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3 November 2000

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Comments on Entity Taxation Exposure Draft - Employee Share Ownership Plans

We have acted for a number of Australia's leading companies in assisting them with the establishment and management of employee share ownership plans. The following submission has been prepared in response to the exposure draft of the *New Business Tax System (Entity Taxation) Bill 2000* ("**Exposure Draft**") released on 11 October.

Our submission focuses on bona fide employee share ownership plans operated by Australian or foreign listed public companies.

1 Executive Summary

Employee share ownership trusts ("**ESOTs**") should be specifically excluded from the proposed entity tax provisions as:

(a) we believe that changing the taxation of employee share ownership plans is inconsistent with previous announcements made by the Government and the Treasurer and would seem to be in conflict with stated Government policy;

(b) many ESOTs will fail to meet the proposed definition of fixed trust and will be subject to entity taxation. The failure to satisfy the relevant conditions arises from the express requirements of Division 13A. Furthermore, these ESOTs will not fall within the categories of exempted trusts proposed to date;

(c) excluding ESOTs from entity taxation is fully supported by the House of Representatives Standing Committee on Employment, Education and Workplace Relations;

(d) subjecting ESOTs to entity taxation would introduce significant complexities to the taxation of employee share ownership plans.

Furthermore, the proposed amendments may have unintended adverse consequences for existing beneficiaries of ESOTs;

(e) a significant body of specific complex rules already exists to govern employee share ownership plans and excluding ESOTs from entity taxation would be consistent with existing legislative policy;

(f) ESOTs are a transparent and very commercially effective vehicle for administering employee share ownership plans and are used by many of Australia's leading listed companies. The beneficiaries of ESOTs are also clearly identifiable;

(g) subjecting ESOTs to entity taxation would act as a disincentive to the establishment of future employee share ownership plans and may significantly restrict the ability of Australian companies to implement share ownership schemes; and

(h) in the event that ESOTs are not specifically excluded from entity taxation we do not agree with the view put forward by some that the majority of "mainstream" employee share plans will not be affected by the proposed reforms.

2 Employee Share Ownership Trusts cover a significant portion of Australia's workforce

A significant number of employee members of share ownership plans operated by Australia's leading companies will, in our opinion, be adversely affected by the proposed entity tax provisions.

A high proportion of existing ESOTs contain discretionary elements such that they would be considered to be "non-fixed trusts" for the purpose of the entity taxation provisions and would not fall within the categories of exempted trusts proposed to date. Accordingly, these ESOTs would be subject to taxation as a company.

The general principles of employee share trusts and the reasons why these trusts will be subject to entity taxation are discussed in further detail at Appendix One.

3 Employee share ownership trusts should be excluded from entity taxation

We believe excluding ESOTs from entity taxation is necessary and a failure to do so will cause significant detriment to employee members of share plans administered under such trusts. The key reasons why ESOTs should be excluded are detailed below.

(a) Many ESOTs will not be fixed trusts because of requirements of Division 13A

Entities that do not meet the requirements of a "fixed trust" will be subject to entity taxation.

By complying with Division 13A, many employee share ownership plans will be prevented from meeting the requirements of a "fixed trust". Division 13A requires the inclusion of forfeiture clauses in certain circumstances, as well as the imposition of restrictions on transfers of the shares held on behalf of employees. Forfeiture clauses may prevent employee members from having indefeasible interests. In addition, the existence of forfeiture and restrictions clauses may mean that, on the Australian Taxation Office's view, employee members are not absolutely entitled to the shares.

It is also a feature of many share ownership plans that trusts may hold shares on behalf of non-specific beneficiaries, for example shares that may have been forfeited by employees that are still to be reallocated. Trusts holding shares on behalf of non-specific beneficiaries will also be unable to meet the "fixed trust" conditions.

Compliance with Division 13A will therefore subject many ESOTs to entity taxation. These trusts will be unable to meet the requirements of a "fixed trust" simply by virtue of their compliance with another provision of the law.

It should also be noted that the categories of exemptions from entity taxation that have previously been put forward will not operate to exclude ESOTs. For example, one suggestion is to exclude trusts with absolutely entitled beneficiaries. However, beneficiaries of ESOTs which are operated in accordance with Division 13A will not be absolutely entitled to shares held by the trust, owing to the reasons already discussed.

