Australian Government
Inspector-General of Taxation
Taxation Ombudsman

SUBMISSION TO THE STANDING COMMITTEE ON TAX AND REVENUE

INQUIRY INTO THE TAX TREATMENT OF EMPLOYEE SHARE SCHEMES

By the Inspector-General of Taxation and Taxation Ombudsman

April 2020

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23 April 2020

Mr Jason Falinski MP
Chair
House of Representatives Standing Committee on Tax and Revenue
PO Box 6021
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Dear Chair

Inquiry into the tax treatment of employee share schemes

The Inspector-General of Taxation and Taxation Ombudsman (IGTO) welcomes the opportunity to provide this submission to the Committee's Inquiry into the tax treatment of employee share schemes (ESS).

About the IGTO

The IGTO is an independent Commonwealth agency that investigates taxation administration complaints, laws and systems to improve the administration of the tax system for all taxpayers. This includes private investigations of actions and decisions of Tax Officials of the Australian Taxation Office (ATO) and Tax Practitioners Board (TPB) as well as public investigations of systems and laws as informed by our complaints service and stakeholder engagement. We advise and report to Government, the relevant Minister, Parliamentary Committees, the ATO, the TPB and the community generally.

The work of this Committee is also important to inform the direction of IGTO investigations. Accordingly, we welcome the opportunity to assist the Committee with this Inquiry.

Terms of Reference

The IGTO understands that the Committee will inquire into the effectiveness of the 2015 ESS changes and examine:

1. how effective the changes in 2015 have been in their goal of bolstering entrepreneurship in Australia and supporting start-up companies;

2. the costs and benefits of these concessional taxation treatments, and deferred taxing points for options, to the broader community;

3. whether the current tax treatment of ESS remains relevant to start-up companies and whether any changes are appropriate to ensure the taxation treatment remains relevant;

4. how companies currently structure their ESS arrangements and how taxation treatment affects these decisions; and

5. the challenges faced by companies in setting up an ESS arrangement and how the standard documents by the ATO, and introduced in 2015, assist this process and whether additional improvements should be made.

This submission is directed in particular to tax administration issues, in particular, the fifth term of reference, namely:

> *…the challenges faced by companies in setting up an ESS arrangement and how the standard documents by the ATO, and introduced in 2015, assist this process and whether additional improvements should be made.*

An overview and summary of our understanding of the ESS rules is included in Annexure A for your information. An Executive Summary is set out below with further detailed comments included in Annexure B.

Executive Summary

IGTO has received a small number of complaints regarding ESS but none relate to the 2015 Amendments

The IGTO has received a small number of complaints and submissions regarding the ATO's administration of the ESS taxation regime – refer Annexure C. However, no concerns have been raised in relation to the ATO's administration of the 2015 changes to that regime. This includes its standard documents and safe harbour market valuations. This may reflect the take up rate amongst taxpayers or suggest that the rules are operating appropriately.

The IGTO is unable to speculate on the reasons for this low level of complaints as we have not conducted a review into this area of tax administration. We would be open to doing so should the Committee consider that an investigative review would be of assistance - including as part of this Inquiry.

ATO's standard documents may reduce compliance costs and uncertainty, but advisory costs are still likely

The IGTO has considered publicly available materials regarding this regime. Based on this material, we note that the ATO's standard documents (which are available from its website, www.ato.gov.au) and the ATO's safe harbour market valuations have been welcomed by some as a positive step that should help to reduce start-up companies' compliance costs and address uncertainty.[1] However, as acknowledged by the ATO on its website, the standard documents do not replace the need for professional advice and are

[1] See for example, employee Ownership Australia website www.employeeownership.com.au

principally planning documents only. For example, the ATO Instruction Guide - *Instructions for using the standard documentation - Employee share schemes: start-up companies* states:[2]

> *The standard documents have been developed to save you some of the time and cost associated with the initial set up of an ESS for the offer of Options (for example, by reducing the time spent consulting with professional advisors.)*
>
> ***The standard documents should be used to assist with the initial planning and information gathering stages, rather than a replacement for professional advice.*** *You will need to seek independent professional advice about certain aspects of your draft plan.* [emphasis added]
>
> *The standard documents are not necessarily designed to meet all the requirements of every company and you may need to change the plan to suit your individual circumstances. You should seek professional advice about any modifications or additions you wish to make to the Employee Option Plan or Offer Letter.*
>
> *To further help start-up companies establish and operate an ESS, the ATO will publish from time to time a list of software developers (and a link to their website) that have produced interactive applications to assist with the task of assembling and populating the standard ESS documents. LawPath (lawpath.com.au/easy-ess) is one such developer and who have an interactive application to create legal documents*

The ATO website also states:[3]

