduction of a VWAP approach to determining market value of a listed security, the submission from Link Market Services stated:

> The current VWAP methodology has a complication as it is calculated up to and including the date of the transaction/taxation point. This can make the acquisition process difficult as the true value can not be determined until the market has closed on the date of acquisition. Where this is a purchase (from an administrative perspective) there is therefore an artificial purchase and reconciliation the day after the acquisition occurs. Likewise the valuation impacts and creates complexities for disclosure under ASIC Class Order 03/184.

3.8 The Link Market Services submission argued for the inclusion of a VWAP valuation methodology that is calculated up to, but not including, the date of acquisition or issue under the ESS arrangement.

3.9 In contrast, the submission received from Baker & McKenzie argued that a VWAP approach is ill-suited for valuing shares issued under an ESS arrangement and instead recommend a 'point-in-time' valuation approach to be applied in valuing listed securities:

> We would suggest permitting, in the case of a company with a significant trading volume on a recognized stock exchange, the consistent use of a point in time market value on the relevant day, based on any consistently used reasonable method, e.g. closing price, average high and low prices on the relevant day or prior day's closing price.

BOARD'S CONSIDERATION

3.10 The Board supports the move to valuation of listed securities in accordance with the ordinary meaning of market value compared with the more prescriptive approach set out in the prior Division 13A provisions. The Board is of the view that such an approach provides greater flexibility for taxpayers to adopt an appropriate valuation methodology to fit their particular circumstances, as well as potentially reducing their compliance costs in undertaking these valuations.

3.11 At the same time, the Board acknowledges the inherent trade-off between certainty and flexibility in undertaking tax law design. Allowing taxpayers greater flexibility in their adopted approach to valuing listed securities creates a greater degree of uncertainty that the valuation undertaken will appropriately determine the market value of the listed security.

3.12 This uncertainty was a clear concern raised with the Board in submissions and was given extensive consideration by the Board.

3.13 In particular, the Board considered a proposal to adopt a single legislative approach to valuing listed securities, namely a 5 day VWAP up to, but not including, the day of acquisition or disposal of the listed security. Such an approach could be readily calculated and hence provide certainty to taxpayers on the market value of their listed security.

3.14 However, concerns were raised that this approach could have inappropriate outcomes, for example where the underlying share is trading cum-dividend for the 5 days on which the VWAP is calculated, and becomes ex-dividend within a day or two of the date of issue to the taxpayer. In this case the 5 day VWAP may result in an inflated market value to the taxpayer who may not have been entitled to receive the dividend. In addition, the Board was advised that costs would also be incurred by taxpayers in collecting the data to undertake the VWAP calculation which is not necessarily publicly available.

3.15 As no single approach was appropriate in all circumstances, the Board considers that relying on the ordinary meaning of market value for valuing listed securities is the best available option.

3.16 Multiple submissions suggested the introduction of a legislative ‘safe harbour’ valuation methodology to alleviate uncertainty. However, the Board considers the introduction of a ‘safe harbour’ valuation methodology is not the most appropriate way to provide greater certainty in the valuation of listed securities.

3.17 Examples of legislated ‘safe harbour’ rules that exist in the tax law are relatively few, and generally are only introduced where taxpayers experience significant complexity and hence large compliance costs in attempting to comply with the tax legislation. In these circumstances, legislative ‘safe harbours’ can be an appropriate mechanism to increase certainty to taxpayers in complying with their taxation obligations through offering an alternative mechanism which aims to reduce the compliance burden placed on taxpayers who qualify for the ‘safe harbour’.[20]

3.18 In the Board’s view, a ‘safe harbour’ is not necessary in this case where compliance with the legislative provisions is not overly onerous or prohibitively costly

---

20 For example, due to the complexity in determining the taxable value of a car fringe benefit an employer can choose to determine the value under either the ‘statutory formula’ or the ‘operating cost method’. The statutory formula method applies unless the employer makes an express choice to apply the operating cost method, however if the statutory formula would result in a lower value for that year, the lower statutory value is taken to apply.

to taxpayers in applying the law. The Board feels that the valuation of listed securities issued under ESS arrangements in accordance with ordinary principles is not overly costly or burdensome to taxpayers, and hence the introduction of a 'safe harbour' rule would not be appropriate.

3.19 In addition, the Board holds the concern that the introduction of a legislative 'safe harbour' for valuing listed securities may not necessarily achieve a reduction in a taxpayer's compliance costs as taxpayers may undertake multiple valuations anyway to determine their most tax effective outcome, that is, a calculation under the 'safe harbour' methodology and again under the ordinary meaning of market value. It could also inadvertently operate to provide taxpayers an alternative mechanism for calculating their tax liability, such that it becomes possible for a taxpayer to 'cherry-pick' the best tax outcome for their circumstances. It is the Board's view that such an outcome would compromise the integrity of the ESS legislation.

3.20 As discussed above, there also does not appear to be a single method that could be the basis for a 'safe harbour' that would not disadvantage certain taxpayers. It would be an inappropriate outcome if taxpayers, some of whom will be unsophisticated taxpayers, adopted a 'safe harbour' that worked to their disadvantage.

3.21 While not supportive of a legislative 'safe harbour', the Board does recognise claims made in submissions that reliance on the ordinary meaning of market value for the valuation of listed shares and rights may lead to some uncertainty and potential compliance cost for employers, employees and the ATO in determining an appropriate market value. This is particularly the case for employees participating in the schemes who will have responsibility for ensuring they comply with the law, but some of whom may be relatively unsophisticated taxpayers.

3.22 The Board notes that the Explanatory Memorandum to the Division 83A provisions expressly states:

> …taxpayers could continue to apply the existing detailed methodologies in the current [Division 13A] employee share scheme rules as these would fall within the scope of those methodologies the ATO currently considers acceptable under the general rules.[21]

3.23 The Board contends that the above statement goes some way in addressing the issues of increased uncertainty and compliance costs experienced by taxpayers when valuing listed securities. However, the Board holds the view that taxpayers could further benefit through the Commissioner of Taxation issuing public guidance detailing acceptable valuation methodologies for valuing listed securities issued under ESS arrangements.

---

21 Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** at paragraph 1.112.

Recommendation 1: Valuation of listed securities

The Board recommends that the valuation methodology for valuing listed securities issued under ESS arrangements be in accordance with the ordinary meaning of market value.

In addition, the Board recommends that the Commissioner of Taxation release a public document which offers taxpayers further guidance on acceptable valuation methodologies for valuing listed securities.

- The Board recommends that the Commissioner of Taxation develop this guidance in consultation with interested stakeholders.

CHAPTER 4: HOW BEST TO DETERMINE THE MARKET VALUE OF UNLISTED SHARES

4.1 Under the prior Division 13A provisions, the market value of unlisted shares was required to be determined by a company auditor, or in accordance with any other method approved by the Commissioner of Taxation as reasonable. The new Division 83A provisions instead require unlisted shares to be valued in accordance with the ordinary meaning of market value. The move is intended to reduce the significant compliance costs that can be imposed by the requirement to use a company auditor or alternatively seek approval from the Commissioner of Taxation.

4.2 In this respect, the Explanatory Memorandum accompanying Division 83A states:

> The general valuation rules for unlisted shares mean that taxpayers will no longer be obliged to use an auditor if they can determine (and sufficiently justify) the market value appropriately without one.[22]

VIEWS IN SUBMISSIONS

4.3 All submissions received by the Board which addressed the valuation of unlisted shares were in favour of the adoption of an ordinary meaning of market value approach to valuing unlisted shares issued under ESS arrangements. Most submissions were of the view that the shift to ordinary meaning of market value had the potential to greatly reduce compliance costs, by eliminating the need to employ a qualified valuer where some other justifiable mechanism for valuing the share existed.

4.4 As stated by Ernst & Young in their submission:

> The previous rules in relation to unlisted shares, which provided that the market value of unlisted shares could only be determined through a written valuation by a "person who is a qualified person in relation to valuing a share" or by a method approved in writing by the ATO, were overly complex, costly and difficult to use practically.

4.5 This view was widely supported by other submissions received by the Board, such as the submission from the Remuneration Strategies Group Pty Ltd which states:

---

22 Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** at paragraph 1.113.

> Currently, the Government proposes that, under the general valuation rules for unlisted shares and rights, taxpayers will no longer be obliged to use an auditor provided they can determine and justify the market value appropriately. This will remove one major obstacle for unlisted companies providing equity to their employees and other workers.
>
> We agree with this approach as it is fair, flexible and enables organisations, who are usually the best judge of their arms length market value, the flexibility to determine and justify that value without engaging an auditor.

4.6 However, there was also some concern that unlisted shares will still require a formal valuation in practice. In particular, this view was reflected in submissions received from the Tax Institute of Australia (TIA) and the Institute of Chartered Accountants in Australia (ICAA).

4.7 In light of this concern, numerous submissions again suggested the introduction of a statutory 'safe harbour' which would offer taxpayers increased certainty and potentially reduced costs in complying with their taxation obligations arising under ESS arrangements.

4.8 The TIA submission stated the following:

> Unlisted shares will still require a formal valuation. However, given the cost associated with corporate valuations, the Taxation Institute considers that a safe harbour should be provided to taxpayers (particularly those granted shares or rights by small and medium enterprises (SMEs)) so that they have a lower cost alternative.
>
> Further, given that the termination of employment is currently still a taxing point, requiring companies (or the taxpayer) to obtain a formal valuation each time an employee ceases employment, this will result in a significant administrative burden. It is likely this will result in some private companies not issuing shares to employees or not allowing those shares to be held post employment.

4.9 When discussing potential valuation methodologies that may be appropriate as a 'safe harbour' for valuing unlisted securities, the TIA submission recommended:

> The safe harbour valuation methodology(s) should be reliable, not overly complex for taxpayers to use and not open to manipulation. It could consist of a choice of specific valuation methodologies such as:
>
> - net tangible assets;
> - profit (EBIT) multiple; or
> - discounted cash flow.
>
> Taxpayers would be required to use the chosen valuation methodology consistently. It would be appropriate for the Government to consider a basis under which the taxpayer could change the valuation method.

4.10 The submissions received by the ICAA and the Remuneration Strategies Group were both in favour of value expensed in a company's accounts under ***AASB 2: Share-based payments*** potentially being offered as an alternative valuation methodology in situations where a valuation in accordance with the ordinary meaning of market value may not be appropriate.

4.11 The submission received from Ernst & Young however adopted a differing view on the issue of the need for special rules in valuing unlisted shares, stating:

> The [Explanatory Memorandum] recognises that the valuation rules in the current law are inflexible, particularly with regard to unlisted shares. It proposes that general valuation rules are used for unlisted shares which would meant that taxpayers will no longer be obliged to use an auditor to determine market value if they can determine (and sufficiently justify) the market value appropriately without one.
>
> If the above proposals are implemented in the final legislation, we do not consider it necessary for there to be any special rules to determine the market value of shares for the purposes of the employee share scheme rules.

BOARD'S CONSIDERATION

4.12 The Board supports the adoption on an ordinary meaning of market value approach to valuing unlisted shares, where the approach adopted can be sufficiently justified, as a positive move for unlisted companies.

4.13 The Explanatory Memorandum explicitly acknowledges that the shift to ordinary meaning of market value is an attempt to offer increased flexibility to ESS participants, as well as reduced compliance costs by potentially eliminating the need for an unlisted company to engage a qualified valuer, or alternatively, seek the written approval of the ATO which can be a costly and time consuming process.[23]

4.14 It was widely acknowledged in the submissions received by the Board that the previous mechanisms required for valuing unlisted shares issued under ESS arrangements were inflexible and prohibitively costly to taxpayers, often resulting in the inability of unlisted companies to offer their employees share or right incentives under an ESS arrangement.

4.15 The Board considers that the adoption of an ordinary meaning of market value approach to valuing unlisted securities issued under ESS arrangements will further assist in the ESS regime achieving its key policy intent of encouraging broad participation in such schemes.

---

23 Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** at paragraphs 1.107 to 1.113.

4.16 The Board acknowledges that while there were divergent views held by stakeholders in relation to the issue of whether additional special rules were required to assist ESS participants in the valuation of unlisted shares, the majority of submissions received by the Board supported the introduction of an additional legislative 'safe harbour' valuation methodology. Again, the primary reason advanced for the introduction of a 'safe harbour' methodology was the increased certainty offered to taxpayers who elect to calculate the market value of their ESS security in accordance with the 'safe harbour'.

