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By E-mail

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To whom it may concern

Arnold Bloch Leibler submission on exposure draft legislation to reform regulatory and tax arrangements for employee share schemes

1 Thank you for the opportunity to provide suggestions and further recommendations on the:

(a) *Treasury Laws Amendment (Measures for a later sitting) Bill 2021: Employee Share Schemes* (**Regulatory Draft**); and

(b) *Treasury Laws Amendment (Measures for a later sitting) Bill 2021: Employee Share Schemes—Removing cessation of employment as a taxing point* (**Tax Draft**) (together referred to as the **Exposure Draft Legislation**).

2 Arnold Bloch Leibler acts for a range of ASX listed companies, share registries, employee share trust providers, private companies and start-up businesses on all aspects of the design, implementation and administration of employee share schemes (**ESS**).

3 We support the Exposure Draft Legislation and the Government's objectives to reduce red tape and support Australian businesses to attract and retain talent. In this submission, we have focused our feedback on recommendations regarding how the Exposure Draft Legislation, and the ESS framework more broadly, can be further refined.

4 We set out our recommended amendments to the Exposure Draft Legislation in the table at **Annexure A**.

5 On 23 August 2021, the House of Representatives Standing Committee on Tax and Revenue (**Committee**) released its report on employee share schemes, entitled *Owning a Share of Your Work: Tax Treatment of Employee Share Schemes* (**Report**). In the foreword, Committee Chair Mr Jason Falinski MP states that:

> [t]he changes announced by the Government in the budget are a significant step forward, removing some of the most egregious barriers to the use of ESS. The following chapters highlight some of the steps that could be taken to make Australia a global leader in this area.

6 We are currently in a state of economic emergency. The opportunity to improve the employee share scheme legislation should immediately be embraced and to the fullest. There is no reason to delay.

7 In in the table at **Annexure B**, we set out our recommendations for further reform, with many of our ideas also canvassed in the Report.

8 We would be pleased to provide more detail around our recommendations and to assist in any way to further improve the Exposure Draft Legislation.

Please contact us on (03) 9229 9685 if you would like to discuss the contents of this submission.

Yours faithfully

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<u>Annexure A: Proposed amendments to the Exposure Draft Legislation recommended by Arnold Bloch Leibler</u>

#	Section	Summary	ABL Recommendation/Reasons
1.	Commencement information & s 9, Tax Draft	The commencement date of the Tax Draft is the first 1 January, 1 April, 1 July or 1 October to occur the day after it receives Royal Assent. The measures set out in the Tax Draft will not take effect until the first 1 July after the commencement date.	The flaws with taxing employees on cessation of employment are widely acknowledged – including that the cessation of a person's employment does not necessarily coincide with a liquidity event that would enable them to realise value from their ESS interests and fund the tax liability. This concern was also echoed by the Committee in Recommendation 9 in the Report. The changes proposed in the Tax Draft are scheduled to apply to ESS interests issued on or after 1 July 2022 (at the earliest). As it stands, for grants made between now and 30 June 2022, the cessation of employment will remain a taxing point – even if the employee ceases employment after 1 July 2022. This is inconsistent with the policy underpinning the removal of the cessation of employment taxing point, which is noted in the Explanatory Materials to the Tax Draft (**Tax EM**) at [1.11] as being to 'support Australian businesses to attract and retain talent'. We recommend that cessation of employment be removed as a taxing point for <u>all</u> ESS interests where the cessation of employment occurs on or after the commencement date of the Tax Draft (**Taxing Point Recommendation**). This will ensure consistent tax treatment of ESS interests on cessation of employment from the commencement date. It will also help facilitate major M&A transactions that occur after 1 July 2022 (where it would no longer be necessary to discriminate between those employees whose 'relevant employment' has ceased). We also note that if cessation of employment is only removed as a taxing point for ESS interests acquired after 1 July 2022, then employers and employees will be required to distinguish between ESS interests issued pre- and post- 1 July 2022 and apply the corresponding tax rules. Conversely, the Taxing Point Recommendation provides for

