

25/08/2021

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Dear Directors,

Deloitte is pleased to provide its submission on the Exposure Draft Legislation relating to the Government's announced changes to regulatory and tax arrangements for employee share schemes.

We welcome the opportunity to participate in any consultations on the proposed changes.

Please contact either Sandra Buth on (03) 9671 6837 or me on (02) 9322 7551 if you would like to discuss further.

Yours sincerely



Rob Basker

Partner, Australia Reward Leader, Global Employer Services

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Deloitte Submission: Draft Legislation to Reform Employee Share Schemes 2021

1 Introduction

Deloitte is pleased to make a submission on the Exposure Draft Legislation relating to the Government's announced changes to regulatory and tax arrangements for employee share schemes (ESS).

In 2015, Deloitte identified several initiatives for the Government to undertake to improve the operation and understanding of ESS legislation for start ups. We were encouraged to see that many of these were acknowledged with the introduction of the ESS start up tax concession and standard plan documents that would engage and focus on start up businesses.

It is positive that the Government continues to look to better help start ups to attract, retain and motivate talented staff and to compete on a global basis. Though we acknowledge that the introduction of the ESS start ups concession was a good start in addressing the special business needs of start ups, we believe that further work can be done **to reduce red tape** and ensure that **all** companies can fully realise the benefits of ESS arrangements. We outline that work below.

2 Tax reforms

2.1 *No early tax on cessation of employment*

We welcome the removal of "cessation of employment" as an early ESS deferred taxing point. The income tax event at the date the individual ceases employment has often left that individual taxable on a benefit without the ability to liquidate and cover taxes. Australia has long been an outlier globally by having an early tax event at the date an individual ceases employment. We believe the removal of "termination of employment" as an early ESS deferred taxing point results in a better alignment as between tax timing / economic remuneration and removes the punitive impact of the previous legislation.

We suggest that the change apply from 1 July 2021 in respect of terminations of employment and acquisitions of ESS interests that occur on or after that date.

2.2 *Regulatory reforms*

2.2.1 **Key features of new law to be reflected in explanatory memorandum**

We welcome the amendment of the *Corporations Act 2001* (Cth) (**Corporations Act**) **to expand on regulatory reliefs for ESS and to codify** the administrative exemptions currently set out in ASIC Class Order [CO 14/1000] (for listed companies) and ASIC Class Order [CO 14/1001] (for unlisted companies).

In particular, the increase of the unlisted body corporate offer value cap from \$5,000 per participant over a 12-month period to \$30,000 will allow for a broader group of employees to receive ESS interests for issue in return for monetary consideration, including tax concessional ESS start up options.

Deloitte believes that having the Australian Securities and Investments Commission (**ASIC**) focus on investigating and enforcing compliance with the Corporations Act with corrective action and increased penalties, rather than addressing deficiencies in the law by way of administrative exemptions is an important step forward in the regulation of ESS.

New law	Deloitte comments
<p><i>If an employee share scheme allows employees or directors to participate without requiring payment the scheme is generally not required to comply with the Corporations Act.</i></p>	<p>We welcome a general exemption from the Corporations Act to facilitate free ESS.</p> <ol style="list-style-type: none"> 1. We suggest that the ESS definitions used in Division 83A of the <i>Income Tax Assessment Act 1997 (Tax Act)</i> be reflected in the Corporations Act. This is to make clear that the Corporations Act relief will apply, at a minimum, to ESS covered by the Tax Act, thus reducing the need for multiple professional advisors. For example, the following. <ul style="list-style-type: none"> • Use the definition of “ESS interest” in section 83A-10 of the Tax Act: <p style="margin-left: 40px;"><i>“(1) An ESS interest, in a company, is a beneficial interest in:</i> <i>(a) a * share in the company; or</i> <i>(b) a right to acquire a beneficial interest in a share in the company.”</i></p> <p>while then recognising that the Corporations Act requires definitions of securities and financial instruments by adding to the above;</p> • Start with the definition of ESS in the Tax Act as applying to “the company” and “subsidiaries of the company”: <p style="margin-left: 40px;"><i>“(2) An employee share scheme is a * scheme under which * ESS interests in a company are provided to employees, or * associates of employees, (including past or prospective employees) of:</i> <i>(a) the company; or</i> <i>(b) * subsidiaries of the company;</i> <i>in relation to the employees' employment.”</i></p> <p>The extension of the relief to apply to ESS participants who are employees etc. of an “associated entity” addresses incentive and reward programs more broadly and reflects market practice; and</p> • See “independent contractor” as set out below. 2. We note that <u>all</u> requirements for listed companies to provide certain information to eligible employees, such as pricing, warning statements, have been removed for ESS, which are generally not required to comply with the Corporations Act. <ul style="list-style-type: none"> • We suggest a minimum level of information still be required given the number of ESS offered by listed but non-Australian headquartered companies into Australia, where offer documents may not be in English, may contain only limited information and no warnings.

