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To Directors
Market Conduct Division and
Individual and Indirect Taxation Division
The Treasury
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Dear Directors

Submission on the proposed Employee Share Schemes draft legislation

1 Overview

King & Wood Mallesons welcomes the opportunity to make a submission on Treasury's exposure draft legislation published on 29 July 2021, which proposes to amend the tax rules and regulatory requirements relating to employee share schemes (**Proposed Amendments**).

The provision of employee equity is a critical tool for producing mutually beneficial and productive workplaces for employees and employers. This has been identified through numerous studies associated with the provision of employee equity which have found resulting improvements in company performance and resilience, together with improvements in employee commitment, engagement and wellbeing.[1]

In that context, we are supportive of the Government's objective to simplify and improve the way in which employee equity is provided in Australia.

The Proposed Amendments are a very positive step towards achieving this objective.

Our submissions seek to maximise the benefit that will be provided by the Proposed Amendments to help ensure that Australia's tax and corporate regimes promote the ability of businesses to engage in employee ownership.

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[1] See, eg, *Sharing Success: The Nuttall Review of Employee Ownership* (July 2012).

We would welcome the opportunity to engage further with Treasury and other stakeholders to discuss our observations in more detail.

2 Executive summary

Removal of the deferred taxing point on the cessation of employment is an important change and its introduction should be accelerated

The proposed removal of the deferred taxing point on the cessation of employment is a very welcome change to the current employee share scheme (**ESS**) regime.

The reform will mean that holders of securities granted under an ESS (**ESS interests**) will only be taxed where they have received an actual benefit. As Treasury has correctly identified, this will "make it easier for businesses to offer ESS and will support Australian businesses to attract and retain the talent they need to compete on the global stage".[2]

Given the substantial benefits that this reform will bring, our strong view is that its effective date should be brought forward as early as possible and should also apply to existing ESS interests.

The no consideration exclusion from ESS offering documents is critical to the promotion of employee equity arrangements: it should extend to "no risk" arrangements

We strongly support the introduction of the "no consideration" exclusion from the prospectus or disclosure.

ESS issuers and holders would benefit from greater clarity around what does and does not qualify for the exclusion. It is important that market value options provided for no consideration should be able to benefit from the new exclusions.

The exclusion could be improved so that, rather than "no consideration", the test is amended to be "no risk". This would align the test to the existing ESS rules.

The elevation of the liability regime for ESS offering documents is not appropriate

The elevation of the liability regime for ESS offering documents in the Proposed Amendments may inhibit the wiliness of employers to offer ESSs.

ESS offering documents should not have to comply with the liability rules that are applicable to prospectuses (as is currently the case in the Proposed Amendments).

Corporate regulatory relief should be modelled on concepts within the existing tax rules for ESS

It is also important that the regulatory relief provided for in the Proposed Amendments is consistent with the existing tax rules for ESSs. This is to ensure that compliance obligations are easy to understand and do not hinder the ability of employers to issue ESSs.

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[2] *Treasury, Consultations, Employee Share Schemes* web page: https://treasury.gov.au/consultation/c2021-138967.

3 Cessation of employment: taxing point

Currently, the Proposed Amendments provide that the deferred taxing point on cessation of employment will be removed for ESS interests that are issued on or after the first 1 July after the commencement date of the regime.

The commencement date is not until the first 1 January, 1 April, 1 July or 1 October to occur the day after the enabling legislation receives Royal Assent.

This approach is in contrast to the approach usually undertaken for most tax amendments, which ordinarily apply to events that occur after the Treasurer's (or other relevant Minister's) announcement of the relevant change. This is because it is generally accepted that taxpayers will change their tax affairs from that date. A different approach should not be taken in this case, especially given the Proposed Amendments are introducing a concession for holders of ESS interests.

The application of the Proposed Amendments to existing ESS interests with effect from the date of the Treasurer's announcement (i.e. 11 May 2021) will not have an adverse administrative impact on the issuers or holders of existing ESS interests. This is the case where existing ESS interests have not had an ESS deferred taxing point occur.

We expect that ESSs which are currently offered will not be required to amend their plan terms if there is a removal of the deferred taxing point on the cessation of employment. Many tax deferred ESSs – particularly rights and options – have certain vesting, settlement and disposal restrictions which can continue beyond the time of cessation of employment.

Furthermore, some ESS plan terms may give the boards of ESS issuers the discretion to deal with ESS interests in certain ways for different types of employee "leavers". Therefore, tax can be deferred beyond the cessation of employment for these plans without an amendment of plan terms being required.

Given the Proposed Amendments are a concessionary measure, they should be brought forward to existing ESS interests so that these interests can also benefit. The current proposed starting date for the Proposed Amendments will not assist with the administration of ESSs.

Some existing ESSs may seek to have their plan terms amended in order to benefit from the Proposed Amendments. This will be a matter for the issuers as to whether they think it appropriate to amend the terms of their plans. These are plans under which the restriction on dealing with the ESS interest shares generally cease on cessation of employment. In these instances, issuers may wish to amend their plan terms in order to take advantage of the Proposed Amendments.