4.17 By their nature unlisted companies experience inherently greater complexity when attempting to determine market value of their shares than a listed company, which has a ready-made market in which its shares and/or rights can be actively traded. This complexity often results in unlisted companies incurring large compliance costs associated with obtaining appropriate market values of their ESS securities.

4.18 However, the Board was not convinced that any of the proposed mechanisms contained in the submissions were suitable as a legislative alternative to valuation in accordance with the ordinary meaning of market value. Similar to the case of listed securities, the Board holds the view that there is no single approach that can generate an appropriate valuation of unlisted shares in all cases. The introduction of a legislative alternative, although potentially reducing compliance costs for taxpayers, could create significant integrity concerns and potential inequities in circumstances where the valuation methodology is not appropriate to determine the market value of an unlisted share.

4.19 The Board therefore considers that the approach proposed in the Division 83A provisions to rely on the ordinary meaning of market value is most appropriate.

4.20 The Board acknowledges that this approach may result in some degree of uncertainty and additional compliance costs for taxpayers, however for the reasons discussed at paragraphs 3.19 to 3.20 above, the Board does not favour a legislated 'safe harbour' to address the uncertainty.

4.21 The ATO's publication, ***Market Valuation for Tax Purposes***, states the following in respect to valuing unlisted shares:

> Where an ordinary share is held privately by an individual or group of shareholders, applying the appropriate valuation method (or methods) may be more complex.
>
> When you value an unlisted share, we would expect you to take into account a number of factors that may affect its market value…

4.22 The publication references a number of factors that may be relevant when undertaking a valuation of an unlisted company, including factors that would ordinarily be considered in determining the value of a business, adjustments to take account of liquidity and degree of control of shareholders, and rights of other debt or equity holders that may influence the value of the company. A company must be able to evidence that a number of these factors have been considered in producing a reasonable and defensible view of the market value of the unlisted share.

4.23 In light of the concerns regarding the inappropriate outcomes that may result from attempting to legislate a valuation approach in order to provide greater certainty, the Board considers that unlisted companies can be provided more certainty and potentially reduced compliance costs by the Commissioner of Taxation releasing ESS specific guidance on acceptable valuation principles to be applied in determining appropriate market values of unlisted shares.

Recommendation 2: Valuation of unlisted shares

The Board recommends that the valuation methodology for the valuation of unlisted shares issued under ESS arrangements be in accordance with the ordinary meaning of market value.

In addition, the Board recommends that the Commissioner of Taxation release a public document which offers taxpayers further guidance on acceptable valuation methodologies that can be applied when valuing unlisted shares issued under ESS arrangements.

- The Board recommends that the Commissioner of Taxation develop this guidance in consultation with interested stakeholders.

CHAPTER 5: HOW BEST TO DETERMINE THE MARKET VALUE OF UNLISTED RIGHTS

5.1 Under the prior Division 13A provisions, unlisted rights issued under qualifying ESS arrangements were required to be valued at the greater of:

- the market value of the share that may be acquired by exercising the right less the lowest amount that must be paid to exercise the right (the intrinsic value of the right); or
- in accordance with the value determined under the statutory valuation tables or the arm's length value of the right, depending on the term to expiry of the right.[24]

5.2 The statutory valuation tables were created when Division 13A was inserted into the ITAA 1936 in 1995. The Explanatory Memorandum to the ***Taxation Laws Amendment Bill (No. 2) 1995*** states:

> The Tables contained in new sections 139FJ-FN use an accepted methodology for valuing options, which has been modified to make them easier to use. Further, the variable factors underlying the tables are generally concessional.[25]

5.3 The new Division 83A provisions and accompanying Regulations require the market value of an unlisted right issued under an ESS arrangement to be valued at:

- the market value of the right;

or alternatively, at the greater of:

- the intrinsic value of the right, or
- in accordance with the value determined under the statutory valuation tables reproduced in the Regulations.[26]

---

24 Section 139FC of the ITAA 1936. Paragraph 139FC(1)(c) stated that where rights could be exercised more than 10 years after the day when the right was acquired, the greater of the arm's length value of the right and the value that would have been determined under the statutory table as if the right could be exercised 10 years after the particular day.

25 Explanatory Memorandum to the ***Taxation Laws Amendment Bill (No. 2) 1995*** at paragraph 2.43.

26 ***Income Tax Assessment Amendment Regulations 2009 (No.)*** at Regulation 83A-315.02.

5.4 The Explanatory Memorandum to these measures states that the existing rules in relation to valuing unlisted rights are replicated in the Regulations as an interim measure, subject to the findings of the Board in completing this Review.[27]

VIEWS IN SUBMISSIONS

5.5 The submissions received by the Board in relation to the valuation of unlisted rights generally addressed the following key issues:

- whether valuation in accordance with the ordinary meaning of market value was appropriate for unlisted rights, or whether other more appropriate techniques should be adopted; and
- whether the statutory valuation tables in relation to unlisted rights should be retained.

Ordinary meaning of market value

5.6 Submissions received by the Board generally supported the approach adopted in Division 83A and the accompanying Regulations, which offer ESS participants the option to value unlisted rights in accordance with the ordinary meaning of market value. This approach was seen as offering greater flexibility in valuing unlisted rights, and potentially reducing compliance costs where the need to obtain a formal valuation of the unlisted right has been removed.

5.7 However, many submissions called instead for unlisted rights to be taxed in accordance with their intrinsic value only. Support for this approach was particularly strong in the situation where access to the tax deferral concession is granted such that taxation will not occur on grant of the right but at some later date, being the earliest of vesting (or the removal of restrictions which prevent exercise of the right by the employee post-vesting), termination of employment or the expiration of 7 years from the date of grant of the right.

5.8 The submission received by the Board from Ernst & Young argued:

> Other than for individuals where an option is subject to tax at the time of grant, we consider that the taxable value of an unlisted right should be the intrinsic value of the right (i.e. the share price less the exercise price (if any)) at the relevant taxing point…)
>
> We consider that the proposed approach of market value equalling the intrinsic value at the deferred taxing point would:

---

27 Explanatory Memorandum to the ***Taxation Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** at paragraph 1.110.

- recognise the real market value of a right to a participant at the deferred taxing point;
- be simpler for individuals to understand and employers to communicate;
- remove the risk that individuals would be subject to income tax at the deferred taxing point on a value that they are subsequently unable to realise; and
- remove the risk that individuals will not be able to obtain a refund of tax payable should the right never be exercised (e.g. if it continues to be underwater).

> We consider that in the limited circumstances, under the provisions of the [Exposure Draft], where income tax may be paid on the grant of a right, a valuation approach akin to the current approach may be appropriate.

5.9 This view was largely supported in the submission received from Baker & McKenzie, which argued for a distinction in taxation methodologies for valuing unlisted rights depending on whether the deferral concession applies. The Baker & McKenzie submission stated:

> [If] Australia persists in taxing stock options at vesting, rather than exercise, then we would suggest permitting companies and employees to report and pay tax on the intrinsic value of the option at the point of vesting…
>
> We recognise that some form of formula may be necessary to value options taxed at grant, but the overwhelming majority of options issued by public multinational companies in Australia would not be taxable at grant (due to vesting conditions).

Statutory valuation tables

5.10 The majority of submissions received by the Board called for retention of the statutory valuation tables. Arguments advanced for retention of the tables centred on the ability of the tables to offer taxpayers increased certainty and reduced compliance costs in light of the significant complexities involved in valuing unlisted rights.

5.11 The submission received from the ICAA stated:

> 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.

5.12 However, a number of submissions highlighted concern at the lack of transparency in relation to the basis and factors used by Government in deriving the tables. It was suggested that due to the time that has elapsed since the development of the tables, the basis and assumptions be reviewed in light of current market conditions, and the factors underlying the tables be made accessible to interested parties by the Government going forward.

5.13 This point was made directly in the submission received from Nissen Kestel Harford which stated:

> Our research has not found the basis and modifications for these tables. It is submitted as part of this process, the basis and modifications be released by the Commissioner of Taxation. It is critical for advisors in this area to have an understanding of this when determining the value of an unlisted right for the purposes of [draft] subsection 83A-315 and [draft] regulation 83A-315.01.

BOARD'S CONSIDERATION

Ordinary meaning of market value

5.14 It is the Board's view that allowing unlisted rights to be valued in accordance with the ordinary meaning of market value offers ESS participants the greatest flexibility in the particular circumstances in calculating market value of the rights, whilst still achieving the underlying policy intent of the ESS provisions.

5.15 In this respect, the Board acknowledges that multiple widely accepted alternative valuation methodologies exist for valuing rights, including the Black Scholes option pricing model, the Monte Carlo option pricing model and the Binominal option pricing model. All these option pricing models attempt to attribute a value to the right, with the outcome largely reflective of the market value of the underlying share and, depending on the model used, other variables such as expected volatility in the underlying share, time to expiry of the right, potential dividend yield, risk free rate of interest, and so on.

5.16 However, the Board also appreciates that these pricing models are often based on complex formulas which are difficult to understand and utilise in practice. In addition, the price of the right as determined by the models remains highly dependant upon the factors that are inputs into the models. Accordingly, the accuracy of the models may be somewhat restricted in the case of unlisted rights where the requisite information may not be readily available, for example, where the company is newly incorporated and does not have reliable historic data or future forecasts in relation to its share price movements or dividend distributions.

5.17 The Board acknowledges the strong support provided in the written submissions for valuation of an unlisted right purely in accordance with its intrinsic value. However, the Board does not believe that the adoption of such an approach adequately takes into consideration factors relevant to determining an appropriate market value of a right, even though it may offer greater simplicity to taxpayers.

5.18 In particular, the Board is concerned that the valuation of an unlisted right purely in accordance with its intrinsic value explicitly ignores the 'time value' of the right, being the value of the potential profit from continuing to hold the right until its expiry.[28]

5.19 The attachment provided to the Board in the submission received from Jon Kirkwood contained the following statement in relation to the intrinsic valuation method:

> This method [intrinsic value] does not consider the value to the holder of having the right to buy the stock at some point in future at a predetermined price. It also does not consider the volatility of the underlying share as well as the incumbent advantages and disadvantages of the same. In addition, it does not consider the advantages and disadvantages of the option holder not receiving the shares or dividends as well as the opportunity cost of purchasing the share and the foregoing interest on the acquisition funds.
>
> Accordingly, this valuation method is rarely used in practice.[29]

5.20 The Board acknowledges the views contained in submissions that the Division 83A provisions and accompanying Regulations can result in a situation where employees are taxed on a value that may not be ultimately realisable by the employee, for example, where the unlisted right remains ‘out of the money’ throughout its life and hence remains unexercised at its expiry.

5.21 However, the Board understands that this outcome clearly falls within the policy intent of the ESS legislation, in ensuring that taxpayers are taxed consistently regardless of the forms of remuneration they receive. That is, if an employee receives shares or rights at a discount to their market value in lieu of cash remuneration, the employee should be taxed on the discount to the market value of those shares or rights at grant (or at the point in time where the employee is able to deal with the share or right unrestricted), irrespective of whether the benefit is ultimately realised by the taxpayer.

5.22 Further support for this view is shown in the Productivity Commission Remuneration Report, which states:

> The Commission considers that once there is no longer any risk of the granted rights being forfeited or any further genuine restrictions on their disposal the employee has received income (in the form of equity). The decision of whether to realise equity or how to finance any tax bill will be made on the basis of portfolio choice and does not alter the fact that he employee has received a benefit for their labour. [30]

---

28 Thomas K.A., “Consider your options”, Fairmark Press Inc., 2009 ed. at p.98.

29 Jansen B., “Dealing with executive options in family property disputes”, Ernst & Young, January 2002.

30 ***Executive Remuneration in Australia***, Productivity Commission Inquiry Report, No. 49 19 December 2009, at p 345.

5.23 In light of the complexity and administrative cost to employers associated with attempting to determine the market value of unlisted rights, the Board acknowledges that valuation of unlisted rights is one area of the tax law where the operation of a 'safe harbour' rule would be appropriate. Introduction of a 'safe harbour' rule in this context would serve to increase simplicity and reduce compliance costs associated with ESS arrangements that offer unlisted rights. In addition, provided an appropriate 'safe harbour' is adopted, the reduction in complexity should serve to strengthen the integrity of the ESS regime in relation to the taxation of unlisted rights.

Recommendation 3: Valuation of unlisted rights

The Board recommends that the valuation methodology for the valuation of unlisted rights issued under qualifying ESS arrangements be in accordance with the ordinary meaning of market value.