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			consistent tax outcomes that will simplify the application of the tax framework for both employees and employers. Moreover, from a revenue collection perspective, we do not see any material drawback to the Taxing Point Recommendation. Employees who cease employment will often have their ESS interests terminated on or before cessation of employment. This may occur through a forfeiture of unvested ESS interests or by an acceleration of the vesting date for the ESS interests. It is only in a small proportion of cases that employees may continue to hold ESS interests with ongoing vesting conditions. The removal of the cessation of employment taxing point will benefit these employees by allowing them to realise their ESS interests and fund their tax liability.
2.	s 9, *Corporations Act 2001* (Cth) (**Corporations Act**),[1] definition of 'ESS loan'	An ESS loan must be offered on the following terms: (a) that the loan has no interest or fees payable; (b) that the rights of the issuer, in the event of default in payment of the loan, are wholly limited to forfeiture of the ESS interests acquired using the loan.	If an ESS loan is interest free, and does not attract fees: • This raises potential issues under the *Fringe Benefits Tax Assessment Act 1986* (Cth) for the employer (and puts pressure on the 'otherwise deductible' rule). • It also raises potential issues under the deemed dividend rules in Division 7A (**Div 7A**) of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) for those ESS participants who may already be shareholders in the company. We recommend specifically exempting ESS loans from fringe benefits tax (**FBT**) and Div 7A. The Committee also notes the need for

[1] Section references to the Corporations Act in **Annexure A** refer to sections of the *Corporations Act 2001* (Cth) as proposed to be amended or inserted by the Regulatory Draft.

#	Section	Summary	ABL Recommendation/Reasons
			clarification that FBT is not in fact payable for discharged ESS loans in Recommendation 15 of the Report.
3.	ss 1100J(1) & 1100N	An offer is an ESS offer if: (a) it is an offer for the issue of ESS interests, of a body corporate or listed registered scheme, to ESS participants of the body corporate or scheme, in connection with an employee share scheme; and … (c) in a case where the offer is made by a body corporate that is not listed and either or both of the following apply: (i) some or all of the ESS interests are offered for issue in return for monetary consideration; (ii) **some or all of the ESS participants are independent contractors**; the offer complies with the offer value cap (see 4 subsection (4). In addition, the disclosure requirements in Subdivision C of new Division 1A of the Corporations Act (refer section 1100N) will also generally apply where either or both: (a) the ESS interests to be offered include ESS interests offered for issue in return for monetary consideration;	The Regulatory EM notes at [1.25] that: [e]mployee share schemes which apply to independent contractors are subject to stricter requirements under the Bill because independent contractors do not receive the same workplace protections as employees under the *Fair Work Act 2009*. In our experience, independent contractors are not a particularly vulnerable class of workers in an ESS context. There are significant administrative costs involved in establishing and operating ESS. Companies typically do not offer ESS participation to casual employees or contractors whose role with the company is likely to be temporary. A common exception to this occurs at a board level, where the Board might engage the services of a consultant or contractor with particular industry expertise. In these circumstances, it is common to offer equity participation to these individuals (or their entities). However, these specialised contractors negotiate from a position of strength and are not a vulnerable class of persons in need of additional protections. Accordingly, our view is that the bifurcation between the treatment of ESS offers made to employees and directors on the one hand, and ESS offers made to independent contractors on the other, is unjustified and adds a complicated overlay to the whole ESS regulatory framework. We recommend that ss 1100J(1)(c)(ii) and 1100N(1)(b) be removed from the Regulatory Draft and that the required consequential amendments also be made.

#	Section	Summary	ABL Recommendation/Reasons
		(b) **the ESS interests will be offered to one or more ESS participants of the body corporate or listed registered scheme who are independent contractors**.	
4.	s 1100E(2)(c), Corporations Act	The definition of 'ESS participant' includes an independent contractor who provides services *predominantly* to the body corporate or to the responsible entity of the listed registered scheme or to an associate of the body corporate or responsible entity.	As noted above in ABL Recommendation #3, our preference is to remove the bifurcation between the treatment of ESS offers made to employees and directors and ESS offers made to independent contractors. However, if that is not accepted, we raise a potential area for uncertainty in the application of the rules regarding participation by independent contractors. Neither the Regulatory Draft nor the accompanying Explanatory Materials (**Regulatory EM**) provide guidance on when an independent contractor is providing services 'predominantly' to the issuer of ESS interests. To provide ESS participants and issuers of ESS interests with greater clarity, we recommend that the Regulatory Draft be updated to include a simple test (measurable by an objective standard) which sets out when an independent contractor will be providing their services 'predominantly' to the relevant entity.
5.	s 1100E(3), Corporations Act	An ESS interest may also be issued to any of the following persons on behalf of the ESS participant: (a) an immediate family member of the ESS participant; (b) another body corporate where each member of the other body corporate is either:	The Regulatory Draft – and particularly s 1100E(3) – does not facilitate the issuance of ESS interests to a family discretionary trust (which in our experience is the most common and desirable vehicle to hold an ESS interest). While s 1100E(3)(b) provides for various companies associated with the ESS participant to receive ESS interests on their behalf, our view is that this option is unlikely to be attractive to ESS participants. This is

