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Inquiry into Employee Share Schemes

The Finance Sector Union (FSU), representing 50,000 employees across the Australian finance industry, welcomes the opportunity to make a submission to the Committee regarding Employee Share Schemes.

Employees across our industry, predominantly in the larger listed companies, have participated in Employee Share Schemes, with varying levels of enthusiasm, since the 1980's.

This submission will seek to address some of the issues identified by the Committee in the context of employment in the finance sector.

a) structure and operation of employee share schemes;

Over time, employee share schemes in the finance sector have evolved in line with changes to legislation and in response to stated objectives and variable degrees of accessibility.

There have been four main kinds of employee share plans in operation in the finance sector, namely:

- fully paid shares funded by employer company loan (a 'loan plan');
- fully paid shares funded by profits, salary sacrifice or bonuses ('subscription plan');
- partly paid share plans; and
- option plans.

Executives have usually enjoyed access to all forms of the plans while non-executive staff have generally only had access to the first two types of plans.

In the 1980's, the most prevalent share schemes available to non-executive staff were comprised of loan scheme arrangements for the purchase of discounted shares. Under such schemes there were differing requirements for loan repayments for managerial and non-managerial staff. In many instances pre-management staff had onerous requirements of paying back loans within 12 months and, not surprisingly, take up by non-managerial staff remained low.

Changes to the scheme over time, including the introduction of twenty year repayment periods, enhanced the take up to a small degree.

More recent changes to taxation laws and arrangements have seen a much wider take up of shares by employees, principally through the \$1000 tax exemption arrangements. Many finance employers implemented an allocation of an annual "free" allocation of shares up to the value of \$1000 with the result that an overwhelming number of employees elect to accept these shares.

Alongside this distribution, employees who qualify can also salary sacrifice to purchase more shares through subscription plans that also allow for the deferral of tax for a period of up to ten years, thus increasing their shareholding.

In both these types of schemes, shares allocated are either held in trust arrangements for three years or restricted from trade for a similar period.

Over the same period, executive employees of the banks have been issued, both as part of their remuneration package arrangements and as part of purchase schemes, millions of dollars of company equity in the form of options or direct shares, some subject to performance qualifiers, some not.

There remains an acute difference in the depth of employee share ownership between executives and non-executive employees which is typified by wide share holdings of minimal amounts being held by non-executive employees, with far deeper share holdings being held by executives.

For the vast majority of non-executive employees, the \$1000 tax exempt annual “free” parcel of shares is their principal, if not only, access to share holding in their company.

b) the benefits of employee share schemes

It remains difficult to provide an accurate measure of the benefits of employee share schemes, mainly due to the fact that they are a part of a broad array of remuneration and management tools.

Many papers and inquiries have grappled with this issue and with the lack of empirical data available to provide an unequivocal finding.

The majority Report of the House of Representatives Standing Committee on Employment, Education and Workplace Relations in 2000 laments the lack of real data on the benefits of plans and called for the establishment of government funded, independent, university-based research to look at the issue of best practice for schemes.

In its report the Committee noted

“The absence of clear data makes framing public policy especially difficult ...while it is difficult to demonstrate a sustained causal link between improved productivity and the operation of an employee share plan, it does appear to be the case that the introduction and operation of an employee share plan may be related to the existence of a progressive workplace culture and related management practices, which in turn can increase enterprise performance.”¹

However, there is a broad and bi-partisan acceptance that ESOPs can have a positive affect on the employee – employer relationship if they are coupled with a range of management practices that aim to promote employee involvement in decision making, and if they are not used as a substitute for other benefits.

Employers in the finance sector maintain that their reasons for introducing the schemes are to:

- encourage employees to build an ongoing shareholding in their organisation;

¹ House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours – an Inquiry into Employee Share Ownership in Australia (Majority Report)* (2000), 46.

- introduce a greater alignment of employee's interests with that of shareholders to work towards the common goal of organisational success;
- utilise such schemes as a vehicle for saving and wealth creation for employees;
- provide tangible expression of desired management style and reinforcement of organisational values;
- reinforce the links between efficiency improvement, excellent customer service and shareholder value.

The extent to which they achieve these outcomes is debatable.

The changes to taxation laws to exempt the first \$1000 of share issues to employees significantly widened the take up of employee ownership in finance companies, particularly across domestically listed banks who moved to providing a 'free' allocation of shares to this value to employees annually.

While some scheme arrangements have been picked up in enterprise bargaining agreements, many were only referenced in such and remained very much at the discretion of senior management and the Board.

The performance measures that were overlaid into the schemes, such as total return on asset triggers are often beyond the control of employees or nebulous in nature. These mechanisms have resulted in management making determinations not to pay the schemes from time to time. The level of anger demonstrated by employees to these decisions certainly provides a sense of the value that they place on the provision of the share allocation.