The Board also recommends a statutory 'safe harbour' valuation methodology in accordance with which participants can elect to value unlisted rights.

'Safe harbour' for valuing unlisted rights

5.24 The current Regulations which accompany the Division 83A provisions adopt an approach similar to that adopted in the prior Division 13A provisions. That is, the Regulations effectively offer taxpayers a 'safe harbour' valuation methodology, should they choose not to value unlisted right in accordance with the ordinary meaning of market value. The 'safe harbour' valuation methodology allows taxpayers to value an unlisted right at the greater of:

- the intrinsic value of the option, being the market value of the share that may be acquired by exercising the right less the lowest amount that must be paid to exercise the right; and
- the value determined in accordance with the statutory valuation tables contained in the Regulations.

5.25 When considering an acceptable 'safe harbour' for valuing unlisted rights, in accordance with the reasons outlined in paragraphs 5.17 to 5.19 above, the Board rejects using a purely intrinsic value valuation approach. The Board believes that the intrinsic value approach gives a clearly inappropriate outcome in certain situations, for example, where the right is 'out of the money' at the taxing point but has a relatively lengthy time period remaining till its expiry.

5.26 In the above situation, the use of intrinsic value is not considered to be an acceptable proxy for market value as it disregards any potential upside associated with holding the right for an extended period of time. In this circumstance, the Board considers that the value determined under the statutory valuation tables, which attempt to place a value on this 'potential upside' in calculating a market value for the right, to be more appropriate.

5.27 However, the Board acknowledges that in certain situations, the valuation of a right in accordance with its intrinsic value may produce the most accurate reflection of market value attributable to the right. For example, intrinsic value provides a more appropriate proxy for market value where the right is 'deep in the money'[31] at the taxing point. This is due to the high likelihood that the taxpayer will exercise the right in the immediate future or as soon as any disposal restrictions placed on the right are lifted. (In contrast, as explained in paragraphs 5.45 to 5.48 below, the value attributed by the statutory valuation tables to rights that are 'deep in the money' at the taxing point are artificially low, as they continue to factor in future volatility and dividend yield up to the time of expiry of the right).

5.28 The Regulations operate to tax all unlisted rights that are granted for a nil exercise price at the market value of the underlying share at the taxing point i.e. the intrinsic value of the right.[32] If the 'safe harbour' did not operate to tax employees at the greater of the value derived under the statutory tables or the intrinsic value, a situation may arise were employers can instead grant rights at a 1 cent exercise price, and effectively ensure their employees face a lower taxable value under the statutory table than would be the case if intrinsic value was applied.

5.29 To demonstrate this by example, assume A Co. (an unlisted company) issues an ESS right to its employee. Under Scenario A, the terms of the right are a nil exercise price, and a term to maturity of the right of 3 years. For this scenario we will also assume all other restrictions are satisfied such that the right qualifies for taxation under Division 83A, and that no restrictions are attached to the right such that the employee is subject to tax on grant of the right. In this scenario, the Division 83A provisions apply to tax the employee at grant on the underlying market value of the share. For this example we will assume a market value of $10, and hence the employee is taxed at grant on the market value of $10.

5.30 Under Scenario B, the same facts apply, however the terms of the right instead stipulate a $0.01 exercise price. In this scenario, assuming the employee elects to use the 'safe harbour' valuation method, the employee will be taxed on the greater of the intrinsic value of the right, or the value determined under the valuation tables. With a market value of $10 on the day of grant, the intrinsic value of the right is $9.99. However, using the valuation tables the right is attributed a market value of just $7.99, $2 lower than the intrinsic value reflecting the fact that the tables assume the right will

---

31 An option is considered 'deep in the money' when the amount required to be paid by the holder to exercise the option (the exercise price of the option) is significantly lower than the market value of the underlying share on that day.

32 ***Income Tax Assessment Amendment Regulations 2009 (No.)*** at Regulation 83A-315.03.

be held for its full 3 year term, rather than being exercised by the employee in the immediate future.

5.31 As a result of the above, the Board favours the retention of a 'safe harbour' that values unlisted rights at the greater of their intrinsic value, or the value attributed to them under some other short-cut valuation mechanism, such as the statutory valuation tables.

Basis and assumptions behind the statutory valuation tables

5.32 The Explanatory Memorandum accompanying the original introduction of the statutory valuation tables acknowledged that the tables were designed to be 'generally concessional' when determining a market value for unlisted rights.[33]

5.33 However, the ESS Consultation Paper, released by Treasury in June 2009, contained the following statement:

> The Government remains concerned that the current valuation rules for unlisted rights under employee share schemes have resulted in a systematic undervaluation and therefore, frequent under-taxation.

5.34 In conducting the current Review, the Board has consulted with the Australian Government Actuary (AGA) in relation to the basis and assumptions behind the valuation tables. The AGA Report is contained at Appendix A to this Report.

5.35 The AGA was involved with the original design of the statutory valuation tables contained in Division 13A of the ITAA 1936, and confirms that the valuation tables were based on a Black Scholes valuation method. The Board understands that the Black Scholes model is an established option valuation model that is widely used in practice in pricing rights and options.

5.36 The AGA have acknowledged that they have not found any direct evidence that points to the preferred use of the Black Scholes model over that of other option pricing models, such as the Binominal or Monte Carlo models. However, in their Report attached at Appendix A, the AGA surmise that the Black Scholes model may have been the preferred pricing model behind creation of the valuation tables as it is relatively easy to codify (as opposed to the Binominal or Monte Carlo models), it is widely used in practice, and under certain assumptions the 3 methods converge in any event.

5.37 The Black Scholes model requires a series of inputs or parameters which directly affect the outcome achieved under the model. These inputs comprise the following:

- relationship between exercise price and current price;

---

33 Explanatory Memorandum to the ***Taxation Laws Amendment Bill (No. 2) 1995*** at paragraph 2.43.

- time to expiry;
- risk free interest rate;
- dividend yield; and
- volatility of the underlying share.

5.38 Determining an accurate market value of an unlisted right under the Black Scholes model would require the inputs into the model to be both company specific (i.e. dividend yield and volatility) and time specific (i.e. time to expiry and risk free rate of interest). Further, accurate determination of market value of a right or option under the Black Scholes model requires the dividend yield and volatility of the underlying shares to be known or accurately ascertainable which is often not possible in the case of unlisted companies.

5.39 In recognition of the above complexities, the statutory valuation tables have been designed to use constants in place of some of the variable inputs required by the model. The Board understands that it is these constants that have been designed to apply concessionally to taxpayers who value unlisted rights in accordance with the tables.

5.40 In order to test the concessional nature of the valuation tables, the AGA have undertaken a high level comparison of the tables against the market value attributed to options over a listed share. This analysis is based on publicly available information for call options over BHP Billiton shares. Both the shares and the options are listed on the Australian Securities Exchange (ASX).

5.41 The results of the AGA's high level analysis indicate that the statutory valuation table consistently results in a lower market value attributed to the right than the value determined by the market on the ASX. Further, the longer the time to maturity of the right, the greater the difference between the traded price determined by market forces, and the value derived under the valuation tables. This result follows from the use of a constant concessional volatility factor utilised in the valuation model, as intuitively the longer the term to maturity, the greater the chance that the option may become 'in the money' or deep 'in the money' prior to exercise.

5.42 The situation of unlisted companies generally means that not all the specific inputs required to make the Black Scholes valuation model produce a more accurate result can be known. If the valuation tables are to be of assistance to taxpayers, they will need to continue to assume some 'constants'. Whether and to what degree the tables will result in concessional outcomes will depend upon the constants that are assumed compared to the specific performance of the underlying share.

Relationship between exercise price and current price

5.43 The value attributed to the right under the current valuation tables is dependant upon the market value of the underlying share at the taxing point, and the exercise price or amount that must be paid by the taxpayer to acquire the share. As these two factors are known at the taxing point, these two factors do not need to be estimated.

5.44 The relationship between the exercise price and the current price is reflective of the intrinsic value of the right, but as noted above, the Board considers that in most situations this is only one factor to be considered when calculating an appropriate market value of the right.

Time to expiry

5.45 One commonly acknowledged limitation to the Black Scholes model is its inability to adequately deal with 'American style' rights or options. 'American style' options are options that can be exercised by the holder at any point up till expiry, as distinct from 'European style' options which can only be exercised upon expiry.

5.46 In practice, once the taxing point for a standard unlisted right has been triggered the taxpayer is free to exercise the right at any point prior to the expiry of the exercise period. In this respect, the modified Black Scholes model that underlies the valuation tables generally results in an overly concessional market value for rights that are 'deep in the money' with a short exercise period remaining. This concessional market value is a result of the fact that the model underlying the valuation tables assumes that the taxpayer cannot exercise the right prior to expiry. Accordingly, the market value of the right must reflect the risk that the value of the underling share may fall prior to exercise of the right at expiry.

5.47 A taxpayer holding a 'deep in the money' option with only a limited period left till expiry will likely exercise the right and acquire the share early rather than wait till the last day of the expiry period. Accordingly, this is one scenario where the intrinsic value of the right will be greater than that determined under the valuation tables. In this scenario, the intrinsic value of the right gives a truer reflection of the market value of the right, as the taxpayer will more than likely exercise the right immediately and hence factors such as future volatility, dividend yield and time value of money become irrelevant to the value of the right.

5.48 That said, for the purposes of a valuation using the Black Scholes method, this factor is known at the taxing point and does not need to be estimated.

Risk free interest rate

5.49 This factor is broadly observable, but it changes over time such that using a constant value in the statutory valuation tables creates some disconnect between the current market conditions and the assumed market conditions reflected in the valuation tables. As advised by the AGA in their Report, at the time the statutory tables were originally developed, a risk free rate of 7.6 per cent p.a. (7.33 per cent continuously compounded) was adopted, which reflected the yield on 3 year Commonwealth bonds at that time.

5.50 The higher the assumed risk free rate of interest, the higher the assessed value of the right or option. Accordingly, in light of current 3 year Commonwealth bond rates which are lower than the 7.6 per cent p.a. used in the tables, it can be assumed that this factor is not concessional to taxpayers utilising the valuation tables to determine market value of an unlisted right.

Dividend yield

5.51 Dividend distribution patterns are unique to the share over which the right is issued, as well as the life of the right, as dividend yields may differ from year to year. Again, as advised by the AGA, the underlying rate used in compiling the statutory valuation tables was 4 per cent p.a. (3.94 per cent continuously compounded).

5.52 The basic Black Scholes model assumes that no dividends are paid on the underlying share. Accordingly, the Black Scholes model underlying the valuation tables is a modified version of the model, deliberately designed to reflect the fact that the majority of listed Australian shares pay some dividend to their shareholders throughout the year.

5.53 The higher the dividend yield assumed, the lower the value of the right. Accordingly, for taxpayers that hold rights over shares that exhibit a zero per cent dividend yield, the use of a 4 per cent p.a. rate in the valuation tables results in a value that is somewhat concessional to the taxpayer. For taxpayers that hold rights over shares that exhibit a dividend yield of greater than 4 per cent however, the valuation tables can be assumed to be artificially inflating the market value of the right.

5.54 Often newly incorporated, fast growing unlisted companies will chose to reinvest any profit back into the company rather than distribute dividends. Where this is the case, a 4 per cent p.a. dividend yield factored into the valuation model can be assumed to be concessional to the employee holding the right.

Volatility of the underlying share price

5.55 Assessing volatility in relation to the market value of the underlying share is particularly problematic in relation to unlisted companies. Again, this factor will vary from share to share and from year to year, being heavily dependant upon the economic performance of the individual company, as well as overall economic conditions more generally.

5.56 As advised by the AGA, the volatility rate underlying the statutory valuation tables is 10 per cent. The higher the volatility factor assumed by the modified Black

Scholes model, the greater the value of the right or option that would be derived from the tables.

5.57 It was asserted in at least one submission received by the Board that most mature companies exhibit a volatility factor of around 20 per cent-30 per cent p.a., with newly established speculative companies generally exhibiting volatility in excess of that.[34] Further, established texts on the subject have suggested typical volatility values of a share range from 20 per cent-40 per cent p.a.[35] In light of these claims, it may be argued that an assumed 10 per cent volatility factor is relatively concessional when valuing unlisted rights.