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		(i) the ESS participant; or (ii) an immediate family member of the ESS participant; (c) a body corporate that is the trustee of a self-managed superannuation fund where the ESS participant is a director of the body corporate.	because where ESS interests are held in a company and disposed of after the taxing point in Division 83A of the ITAA 1997 (**Div 83A**), the capital gains tax discount will not apply. Accordingly, we recommend that s 1100E(3) be amended to include the trustee of an ESS participant's family discretionary trust as one of the persons who may be issued ESS interests on the participant's behalf. We also note that s 1100E(3)(c) provides for the issuance of ESS interests to a body corporate that is the trustee of a self-managed superannuation fund (**SMSF**) where the ESS participant is a director of the body corporate. On 28 July 2021, the Commissioner of Taxation (**Commissioner**) published Law Companion Ruling LCR 2021/2, titled *Non-arm's length income – expenditure incurred under a non-arm's length arrangement* (**LCR 2021/2**). The Commissioner notes in LCR 2021/2 at [27]: [w]here a complying superannuation fund purchases an asset at less than market value under a scheme where the parties were not dealing at arm's length, the fund incurs non-arm's length expenditure for the purposes of applying the non-arm's length expense provisions. In applying those provisions, it does not matter whether the amount of the loss, outgoing or expenditure is revenue or capital in nature. The Commissioner further notes in his proposed draft amendments to Taxation Ruling TR 2010/1 *Income tax: superannuation contributions* at [25C]: [i]n circumstances where a superannuation provider purchases an asset under a contract at less than market value, the superannuation provider has incurred non-arm's length expenditure under a non-arm's length dealing for the purposes of

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			applying the 'non-arm's length income' provisions in section 295-550. We do not consider that the difference between the consideration paid (if any) and the market value represents an *in specie* contribution being made as the asset has been acquired under the terms of the contractual agreement and not through an *in specie* contribution. The above scenarios postulated by the Commissioner appear to capture the acquisition of ESS interests at a discount by an SMSF. Where the acquisition of an ESS interest falls within the scope of non-arm's length expenditure (as set out in s 295-550 of the ITAA 1997) the income subsequently derived from that ESS interest – and any future gain made on its disposal – will be taxed at the top marginal rate of 45 per cent. This is a significant risk, and one which could be exacerbated by the Regulatory Draft, which could be interpreted as 'green lighting' the acquisition of ESS interests by SMSFs. With the law as it currently stands, we suggest removing SMSFs from the list of eligible acquirers and replacing it with a trustee of a discretionary trust. Alternatively, the non-arm's length income rules should be amended to carve out the acquisition of ESS interests at a discount under Div 83A.
6.	ss 1100E(5)&(6), Corporations Act	ESS interests may be issued by a trust. However, the trust deed must contain terms to the effect that: (a) the activities of the trustee of the trust are limited to managing the employee share scheme of the	The requirements for a trust issuing ESS interests under the Regulatory Draft appear broadly analogous with the requirements of an 'employee share trust' in s 138-85(4) of the ITAA 1997. However, these requirements are *not identical*. We recommend that consideration be given to aligning the requirements of a trust deed as set out in s 1100E(6) with the definition of 'employee share trust' in the ITAA 1997. This would prevent unnecessary complexities arising from the lack of harmonisation between the tax and

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		body corporate or listed registered scheme referred to in subsection; (b) the trustee of the trust will keep written records on the administration of the trust; (c) the trustee of the trust will not charge any fees or charges for administering the trust, other than reasonable disbursements; (d) if the trustee of the trust is an associated entity of the body corporate or the responsible entity of the issuer—that the trustee may only exercise voting rights associated with the ESS interests in accordance with the instructions of the ESS participants or consistent with the trustee's fiduciary duties; (e) the trustee of the trust, either alone or together with any other trustee of a trust, will not hold more than: (i) for a listed body corporate or a listed registered scheme—5 per cent of the fully paid ordinary shares of the body corporate or interests in the listed registered scheme; or (ii) for a body corporate that is not listed 20 per cent of the fully paid ordinary shares of the body corporate.	regulatory regimes and prevents these complexities from hindering the issuance of ESS interests to participants.

