Attachment A

Taxation of ESOP trusts as companies: implications for employee ownership

The Australian Employee Ownership Association (AEOA) is concerned with the Government's proposal to treat trusts, for taxation purposes, as if they were companies and its failure, so far, clearly to exempt ESOP trusts from the new, so-called “entity taxation” system. We believe that employee share trusts require specific and separate treatment for the reasons stated below.

The key differences of trust structure over the corporate structure, in terms of general law and taxation law are:

- Beneficiaries have interests or rights in the property held by the trust whereas shareholders in a company have no interest in, or right to, the property of the company.
- Income or property received by the trustee retains its character under the so-called "conduit principle" - whereas, any distribution by a company, generally speaking, experiences a change of character (e.g. income of the company distributed to shareholders becomes dividends).
- Trusts and their beneficiaries, like partners in a partnership, are taxed under an "integration system" (which prevents double taxation of trust income) rather than the "imputation system" which applies to companies (which prevents the double taxation of dividends).

Given the above, the major potential problems which occur in respect of this proposal are as follows:

1. Shares presently held for the benefit of employees in an ESOP trust would need to be treated as the legal and beneficial property of the company. Employees, therefore, would lose their legal interest in, or rights to, shares which, morally and legally, should be held for their benefit.
2. Distributions by ESOP trustees to employees could represent a capital disposal subject to capital gains tax and payable by the trustees.
3. To accommodate dividends received by an ESOP trust would require the establishment of separate dividend imputation and franking credit accounts for each of its employees. This would be expensive and burdensome on the trustee, and the sponsoring company, and would be certain to discourage the implementation of ESOPs.
4. Shares distributed to employees would be treated as ordinary dividends in the hands of the employees. This causes a number of contradictions to exist in employee share plan taxation provisions including:

    (a) tax exempt employee shares would now be treated as fully taxable dividends;

    (b) shares held prior to 1996 to be distributed as eligible termination payments would now be taxed directly as dividends (this goes against direct assurances provided by the ATO to several of our members);

    (c) dividend withholding tax credits cannot be passed on to employees under the corporate tax system;

    (d) bonus shares and rights issues received and passed on to employees would be fully taxable as dividends (i.e. these are not usually taxable under the current regime);

    (e) loans to employees by the trustee could be considered taxable dividends under the newly implemented provisions of Division 7A.