5.58 However, when considering the appropriateness of a volatility factor in relation to unlisted rights, one must have regard to the relatively illiquid market for shares and rights in unlisted companies, and the typical restrictions placed on employees over any future disposal of the rights or shares. These characteristics may reduce the volatility that may otherwise be expected in the share price from a typical listed company. Shares that do not distribute dividends generally exhibit a lower volatility than those shares that exhibit a regular dividend pattern.

Overall concessionality of the statutory tables

5.59 The current concessional nature of the valuation tables is in accordance with the policy intent of the Government at the time the tables were introduced.[36]

5.60 Further, the statutory valuation tables are intended to operate within the income tax regime as a ‘safe harbour’ valuation option, that is, the purpose of the tables is to offer ESS participants who receive unlisted rights a simpler and less costly alternative when attempting to attribute a value to those unlisted rights.

5.61 The Board understands that generally the statutory valuation tables give a concessionary tax outcome to taxpayers, when compared with the price as dictated by market forces for listed securities. That is, where full information is known, the market generally ascribes a higher price to the right than that which is calculated under the valuation tables using the above assumptions.

5.62 As acknowledged by the AGA in their findings however, when considering unlisted rights, the value of the right to an employee may in practice be something less than the comparable ‘market value’ due for example to the fact that the unlisted right may be subject to certain disposal restrictions, or not have a purchaser ready and willing to acquire the right. This would suggest that some concessionality built into the valuation tables may not necessarily be inappropriate. However, the Board

---

34 Submission received from ***Remuneration Strategies Group***

35 Hull, J.C., “Options, futures, and other derivatives”, 4th edition, ***Prentice-Hall International, Inc.,*** 2000, p 241.

36 Paragraph 2.43 of the Explanatory Memorandum to the ***Taxation Laws Amendment Bill (No. 2) 1995.***

acknowledges the policy position that when valuing unlisted rights issued under ESS arrangements, any conditions and restrictions placed on the underlying shares or rights should be disregarded.[37]

5.63 The statutory valuation tables introduce greater simplicity and reduced compliance costs for both employers and employees who utilise unlisted rights under ESS arrangements. As part of the trade-off of offering this increased certainty to taxpayers, the Board acknowledges that the statutory tables may result in undervaluation and under-taxation of some unlisted rights.

5.64 Further, the Board holds the view that due to the unique nature of unlisted rights, and the fact that full information on the right cannot be known, care should be taken in placing too strong a reliance on the concessionality conclusions drawn from the analysis undertaken on the market value of the right as determined by the tables, in comparison to the market value determined for listed shares.

Valuation tables to reflect current market conditions

5.65 In light of concerns held by the Government that the valuation tables result in consistent undervaluation leading to under-taxation of unlisted rights, the Board has consulted with the AGA in considering new statutory valuation tables which attempt to more accurately reflect current market conditions.

5.66 High level analysis undertaken by the AGA using listed option prices has revealed that the value assessed to an option using the current statutory tables is roughly a third or less than the value attributed to the option in the traded market. This result could be taken as an indication of undervaluation of unlisted rights under the valuation tables. In light of this, the Board recommends the adoption of the following constants, which attempt to more accurately reflect current market conditions.

Volatility

5.67 The Board understands that an assumed volatility rate of 10 per cent is unrealistically low when attempting to attribute a value to unlisted rights. The Board requested the AGA to recreate the statutory valuation tables using a volatility rate of 20 per cent, which is viewed by the Board as a more realistic volatility parameter in light of the information available in respect of listed rights.

5.68 As advised by the AGA, a volatility rate of 20 per cent (combined with the other modified inputs discussed below) would still result in a market value lower than that attributed by the market, however the amount of the discount would have been reduced. The Board agrees that a volatility rate of 20 per cent is a more appropriate input to be assumed by the model. Although 20 per cent is generally lower than the

37 Subdivision 960-S of the ITAA 1997.

volatility exhibited by listed options, the Board notes that the term of most traded options are much shorter than ESS options and hence are likely to exhibit a higher volatility than what is appropriate for valuing an unlisted ESS option.

Dividend yield

5.69 As discussed above, the higher the dividend yield assumed, the lower the value of the option or right. The statutory tables adopt a dividend yield of 4 per cent p.a.

5.70 The Board is of the view that a dividend yield of 4 per cent p.a. should be maintained in the statutory tables as it is broadly reflective of the average dividend yield currently exhibited by listed companies[38]. The Board acknowledges that unlisted rights can be issued over both listed and unlisted underlying shares that may or may not regularly distribute dividends, however the Board holds the view that an assumed statutory rate of 4 per cent p.a. ensures that the valuation tables do not operate in an overly penal manner to those entities that regularly distribute dividends to their shareholders.

Risk free rate of interest

5.71 The risk free rate of interest, although broadly observable, is required to be factored into the statutory tables as a constant. Accordingly, the AGA has adopted a risk free rate of 5 per cent p.a. which is broadly reflective of the current 3 year Commonwealth bond rate.[39]

Conclusion

5.72 The Government holds some concern that the operation of the statutory valuation tables lead to situations of undervaluation and under-taxation of unlisted rights. To address this concern, the Board recommends that the inputs into the statutory valuation tables be amended to reflect the above assumptions which are more reflective of current market conditions.

5.73 The Board notes however that although the adoption of the above assumptions will go some way to reducing the concessionality present in the statutory valuation tables, the amended tables will still operate to afford some degree of concessionality to participants who elect to value unlisted rights in accordance with the tables.

5.74 The Board considers that a degree of concessionality to the statutory valuation tables is not necessarily inappropriate in light of the reasons discussed at paragraphs 5.60 to 5.64 above. However, the Board recommends that the basis and assumptions

---

38 Dividend yield per cent per annum as reported in RBA Statistics: F.7 Share Market at http://www.rba.gov.au/statistics/tables/pdf/f07.pdf

39 3 year Australian Government bond as Reported in ABS Statistics F2 Capital Market Yields: Government Bonds at http://www.rba.gov.au/statistics/tables/xls/f02hist.xls

underlying the statutory valuation tables be reviewed from time to time to ensure that the tables remain broadly reflective of the market conditions of the time.

ATO calculator for valuing unlisted rights

5.75 The Board notes that the statutory valuation tables as contained in the previous Division 13A provisions, and in the Regulations accompanying the Division 83A provisions, have been criticised for being non-user friendly and overly complex to use. In light of these criticisms, the Board feels that scope exists for the ATO to develop an online calculator tool for the valuation of unlisted rights in accordance with the statutory valuation tables i.e. based on the same modified Black Scholes formula, which will assist both employers and employees in attributing a value to these interests.

5.76 The Board notes that the ATO has developed a series of online calculators to assist taxpayers in relation to a range of areas of the taxation law. These online calculators offer taxpayers increased simplicity in conducting their tax affairs, but also increased certainty that they are applying the taxation legislation as intended. The Board believes that participants would greatly benefit from both the increased simplicity and certainty offered by an online calculator tool when determining a taxable value for these interests.

Transparency of the valuation tables

5.77 The Board shares the concern raised in submissions that there is a lack of transparency behind the operation of the statutory valuation tables. In order for taxpayers to make a decision on whether to use the ‘safe harbour’ valuation method or the ordinary meaning of market value, the Board agrees that it is important that taxpayers have adequate information in order to make an informed choice.

5.78 Appendix A contains the modified Black Scholes formula under which the statutory valuation tables were prepared. At the request of the Board, the Appendix also contains modified statutory valuation tables to reflect current market conditions as discussed in paragraphs 5.67 – 5.71.

Recommendation 4: Statutory valuation tables

The Board recommends the continued use of the statutory valuation tables as a ‘safe harbour’ for valuing unlisted rights, however the Board recommends that the factors underlying the statutory valuation tables be reviewed and updated to more accurately reflect current market conditions.

Further, the Board recommends that the tables be reviewed from time to time to ensure the tables remain broadly reflective of market conditions, and the basis and assumptions behind the statutory valuation tables be made available to the public.

The Board recommends the Commission of Taxation develop an online calculator tool to assist taxpayers to apply the statutory valuation tables to value their unlisted rights.

CHAPTER 6: START-UP, RESEARCH & DEVELOPMENT AND SPECULATIVE-TYPE COMPANIES

6.1 During the consultation process undertaken by Treasury on the Government's 2009 Budget announcement, the Government received a number of submissions that raised concerns that the proposed changes to the ESS provisions would disproportionately affect start-up, R&D and speculative-type companies.

6.2 The Government referred the issue to the Board for further consideration.

6.3 In its deliberation on this element of the terms of reference, the Board considered a number of issues including:

- whether start-up, R&D and speculative-type companies have characteristics that would allow them to be suitably identified;
- whether it is appropriate or necessary to provide these types of companies special treatment; and
- if so, what should be the nature of the treatment.

6.4 In undertaking this analysis, the Board paid specific attention to the broad range of Government programmes currently on offer in Australia specifically aimed at supporting start-up, R&D and speculative-type companies. In addition, the Board undertook a high level review of ESS tax incentives offered in certain other jurisdictions aimed at achieving the same outcome.

INTERNATIONAL COMPARISON

6.5 In undertaking any comparison of the tax regimes of different countries, care must be taken in having regard to differences in the fundamental design features of the regimes. Such differences can have a significant impact on the effectiveness and concessionality of individual tax measures that operate within those tax regimes.

6.6 That said, this paper does not attempt to undertake a detailed analysis of the fundamental tax design principles of the United Kingdom, Singapore, the United States or Canada. However it does attempt to provide a high level analysis of the various tax concessions offered by these countries to start-up, R&D and speculative-type companies within the ESS space.

United Kingdom

6.7 There are 4 types of arrangements in the United Kingdom (UK) that offer tax preferred treatment of shares or rights issued under ESS type arrangements, one of which is the Enterprise Management Incentive (EMI) scheme. The EMI scheme is a tax advantaged share option scheme designed to help small, higher risk companies recruit and retain employees who have the skills to help them grow and succeed. It is also a way of rewarding employees for taking a risk by investing their time and skills to help small companies achieve their potential.[40]

6.8 In order to qualify for this concession, the company must not be more than 51 per cent owned or controlled by another company; the company's gross assets must not exceed £30 million at the date of the grant of the option; must have less than 250 full-time equivalent employees at the date the option is granted; and must carry out commercial trade activities and not be carrying on to any substantial extent certain specifically excluded trade activities.

6.9 To constitute a qualifying employee, the employee must have been granted options in the qualifying company and meet the following conditions:

- be an employee of the company or a qualifying subsidiary of the company;
- be required to spend at least 25 hours each week, or at least 75 per cent of their working time, as an employee of the company or its qualifying subsidiary; and
- not have a material interest (broadly defined as the ability to control, directly or indirectly, more than 30 per cent of the ordinary share capital of the company) in the company or any other group company.

6.10 If the above qualifying conditions are met by both the employer and the employee, tax advantaged share options with a market value of up to £120,000 (£100,000 prior to 6 April 2008) may be granted to a qualifying employee subject to a total share value of £3 million under EMI options to all employees. The grant of the option is tax-free and there will normally be no tax or National Insurance Contributions (NICs) for the employee to pay when the option is exercised.

Singapore

6.11 Singapore operates an equity remuneration incentive scheme (ERIS) for new start-up companies. In order to access the ERIS, a qualifying company has to grant the options or shares within the first 3 years of its incorporation to a qualifying employee to acquire ordinary shares in the qualifying company.

---

40 "Enterprise Management Incentives: A guide for employees, employers and advisors", HM Revenue & Customs, at http://www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm

6.12 To be a qualifying company for ERIS purposes, the company issuing the shares or options must be a Singapore resident; carry on business activities in Singapore; have total share capital beneficially held by no more than 20 shareholders, all of whom are individuals, or at least one of which is an individual holding at least 10 per cent of issued ordinary shares; and aggregate value of total assets held by the company at the date of grant does not exceed $100 million.[41]

6.13 To be a qualifying employee under the ERIS, the employee must have been granted shares or options by a qualifying company, and also meet the following requirements at the time of grant:

- be exercising employment for the qualifying company;
- committed working time per week with the company must be at least 30 hours per week; and
- does not have effective control over the qualifying company.[42]

6.14 If the above qualifying conditions are met by both the employer and the employee, the employee is entitled a tax exemption of 75 per cent of up to $10 million of gains accruing to the employee participating in the ESS arrangement over a 10-year period.

6.15 Gains from disposal of the shares or rights are taxable to the employee at the time the options are exercised, the shares are granted or vested, or when the moratorium on the disposal of the shares is lifted.