(b) Changing the taxation of employee share ownership plans is inconsistent with previous Government assurances

Taxing ESOTs as companies is clearly inconsistent with announcements made by the Government and public comments made by the Treasurer. The Treasurer in his submissions to the Shared Endeavours Committee indicated that it was the Government's intention to maintain the existing treatment for taxation of employee share plans and ESOTs. In his submission the following comments were made:

> *"…the overview to the final report of the Review of Business… noted that moving to a consistent entity tax regime does not preclude the maintenance of entity focussed tax concessions, including employee share acquisition scheme arrangements.*
>
> *In implementing a consistent entity regime, consideration will be given as to whether to exclude trusts from that regime, or to formally include them but with some modifications* ***to maintain the necessary features of their current treatment****…(emphasis added)*
>
> *Under Division 13A, where an employee share scheme provides discounted shares or rights to employees through a trust, the transfers to and from the trust will not… be taxable transactions."*

The Treasurer's own submission supports the proposition that the Government does not intend to alter the fundamental taxation of employee share plans and ESOTs. We fully agree with this approach.

The most effective and efficient mechanism for ensuring the taxation of employee share ownership plans remains unchanged is to specifically exclude ESOTs from entity taxation. To do otherwise would be a reversal of the Government's stated position, and for the reasons set out below, highly undesirable.

(c) Shared Endeavours Report recommends the exclusion of ESOTs

The House of Representatives Standing Committee on Employment, Education and Workplace Relations report on employee share plans, "Shared Endeavours" recommended that:

> *"the Government clarify the taxation treatment of trust arrangements that are used to operate bona fide employee share plans established under Division 13A, and legislate specifically to exempt such trusts from proposed entity taxation provisions" (recommendation 26)*

The Committee noted that:

> *"The taxation treatment of trusts used in employee share plans is a matter of concern. As noted, trusts are used extensively. They offer considerable advantages to the administration of share plans."*[1]

It was concluded by the Committee that the use of ESOTs to administer employee share plans provided significant benefits, including:

(a) minimising costs associated with the operation of employee share plans;

(b) assisting plans to comply with taxation and corporations law requirements; and

(c) providing for a well established and familiar legal structure founded on a long established and clear body of law.[2]

For these reasons, a key recommendation of the Committee was that the Government should legislate specifically to exempt ESOTs from the entity taxation provisions. We fully agree with the Committee's recommendations and conclusions in this respect.

(d) **Reasons why trusts are a common and effective vehicle**

Trusts are generally used in share ownership plan structures as they:

(a) allow shares to be provided as security against loans made to employees to acquire shares, including loans that may have been provided by their employers;

[1] Shared Endeavours, p. 127.
[2] Shared Endeavours, Pgs. 128-129.

(b) allow flexibility in providing for conditions under which shares can be offered and for re-allocating shares that are forfeited, without the trustee being taxed on unrealised gains;

(c) assist companies and their employees to comply with "insider trading" provisions by ensuring that the acquisition of shares on market is conducted by persons who are generally not in possession of such information;

(d) provide substantial cost efficiencies when handling a large number of employees with low volume holdings. Furthermore, trusts enable employees to maintain rights over the shares including rights to income and capital distributions in respect of those shares; and

(e) are appropriate for enabling share schemes to be offered to employees residing outside of Australia and assist the share ownership plan in complying with international regulatory provisions.

(e) Taxing ESOTs as companies would create significant practical difficulties

Taxing ESOTs as companies would fundamentally alter the basis of taxing 'benefits' provided under employee share ownership plans. It is also clearly inconsistent with the provisions contained in Division 13A and the underlying policy governing the taxation of these 'benefits'.

The following difficulties could arise in the event that ESOTs were not specifically excluded from the entity taxation regime. In particular:

(a) for tax purposes, it is likely that the shares held by the trust would be treated as the property of the trustee with the beneficiaries having no interest in the particular shares previously held by the trustee on their behalf;

(b) distributions of shares by the trustees to employees could potentially become subject to capital gains tax which would be payable by the trustee on the transfer of shares to eligible employees. That is, unrealised gains could be taxed at the point of transfer to employee;

(c) significant administrative burdens would be imposed on the trustee. For example, separate dividend accounts would be required to be maintained for each employee; and

(d) in the case of private companies, loans to employees which are currently excluded under Division 7A in respect of qualifying shares would appear to become subject to these provisions.