This will not result in an undue administrative burden being placed on plan issuers as, given the Proposed Amendments are purely concessionary, these issuers may validly elect not to take advantage of the concession by not amending their plan terms.

There will be no undue administrative burden placed on ESS issuers if the Proposed Amendments are to apply to existing ESS interests. The Proposed Amendments should apply to all ESS interests from the date of the Treasurer's announcement.

Application to existing ESS interests from the date of Royal Assent may be a viable alternative if Government does not wish the Proposed Amendments to commence from the date of the Treasurer's announcement.

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If Government does not wish for the concession to apply to existing ESS interests, then – at the very least – the concession should be brought forward to align with the date of the Treasurer's announcement.

Our sliding order of preference for the commencement date and scope of the securities to which it applies is set out in the table below.

Order	Preference
Preference 1	The concession applies to existing ESS interests for which a taxing point has not yet occurred and new ESS interests from the date of the Treasurer's announcement.
Preference 2	The concession applies to existing ESS interests for which a taxing point has not yet occurred and new ESS interests from the date the enabling legislation receives Royal Assent.
Preference 3	The concession applies to new ESS interests that are granted from the date of the Treasurer's announcement.
Preference 4	The concession applies to new ESS interests that are granted from the date the enabling legislation receives Royal Assent.

4 Liability regime

We have material concerns with the proposed elevation of the liability regime relating to ESS offering documents.

We understand that Treasury's intention is for the proposed offences, civil penalty provisions and defences to be consistent with those that are imposed on other disclosure documents that are used for issuing interests under the *Corporations Act 2001* (Cth) (**Corporations Act**), such as prospectuses.[3]

This fulsome liability regime should only apply where an offering document is being used for fundraising purposes under the Corporations Act.

In instances of fundraising, there may be a greater risk that offering documents may contain misleading information to make the offer more attractive to shareholders in order to raise funds for the company. An extended liability regime may be appropriate to protect against this risk.

This is distinguishable from an ESS, where the intention is not to raise funds but to provide an incentive to employees and to recognise their contribution to the company. The likelihood that the offering documents would contain misleading information is therefore materially reduced in comparison to fundraising activities.

Given the nature of the restrictions of offers of ESSs in terms of quantum, these offers are not considered to be "fundraising" under the Corporations Act.

[3] *Regulatory Exposure draft – Explanatory materials* at section 1.116.

It would, therefore, be inappropriate to apply the rules relating to fundraising. The increased liability regime may also act as a real disincentive for employers to offer ESSs, which would run counter to the intention behind the Proposed Amendments.

We are not aware of issues with the quality of offering documents under the current regime.

In our experience, employers undertake prudent measures to ensure that they provide employees with high quality information in order to assist them with the decision to acquire ESS interests.

Employers are seeking to provide their employees with a benefit. Their aim in that context is to "do the right thing" by their employees. They are very aware of potential consequences (both internally and externally) if they do not. The importance of maintaining the goodwill of employees is critical in employee offers. It is not appropriate to impose the liability regime that is currently contained in the Proposed Amendments on ESS offering documents.

5 "No consideration" exclusion

5.1 Clarity regarding scope of exclusion

We welcome the introduction of the no consideration exclusion which will present a significant benefit for ESSs.

It is important that greater clarity be provided around what is and is not included in the exclusion.

The concepts of 'no consideration' should be consistent between both the Corporations Act and the tax rules. There should be no bifurcation between them.

A large issue with the current ESS regime is understanding how the different regulatory regimes interact: the tax legislation, the Corporations Act and ASIC Class Orders. This complexity is a deterrent to offering ESSs.

Removing some of this complexity will mitigate against the perception that the process is too hard and expensive. The consolidation of regulatory relief within the Corporations Act is helpful. However, the Proposed Amendments should consider the holistic consolidation of regimes. Relevant concepts should be aligned to the tax rules where possible.

On that basis we consider that the no consideration exclusion should apply in the following circumstances:

Circumstance	Observations
Salary sacrifice arrangements	In all cases of an effective salary sacrifice arrangement, monetary consideration is not provided. This is the critical element of effective salary sacrifice arrangements. The essence of these arrangements is that an amount of the total remuneration of the employee is provided in the form of shares. They are provided at no cost to the employee and without any monetary consideration by the employee.
Free options	Where options otherwise would have a market value but are provided for free, they should be treated as being provided for no consideration.
Provision of share at the	Arrangements where the provision of shares is at the election of the company should be treated wholly as a provision of shares for no

Circumstance	Observations
election of the company	monetary consideration. An example of these arrangements is where an employer decides to provide a bonus to an employee and that bonus is provided at the election of the employer in the form of shares. In that case, the employee has no choice in relation to the form in which a bonus may or may not be provided.

5.2 No consideration should mean "no risk"

The introduction of the no consideration exclusion is a significant advance.