United States

6.16 In the United States (US) employee stock options are classed as either statutory (share-holder approved plans) or non-statutory schemes. While the nature of the tax concession offered to employees in the US depends on the type of scheme entered into, the US does not offer a scheme that is directly aimed at start-up or speculative-type companies.

Canada

6.17 In Ontario, Canada, the Ontario Research Employee Stock Option[43] (ORESO) credit was available as an incentive to help Ontario high technology companies find and keep highly skilled research employees. The credit was available to offers made to employees between 21 December 2000 and 18 May 2004.

---

41 IRAS Circular, "Equity Remuneration Incentive Scheme (Start-ups)", Inland Revenue Authority of Singapore, at p 5-6.

42 Ibid., at p 6.

43 Ontario Ministry of Finance Income Tax Related Programs Branch Information Bulletin "Ontario Research Employee Stock Option Credit" February 2002

6.18 In order to access the ORESO, the employee was required to be an eligible employee at the time a stock option was granted. To be an eligible employee, the employee must:

- spend at least 30 per cent of their time on scientific research and experimental development for the employer;
- be employed by the eligible employer for at least six consecutive months;
- be a full-time employee; and
- not be an incorporated employee providing services on behalf of a personal services business.

6.19 In addition, to qualify for the ORESO, the employer was required to carry on a business in Ontario, directly undertake scientific research and experimental development and incur at least 10 per cent of total revenue on eligible expenditures.

6.20 Where the qualifying conditions were met by both the employer and the employee, the ORESO credit was available and the employee could reduce or eliminate their income tax on up to $100,000 of taxable income each year.

6.21 The ORESO credit was withdrawn in 2004. The 2004 Ontario Budget Paper C: Ontario's revenue plan, contained the following statement in respect of this withdrawal:

> Several tax expenditures were assessed to determine whether they are meeting their objectives effectively and whether they are consistent with current priorities. Some were found to be ineffective or had very low take-up. Some may be delivered more effectively through other programs. Others simply do not measure up to current priorities.

6.22 In the same Budget Paper, the Ontario government committed to further improve the climate for venture capital investment to support the growth and development of entrepreneurial technology firms by working more closely with the federal government.

Overall assessment

6.23 As can be observed from the above comparison, offshore jurisdictions do not exhibit a clear pattern or set of characteristics which could be adopted by Australia in relation to additional ESS tax concessions for start-up, R&D and speculative-type companies. While the concessions offered by some countries are in some respects quite liberal, for example the United Kingdom which affords employees up to £120,000 in share options tax free, they are also more prescriptive compared to the regime in Australia. Other regimes impose tighter restrictions on the concessions, such as Singapore which allows grant of such options only in the first 3 years of a company's operation. Further, other countries, such as the United States and Canada, have elected not to offer specific ESS tax concessions to start-up, R&D and speculative-type companies outside of their more broad-brush ESS tax regimes.

6.24 In any event, all regimes examined impose some degree of conditionality on the ability of the employee to access the additional tax concession, highlighting the importance of adequately restricting access to the concession to those employees deliberately targeted by the measure.

VIEWS EXPRESSED IN SUBMISSIONS

6.25 The majority of submissions received by the Board were in favour of shares and rights issued by start-up, R&D and speculative-type companies under ESS arrangements being subject to separate tax deferral or other concessionary arrangements, outside of those contained in Division 83A of the ITAA 1997.

6.26 The main argument provided in submissions to support these separate tax deferral arrangements focused on the characteristics of start-up, R&D and speculative-type companies, which are usually cash poor and hence heavily reliant on the use of shares and rights to attract and retain key employees in addition to offering key employees cash remuneration.

6.27 The submission received by the Board from Innovation Capital Associates states:

> There are gross differences in the structure, implementation, motivation and resulting outcomes of an employee share scheme for a top 50 ASX listed company and a start-up company that is cash flow negative and has a limited small number of employees that are typically paid below market.
>
> Australia cannot seriously expect to compete globally in terms of technology commercialisation unless it can secure world class management. To attract individuals of this calibre, the opportunity to be rewarded in a manner consistent with the professional risk undertaken must exist.

6.28 Further, the submission received from the Australian Institute of Company Directors states:

> An SME's [small to medium enterprises] approach to remuneration is often the key to it attracting, motivating, and retaining appropriate senior staff and board members. The use of options (and performance rights) – which are used more frequently as a component of remuneration in SME's than in larger companies – can serve as an enticement for senior managers and board members, through allowing them to share in the success of the business venture. Options allow cash starved entities (e.g. start-ups, mining exploration companies, research and development entities and other SME's not

yet earning revenues) to obtain senior staff at cash salaries or fees that are lower than the market rate.

It is our view that the removal of the pre-Budget taxation provisions, which allow deferral of taxation until options are exercised, will have a disproportionate negative impact on SMEs.

Eligibility

6.29 A number of submissions received by the Board acknowledged the potential integrity concerns associated with offering additional tax concessions and hence suggested potential eligibility restrictions be placed on companies looking to access any additional tax concessions that may be offered.

6.30 As acknowledged in the submission received from Ernst & Young:

> The availability of any concessional tax treatment should be on the basis that the only entitlements which fall within any new regime are equity entitlements that are granted as remuneration entitlements (and proprietor type interests are not inadvertently included).
>
> Assuming the grants are remuneration entitlements, defining the types of companies that can offer concessionally taxed equity will also be critical. There needs to be some relatively tightly defined criteria around qualification to ensure appropriate targeting of concessions.

6.31 The submission received from the Australian Institute of Company Directors suggested that any tax concessions should be available to all SME's, while the submissions received from AVCAL, Starfish Ventures and Innovation Capital Associates suggested the concessions be available to companies that are eligible to access the new 45 per cent refundable R&D tax credit.

6.32 Multiple submissions suggested that eligibility could be restricted through the use of one or a combination of company measurements, such as company size, number of employees, industry type, annual turnover, revenue threshold or market capitalisation.

6.33 The submission from Mr Warren Kalinko suggested restricting access to any additional tax deferral to companies that satisfy the definition of a 'small proprietary company', as defined in section 45A of the ***Corporations Act 2001***. Broadly, a small proprietary company is a company that satisfies at least 2 of the following criteria:

- consolidated revenue for the financial year of less than $25 million;
- value of the consolidated gross assets of the company and its controlled entities at the end of the financial year of less than $12.5 million;

- the company and its controlled entities have fewer than 50 employees at the end of the financial year.

6.34 Many submissions received by the Board also referred to the various taxing regimes of comparative OECD countries when discussing both eligibility and tax concession design in relation to ESS arrangements. These submissions urged the Board to have regard to the key design features behind these countries' tax concessions for ESS type arrangements when discussing the issue of whether additional tax concessions are necessary or appropriate for ESS arrangements offered by start-up, R&D or speculative-type companies in Australia.

Existing restrictions to access ESS tax concessions

6.35 In addressing the particular concessions that may be offered to assist start-up, R&D and speculative-type companies, Ernst & Young supported the approach of providing these types of companies additional concessions for accessing the deferred taxation treatment offered under Division 83A. The Ernst & Young submission argues that the unique nature of the types of equity remuneration used by these types of companies means it may be difficult for the companies to meet the requirements to access the Division 83A concessions. If a company cannot meet the qualifying requirements, the company is unable to access the tax concessions.

6.36 The qualifying requirements attempt to limit access to the concessions to genuine schemes broadly available to all permanent employees who do not already hold anything other than a minor interest in their employer. These restrictions include:

- at the time of acquiring the interest, the employee is employed by the company offering the scheme, or one of its subsidiaries;
- the scheme must relate to ordinary shares;
- the scheme must satisfy certain integrity requirements about share trading and investment companies;
- the scheme must be non-discriminatory i.e. available to 75 per cent of resident permanent employees of the company with 3 years of service (this restriction does not apply to ESS arrangements that offer only rights to acquire a share, rather than shares);
- a 5 per cent limit on shareholding and voting power, such that immediately after acquiring the interest, the employee seeking to access the tax concessions does not hold a greater than 5 per cent beneficial interest in the company or have a greater than 5 per cent right to control the attached votes.

6.37 In addition, to access the deferral concession under Division 83A, a real risk of forfeiture must exist in relation to the interest, or the interest must be acquired at a discount under a salary sacrifice arrangement that does not exceed $5,000.[44]

6.38 In relation to the above requirements, the Ernst & Young submission recommended the following :

> Relaxing the 5 per cent limit: … Increasing or removing the 5 per cent limit would provide these companies with additional flexibility to provide competitive equity grants.
>
> Removing the 75 per cent requirement for the award of shares: … Start-up or R&D companies may wish to provide selected key employees with access to shares but be unable to provide a broad-based employee share scheme (e.g. due to cost / dilution issues or being unable to meet the relevant prospectus disclosure requirements where a company is unlisted). Removing the 75 per cent requirement would provide greater flexibility for these companies in providing access to equity to employees.
>
> Removing the requirement that all interests must be over ordinary shares: … there may be certain situations where start-up or R&D companies want to provide awards to individuals over a different class of share due to the particular structure of the business or agreements with existing shareholders…
>
> Removing the requirement for a real risk of forfeiture: … The use of disposal restrictions or a lesser forfeiture requirement (e.g. for reasons of fraud or gross misconduct) would be more appropriate to enable tax deferral.

6.39 In direct contrast to the above submissions however, the TIA's submission directly rejected the calls for a separate taxing regime for taxing these types of companies, instead preferring that start-up, R&D and speculative-type companies be subject to the Division 83A provisions like all other companies that offer ESS arrangements. Instead of additional deferral concessions, the TIA submission supported the introduction of valuation concessions to support these types of companies, stating:

> … the Taxation Institute would support valuation concessions being introduced to assist small to medium unlisted companies being able to satisfy the valuation requirements in a cost effective manner. Eligibility for the concessions would need to be restricted (e.g. based on turnover). Further, integrity measures would also be required.

6.40 Numerous submissions received by the Board also called for various individual tax concessions to be available to employees of these start-up, R&D and speculative-type companies in receipt of ESS securities. The submissions received from Ernst & Young, Starfish Ventures, Link Market Services and the Australian Private Equity &

44 The salary sacrifice concession only applies to shares issued to employees under ESS arrangements and does not apply to rights issues.

Venture Capital Association Limited (AVCAL) suggested some or all of the following tax concessions:

- removing or increasing the $5,000 salary sacrifice limit on shares;
- discounts on the value of rights (and shares) granted to employees of eligible companies would only be assessed on actual realisation of any gain and be assessed only as a capital gain and not as assessable income under proposed Division 83A;
- if the right or shares are held for more than 12 months prior to the realisation of the gain, then the gain should qualify as a discount capital gain;
- employees of eligible companies who have held the right for at least 12 months should be able to access the capital gains tax (CGT) discount regardless of whether the rights are sold to a third party, cancelled or exercised and the shares immediately sold.

6.41 This suggestion of only taxing any discount on the value of rights and shares granted to employees on actual realisation of the benefit by the employee, that is, further extending the operation of the deferral concession for these types of companies was a common theme in submissions received by the Board.[45] However, multiple submissions made this recommendation in relation to the taxation of ESS discounts more generally, and did not necessarily consider that this deferral concession should be restricted to start-up, R&D and speculative-type companies in particular.[46]

BOARD'S CONSIDERATION

Whether it is appropriate or necessary to provide additional support to start-up, R&D and speculative-type companies

Access to the Division 83A concessions

6.42 Certain submissions received by the Board expressed the view that the restrictions on accessing the concessions afforded under Division 83A of the ITAA 1997 (and under the previous Division 13A provisions) operate to unfairly exclude start-up, R&D and speculative-type companies from access to the concessions, due to the unique characteristics of their ESS arrangements.

---

45 Submissions received from Innovation Capital Associates Pty Ltd, Australian Institute of Company Directors, The Australian Private Equity and Venture Capital Association, Link Market Services Limited, Starfish Ventures, CRA Plan Managers Pty Ltd.

46 Submissions from Remuneration Strategies group and from Jon B Kirkwood (more generally) and from Backer & McKenzie and Taxation Institute of Australia (in relation to taxation of options).

6.43 The key restrictions of interest include the 'ordinary share' restriction, the 'accessibility by 75 per cent of permanent employees' restriction and the '5 per cent of shares or voting rights' restriction. In addition, the 'real risk of forfeiture' restriction must also now be met to access the deferral concession under the new Division 83A provisions.