Annexure B: Further recommendations from Arnold Bloch Leibler

	ABL recommendation	Reason for recommendation
1.	Explicitly address whether the existing ASIC class order relief will remain in its current form.	The Regulatory EM notes at [1.13] that the reforms in the Regulatory Draft: build on the: • Government's previous announcement on 13 November 2018 that it would streamline the exclusions under the Act and ASIC class orders to make it easier for businesses to offer employee share schemes; and • Consultation paper released on 3 April 2019 outlining possible approaches. However, it also notes at [1.70] that even after the Regulatory Draft is enacted: [a]n employee share scheme can rely on other existing exemptions in the Act when making an offer of ESS interests under an employee share scheme, for instance, in making offers only to senior managers (see section 708 of the Act). It is therefore unclear whether the class orders will continue to exist in their current form.[2] As the Regulatory Draft is based on the existing ASIC class orders for ESS and provides similar forms of relief to those class orders, it will potentially render the class orders obsolete.
2.	Amend s 83A-33 of the ITAA 1997 to broaden the scope of the eligibility criteria for access to ESS start up concessions, including: • increasing the maximum turnover threshold or removing this threshold requirement;	When the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Act 2015* (Cth) was introduced, the ESS start up tax concessions it included were welcomed by many. However, in our experience the use of the concession has been limited by the restrictive conditions that a company must meet to qualify for the 'start up' concessions. These include that the company, broadly: • must be an Australian resident; • must not be listed on any stock exchange; • must not have been incorporated for more than ten years;

[2] ASIC Class Order [CO 14/1000] *Employee incentive schemes: Listed bodies* and ASIC Class Order [CO 14/1001] *Employee incentive schemes: Unlisted bodies*.

	ABL recommendation	Reason for recommendation
	• removing the 10 per cent ownership or control threshold; • increasing or removing the ten-year limitation on the company's length of incorporation; and • removing the restrictions on listed companies that otherwise meet the criteria from accessing the start-up concessions.	• must not have annual turnover exceeding $50 million; In addition: • if the company provides shares at a discount, the discount must not be more than 15 per cent of their market value on the date of acquisition; • if the company grants share options, the exercise price of the options must not be less than the market value of a share in the company on the day that the option was granted; • employees cannot hold more than 10 per cent ownership or voting rights in the issuing company; and • the participants must hold their interests for at least three years. We recommend that the requirements be relaxed to enable greater participation by companies that ought to qualify, but for an innocuous technical reason do not. Our view that the current definition of 'start-up' is too narrow and that the restrictions are too onerous broadly appear to be shared by the Committee. At Recommendation 6 of the Report, the Committee submits that the definition of 'start-up' for the purposes of the concessions should be broadened. Moreover, at Recommendation 11, the Committee proposes that the requirement for a maximum 15 per cent discount be 'scrapped.'
3.	Align the tax deferral conditions for share issues and rights issues, by: • removing the real risk of forfeiture condition on share issues; and • removing the 75% Requirement.	There is currently a misalignment between the tax treatment of an offer of shares under ESS and an offer of rights. There is no policy reason why this should be so. While the ITAA 1997 allows tax to be deferred on both shares and rights, there are different conditions imposed on deferral, and no apparent rationale for these differences. For example, to access the deferred taxing point, an offer of shares must be open to 75 per cent of permanent employees with at least three years' service on the same terms and conditions (**75% Requirement**). However, an employer may be selective in who they make offers of rights to and may make rights offers to a more limited set of participants. In our view, the need to identify permanent employees who have been employed by the business for three years or more adds unnecessary cost and complexity.