In a recent example of this occurrence the National Australia Bank decided not to provide staff with the normal share allocation as a result of the tumultuous year experienced from the Foreign Exchange losses and subsequent Board in-fighting. NAB employees, who had no control over the issues plaguing their employer, felt rightly outraged that they were being punished for mistakes made by executives and the board. The union received thousands of complaints from NAB employees expressing their anger at the bank in the wake of the announcement.

It is difficult to quantify whether the reaction would have been similar if NAB withdrew some other form of payment; however what can be drawn from this example is that employees view share allocations as a deserved benefit and recognition of their contribution to the organisation in which they are employed. Lack of transparency in how they are allocated or perceived unfairness in their distribution will have a negative impact on engagement with their employer.

It is clear, however, that shareholdings by employees have allowed them to participate in issues around corporate governance. This has meant that they have been able to take an active interest in shareholder/board deliberations and has facilitated a direct dialogue between employees and shareholders.

In this regard the benefit of employee share plans has been to increase the democratic process of corporate governance and to hold boards and executives of listed corporations to a higher level of scrutiny about their strategies and decision making.

It is the FSU's experience that employee-shareholders have exercised their rights constructively and in the interests of the organisation that they are employed in.

c) the taxation issues relating to compliance of employers and employees participating in employee share schemes

There have been a number of changes introduced into Australian taxation law designed to promote the use and uptake of employee share schemes.

In the case of the finance industry, the introduction and refinements of Division 13A of the *Income Tax Assessment Act 1936*, have had a profound impact in assisting with the widening of participation in the schemes.

As mentioned, the introduction and subsequent extension of the tax exemption to \$1000 for shares allocated in each tax year and the employer response to issue such a grant free of charge to employees, has seen many, many more employee elect to participate.

However, tax confusion still exists around the different schemes and as the Australian Tax Office conceded in its submission to the 2000 House of Representatives Inquiry, the introduction of the Division 13A rules has not completely eliminated tax avoidance in the context of employee share ownership.²

Most non-executive employees elect to take up the \$1000 tax exempt allocation and are therefore not subject to income tax on their shares. They are however subject to declaring any received dividend payments and are subject to capital gains tax on any growth in the value beyond the initial grant at the time of sale.

While further take up of shares through tax deferred, salary sacrifice arrangements can complicate the taxation requirements, the vast majority of non-executive employees who qualify and avail of these arrangements both understand and comply with their tax requirements in regard to their ESOP participation.

Nonetheless, the FSU would also argue that more can be done to both educate and assist employees regarding their tax obligations at point of election, purchase, vesting and realisation of shares through ESOP programs. The FSU would also agree with a range of commentators that greater TFN and withholding rights could occur between the employer and the ATO to assist with correcting taxation oversights.

For Executives participating in ESOP schemes there is a history of concern regarding aggressive tax planning aimed at using the schemes to minimise or avoid tax obligations.

The ALP have been acutely aware of this matter both in Government and in Opposition and have sought on numerous occasions to amend legislation to address what they, on advice from Treasury and the ATO, have determined to be loopholes for tax avoidance by high worth individuals participating in employee share schemes.

The Labor members of the House of Representatives Standing Committee on Employment, Education and Workplace Relations submitted a dissenting report to the Inquiry into Employee Share Ownership in 2000, in which they observed:

“Employee share plans are of two distinct types.

The first can be defined as ‘genuine’ or ‘bona fide’ employee share plans, which are available to employees throughout the employing company, and have as their predominant purpose more clearly aligning the interests of

² Australian Taxation Office, *Submission to the House of Representatives Standing Committee on Employment, Education and Workplace Relations* (1999), 4.

employees and the employer in order to increase productivity and workplace harmony.

The second can be defined as ‘executive’ employee share plans. These plans are available only to executive, high income employees and have as their real purpose the tax effective or tax free provision of remuneration. Many of these arrangements are designed and marketed by aggressive tax planners and are described by the ATO as ‘blatant, artificial and contrived’.”³

The FSU concurs that there is and has been fundamentally two distinct types of employee share plans in our industry. Those devised to extend executive remuneration through tax effective (avoidance) means primarily utilising tax deferral options and those devised with a genuine view of providing the majority of employees with share ownership and the organisational benefits that flow from that ownership – namely the allocation of wide (more than 75% of employees) and smaller amounts of shares per person per year (usually gifts of up to \$1000 that qualify as tax exempt).

