



AUSTRALIAN EMPLOYEE OWNERSHIP ASSOCIATION

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To: Australia's Future Tax System Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Submission on Employee Share Ownership Tax Incentives to the AFTS Review.

Dear Tax Review Secretariat

The Australian Employee Ownership Association (AEOA) is the only member based, non-profit association dedicated to the growth of employee ownership at all levels of Australian society. It is the leading advocate for cutting employees into "a piece of the pie" in a significant way in Australian businesses.

The AEOA's membership represents a diverse range of interests from specialist consultants to academics, corporate members, individuals and trade unions who have an interest in the development of employee share plans.

A mass of international research over the past 20 years shows that there is a very strong correlation between increased productivity and broad-based employee share ownership and participation plans operating within the businesses concerned. All of this research has been documented and can be found on the AEOA's website at www.aeoa.org.au.

Australia considerably lags the rest of the developed world in the growth and development of employee share ownership. For instance, while broad-based employee share ownership is relatively widespread in the listed company sector in Australia, it is estimated that only 3% of private and unlisted companies have 'all-employee' share ownership schemes, compared to 23% in the US.

In view of the contributions that employee share ownership can make to increasing productivity, employee savings and human capital development, it is disappointing therefore to note that the Tax Review report, ***Architecture of Australia's Tax and Transfer System*** made no mention at all of the key section in the Income Tax Assessment Act (ITAA) which covers tax concessions/incentives for encouraging broad-based employee share ownership in Australia – that section being Division 13A of ITAA.

The Tax Review's "Terms of Reference": Why Division 13A of the ITAA Needs to be Reviewed

In relation to the "Terms of Reference", broad and deep employee ownership in Australian industry would contribute to overall economic, social and environmental well being in the following ways:

4.1. Workforce participation and skill formation;

Employee ownership has been documented around the world as having a major impact on workplace cultures. With human capital becoming more important than physical assets, the stake in the business that employee share ownership provides has been reported as often critical to the skills formation, workforce participation and talent retention that sees creative enterprises thrive.

4.2. Individuals to save and provide for their future, including access to affordable housing;

Employee share ownership provides an attractive medium term savings option to employees, which complements their existing, but longer term, compulsory superannuation, while enabling direct participation in the performance of the business that employs them.

4.3. Investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness;

Employee share ownership will be one of the key factors contributing to productivity growth, corporate performance, increased investment and international competitiveness in the 21st century. Employee ownership results in increasing profit shares being directed into more productive investment, while spreading the wealth created by economic growth in a more equitable manner.

4.4. Reducing tax system complexity and compliance costs.

The major reason that employee share ownership has not grown in SMEs in the Australian economy – as research by the former Department of Employment and Workplace Relations (2004) has found - is because of complexity and compliance issues, particularly surrounding the costs of implementing employee share ownership under Division 13A of the ITAA.

Current State of Legislation

Division 13A of the Income Tax Assessment Act currently provides for:

- A definition of a qualifying ESOP (i.e. one which complies with the legislation) includes plans which offer at least 75% of permanent employees of 3 years standing an ordinary share, or right thereto, in the employer's company;
- A tax-exempt option under which employees can receive up to \$1,000 worth of shares per year;
- A tax-deferred option under which employees can defer tax liabilities for up to 10 years;
- Up to 5% of the firm's voting shares per individual employee;
- A 10-year tax deferral on share options;
- An exemption for option plans from the 75% rule.

General tax law also allows for the full tax-deductibility for employer contributions to an ESOP.

There are several defects in the Division 13A ESOP legislative provisions. The AEOA has pointed these out many times before. They include:

1. A two-tiered system of share ownership; one for traditional shareholders where capital growth is taxed under CGT (including the 50% CGT concession) and who can hold their equity in perpetuity; and one for employee-owners where capital growth is taxed as income and who must pay this tax after ten years, even if they wish to hold their shares for much longer.
2. A limit on employees holding, via a qualifying Employee Share Ownership Plan (ESOP), more than 5 per cent of the voting shares in their employer's company - which means that most small companies cannot implement succession planning arrangements where the retiring employer uses an ESOP to sell the company to his employees.
3. Restricting qualifying ESOPs to ordinary shares (including stapled securities) in the employer's company: which means that those companies where it is not viable to issue an ordinary share - for example, a wholly-owned foreign subsidiary or a small firm whose owners do not wish to relinquish control before retirement - can do nothing to help their employees become part-owners of the business.

While no election promises were made to address - let alone solve - any one of the problems in Division 13A, nor their corollary - a systematic discrimination against the small business sector and those employed in it towards accessing ESOPs – the Tax Review now offers the perfect opportunity to start looking at them afresh. More broadly, there are many other unnecessary complexities in the regulation of ESOPs that restrict their take up in practice and which the review could also be highlighting if employee share ownership is to become important to achieving the objectives of the AFTS Review as set out in the terms of reference.

Principles of Employee Ownership

It is the AEOA's view that the Division 13A legislation falls far short of what is required of a modern economy such as Australia's – and, in comparison, far short of what is needed for Australia to maintain its competitiveness in the global economy in terms of productivity growth, human capital development, employee retention, employee savings and positive workplace cultures.