(f) Employee share ownership plans and ESOTs are already extensively regulated

Employee share plans are already governed by detailed specific tax provisions. Division 13A of the *Income Tax Assessment Act 1936* ("**ITAA 1936**") provides comprehensive rules and ensures that rights and shares granted under employee share ownership plans are subject to tax in the hands of employees and that they are not subject to fringe benefits tax.

Division 13A operates in conjunction with specific capital gains tax provisions contained in Subdivison 130-D of the *Income Tax Assessment Act 1997* ("**ITAA 1997**") which governs the CGT consequences of employee share ownership plans.

Furthermore, the holding period and related payment rules contained in Division 1A of Part IIIAA of the ITAA 1936 are also modified in their application to employee share plans. The rules applying to private companies contained in Division 7A of the ITAA 1936 contain special rules for employee share schemes. Division 7A treats certain loans as dividends but does not apply to loans made solely for the purpose of enabling a shareholder or associate to acquire qualifying shares or options under employee share schemes covered by Division 13A.

Section 530A of the ITAA also provides special rules for shares acquired under employee share plans that are considered to be interests in a foreign investment fund.

Given the number of existing specific provisions directed to the taxation of employee share plans it would appear unnecessary and inappropriate to add yet another layer of complexity by taxing ESOTs as companies under the proposed rules.

(g) ESOTs used in conjunction with qualifying plans encourages employee ownership of their employer and does not facilitate tax avoidance

There is a concern that trusts have been used by certain taxpayers to avoid the payment of tax. In June this year the Assistant Treasurer announced that legislative changes were to be introduced to address aggressively marketed employee benefit arrangements.

On the basis of this review and any recommendations that might arise from it, there would appear to be no further benefit gained by subjecting ESOTs to the entity taxation regime. It should also be noted that the review and the issues it is seeking to address are not relevant to share plans operated by listed public companies. Furthermore, beneficiaries of ESOTs are clearly identifiable in contrast to many employee benefit arrangements.

(h) Subjecting employee share plans to entity tax would discourage the establishment of future plans

Subjecting ESOTs to entity taxation would extensively impact many of the employee share plans currently operated by Australia's leading companies and could well jeopardise the establishment of future plans. Such a result would be in conflict with the Government's stated policy with respect to share plans in Australia.

In his submission to the Shared Endeavours Committee the Treasurer made the following comments:

> *"The Government strongly supports the development of employee ownership schemes within Australia. These schemes are consistent with Government policy of allowing employees and employers greater flexibility and choice in their working arrangements."*[3]

By severely limiting the type of plan that may be chosen by employers and by creating administrative and economic hurdles to the effective establishment and management of such schemes, the government would in effect discourage employee share ownership in Australia.

(i) Australian Taxation Office view

The Australian Taxation Office ("**ATO**") made a submission to the Shared Endeavours Committee earlier this year prior to the release of the Exposure Draft. In its submission to the Committee, the ATO advised that there was nothing contained in the business tax reform process that would be inconsistent with the policy objectives of Division 13A and that mainstream trust arrangements used in employee plans would not suffer any detrimental effects from the proposed reforms[4].

The ATO was of the opinion that sufficient protection would be provided by adopting the Ralph Report's recommendations. Although the ATO recognised that the consistent entities taxation rules may apply to trusts used in employee share schemes it was their opinion that such a result would only arise in limited situations.[5]

The ATO's submission does not appear to recognise that it is a feature of "mainstream" employee share ownership plans offered by major Australian companies that participants are not absolutely entitled to the shares held on their behalf in ordinary circumstances.

It is possible that the ATO's position on the specific exclusion of ESOTs from the entity tax provisions may have changed as a result of the amended proposals put forward by the Government. It remains our opinion, however, that a failure to specifically exclude ESOTs from entity taxation would subject a wider range of ESOTs to entity taxation than has previously been acknowledged by the ATO, including schemes operated by Australia's largest publicly listed companies.