> *These standard documents are not designed to meet all the requirements of every company.*
>
> *The standard Plans and Offer letters have been provided in Word format so that you can download and alter to suit your particular circumstances.*
>
> *To further help start-up companies establish and operate an ESS, we will provide a link (see below) to digital service providers who have produced interactive applications to help with the task of assembling and populating the standard ESS documents.*
>
> *…*
>
> *There are many legal and regulatory requirements to consider in implementing an employee share scheme (ESS). You must be aware of the following:*
>
> - *the provisions of the Corporations Act 2001 [External Link] relating especially to offers of shares (in particular, sections 706, 708 and 710 – 716) including disclosure requirements and exemptions*
> - *for listed companies, the relevant stock exchange listing rules (ASX listing rules)*
> - *the company constitution*

[2] Australian Taxation Office, *Employee Share Schemes: Start-Up Companies*, <https://www.ato.gov.au/uploadedFiles/Content/MEI/downloads/ESS%20standard%20docs%20instructions.pdf >

[3] ATO, ESS – standard documents for the start-up concession (15 January 2018) <https://www.ato.gov.au/General/Employee-share-schemes/In-detail/ESS---Standard-documents-for-the-start-up-concession/>.

- *the provisions of the Corporations Act restricting companies from dealing with their own shares*
- *taxation law issues, including income tax, capital gains tax, pay as you go withholding and fringe benefits tax*
- *the provisions of the Corporations Act relating to financial services regulation, and the rules regulating financial advice (unless you have an exemption from this by using section 708 of the Corporations Act or Australian Securities and Investments Commission (ASIC) Class Order exemptions for ESS)*
- *other provisions of the Corporations Act relating to licensing, advertising, hawking, managed investment schemes and on-sale of financial products*
- *accounting standards*
- *privacy legislation.*

In addition, an employer will need to consider workplace relations and relevant employment laws.

The Committee may wish to consider whether the ATO's standard documents and valuation methods should be limited only to start-up concession companies.

Additional ATO Guidance

A critical taxing point for an ESS tax deferred scheme arises when there is no longer any real risk of forfeiture – that is, of the ESS interest. Commercially, it will generally be desirable to include 'good leaver' and 'bad leaver' provisions to ensure the ESS interest is awarded in appropriate circumstances only. These will inevitably create a risk of forfeiture. Different views about what constitutes a real risk of forfeiture may exist in the market and uncertainty about the relevant taxing point arises when there is such ambiguity. Additional ATO guidance and practical examples may improve the community's understanding of this aspect of the rules – especially which circumstances would amount to a 'real risk of forfeiture' and its timing. For example:

- Is forfeiture upon resignation a real risk of forfeiture?
- Is forfeiture determined by good leaver and bad leaver notions?
- Is a risk of forfeiture necessarily asymmetrical – i.e. only where the employer can determine the circumstances which give rise to a forfeiture?
- Can a period of time be used as a rule of thumb (e.g. a 12-month rule of thumb) in determining the timing of a real risk of forfeiture? If so, when should such a period commence and upon what event – eg. should it start either on the expiry or upon entry into an ESS or after a 'cliff' period?

These considerations apply to tax-deferred schemes generally but may equally apply to the ATO's standard document for the start-up concession as well. This is because Division 83A of the *Income Tax Assessment Act 1997* (ITAA 1997) ensures the start-up concessions apply (i.e. a reduction in taxable income) in priority to any deferral of the taxing point.

Further Opportunities to reduce compliance costs

We also note that there may be benefit in exploring whether there are further opportunities for the ATO to assist employers in reducing compliance costs and uncertainty in implementing the 2015 changes to the ESS regime.

Such opportunities may include the ATO:

- providing a repertoire of standard clauses for the standard documents provided on its website for start-up companies implementing ESSs, including 'good leaver' and 'bad leaver' clauses;
- incurring the cost for private binding rulings on market values and providing binding advice on issues of tax uncertainty to help reduce employers' costs; and
- broadening the range of companies that are eligible to use the safe harbour market valuations in Legislative Instrument ESS 2015/1.

ESS interactions involve Tax and Corporations Law including remuneration reporting

The publicly available materials also raise a number of broader issues regarding the 2015 changes to the ESS regime, such as the impact of Corporations law obligations on implementation costs.

Other professional advisory firms may be better placed to provide insight on such issues as they extend beyond our jurisdiction. The Committee may wish to explore with professional advisory firms in particular what the impact of Corporations Law issues may have on the intended tax policy objective and the prevalence of ESSs both before and after 1 July 2015.