The AEOA believes that the legislation needs to be renewed and guided by the following "Principles of Employee Ownership" which have been developed over the years in consultation with industry groups, individual businesses, consultant practitioners and trade unions. These "Principles" need to be supported if

Australia is to catch up with its competitors – especially the UK and the USA, where employee share ownership is much more advanced.

The AEOA's view is that these "Principles" should guide broad policy development for employee share ownership, in combination with decision-making on the most appropriate tax incentives to achieve them.

Therefore, in order to develop a sound, strategically conceived tax policy on employee ownership, it is recommended that the following general principles should be adopted:

1. It should be practically possible for the majority of employees to benefit from some form of equity participation arrangement.
2. Diverse forms of equity participation are required to enable the majority of employees, especially private sector employees, to secure a stake in their employer's enterprise.
3. Employees should be able to use Employee Share Ownership Plans (ESOPs), where feasible, to buy out their employer, or to participate in buy-outs (or buy-ins) in concert with other investors.
4. Employees of foreign companies should have the opportunity to share in, and increase, Australian ownership of these firms by means of appropriately designed employee equity plans.
5. Employee-owners should have the same rights as other owners. Like them, where applicable, employee owners should (where ordinary shares are used) be able to vote their shares, receive dividends, and be free of any artificial restriction upon the length of time they can hold shares in their employer's company.
6. The use of ESOPs as a mechanism for funding the formation of new productive capital, particularly in unlisted companies, should be encouraged.
7. All privatisations should be premised upon employees obtaining through ESOPs, or ESOP-like structures, a significant stake in the new enterprise.
8. ESOPs should be promoted as a key element in national savings policy, providing a new level of medium term savings in addition to longer term superannuation, and capable of meeting different objectives through being tied directly to productive investment.
9. In order to realise the full savings potential of ESOPs (and, over the longer term, to increase Treasury tax receipts):
 - All contributions to savings instruments, and the subsequent returns thereon, should be taxed progressively when the savings are withdrawn and at that point only.
 - Employees should be able to roll over all, or part of, the savings accrued in one ESOP into that of their immediately subsequent employer without the savings being subject to tax at the point of termination.
 - Tax should only be imposed on realised gains, and even then should be divided into:
 - (i) The gain at the time of acquisition, which should be taxed as income;
 - (ii) Any subsequent capital gain, which should be taxed as under CGT
10. Major Government economic, taxation, and business regulatory decisions should be subject to an "ownership impact" assessment to determine whether they conform to the above principles and whether they promote a wider and more diversified ownership of our wealth-producing assets.

The Bottom Line

To correct the anti-small business bias of the current ESOP legislation, the AFTS Tax Review should consider some immediate steps. The AEOA recommends that existing ESOP tax law should be amended as soon as possible to enable small business to more easily implement employee share ownership arrangements, through the following minimum reforms:

- To raise, in the case of small companies, the limit on employees holding more than 5% of voting shares;
- To lift the prohibition against qualifying ESOPs using equities other than ordinary shares, thereby allowing for the use of other equity types useful to small business;

- To tax upfront gains as income and capital growth as CGT (upon the realisation of the shares in both cases).

The Broader Vision

Further, the AEOA submits that the new ALP Government needs to do something more than make minimalist amendments to the legislation it inherited from the Coalition. The new Government has the opportunity to set the agenda for a popular and inclusive economic and social program by developing an integrated, strategic policy on employee ownership.

Achieving this requires a grasp of where employee share ownership fits into a spectrum of policies covering taxation, industrial relations, savings, company financing and expanding Australian equity in foreign-owned companies.

To start this policy development process, the AEOA provides the following list of key questions that need to be considered by the AFTS Review, and formally offers them for consideration.

Developing an ESOPs Tax policy – the major questions

To develop a strategic approach to tax incentives for employee share ownership, the Government should consider the following – all of which are based on the “Principles” outlined above:

1. Whether all employees – rather than the minority who work for listed companies – should be entitled to share in the ownership of the enterprise in which they work.
2. Whether diverse forms of equity participation are required to enable all employees to secure a stake in their employer’s enterprise.
3. Whether all employees, and particularly those who work in small companies, should be able to use ESOPs to buy-out their employer, or otherwise to participate in a buy-out (or buy-in).
4. Whether the employees of foreign companies should have the opportunity to share in, and increase, Australian ownership of these firms by means of appropriately designed employee equity plans.
5. Whether employee-owners should have the same rights as other owners, or whether they should be treated as second class owners by being limited, in effect, to holding their shares for ten years (as they do under the current provisions of Division 13A of the ITAA).
6. Whether ESOPs should be encouraged as a mechanism for funding the formation of new productive capital, particularly in unlisted companies.
7. Whether ESOPs should be seen as a key element in national savings policy, providing a new level of medium-term savings in addition to longer term superannuation, and capable of meeting different objectives through being tied to the participation of employees directly in productive investment and wealth creation in their workplaces.
8. Whether, and to what extent, Australia should follow the example set by other leading economies to provide tax and other incentives to promote the spread of ESOPs – or to at least minimise the disincentives towards implementing employee share ownership.

The AEOA would be pleased to assist the “Australia’s Future Tax System” Review to achieve its objectives as set out in its terms of reference through the development of comprehensive and rejuvenated tax policy aimed at growing broad-based employee share ownership in Australia.

Australian Employee Ownership Association.
10th September, 2008