4 Conclusion

We believe the uncertainty surrounding the taxation of employee share trusts under the entity taxation regime needs to be eliminated. Employee share ownership trusts established in accordance with Division 13A should be specifically excluded from the entity taxation provisions. We do not agree with the view of the ATO that ESOTs would be adequately protected by adopting the exclusions recommended by the Ralph Report.

5 Recommendation

We recommend that:

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[3] Shared Endeavours, Treasurer's submission no. 46.2.
[4] Shared Endeavours, ATO submission no. 24.2, p. 2.
[5] Shared Endeavours, ATO submission no. 24.2, p. 2.

Bona fide trusts established for the sole purpose of acquiring or holding shares or rights which are governed by the rules in Division 13A (or which would be so governed if the shares or rights were acquired at a discount for the purpose of the rules in Division 13A) should be specifically excluded from the proposed entity taxation provisions.

We would be happy to draft any specific exclusions required to take into account our recommendation. Please contact Andrew Clements on (03) 9643 4089 should you wish to discuss any aspect of this submission or if you require assistance with any drafting.

Yours faithfully

[Sgd] Mallesons Stephen Jaques

1 Common features of employee share ownership trusts

Employee share ownership plans are commonly implemented by using ESOTs. Common features of these trusts include:

(a) employees are allocated shares which are held on their behalf by the plan trustee, the legal owner, until specified conditions are met;

(b) where employees are granted options, a trustee would acquire shares with funds provided by the company and may hold the shares underlying the options until the options are exercised. Trustees may also hold a "pool" of shares from time to time (arising for example as a result of forfeiture of shares previously allocated to employees) which are to be allocated to employees at a later date;

(c) beneficiaries of share ownership plans may be entitled to any dividends or rights issues made in respect of those shares and may be able to exercise any voting rights attached to the shares whilst those share are held by the trustee; and

(d) trustees are restricted in their dealings with the shares, including any unallocated shares or income from those shares, in accordance with the terms of the particular trust deed.

Accordingly, ESOTs are a common, cost effective and administratively convenient mechanism for managing employee share ownership plans and encourage employee share ownership in Australia.

2 Basic premise of Exposure Draft

In general terms, the Exposure Draft provides that:

(a) "non-fixed trusts" will be liable for tax on their taxable income in the same way as a company. Most distributions from "non-fixed trusts" will be taxed as dividends under the proposed legislation;

(b) distributions from "non-fixed trusts" will be taken to be distributions of profits to the greatest extent possible with any balance being treated as a return of contributed capital; and

(c) in the case of discretionary interests in a "non-fixed trust", provided that certain conditions are met, returns of contributed capital will not be assessable nor will they reduce the cost base of the relevant membership interest.

3 Treatment of ESOTs under existing law

Under existing law, liability for taxation under ESOTs resides with the employee, to the extent that the employee is presently entitled to the income of the ESOT. To the extent that an employee is not presently entitled to the income of the ESOT;

- the trust deed may permit the trustee to distribute income to the discretionary objects of the trust; or

- the trustee may be assessed on the income.

In the event that ESOTs are subject to the proposed entity taxation provisions, primary tax liability will rest with the trustee.

4 Treatment under entity taxation regime

Entities that meet the definition of “non-fixed trusts” will be subject to the entity tax provisions. A “non-fixed trust” is defined as a trust that is not a fixed trust. A trust will be a fixed trust where beneficiaries have fixed entitlements to all of the income and capital of the trust. A beneficiary will be considered to have a fixed entitlement where they have a vested and indefeasible interest in the trust property.