6.44 Criticisms that these restrictions operate to unfairly restrict companies such as start-up, R&D and speculative-type companies from taking advantage of the tax concessions in relation to ESS arrangements offered under Australia's tax legislation are not new, and were voiced by numerous parties in submissions received by the House of Representatives Committee in relation to the "Shared Endeavours: An inquiry into employee ownership in Australia" Report (the Shared Endeavours Report), published September 2000.[47]

6.45 Numerous Reports commissioned by Government, as well as independent research jointly conducted by The University of Melbourne, the Centre for Employment and Labour Relations Law and the Centre for Corporate Law and Securities Regulation in relation to the Employee Share Ownership Project, have concluded that the take up of ESS arrangements in Australia is much more prevalent in listed companies than in unlisted companies.[48] Start-up, R&D and speculative-type companies would be much more likely to fall into the unlisted company rather than the listed company category.

6.46 While there are a range of differing factors that may account for the lower take up of ESS arrangements by unlisted companies, it has been acknowledged in both the recommendations handed down in the Shared Endeavours Report, as well as in conclusions formed from the joint independent research undertaken, that the restrictions to access the ESS tax concessions pose a particular problem for unlisted companies due to the unique characteristics of the companies, and their key drivers in offering employees shares or rights under ESS arrangements.

6.47 The Board has considered whether scope exists to relax access to the Division 83A concessions for ESS regimes offered by start-up, R&D and speculative-type companies to ensure that these companies are not unfairly prohibited from accessing the tax concessions available to other ESS participants. Such relaxation would be in line with certain recommendations handed down in the Shared Endeavours Report and would ensure these types of companies are able to benefit from the policy intent of the ESS regime.

---

47 House of Representatives Standing Committee on Employment, Education and Workplace Relations, "Shared Endeavours Report: An inquiry into employee ownership in Australia", September 2000, (Shared Endeavours Report).

48 See, the Shared Endeavour Report at p 21-22, and A. O'Connell, 'Employee Share Ownership in Unlisted Entities: Objectives, Current Practices and Regulatory Reform' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, December 2008) at p 9-10.

6.48 However, the Board recognises that any relaxation of the restrictions would need to be carefully targeted to ensure that the integrity of the ESS regime is not inappropriately compromised.

6.49 Further, in considering what restrictions should be relaxed and to what extent, the Board found it prudent to keep in mind the overall rationale for offering tax concession to companies with ESS arrangements. As discussed in Chapter 2 of this Report, the tax concessions are provided on the grounds that ESS arrangements can contribute to aligning the interests of employees and employers, encourage positive working relationships, boost productivity through greater employee involvement in the business, reduce staff turnover and encourage good corporate governance.

6.50 In this regard, the Board holds concerns with regards to relaxing the ordinary share and 75 per cent requirements, as well as the real risk of forfeiture requirement. These concerns are discussed further below.

5 per cent shareholding limit

6.51 In line with the claims made in numerous submissions received, the Board considers that the 5 per cent shareholding restriction operates to limit the ability of start-up and speculative-type companies in particular to offer equity remuneration packages to key employees. This is due to the fact that these types of companies are often relatively small in size with significant cash flow shortages, which often pay below-market salaries and accordingly look to offer a large number of shares or rights to key employees to attract and retain their services.

6.52 The Board is of the view that there would be scope to relax this 5 per cent restriction for start-up, R&D and speculative-type companies, subject to the development of eligibility criteria to appropriately restrict access. The Board notes this is in-line with the previous recommendation handed down in the Shared Endeavours Report.[49]

6.53 Any relaxation of this restriction would need to be designed to ensure that owner / managers i.e. significant shareholders in the business are not inappropriately able to access the ESS tax concessions designed for employees. In this respect, the Board feels that relaxation of the rule to the same extent as the UK (30 per cent shareholding) or Singapore (effective control) would allow such owner / managers inappropriate access to the concession. Accordingly, the Board is of the view that, subject to the identification of adequate eligibility criteria, this restriction could be relaxed to allow employees in these types of companies to hold a maximum shareholding of 10 per cent.

49 Shared Endeavours Report, Recommendation 34 at p. 158.

Ordinary shares or rights to ordinary shares

6.54 In order to continue to achieve the underlying policy intent, the Board considers that it is crucial that ESS interests offered to employees continue to give employees the ability to have some control and influence over the operations and future direction of the company.

6.55 To allow the tax concessions to be extended to employees that are issued with something lesser than an ordinary share in the company moves away from the rationale of aligning the interests of employees and employers and introduces scope for misuse of the tax concession, especially in situations where the 5 per cent shareholding limit has been relaxed.

75 per cent of employees

6.56 The Board notes that as was the case with the Division 13A provisions, this restriction only applies to schemes that offer employees shares, or shares and rights in the company, but does not apply to schemes that offer employees rights in the company only. Accordingly, should this restriction prove prohibitively onerous to these types of companies, it may be open to them to structure their ESS as a rights only arrangement thus circumventing the operation of this restriction.

6.57 In addition, the Board holds similar concerns to those discussed in paragraph 6.53 above that any relaxation of this broad based requirement may facilitate situations where the ESS tax concessions are inappropriately accessed by owner / managers, rather than true company employees.

Real risk of forfeiture

6.58 Certain submissions received by the Board contained the view that the new real risk of forfeiture restriction does not mesh well with the types of ESS interests offered by start-up, R&D and speculative-type companies. This is due to the fact that these types of companies offer equity remuneration to key employees in-lieu of cash remuneration, and hence the shares or rights that are granted are often not subject to a real risk of forfeiture, though they may be subject to some performance hurdles or vesting period.

6.59 The submission received from Ernst & Young suggest the use of disposal restrictions or a lesser forfeiture requirement (e.g. for reasons of fraud or gross misconduct) rather than risk of forfeiture would be more appropriate to enable tax deferral to these companies.

6.60 As acknowledged in the Explanatory Memorandum, the real risk of forfeiture restriction operates to ensure that whether a share or right is subject to taxation upfront, or subject to the tax deferral concession, depends on the structure of the scheme.[50] The Board is of the view that the real risk of forfeiture restriction performs a fundamental role in the design of the Division 83A provisions, and accordingly it would not be appropriate to allow the restriction to be relaxed.

Access to additional concessions beyond the Division 83A concessions

Tax deferral concessions

6.61 While the Board acknowledges the claims made in submissions that these types of companies should be able to access ESS tax concessions in addition to those offered to all companies under Division 83A of the ITAA 1997, the Board has not found the reasons advanced in support of this position to be overly persuasive.

6.62 A number of submissions received by the Board asserted that due to the high level of reliance placed on the use of these ESS arrangements to recruit and retain key employees to their organisations, these types of companies should be offered a further deferral concession under which employees will not be subject to tax until the share granted under the ESS arrangement is disposed of, or the option granted under the ESS arrangement is exercised by the employee.[51] That is, it was argued for the further concession offered to these types of companies to be a 'tax on realisation of benefit' concession.

6.63 The main argument advanced in support of this position was that equity remuneration becomes less attractive to key employees where the equity is taxed on grant, or at some earlier point than realisation, such that the employee has a tax liability which he may not be in a position to readily be able to fund. Further, multiple submissions were concerned with the situation described in paragraph 5.21 above, where an employee may be subject to tax on a benefit that is not ultimately realised, for example, if the option remains 'out of the money' at expiry.

6.64 While the Board understands these concerns, the Government has acknowledged that one of the key design features behind the Division 83A provisions was to 'improve horizontal equity in the tax system by treating all forms of remuneration more consistently'[52].

6.65 Accordingly, the Government has deliberately adopted a default position of tax on grant of an ESS interest unless the conditions for limited deferral are met, in which case taxation of the benefit received will not occur until any real risk of forfeiture (and any pre-existing disposal restrictions) have been lifted. The Board is of the view that the current provisions operate to achieve the policy intent of the law, that is, the benefit

---

50 Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** at paragraph 1.38.

51 Refer to paragraphs 6.21 and footnotes 42 and 43.

52 Explanatory Memorandum to the ***Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*** at paragraph 1.15.

is taxed as remuneration to the employee as soon as it is realisable to the employee. The fact that the employee may choose not to realise the benefit at that point in time does not alter the fact that the employee has received additional remuneration in connection with their employment, albeit in a non-cash form.

6.66 In the Board's view, offering these types of companies a 'tax on realisation of benefit' concession i.e. where tax is only payable when the right is exercised or the share is sold, effectively shifts any downside market risk associated with holding the share or right from the employee to the government revenue. In light of the fact that the market value of the share or right specifically factors in this downside risk in determining the appropriate amount of tax to be paid by the employee in respect of the share or right, the Board holds the view that offering such a tax concession to these types of companies is inappropriate.

Valuation concessions

6.67 As an alternative to additional tax deferral concessions, the submission received by the Board from the TIA instead argued for additional valuation concessions to be made available when valuing shares and options issued by start-up, R&D and speculative-type companies under ESS arrangements.

6.68 The Board believes that the changes introduced by Division 83A for valuing both unlisted shares and unlisted rights (i.e. the ability to value the shares or rights in accordance with the ordinary meaning of market value, coupled with the removal of the requirement to engage an external valuer where some other reasonable valuation methodology exists) reduces concerns expressed by start-up, R&D and speculative-type companies that the compliance costs associated with valuing interests issued under ESS arrangements are prohibitively onerous.

6.69 In particular, the Board feels the shift away from the requirement for an unlisted company to receive a formal valuation every time they grant shares under ESS arrangements, where some other valuation method is sufficient to be relied on by the company, should significantly reduce the costs associated with unlisted companies undertaking ESS arrangements.

6.70 Further, as acknowledged in the above Chapter, the prescribed valuation techniques for companies that issue unlisted rights to their employees operate with a 'safe harbour' valuation methodology that will continue to be concessional if the Board's recommendations are accepted.

Nature of start-up, R&D and speculative-type companies

6.71 In considering whether the existing restrictions should be relaxed, or additional tax concessions made available to start-up, R&D and speculative-type companies, the Board considers it critical to examine the nature of these companies to assist in determining common elements that maybe used to determine access to any additional concession.

6.72 In the absence of a set of strictly defined eligibility requirements, the Board holds the view that the integrity of the ESS taxation regime would be compromised, creating situations of inequity and potentially increasing the risk of taxation avoidance.

6.73 The Board notes that these potential outcomes contradict the policy intent behind the Government's 2009 Budget announcements, which focused on improving horizontal equity in the tax system and reducing the scope for tax evasion and avoidance.

6.74 In accordance with the usage of the terms in common English language, the Board acknowledges the term 'start-up' generally refers to a stage of development, 'R&D' refers to a function and 'speculative' refers to the degree of risk involved in the business activities, though embedded in all of the above companies would be a certain degree of risk.

6.75 The Board also considered other sources that may have an appropriate definition. Section 26 of the ***Pooled Development Funds Act 1991*** defines a company as a 'start-up' company unless it carries on an eligible business that is a substantial established business; or is declared by Innovation Australia to be a substantial established business.

6.76 A start-up company may generally be characterised as possessing the following characteristics:

- a relatively short history;
- limited tangible assets;
- intangible assets, usually in intellectual property or exploration;
- limited revenue; and
- perceived potential for product development.

6.77 The ITAA 1936 currently defines 'research and development activities' as:

(a) systematic, investigative and experimental activities that involve innovation or high levels of technical risk and are carried on for the purpose of:

    (i) acquiring new knowledge (whether or not that knowledge will have a specific practical application); or

    (ii) creating new or improved materials, products, devices, processes or services; or

(b) other activities that are carried on for a purpose directly related to the carrying on of activities of the kind referred to in paragraph (a).[53]

6.78 An R&D company is likely to have considerable intellectual property, patents or patents pending and assets associated with the nature of its R&D endeavours.

6.79 A speculative-type company, while not specifically defined in any Commonwealth legislation, is generally concerned with investment in a potentially profitable enterprise. The emphasis in a speculative company is its preparedness to accept a higher level of risk in its activities and investment than would be expected in an established substantial company (but for commensurably higher returns).

6.80 While the Board acknowledges that there is some degree of similarity in characteristics exhibited by the above companies, it does not consider that these characteristics readily lend themselves to the development of a set of workable eligibility criteria.

6.81 Rather, the Board holds the view that, similar to the definition of eligible R&D activities, eligibility would need to involve the weighing up of a range of characteristics. The characteristics could include the length of time the business has been in operation, capital requirements for growth/expansion, profitability, level of growth and potential future listing or management buy-out/buy-in. Such an assessment would require either an existing, or newly created, government agency to assess the eligibility of potential participants.