New law	Deloitte comments								
<p><i>If an employee share scheme requires payment to participate or is offered to independent contractors, the scheme must comply with a streamlined set of obligations under the Corporations Act. This relief is available even if the scheme has an associated loan or contribution plan which requires participants to pay for the interest.</i></p>	<p>We welcome a streamlined set of obligations under the Corporations Act.</p> <ol style="list-style-type: none"> However, the operation of these streamlined set of obligations could be made clearer by including in the explanatory memorandum examples of instruments that do require “payment to participate” together with the relevant “ESS offer” and accompanying “ESS offer document”. <ul style="list-style-type: none"> In particular, and in accordance with what we understand is the intention of the proposed amendments, to confirm that for unlisted companies, share options with an exercise price greater than nil or a nominal amount in money must only meet the streamlined set of obligations under the Corporations Act at the time of option vesting / at exercise (i.e. when the employee could first make payment (see also our comments at 2.3) and not also at offer). We also note the drafting of the definition of “ESS interest” for listed body corporates. It does not include, for example, options if payment of money is required at acquisition or if exercisable. This may indicate that for share options with monetary consideration at exercise the ESS offer is to be read as one of <u>shares</u> for monetary consideration and that is the offer that is to meet the Corporations Act obligations. Provide a definition of ‘independent contractor’ or, alternatively, use the ‘relationship similar to employment’ definition that aligns to independent contractor as set out at Item 3. of section 83A-325 of the Tax Act, i.e.: <table border="1" data-bbox="699 1176 1385 1697"> <thead> <tr> <th data-bbox="699 1176 791 1339">Item</th> <th data-bbox="791 1176 991 1339">Column 1 This Division applies to an individual who:</th> <th data-bbox="991 1176 1187 1339">Column 2 as if he or she were employed by:</th> <th data-bbox="1187 1176 1385 1339">Column 3 and this constituted that employment:</th> </tr> </thead> <tbody> <tr> <td data-bbox="699 1339 791 1697">3</td> <td data-bbox="791 1339 991 1697">provides services to an entity (other than services covered by a previous item in this table and services provided as an employee)</td> <td data-bbox="991 1339 1187 1697">the entity</td> <td data-bbox="1187 1339 1385 1697">the arrangement between the individual and the entity under which those services are provided</td> </tr> </tbody> </table> <ol style="list-style-type: none"> Confirm the meaning of ‘predominantly’. It may be that the current casual employee exemption (i.e. employees who work a pro-rata equivalent of 40% or more of a comparable full-time position) will need to be carried forward in the definition of independent contractor. Again, definitions used in the ESS provisions of the Tax Act should be reflected in the Corporations Act to “reflect the policy intent...for body corporates, where possible, to be able to use the same valuations that they make to assist participants with determining their income tax liabilities”, for example, “aggregated turnover”. 	Item	Column 1 This Division applies to an individual who:	Column 2 as if he or she were employed by:	Column 3 and this constituted that employment:	3	provides services to an entity (other than services covered by a previous item in this table and services provided as an employee)	the entity	the arrangement between the individual and the entity under which those services are provided
Item	Column 1 This Division applies to an individual who:	Column 2 as if he or she were employed by:	Column 3 and this constituted that employment:						
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As a general observation, to assist with interpretation of the new provisions under the Corporations Act, it may be appropriate to incorporate, to the extent applicable, the explanations set out in Regulatory Guide 49 <https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-49-employee-incentive-schemes/> into the explanatory memorandum to the legislation.

2.2.2 Amendments will still act against the use of the start ups tax concession

The proposed regulatory framework with exemptions under the Corporations Act will still be difficult to understand and apply with minimal need to access external advisors. Thus, the exemptions do not go far enough to support low cost administration of **ESS that thread the needle of the complex array of non-regulatory ESS hurdles.**

Of concern, any continued requirement for financial information at offer for options with an exercise price disadvantages unlisted companies making offers of ESS interests – including ESS start up options (which must have an exercise price set at share market value at option issue). We note that options offered by unlisted companies (and listed companies) are almost always subject to conditions for vesting (i.e. the options may not become exercisable unless the conditions are met (and if not vested, the option lapses and no money is required to be paid)). Even if vested, the option holder is under no obligation to exercise. On that basis, Deloitte believes it sufficient that financial information / valuation / directors' solvency resolution only be first required when interests are vested and / or exercisable, not at the time of offer.