(a) No vested and indefeasible interest

Many ESOTs are arranged such that beneficiaries do not have a vested and indefeasible interest in the shares held by the trustee. Furthermore, where ESOTs have a discretionary element they will not meet the requirements of a fixed trust. Many ESOTs will fail to meet the definition of fixed trusts because:

(a) ESOT trust deeds often contain forfeiture provisions that provide that shares allocated in accordance with an employee share ownership plan may be forfeited in certain circumstances. The following is an example of a common forfeiture clause:

> *“The Board may determine, for the purposes of an offer of Shares, that the Shares may be forfeited in the circumstances determined by the Board and notified to Participating Employees at the time of the offer.”*

(b) ESOTs often confer discretions on the share plan trustees. Common examples of discretions granted under employee share plan trust deeds include:

(i) a provision that on termination of the trust, the balance of the capital or income of a trust to which no employee is entitled to may be applied in whole or in part at the limited discretion of the trustee;

(ii) terms conferring powers on the trustee to apply, at their discretion, the balance of the net income of a trust for a year of income to which no participating employee is presently entitled; and

(iii) provisions granting the trustee the power, prior the termination of a trust, to apply any part of the capital of the trust to which no employee is entitled at their discretion. This discretion would ordinarily be limited to objects including the employees, superannuation funds or charities.

(c) in some situations, where employees are granted options, the trustee may acquire and hold shares to underlie those options. Under these plans, employees do not acquire a beneficial interest in the underlying shares until their options are exercised. The exercise of the options may be subject to certain pre-conditions (for example, performance hurdles). Until the time that the options are exercised, and further, in the event that the conditions are not met, or the employee declines to exercise the option, the shares remain are held by the trustee may determine to distribute the amounts in accordance with the discretionary objects of the trust, or to retain them and pay tax in its own right. The trustee may also be authorised to allocate those shares to other participants in the plan; and

(d) often companies lend funds to their employees to enable them to acquire shares. Any shares acquired with these funds will be held in trust until the loan is repaid and until this time the employee will have no right to call for the shares (and accordingly, is not absolutely entitled to the shares).

(b) Uncertainty following Review of Business Taxation Committee Report

In accordance with the recommendations of the Review of Business Taxation Committee ("t**he Ralph Report**"), the explanatory material to the Exposure Draft states at paragraph 2.8:

> *"However, not all non-fixed trusts will be subject to the new regime. Essentially these trusts, called excluded trusts, are created in circumstances where there was no choice to use a structure other than a non-fixed structure. Rules explaining what trusts are excluded trusts are to follow."*

On the basis of information available, it is presently unclear which trusts, apart from fixed trusts, will be excluded from entity taxation and, in particular, whether ESOTs will be excluded from the proposed legislation.

The Ralph Report recommended that all trusts, with minor exceptions, should be treated as companies. Recommendation 16.10 of the Ralph Report suggested that only those trusts which were created or settled as a legal requirement or subject to a legal test or sanction should be excluded. Trusts that would be excluded pursuant to these recommendations were listed and included deceased estates, bankruptcy trusts and court trusts. Trusts used in conjunction with employee share ownership plans were not included on the list.

The Ralph Report also recommended that trusts for absolutely entitled beneficiaries be disregarded for tax purposes. Recommendation 16.11 provided:

> *"That if a trustee merely holds property on trust - with no interest in or active duty as to the management of the trust property other than to hold each item of that property for the absolute benefit of a specific beneficiary or of joint beneficiaries, who have an absolute entitlement to that property from the outset of the trust - the trust relationship be ignored and the acts of the trustee be treated as those of the beneficiary or joint beneficiaries."*

This recommendation, formulated at the time when it was expected that all trusts would be taxed as companies, was specifically directed to fixed trusts with single or joint beneficiaries. Such an exclusion would not be applicable to ESOTs as such trusts ordinarily have multiple beneficiaries who may not be absolutely entitled to the trust property.

Accordingly, it remained unclear following the Ralph Report recommendations whether ESOTs would be subject to the entity taxation rules.

(c) Shared Endeavours Report

In September 2000 the Shared Endeavours Committee recommended that:

(a) Parliament enact a single piece of legislation, bringing under one act all laws governing employee share plans, their structure, taxation treatment, reporting and disclosure requirements (recommendation 8); and

(b) the Government clarify the taxation treatment of trust arrangements that are used to operate bona fide employee share plans established under Division 13A, and legislate specifically to exempt such trusts from proposed entity taxation provisions (recommendation 26).

The Committee clearly recognised that uncertainty existed as to the treatment of ESOTs under an entity taxation regime. Following the release of the Exposure Draft, the position still remains unclear as to whether ESOTs will be excluded from the entity taxation rules. For the reasons previously detailed it is our opinion that ESOTs should be specifically excluded from the provisions.