Refundable R&D tax offset scheme

6.82 A number of submissions received by the Board recommended that the eligibility criteria in relation to the new refundable R&D tax offset would be appropriate to restrict access to any additional ESS tax concessions.

6.83 In this respect, the Board notes that under the new R&D tax incentive which will have effect from 1 July 2010, companies that have a grouped turnover of less than $20 million will be eligible to access the 45 per cent refundable tax offset. The refundable R&D tax offset can only be accessed by entities that incur eligible expenditure in undertaking eligible R&D activities.

6.84 The Treasury Consultation Paper, '***The new research and development tax incentive***', released in September 2009, acknowledges that the new R&D tax incentive intentionally redistributes support in favour of small and medium sized business which are viewed as more responsive to fiscal incentives. The new R&D tax incentive

---

53 This definition will be revised as part of the implementation of the Government's new R&D tax incentive. However, the exposure draft legislation for the new scheme demonstrates that the definition will continue to have multiple elements. See the exposure draft of the Tax Laws Amendment (Research and Development) Bill 2010 released on 18 December 2009.

provides a targeted subsidy for companies that incur expenditure in undertaking activities with particular characteristics and the subsidy is greatest for smaller companies.

6.85 The proposed R&D tax incentive is intended to work on a self-assessment basis, however the Innovation Australia Board (a group of independent experts assisted by AusIndustry) will continue to assess whether an activity is an eligible R&D activity. In addition, the ATO will continue to determine whether an amount of expenditure is validly incurred on that activity. Accordingly, the roles played by ATO, Innovation Australia and AusIndustry will remain crucial to the integrity of the new R&D tax incentive.

6.86 It is the Board's view that the development of a concessional ESS regime, based on criteria used to access the new R&D refundable tax offset, would require significant resources from both the ATO and other statutory bodies, such as AusIndustry, to enforce the regime and ensure that only eligible parties are accessing the concessions.

6.87 Without the assistance of such statutory bodies, it is the Board's view that the integrity of the ESS tax regime could be compromised, resulting in companies accessing the concessions to which they may not be entitled and increasing the risk of tax avoidance or tax evasion. Again, the Board notes that this may particularly be the case for employees participating in the schemes who will have responsibility for ensuring they comply with the law, but some of whom may be relatively unsophisticated taxpayers.

6.88 Further, the Board notes the eligibility criteria for the refundable R&D tax offset has been developed for a different purpose and that reliance on it would not be broad enough to encompass all start-ups or speculative-type companies. For example, companies undertaking mining exploration would be unlikely to qualify as they would more than likely not be carrying on eligible R&D activities, particularly whilst still in their speculative stage.

Eligibility based on company characteristics

6.89 The Board acknowledges the views in submissions received that access to additional tax concessions offered to start-up, R&D and speculative-type companies may be restricted on the basis of key characteristics. Suggested key characteristics included: company size, number of employees, industry type, annual turnover, revenue threshold and/or market capitalisation.

6.90 The Board holds the view that these characteristics of themselves would not be sufficient to appropriately target access to any additional concessions that may be offered in respect of ESS arrangements.

6.91 In particular, the Board notes that due to the nature of these types of companies and the inherent risk associated with their activities, traditional performance indicators such as turnover, revenue threshold or market capitalisation may not operate to adequately target access to the concessions. In addition, companies that are close to the set 'threshold levels' could be faced with the situation that they may fall into, or out of, the concessions in different years depending on market conditions, creating increased uncertainty for the ESS participants and increased risk to Commonwealth revenue.

6.92 The Board notes that in relation to the concessional schemes offered by other offshore jurisdictions as outlined in paragraphs 6.7 – 6.22 above, access to these concessional regimes is generally restricted by a common set of restrictions required to be met by both the employee and the employer in relation to the issued share or right.

6.93 In particular, to access the concessions companies are generally required to satisfy the following:

- some prescribed maximum gross asset value;
- some prescribed maximum number of employees; and
- be resident in the country and be carrying on trading activities (companies carrying on certain activities are often specifically excluded from access to the concessions).

6.94 In addition, some countries prescribe a maximum time length, such that the company can only access the additional concessions in relation to shares or options issued within the first say 3 years of its incorporation.

6.95 To access the concessions employees are generally required to satisfy the following:

- have a current employment relationship with the company or in certain circumstances one of its subsidiaries;
- be committed to working some proscribed minimum number of hours per week in that employment; and
- not be in a position to exercise effective control over the company, or hold a material interest in the shares of the company.

6.96 Generally, these concessional regimes require companies to notify the appropriate revenue authority when a grant of options has been issued to an employee, or alternatively, are required to retain sufficient documentation to satisfy the revenue authority that the grant would qualify for concessional treatment. In addition, employers are generally required to give certain minimum information to the employee confirming that the qualifying conditions for access to the concession have been met.

6.97 The Board acknowledges that the above restrictions are broadly similar, though perhaps less stringent, than the current restrictions that operate to restrict access to the

ESS tax concessions that operate in Division 83A. That is, they do not operate in such a way that a subset of those currently eligible under Division 83A could be isolated for more concessional treatment.

6.98 Accordingly, although the Board feels there is some merit to the argument that the existing restrictions to access the ESS tax concessions could be relaxed in the case of start-up, R&D and speculative-type companies, it holds concerns as to the ability of the legislature to appropriately ring-fence access to any additional tax concessions due to the disparate nature of these companies.

6.99 In the absence of a set of strictly defined eligibility requirements, the Board holds concerns that offering additional ESS tax concessions to these types of companies, including relaxing the existing eligibility restrictions, would compromise the integrity of the ESS taxation regime, potentially creating situations of inequity and increasing the risk of taxation avoidance. The Board notes that these outcomes contradict the policy intent behind the Government's 2009 Budget announcements, which focused on improving horizontal equity in the tax system and reducing the scope for tax evasion and avoidance.

6.100 In light of the significant concerns surrounding inappropriate access to any additional ESS tax concessions, the Board does not recommend the establishment of a separate taxation deferral arrangements for start-up, R&D and speculative-type companies. Rather, it is the Board's view that there are more targeted approaches available to Government, outside of the ESS tax regime, to offer additional support to these types of companies.

6.101 Currently, a broad range of Government grants and concessions exist which aim to provide additional support to these types of companies (see Appendix B to this Report for further detail). Should the Government wish to provide further additional support to the start-up, R&D and speculative-type industries, such support could be more effectively delivered by offering additional grants and concessions to these 'cash strapped' companies, rather than through offering additional ESS tax concessions to their employees.

Recommendation 5: Separate tax deferral regime for start-up, R&D and speculative-type companies

The Board does not recommend the introduction of separate tax deferral arrangements for start-up, R&D and speculative-type companies.

The Board recommends that should the Government wish to provide additional support to start-up, R&D and speculative-type companies, the Government consider more targeted approaches to providing this support outside of the ESS tax regime.

'Off the shelf' ESS arrangements

6.102 The Board notes the view expressed in additional consultations that even apart from tax issues, one of the barriers to these types of companies offering ESS arrangements was the complexity and high professional costs associated with their introduction.

6.103 In this respect, it was suggested that an 'off the shelf' ESS arrangement may be of particular benefit to these cash strapped companies, due to the increased certainty provided to both employers and employees, and the reduced costs incurred by employers in implementing such as scheme.

6.104 While the Board acknowledges the potential merits of such an approach, it does not consider it to be the role of Government to provide such ready-made schemes.

APPENDIX A: AUSTRALIAN GOVERNMENT ACTUARY REPORT ON THE VALUATION TABLES OF UNLISTED RIGHTS

Australian Government

Australian Government Actuary

VALUATION OF UNLISTED RIGHTS FOR TAXATION PURPOSES - EMPLOYEE SHARE ACQUISITION ARRANGEMENTS

INTRODUCTION

Australian Government Actuary (AGA) has been asked by the Board of Taxation to provide some background on the statutory valuation factors contained in Division 13A of the ITAA 1936 which are used, for taxation purposes, to value certain options provided to employees as part of their overall remuneration package.

The Board is considering whether the factors remain relevant today, given that they were developed about 15 years ago.

The statutory valuation factors are based on the Black Scholes method for valuing options. The Board has asked AGA to:

- outline briefly the Black Scholes method;
- comment, if possible, on why the Black Scholes method was preferred to other methods such as Monte Carlo simulation and Binomial;
- comment on the parameters that underpin the statutory valuation factors, including on whether those parameters remain valid today; and
- comment briefly on the results of the tax valuation method in practice.

This note is intended only to provide some very brief background to, and commentary on, the issue. It does not, for example, make any recommendations.

Finally, the Board has asked us to prepare an alternative set of statutory valuation factors. This is dealt with in the Appendix to this report.

CALL OPTIONS

A call option gives the employee the right to purchase a share on or before a specified date in the future at a specified price (exercise or strike price).

Volatility

Share prices exhibit volatility. Volatility in the price of a share means that call options can have real economic value, even if they are currently ‘out-of-the-money’.

For example, at the time these numbers were prepared, BHP was trading at $36.62[54]. Options were available to buy BHP (expiry date 17 December 2009) at $37.00. If there was no movement in share prices, then this option would have been worthless. However, since share prices can move in unpredictable ways (that is, they exhibit volatility), the right to buy BHP at $37.00 before 17 December 2009 was worth something, even though BHP was then trading at $36.62. This is because there was a chance that BHP would have been trading above $37.00 by 17 December 2009. In fact, this option was trading for $1.63 on 29 October 2009.

That is, the market had valued the right to buy BHP on or before 17 December 2009 for $37.00 at $1.63, even though BHP was trading at only $36.62.

As a general rule, the higher the volatility in a share’s price, the higher the value of an option to buy that share, all else being equal.

To value or price an option reliably, it is necessary to know what the future volatility of the price of the underlying share will be. However, this is unknowable. At best, estimates of future volatility can be obtained using a variety of means, such as examining historical volatility.

For options that are traded, it is reasonably possible to derive the option’s ‘implied volatility’. This is the volatility that is implied by the option price on the assumption that the Black Scholes (see below) method for pricing options holds.

54 As at 29 October 2009

BLACK SCHOLES METHOD - BACKGROUND

The statutory valuation tables contained in Division 13A of the ITAA 1936 were derived using the Black Scholes method for valuing options. The Black Scholes method is a well known method for valuing options.

The Board has asked us why the Black Scholes method was preferred to other methods, including the Binomial method and Monte Carlo simulation. We have not found any discussion in the working papers on these other methods. According to our reading, at one stage, a very simple Net Present Value method was considered but this was disregarded because its performance was considered too poor.

We are not experts in option pricing. However, the following comments might help explain the (implicit) preference for Black Scholes over Binomial or Monte Carlo.

Under the Binomial model, the future path of a share's price is broken down into intervals. At each interval, the share price is assumed to either go up or down at a particular rate. Also, the probabilities of going up and down are prescribed. A tree of possible ultimate prices and therefore ultimate call values (at the time of exercise of the option) can be determined. Then, working backwards one time interval at a time, it is possible to derive the theoretical value of a call option on the share at each intermediate step, taking account of the probabilities of the share going up or down and of the risk free rate of interest. Finally, the call price at the beginning can be determined as the sum of the discounted, probability-weighted, intermediate call prices.

The Black Scholes method represents the limit of a version of the binomial method, as the number of time intervals approaches infinity. In particular, if the binomial method assumes that returns are normally distributed and that the probabilities of going up or down at each step are consistent with the return process assumed by the Black Scholes method, then the binomial result will converge to the Black Scholes result. A possible advantage of Binomial is that it is not, in theory, restricted to the (Black Scholes) assumption that returns are normally distributed.

Somewhat similarly, Monte Carlo can be used to simulate share prices (and therefore call values) at expiry. The estimated price of the call is the discounted present value of the average call value at expiry. If the Monte Carlo simulation is based on the same share price model as the Black Scholes method (returns are normally distributed), then the result of a Monte Carlo simulation is an approximation to the Black Scholes result.

In summary, Black Scholes may have been (implicitly) preferred because:

- it is relatively easy to codify relative to Binomial or Monte Carlo;
- it is reasonably widely used; and

- under certain assumptions, the three methods converge anyway.

The Black Scholes method works very approximately as set out below. This is highly simplified and should not be taken as a reliable description of the model. It is intended merely to give a very broad overview of the model.