We welcome the use of the ATO's safe harbour methodology for valuing ESS interests of start ups as a reasonable basis for a director valuation of ESS interests.

However, we note that only one safe harbour methodology will be adopted (i.e. Net Tangible Assets (**NTA**)) that applies only to companies where the ESS interest is eligible for the ESS start up concession (shares with a no more than 15% discount or options with an exercise price equal to market value of the shares at option issue), are small business entities or have been incorporated for less than seven-years, and have not raised over \$10 million in capital (either debt or equity combined) over the preceding 12 month period, reduced by the return on preference shares on issue.

The other safe harbour methodology (the alternative comprehensive method which shows steps to valuation) is not available. Further, we also note that, although the alignment between the Corporations Act and the Tax Act is important, the ATO is reconsidering its approach to the market valuation of, among other things, shares and other securities, which may result in misalignment over time.

This continued fragmentation and complexity with the attendant high costs of compliance causes start ups to abandon an ESS before they even begin, notwithstanding the companies' needs to attract and retain employees, which needs are ably served by an ESS and the benefits of the start ups tax concession.

3 Other observations

3.1 The ESS tax start ups concession

From our experience, tax considerations are an important factor for companies when deciding whether or not to offer an ESS.

Companies want to offer discounted ESS interests such as options and shares as a benefit to employees but do not want to risk income tax up-front due to the economic impact on employees i.e. **employees should not be taxed** on the issue of options or shares – the default position under the ESS provisions – **before any real economic benefits arise** (which may only occur at a later point in time if at all due to vesting / disposal restrictions).

The tax concession for start ups was a positive step in support of the use of ESS by small unlisted companies. **In our view, more can be done.**

3.1.1 Expand to include companies incorporated within 15-years

Under current legislation, a company and its subsidiaries must have been incorporated for less than ten-years to qualify for start up status. However, our experience suggests that many otherwise start up businesses fail this requirement simply because founders 're-use' a company from an earlier (often failed) venture.

We therefore believe that extending the maximum period of incorporation to 15-years would enable more start ups to access the start ups tax concession. Equally, our experience suggest that companies do not consider an ESS before five-years of operation (i.e. before the company has developed sufficient momentum in its business). Therefore, the 10 year period for eligibility continues to be observed in real effect.

3.1.2 Specific exception to minimum three-year holding period condition needs to be made clear

To receive the start ups concession, the ESS interest must be held for a three-year minimum holding period. An earlier time may be permitted where the Commissioner of Taxation (**Commissioner**) allows.

This requirement to make an application to the Commissioner to allow for an earlier time is administratively and practically burdensome We suggest, for example:

- a Commissioner safe harbour such that, if the criteria are met, then the taxpayer may self-assess (similar to the fixed trust practical compliance guidance)
- an amendment to the provision to include accepted situations where the three-year holding period condition will lapse, for example, third party acquisitions (the obverse to the ESS rollover provisions applying), with the default position at the Commissioner's discretion or
- an Australian Taxation Office (**ATO**) tax determination setting out when and how the Commissioner's discretion will be exercised.

3.1.3 Conditions relating to market value – discount on shares no more than 15% of its market value is unworkable

Only two sorts of ESS interests are eligible for the start ups tax concession, broadly, options with an exercise price set at market value of the underlying shares at the date of issue of the options and shares acquired at no more than a 15% discount to market value. We have found the maximum 15% discount in respect of shares is unduly restrictive given the conditions of the exemption from disclosure etc. currently granted by ASIC and proposed to be incorporated into the Corporations Act.

For shares with a maximum 15% discount as required by the Tax Act, it is very difficult to meet the nominal monetary consideration requirement and be exempted from having to provide a prospectus or an offer information statement (which are expensive to prepare) except for very limited offerings in very early stage start ups (i.e. companies that have almost no value at the time of issue).

We acknowledge that that the \$1,000 tax reduction is available for all companies where conditions are met. However, a free share offer (i.e. a 100% discount) of between \$1,000 and \$5,000 for start ups would align both tax and ASIC / proposed Corporations Act requirements.

3.1.4 Standard documents

From our experience, the standard documents published by the ATO are used by start ups (see further comments below). In addition, there has been a flow-on effect in that the standard documents/precedents used by advisors (i.e. accounting and legal firms) to provide low cost advice and assistance to start ups.

It is Deloitte's view that the ATO standard documents could be reviewed and updated to simplify them and to reflect five-years of practical application since their introduction. This would enable the documents to better serve start ups without access to external advisors.