The majority report of the Committee found that:

*“The Committee also concludes that while Division 13A has reduced some aggressive tax planning, attention has shifted, as indicated by the ATO, to other arrangements, some involving employee share plans, involving the exploitation of the existing legislative arrangements. The present legislative arrangements inherited from the Keating Government, concerning all types of employee share plans have not eliminated the proliferation of aggressive tax planning employee share schemes”*⁴

It is disappointing to note that the majority report of the Committee made some 45 recommendations of which 30 or more were rejected by the then Coalition Government. A number of these recommendations went to the matter of the use of aggressive tax planning around ESO schemes. The FSU believes that the failure of the then Government to move to address the identified loopholes for aggressive tax planning was both an opportunity and revenue lost.

We note recent evidence from the ATO in Senate Estimates⁵ regarding their audit of individuals earning over \$1 million per annum which found substantial compliance issues relating to their use of employee share schemes. The examples cited regarding two individuals (one at CEO level) who had unpaid tax liabilities of around half a million dollars each demonstrate that aggressive tax planning in employee share schemes by executives and high income earners has continued unabated despite the 2000 Inquiry.

That being the case, the question then goes to how the Government of the day seeks to amend the legislation to ensure fair application of tax rules, while ensuring the objectives of employee share ownership are met.

d) the recent announcement of proposed changes to the treatment of employee share scheme, the background to these changes, consultation undertaken to develop these changes and the anticipated impact of these changes on employees, employers and Australian business generally;

³ Dissenting Report – Labor members of the Committee, House of Representatives Standing Committee on Employment, Education and Workplace Relations, *an Inquiry into Employee Share Ownership in Australia (Minority Report)* 2000, 277.

⁴ House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours – an Inquiry into Employee Share Ownership in Australia (Majority Report)* (2000), 67.

⁵ Senate Economics Legislation Committee consideration of Budget Estimates, 2 June 2009, page 115.

FSU assumes that this reference by the Committee concerns the recent announced changes to the taxation treatment of employee share schemes as announced by the Federal Government on the 1 July 2009.

The FSU and other unions including the Australian Workers Union, the Australian Services Union and the Shop, Distributive and Allied Employees Association welcomed the announcement by the Minister, Senator Sherry, setting out changes to the tax treatment of employee share schemes.

Specifically, unions on behalf of the many thousands of employees they represent that participate in genuine employee share schemes welcomed the Minister's decision to introduce:

- income testing for the \$1000 tax exemption with the threshold to be set at \$180,000, to align it with the top marginal rate threshold.

Under these changes the majority of our members (and the majority of employees) will continue to qualify for the tax exemption on their modest share ownership in their employers companies.

Aligning the means test to the top marginal tax rate threshold is also sensible in that high income earners are more likely to have the disposal income to meet immediate taxation requirements.

- Deferring the taxing point

Unions agree that deferred taxation is reasonable where there is a genuine risk of forfeiture regarding the shares in question or where there is a capped salary sacrifice scheme offering no more than \$5000 worth of shares.

Again, this would allow for the our members to continue to participate in the purchase of further shares, beyond the \$1000 tax exempt employer 'bonuses' where they are able to do so through salary sacrifice arrangements.

Removing the deferral of taxing points for high income employees, by seeking to remove contrived forfeiture arrangements will lead to real alignment with genuine corporate and performance goals and/or provide for greater tax compliance.

The lowering of the maximum deferral period from 10 years to 7 will assist in taxation record keeping, reporting and tracking.

- Reporting requirements for employers
- Withholding arrangements

Provides better tracking and reporting arrangements by providing incentive for the provision of TFNs or ABNs or allow employers to withhold tax.

It is our view that the most recent announcement by the Government in relation to proposed changes to the treatment of employee share schemes reflects a history of concern of aggressive tax planning associated with the schemes that are discussed above and with the Government's stated objectives of maintaining integrity in the taxation system while continuing to support genuine employee share schemes.

The FSU and other unions were invited to make submissions to *The Treasury's Reform of the Taxation of Employee Share Schemes, Consultation Paper June 2009*. The joint union submission is publicly available for the Committee's review.

It is the view of the unions that these changes will ensure the continued operation of employee share schemes, continue to allow for employees to participate in these

schemes and therefore allow both employees and employers to derive the benefits that such schemes seek to provide.

- e) the rules governing employee share schemes in other countries; and*
- f) any other related matter*

The FSU and other unions strongly support the ongoing viability of employee share schemes as they allow employee's to benefit directly when their employers' business does well, help align their interests, provide an insight into share ownership and provide them with access to participate in corporate governance matters.

We appreciate that the Government responded to community concerns regarding the initial 2009 Budget announcement and believe that the measures now proposed as announced by the Minister, Senator Sherry, address those concerns while advancing the objectives of integrity in the tax system and support for employee share schemes.

If you have any questions in relation to this submission please contact our National Communication and Policy Manager, Rod Masson, on (03) 9261 5330.

Yours sincerely



Leon Carter
National Secretary
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