- A probability distribution of the share price at the time of exercise is determined based on certain assumptions – that returns are distributed normally and that the expected (simply compounded) return is the risk free rate. That is, an underlying assumption is that investors do not demand a risk premium on risky assets.
- From this a probability distribution of the value of the option at the time of exercise can be obtained
- From this an expected value of the option at the time of exercise can be determined
- The expected value of the option at the time of exercise is then discounted to obtain a current value of the option

The Black Scholes method is limited in a number of ways. In particular, it relies on a number of assumptions which are unlikely to be borne out in practice. For example, the Black Scholes method assumes that volatility in a share's price will be constant from time to time and can be reliably estimated. Historically, however, volatility has varied from share to share and from time to time. Implied volatility in an option price typically might vary from exercise price to exercise price (for options in the same share with the same expiry date).

Despite its shortcomings, however, the Black Scholes method is not necessarily unsuitable for certain purposes. For example, it should not be concluded that the Black Scholes method is unsuitable as a valuation model for tax purposes, simply because of its theoretical limitations.

However, it is appropriate to have an appreciation of any limitations of the model, in order to (subjectively, at least) adjust for these in light of the particular context in which the model is being used.

The basic Black Scholes model assumes that no dividends are payable. However, the statutory valuation factors were derived using an adjusted Black Scholes model, with some allowance for future dividends. This adjustment was needed to ensure that the valuation factors were not penal, to reflect the fact that it is quite common for listed Australian equities to pay dividends.

For reference, the formula used to derive the statutory valuation factors is set out below.

$$C(S,T) = e^{-rT}\left(FN(d_1) - KN(d_2)\right)$$

where:

$$F = Se^{(r-q)T}$$

$$d_1 = \frac{\ln(F/K) + \left(s^2/2\right)T}{s\sqrt{T}}$$

$$d_2 = d_1 - s\sqrt{T}$$

C(S, T) is the price of a European call option

S is the spot price of the underlying stock

K is the strike price of the underlying stock

N(•) is the cumulative distribution function of the standard normal distribution

T is the time to maturity

r is the risk free rate (annual rate, expressed in terms of continuous compounding)

q is the dividend yield (annual rate, expressed in terms of continuous compounding)

σ is the volatility of the underlying stock

PARAMETERS REQUIRED IN THE BLACK SCHOLES METHOD

The Black Scholes method, as adjusted for dividends, requires a number of inputs. The table below sets out the required inputs, together with brief commentary on the 'current validity' of the actual inputs that were adopted.

Required Input	Status	Comment
Relationship between exercise price and current share price	Known	Since this input is known in any individual case, it is valid.
Time to expiry	Known	Since this input is known in any individual case, it is valid.
Risk free interest rate	Broadly observable but changes over time	The rate underlying the statutory valuation factors is 7.6% (7.33% continuously compounded). At the time the factors were developed, 7.6% was the yield on 3 year Commonwealth bonds. This might be considered too high in the current environment. This assumption has most impact on the valuation of options which have a long time to expiry. The higher the interest rate, the higher the assessed value of the option.
Dividend yield	Varies from share to share and over time	The rate underlying the statutory valuation factors is 4% (3.92% paid continuously). This might continue to be considered broadly reasonable in the current environment. This assumption has most impact on the valuation of options which have a long time to expiry. The higher the dividend yield assumed, the lower the assessed value of the option.
Volatility	Unobservable. Historically, volatility has varied from share to share and from time to time. Implied volatility has varied from exercise price to exercise price (for options in the same share with the same expiry date).	The rate underlying the statutory valuation factors is 10%. In general, the implied volatility on exchange traded Australian options appears higher than this.

THE STATUTORY VALUATION FACTORS IN PRACTICE

The Board has asked us to compare the valuation result that is derived using the statutory valuation factors with the actual market price of a number of options.

The table below sets out the results for a number of BHP call options all maturing in September 2010.

Australian Government Actuary

Share (actual price[55])	Expiry	Exercise	'Market' price	Tax Valuation
BHP ($36.71)	23/9/2010	$37.00	$4.80	$1.22
BHP ($36.71)	23/9/2010	$34.00	$6.41	$3.50
BHP ($36.71)	23/9/2010	$52.00	$0.93	$0.00

The concessionality of the factors is evident. For example, the at-the-money option is trading for $4.80, compared to an assessed valuation for tax purposes of $1.22. Increasing the assumed volatility will have an impact on the assessed value, particularly of short term options. For example, increasing volatility from 10% to, say, 25% would lead to an assessed value on that option of around $3, compared to a market value of $4.80.

The table below sets out the results for a longer dated BHP call option, maturing in September 2014.

Share (actual price)[55]	Expiry	Exercise	'Market' price	Tax Valuation
BHP ($36.71)	25/9/2014	$45.00	$10.10	$1.40

Again, the valuation factors underestimate the market value of the option (although note that trading volumes are limited leading to uncertainty around market value). This is despite the relatively high underlying risk free interest rate assumption. The tax valuation implies a required rate of growth on BHP shares of 5% per annum to break even. In other words, for an investor who believes that BHP will grow at more than 5% pa, the tax value of the option represents good value. On the other hand, the estimated market value implies a required rate of growth of 10% pa to break even.

If the objective is to approximate market value, then there might be some room to strengthen the basis used in the valuation factors. However, care would be needed for a number of reasons. For example, it can be the case that employee options are subject to some restrictions – for example, exercisability might be conditional on employment status or performance. In other words the value of the option to the employee might be less than a comparable 'market value', which in turn would suggest that some concessionality in the parameters is not necessarily inappropriate. Furthermore, market values in the current climate might not be a good yardstick, given recent high levels of volatility.

55 As at 2 November 2009

Peter Martin

Australian Government Actuary
11 February 2009

Appendix

The Board has asked us to prepare an alternative set of valuation factors along the following lines:

- Retain the existing Black Scholes methodology and general table structure
- Reduce the assumed rate of interest from 7.6% pa to 5% pa (4.88% pa continuously compounded)
- Retain the assumed dividend yield of 4% pa (3.92% pa continuously compounded)
- Increase the assumed volatility from 10% to 20%

The factors derived on this basis are set out below. Note that the column headings for Table 2 have the same meanings as in the equivalent table currently incorporated in the draft Income Tax Assessment Amendment Regulations 2009 which you provided.

Table 1:

Calculation percentage

Exercise period (months)	50% to 60%	60% to 70%	70% to 75%	75% to 80%	80% to 85%	85% to 90%	90% to 92.5%	92.5% to 95%
72 to 84	1.2%	2.7%	5.1%	6.7%	8.4%	10.3%	12.4%	13.5%
60 to 72	0.8%	2.1%	4.3%	5.7%	7.4%	9.3%	11.4%	12.5%
48 to 60	0.5%	1.5%	3.4%	4.7%	6.2%	8.1%	10.1%	11.2%
36 to 48	0.2%	0.9%	2.3%	3.4%	4.8%	6.5%	8.5%	9.6%
24 to 36	0.1%	0.3%	1.2%	2.0%	3.2%	4.6%	6.5%	7.5%
18 to 24	0.0%	0.1%	0.7%	1.3%	2.2%	3.5%	5.2%	6.2%
12 to 18	0.0%	0.0%	0.3%	0.6%	1.2%	2.2%	3.7%	4.6%
9 to 12	0.0%	0.0%	0.1%	0.3%	0.8%	1.6%	2.8%	3.7%
6 to 9	0.0%	0.0%	0.0%	0.1%	0.3%	0.8%	1.8%	2.6%
3 to 6	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.7%	1.2%
0 to 3	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%

Table 1 (continued):

Calculation percentage

Exercise period (months)	95% to 97.5%	97.5% to 100%	100% to 102.5%	102.5% to 105%	105% to 107.5%	107.5% to 110%
72 to 84	14.7%	15.9%	17.2%	18.5%	19.8%	21.1%
60 to 72	13.7%	14.9%	16.2%	17.5%	18.9%	20.3%
48 to 60	12.4%	13.7%	15.0%	16.3%	17.7%	19.1%
36 to 48	10.8%	12.0%	13.4%	14.7%	16.1%	17.6%
24 to 36	8.7%	9.9%	11.2%	12.6%	14.0%	15.6%
18 to 24	7.3%	8.5%	9.8%	11.2%	12.7%	14.3%
12 to 18	5.6%	6.8%	8.1%	9.5%	11.0%	12.6%
9 to 12	4.6%	5.8%	7.0%	8.4%	10.0%	11.6%
6 to 9	3.4%	4.5%	5.8%	7.2%	8.7%	10.5%
3 to 6	1.9%	2.9%	4.1%	5.5%	7.2%	9.0%
0 to 3	0.6%	1.3%	2.3%	3.8%	5.7%	7.8%

Table 2:

Exercise period (months)	Column 1	Column 2
72 to 84	21.1%	0.7%
60 to 72	20.3%	0.7%
48 to 60	19.1%	0.7%
36 to 48	17.6%	0.8%
24 to 36	15.6%	0.8%
18 to 24	14.3%	0.8%
12 to 18	12.6%	0.9%
9 to 12	11.6%	0.9%
6 to 9	10.5%	0.9%
3 to 6	9.0%	0.9%
0 to 3	7.8%	1.0%

Appendix B: Existing concessions offered to start-up, R&D and speculative-type companies

Governments in Australia run some 155 programs to support business innovation — 45 administered by the Commonwealth and 110 by the states and territories.[56] The Commonwealth's support for business innovation is expected to exceed $2 billion in 2009-10.[57] The existing R&D Tax Concession – soon to be replaced with the new R&D tax incentive – is the largest component of this support.

As noted above, the Government's new R&D tax incentive will provide more generous and timely support to smaller innovative firms, regardless of whether they are in tax profit or loss, through the 45 per cent refundable tax offset for companies with a grouped turnover of less than $20 million per year. Larger companies will also benefit from the 40 per cent non-refundable tax offset available under the new incentive.

Assistance is available through Commercialisation Australia to assist researchers, entrepreneurs and innovative firms to turn ideas into successful commercial ventures. Funding is available to help commercialise an idea, engage experienced executives, test the commercial viability of a new product, process or service, and undertake activities that enable a new product, process or service to be taken to market.

In addition, the Government announced in March 2009 the establishment of an Innovation Investment Follow-on Fund to address the lack of capital available to the most promising innovative companies during the Global Financial Crisis. The fund will distribute $64 million to assist 35 early stage companies to develop and commercialise innovative technologies.

An accompanying media release[58] to the above announcement acknowledged that:

> The companies that benefit from this fund employ more than 450 people in high-skill, high wage jobs.

---

56 Department of Innovation, Industry, Science and Research "Powering Ideas: An Innovation Agenda for the 21st Century" 2009, pg29. [Note this figure may have changed since this was published in May 2009 – DIISR will be publishing an updated figure during the year, but not sure when.]

57 Department of Innovation, Industry, Science and Research, 2009-10 Science and Innovation Tables, Table 1 (total support for the 'Business Enterprise Sector').

58 Media Release, Senator the Hon Kim Carr "$64M for fund managers to help start-ups grow" 18 December 2009

The Innovation Investment Follow-on Fund builds on the Innovation Investment Fund as well as the Early Stage Venture Capital Limited Partnership and Venture Capital Limited Partnership Schemes, the Pre-Seed Fund, and the Pooled Development Fund. These programs support the venture capital sector to provide financing for research and development and innovative start-up companies.

The Government has also taken steps to support small innovative companies through programs such as Enterprise Connect or support priority areas of research such as climate change through initiatives such as Clean Business Australia and the Renewable Energy Equity Fund. Further Government programs are targeted at supporting innovation in specific industry groups including the textile, clothing and footwear industry and the automotive industry.

APPENDIX C: LIST OF SUBMISSIONS

The Board received 21 submissions on the review into elements of the taxation of employee share scheme arrangements from the following parties:

Association of Mining and Exploration Companies Inc

Australian Institute of Company Directors

Australian Petroleum Production & Exploration Association

AVCAL: The Australian Private Equity & Venture Capital Association Ltd

Baker & McKenzie

Cox, K.

CRA Plan Managers Pty Ltd

Eggleston, T.

Ernst & Young

Innovation Capital Associates Pty Ltd

Institute of Chartered Accountants in Australia

JLR Partners Group

Kalinko, W.

Kirkwood, J.

Link Market Services Limited

Nissen Kestel Harford

Origin Energy Limited

Remuneration Strategies Group Pty Ltd

Starfish Ventures Pty Ltd

Taxation Institute of Australia

Woolworths Limited