Financial Impact

The Explanatory Memorandum noted the financial impact as follows -

> ***Financial impact***: This measure has the following financial impact:

2014-15	2015-16	2016-17	2017-18
–	–$52m	–$56m	–$88m

The Committee may wish to inquire how the financial impact of the actual implementation compares with this estimate and where the differences in assumptions arise. In addition, the Committee may wish to explore through submissions from professional advisory firms what additional professional advisory costs are necessary to be incurred in circumstances where the ATO's standard documents are used. Such advice may arise each time rights are granted to employees. This information may assist in a costs versus benefits analysis.

The importance of the inquiry

The IGTO welcomes the opportunity to make this submission and to share some observations, insights and recommendations on the effectiveness of the 2015 changes to the ESS regime. Please do not hesitate to contact us should you require any further information or assistance.

Yours sincerely

Karen Payne

Inspector General of Taxation and Taxation Ombudsman

Annexure A — Overview of taxation arrangements for employee share schemes

The following provides a general summary and overview of the taxation arrangements for employee share scheme (ESS) interests is provided by way of background and context. We understand that this Inquiry is concerned with the 2015 amendments which can broadly be summarised as:

a. Changes to existing concessions - the main changes are:

   - to the timing of the deferred taxing point for ESS interests acquired under tax-deferred schemes, including increasing the maximum deferral to 15 years;
   - to the test for significant ownership, including the easing of voting right limitations;
   - to provide a tax refund in some circumstances where an employee acquires rights but chooses not to exercise them; and

b. New concessions for start-up companies.

Overview

In general, Australia's taxation laws seek to tax individuals (and their related entities) on any discount they receive on an issue of an ESS interest - that is, as if the ESS interest were income in kind. Two issues arise in taxing the issue of a discounted ESS interest:

- Timing – when is the relevant taxing time. This determines the year in which any discount is to be taxed.
- Valuation – how is the discount to be calculated. This determines the accepted methods for ascertaining the value of the ESS interests (rights or shares) to be acquired.

For ESS interests acquired after 30 June 2009, the ESS taxation rules as set out in Division 83A of the ITAA 1997 apply. From 1 July 2009, there are four different taxation outcomes for ESS interests, which depend on the terms of the scheme and ESS issue, the value of the discount and the time when the ESS interest is acquired and cannot be forfeited:

- Taxed-upfront scheme: the default position – if the scheme does not meet the conditions for concessional tax treatment, employees will be **taxed on the discount on the ESS interests in the income year the ESS interests were provided to them**.
- Taxed-upfront scheme: eligible for reduction – subject to certain conditions being met by both the ESS and employees, concessional tax treatment is available for employees who have received ESS interests under a taxed-upfront scheme if they also meet an income test. The concession allows **employees to reduce their taxable discount income by up to $1,000**.
- Tax-deferred scheme: salary sacrifice – subject to certain conditions being met by both the ESS and employees who have acquired ESS interests under salary-sacrifice arrangements, these ESS interests will be **taxed in the income year that the deferred taxing point occurs**.
- Tax-deferred scheme: real risk of forfeiture – subject to certain conditions being met by both the ESS and employees who have acquired ESS interests when there is a real risk of forfeiture under the conditions of the scheme, these ESS interests will be **taxed in the income year that the deferred taxing point occurs**.

The concessional tax treatment that can apply accordingly is either a reduction in the amount that is assessable or a deferral in the relevant taxing time.

Concessional Tax Treatment

To qualify for any concessional tax treatment, the ESS and the employee must meet all the following conditions:

- the ESS interests acquired by employees must be in their employer or a holding company of the employer;
- when an employee acquires the interest, all ESS interests available for acquisition under the scheme must relate to ordinary shares; and
- the ESS interests provided must not result in either of the following immediately after acquisition:
  - an employee owning more than ten per cent (previously 5%) of the shareholding in their employer; or
  - an employee controlling more than ten per cent (previously 5%) of the maximum voting rights.

Taxed upfront – but $1,000 reduction

In addition to the above general conditions, employees must meet other specific conditions to qualify for the taxable income reduction - up to $1,000. These conditions are:

- the employee must not have a real risk of forfeiting the ESS interest under the conditions of the scheme;
- the scheme must be operated so that all the employees must hold the ESS interest (or any share acquired on exercise of an ESS interest that is a right) for three years or until the employee ceases employment; and
- the scheme must be offered on a non-discriminatory basis to at least 75 per cent of the company's Australian-resident permanent employees with at least three years of service.

The employee must also meet the income test - the employee's taxable income (after adjustments) for the income year must be $180,000 or less.

Disqualifying Activity

Employees will not be eligible for the upfront or deferred tax concession if:

- the predominant business of the employing company that the employee acquires ESS interests in, is the acquisition, sale or holding of shares, securities or other investments (directly or indirectly);
- they are employed by the company that conducts that business; and
- they are also employed by a subsidiary of that company or a holding company of the company that conducts that business, or a subsidiary of a holding company of the first company that conducts that business.