The appropriate test for the exclusion should not be "no consideration", but rather "no risk". Our strong view is that when examining the concept of the no consideration exclusion, a distinction arises between:

- *a plan where "at risk" monetary consideration is provided in relation to the relevant ESS interests.*

  An example of a scheme of this type might include where an employee contributes an amount of cash for the acquisition of the relevant securities or directs an amount of their after-tax salary to acquire shares; and

- *a plan where no "at risk" monetary consideration is provided in relation to the acquisition of the securities.*

  An important example of the provision of securities of this type is the acquisition of securities which have been funded through the provision of a limited recourse loan arrangement. In this case, the employee is not "at risk" in relation to the monetary consideration which has been provided in relation to the acquisition of the securities.

  On this basis, these should be treated differently from plans where "at risk" monetary consideration is provided.

In order to capture this distinction, it is appropriate to amend the test for no consideration in the Proposed Amendments so that it means "no risk".

It is particularly important for limited recourse loan arrangements to have access to the concessional treatment that the no consideration exclusion provides.

Limited recourse loan arrangements to fund the acquisition of securities are a very common form for providing equity to employees in unlisted companies. Arrangements of this type are critical to satisfying the relevant tax rules and accommodating the needs of employers to effectively provide appropriately structured equity to employees.

The critical element is to recognise that those loans are constructed in a way that the employee is not at risk. These arrangements should, therefore, be treated in the same way as any form of providing employee equity where no consideration is provided by the employee.

It is important that the range of activities which are covered by the exclusion are flexible enough to reflect that the tax rules associated with offering employee equity change from time to time and, accordingly, the forms of conventional employee offerings will need to alter.

The key to protecting employees is to establish appropriate mechanisms which operate in the event that there are “at risk” schemes in which monetary consideration is provided by the employee.

The additional obligations which may exist in relation to employee offerings should focus on arrangements of this type. It would be preferable that the provisions dealing with these schemes be not so specific that it is necessary to establish specific exemptions in relation to different forms of equity arrangements.

6 Modify the $30,000 cap

Any monetary limit is likely to be arbitrary and not tailored to the circumstances of a particular company, which will change over time. The monetary limit may also require regular updating to keep pace with Australian and international developments.

For SMEs looking to implement a succession from the founder to the employees, the monetary cap may also not be meaningful. Without higher amounts being able to be offered to certain employees, succession planning is impossible. The key benefit of modifying the monetary cap relates to the fact that primarily, at the moment, companies rely on sections 708(1) and 708(12) of the Corporations Act or tend not to proceed for all employees if they exceed those caps.

Ideally, the “20/12” exemption in the Corporations Act should be adopted. That is, there is an exemption for 50 employees in 12 months up to $2 million. This overarching cap would effectively operate to restrict fundraising. It would also allow SMEs to offer a meaningful amount of employee equity, particularly in succession contexts.

7 Consistency between the tax and corporate rules

More should be done to ensure that the tax rules and the Corporations Act are consistent. The Proposed Amendments will provide significant and appropriate relevant regulatory relief provisions in the Corporations Act.

This will ease the compliance burden on employers and marks the introduction of a coordinated regime that deals with employee ownership generally.

The key to the success of the coordinated regime is consistent regulation of schemes. This coordinated regulation is critical to provide a low risk, easily understood mechanism for providing employee equity.

Simple examples of this lack of consistency include:

- the definition of what constitutes an ESS under the Corporations Act and the scope of its equivalent definition under the tax legislation; and
- the different treatment of ESSs under the start-up concession. The tax rules provide that there should be a maximum discount of 15%, whereas the Corporations Act requires a 100% discount.

There may be policy differences between corporate regulation and tax regulation. However, these differences should be limited to matters of substance. Insofar as possible, the form of regulation and its scope should be consistent for both Corporations Act and tax law purposes. In this context, certain aspects of the tax rules and corporate rules relating to ESSs should be the same.

Specific areas of concern include:

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- *the treatment of independent contractors:* the existing narrow definition of contractors (and casual employees) should be amended because it creates particular difficulties in new forms of industry. The threshold in relation to the level of employment is currently too restrictive and should be expanded so that it captures new forms of industry (such as gig economy employees / contractors);
- *nature of shares offered:* relief from the prospectus rules only applies to ordinary shares that are offered under an ESS. There is no reason why this relief should not apply to other classes of shares (e.g. preference shares);
- *the scope of the loan exemptions:* there are specific exclusions from provisions that apply to ESS loans under the Corporations Act when those loans are made interest free. The provisions of Division 7A of Part III of the *Income Tax Assessment Act 1936* (Cth) may require the charging of interest;
- *definition of an employee share trust:* the concept of an employee share trust is not consistent between regimes. If a trust is treated as an employee share trust for the purposes of the tax rules, this should be sufficient for the purposes of the Corporations Act; and
- *exclusion from the "20/12" rule for employee offers:* complying offers for the purposes of ESSs should be excluded from the "20/12" rule, as the rule may otherwise restrict the offering of equity to employees.

We would welcome the opportunity to engage further with Treasury in relation to our above observations.

Yours faithfully

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