3.1.5 Address the start ups tax concession on an ongoing basis

To assist both the Government in better understanding the breadth of use of the start ups tax concession and to help eligible companies to manage their ESS obligations, we suggest a restructure of the ATO's website with a single page addressing and linking all ESS matters affecting start ups. At present, the following must be worked through to get the full picture:

[https://www.ato.gov.au/General/Employee-share-schemes/Employers/Types-of-ESS/Concessional-ESS/Start-up-concession-\(interests-acquired-after-30-June-2015\)/](https://www.ato.gov.au/General/Employee-share-schemes/Employers/Types-of-ESS/Concessional-ESS/Start-up-concession-(interests-acquired-after-30-June-2015)/);
<https://www.ato.gov.au/General/Employee-share-schemes/In-detail/ESS---Standard-documents-for-the-start-up-concession/>; <https://www.ato.gov.au/General/Employee-share-schemes/In-detail/ESS---Safe-harbour-valuation-methods/>; <https://www.ato.gov.au/General/Employee-share-schemes/Employers/>; <https://www.ato.gov.au/General/Employee-share-schemes/In-detail/Employer-reporting-requirements/ESS---Reporting-requirements-for-employers/>; and [no link] 'To further help start-up companies establish and operate an ESS, we will provide a link (see below) to digital service providers who have produced interactive applications to help with the task of assembling and populating the standard ESS documents'.

We suggest that a simple alternative to full ESS reporting and tracking would be a once off registration on the [My Gov site].

3.2 Other ESS tax

3.2.1 Increase tax reduction to \$2,500

The \$1,000 exemption amount has not been increased since 1997, when the exemption amount was increased from \$500 to \$1,000 under the Howard Coalition government to "build a greater sense of employee participation in the success of Australian business".

In 1997, the average weekly ordinary time earnings (**AWOTE**) was \$706; in October 2020 it was \$1,711. This is an opportunity to revisit the \$1,000 tax reduction and the corresponding corporate tax deduction. The \$1,000 tax reduction amount and corresponding deduction should be increased to at least \$2,500.

3.2.2 Increase tax amount that can be salary sacrificed

We welcome the change that rights (options) do not need to meet a gateway test of real risk of forfeiture in order to access tax deferral under the new rules. We note that there is no maximum value of rights eligible for this tax concession.

However, salary sacrificed shares continue to have a \$5,000 maximum value eligible for the tax concession. However, in line with the new law in respect of rights, this \$5,000 cap should be removed. Alternatively, to reduce any unintended consequences from a deferral of tax on income as a result of salary sacrifice, the \$5,000 maximum should be increased under the new law to \$10,000. An increased maximum would be in line with global practice.

3.2.3 Remove the 30-day rule in respect of the ESS deferred taxing point

The current law requires that, for example, if an ESS interest is disposed of within 30 days of the original ESS deferred taxing point, the ESS deferred taxing point is moved to the date of disposal. This is known as the 30-day rule. The 30-day rule was intended to make compliance easier by avoiding unnecessary valuations and the application of multiple taxing regimes (e.g. income tax and capital gains tax) within short periods of time.

In determining the ESS deferred taxing point, the 30-day rule causes anomalies. We suggest the removal of the 30-day rule and the substitution of the time of receipt of the share in respect of rights as the ESS deferred taxing point. Alternatively, confirmation should be required that "the time between vesting and delivery of shares is a genuine disposal restriction" where delivery is outside of the participant's control.

3.2.4 Payroll withholding

The Australian government may wish to reconsider ESS payroll withholding – which is global practice – by using the New Zealand (NZ) model. NZ employers can make a voluntary election by calculating and withholding PAYE on ESS benefits and disclosing this amount through the employer monthly schedule.

We have seen an increase in global companies seeking to utilise a common global approach to withholding tax obligations for their global participants, including Australia. However, currently in Australia they are restricted from remitting taxes through the PAYG system where the employer already has the individuals TFN / ABN. We suggest a change be incorporated to allow any employers who wish to remit income taxes for their Australian participants.

3.2.5 Rollover

Given the requirement for matching interests for rollover relief (e.g. options for options, shares for shares) and the multiple alternative instruments offered by companies both domestically and globally, the Tax Act should be amended to allow for rollover where the economic value matches rather than the instrument so that rollover relief continues to be available (see ATO ID 2008/59 for an opposing view).

3.2.6 Genuine disposal restrictions

We welcome updated ATO guidance on genuine disposal restrictions.

3.2.7 Volume weighted average share price

Given the effects of Covid19 on business, we welcome ATO guidance on whether a volume weighted average price of shares of greater than five days would be acceptable.

3.2.8 Interaction as between fringe benefits tax (FBT) and capital gains tax

We welcome ATO consideration to a step up in market value for capital gains tax purposes of an asset held by an employee where the employer has paid FBT on that asset as a fringe benefit rather than under the ESS provisions.