	ABL recommendation	Reason for recommendation
		Another gateway criteria for a share offer in connection with ESS to be eligible for tax deferral is that there must be a real risk of forfeiture. This does not apply to rights offers. Receiving shares – as opposed to rights – is beneficial for ESS participants. As a shareholder, the ESS participant will receive dividends and will have voting rights. Share offers should be encouraged from a policy perspective, and the conditions for tax deferral with respect to share offers should be aligned with those of rights offers so that it is as attractive for companies to issue shares as it is for them to issue rights. The current tax settings do not achieve this objective. We note that this ABL recommendation aligns with Recommendation 17 in the Report.
4.	Adopt a safe-harbour methodology for ESS buybacks for determining the dividend/capital split.	Share buy-backs are a necessary part of the management and administration of ESS. Participants in ESS run by private companies generally cannot realise value unless the issuing company offers a way for them to dispose of their interests. In addition, many private companies do not wish for participants to continue holding their equity interests after they cease engagement with the company. It is therefore important that private companies have in place a mechanism for former participants to sell or otherwise dispose of their shares on cessation of their engagement with the company. The current share buyback provisions for unlisted companies may engage the anti-avoidance rules in relation to capital streaming if the total amount is debited to share capital. Alternatively, s 159GZZZP of the ITAA 1936 provides that the part of the purchase price which exceeds the part debited against the share capital account is treated as a dividend paid to the shareholder. As a result, the disposal of shares to the company under a share buyback may lead to a significantly different tax outcome for a participant than if the shares were disposed of to an employee share trust or an existing shareholder. In addition, the existing framework that applies to share buybacks for unlisted companies are exceedingly complex, and the process to determine the dividend/capital split when a buyback occurs involves unnecessary ambiguity, cost and uncertainty. Accordingly, we have recommended that a 'safe harbour' methodology for the purposes of determining the dividend/capital split be introduced. This approach has been endorsed by the Committee in Recommendation 14 in the Report.

	ABL recommendation	Reason for recommendation
		This will provide private companies with the ability to undertake share buybacks without the need to have a complex trust arrangement or matching purchases when employees leave the company, and removes the cost and complexity of existing buyback arrangements as: • the retiring employees are being taxed under the ESS provisions; and • the ambiguity regarding the sourcing of the buyback amount no longer exists.
5.	Increase and index the $1,000 threshold for the tax exemption concession.	Currently, and subject to certain conditions being met, employees with taxable income of less than $180,000 per annum may receive free shares of up to $1,000 per annum from their employer, tax free. However, this limit was set in 1997 and has not been increased or indexed since. Accordingly, the real value of this concession has declined significantly. We submit that the operation and compliance costs of implementing a plan under which the employer distributes $1,000 worth of tax-free shares to its employees is now likely to outweigh the benefits received, and that this concession no longer promotes broad-based employee share ownership, other than amongst Australia's largest listed companies which have the resources to administer these plans. We note that Recommendation 8 in the Report is that '[t]he Committee recommends increasing the $1,000 limit in section 83A.35(2)(a) of the *Income Tax Assessment Act 1997* to $50,000.' We fully support this recommendation.
6.	Include in Div 725 an express carve out from value shifting rules for ESS interests granted under an ESS at a discount.	There is currently some technical uncertainty regarding the application of the value shifting provisions in Division 725 of the ITAA 1997 (**Div 725**). There is no express carve out from Div 725 for ESS interests to which Div 83A apply. In our view, there ought to be an express carve out and the value shifting rules should not have any application in circumstances where ESS interests are granted at a discount under Div 83A. We are not aware of the value shifting rules ever having been applied in an ESS context and would consider this to be a technical (as opposed to substantive) amendment. Broadly, the value shifting provisions in Div 725 can apply where, amongst other things, shares or options in the company are issued at a discount. The value shifting provisions can result in a deemed capital gain arising if there is a shift in value from existing equity interests, such as from issuing new shares at a discount to market value. In practice, it is often relatively easy to dismiss the value shifting rules – for example, where the company does not have a controller, or where it has more than 300 members (eg. most listed companies). Also, there are no

	ABL recommendation	Reason for recommendation
		consequences under the value shifting provisions if the decrease in market value of existing equity interests is less than $150,000. Notwithstanding the above, we have seen some situations where an unlisted early stage or scale-up company has a controller, and the de minimis exception does not apply. In our view, if, for example, a company grants start-up qualifying shares under ESS at a discount, the value shifting provisions should not be applicable.