Tax Deferred Schemes

If the employee is provided with ESS interests under a deferral scheme and they meet certain conditions, they will be assessed for tax purposes in the income year that the deferred taxing point occurs. The amount assessed will be the market value of the ESS interests **at the deferred taxing point**, reduced by the cost base of the interests. In addition to the general conditions, the following conditions must be met for the scheme to be considered a *tax-deferred scheme – real risk of forfeiture*:

- the employee must have a real risk of forfeiting the ESS interest under the conditions of the scheme or forfeiting the share resulting from the exercise of the ESS interest; and
- if the ESS interest is a share, at least 75 per cent of the Australian-resident permanent employees with at least three years' service are, or at some earlier time had been, entitled to acquire ESS interests in their employer or a holding company under an ESS.

Prior to the amendments in 2015, where an ESS right was subject to deferred taxation, the taxing point occurred at the earliest of one of the following times:

- when the employee ceases the employment in respect of which they acquired the right;
- seven years after the employee acquired the right;
- when there are no longer any genuine restrictions on the disposal of the right (for example, being sold), and there is no real risk of the employee forfeiting the right; or
- when there are no longer any genuine restrictions on the exercise of the right, or resulting share being disposed of (such as by sale), and there is no real risk of the employee forfeiting the right or underlying share.

The amendments in 2015 change the second and fourth of those taxing points so that the taxing point occurs at the earliest of one of the following times:

- when the employee ceases the employment in respect of which they acquired the right;
- fifteen years after the employee acquired the right;
- when there are no longer any genuine restrictions on the disposal of the right (for example, being sold), and there is no real risk of the employee forfeiting the right; or
- when the right is exercised and there is no real risk of the employee forfeiting the resulting share and there is no genuine restriction on the disposal of the resulting share (if such risks or restrictions exist, the taxing point is delayed until they lift).

Importantly, the deferred taxing point concessions can apply to rights schemes **which do not contain a real risk of forfeiture**. The scheme rules must however state that tax deferred treatment applies to the scheme and the scheme genuinely restricts an employee from immediately disposing of the right.

Small start-up Tax Concession

After 1 July 2015, employees of certain small start-up companies may receive the start-up tax concession, if their employer and the scheme meet a number of conditions.

Eligibility criteria for start-up concessions

In addition to the general conditions that apply to all concessional schemes, the following specific conditions apply to the start-up concession:

Start-up company -

- Must be an unlisted company – no equity securities may be listed on any stock exchange
- All companies in the corporate group must have been incorporated for less than 10 years
- Aggregated annual turnover must not exceed $50 million.

Employer - The employing company must be an Australian resident company.

Scheme - Employees must hold ESS Interests for at least three years (commencing on the date the ESS interests were acquired).

ESS interests -

- must only be ordinary shares or options to acquire ordinary shares, or rights (including options) to acquire ordinary shares.
- A share must be provided at a discount no greater than 15% of the market value of the shares at the date of grant ; or
- A right must have an exercise price (or strike price) that is greater than or equal to the market value of an ordinary share in the issuing company at the date of grant of the options.

Taxation of ESS Discount is exempt and instead only the capital gain on disposal of shares is taxed

The start-up concession provides that an employee does not include a discount on ESS interests in their assessable income. Any gain or loss on disposal of the rights or shares will be assessed under the capital gains tax regime. When working out if the 50% CGT discount applies, **the period of ownership of a share acquired on exercise of a right is taken to have started when the right was acquired**.

Comparison to illustrate changes to the ESS taxing rules before and after 2015

After 2015	Before 2015
In ESS deferred schemes where income tax is deferred, the taxing point is the earliest of: *For shares* • when there is no real risk of forfeiture of the shares and any restrictions on the sale are lifted; • when the employee ceases employment; or • 15 years after the shares were acquired. *For rights* • when there is no real risk of forfeiture of the rights and any restrictions on the sale of the rights are lifted; • when the employee exercises the right, and after exercising the right there is no real risk of forfeiture of the underlying share and the restrictions on sale of the share are lifted; • when the employee ceases employment; or • 15 years after the rights were acquired.	In ESS deferred schemes where income tax is deferred, the taxing point is the earliest of: • when there is no real risk of forfeiture of the benefits and any restrictions on the sale or exercise are lifted; • when the employee ceases employment; or • seven years after the shares or rights were acquired.
Employees of certain small start-up companies receive further concessions when acquiring certain shares or rights in their employer or a holding company of their employer. These further concessions are an income tax exemption for the discount received on certain shares and the deferral of the income tax on the discount received on certain rights which are instead taxed under the capital gains tax rules.	All ESS rules and concessions apply equally to all corporate tax entities and their employees.
The ESS rules generally use the ordinary meaning of market value. The Commissioner can, by legislative instrument, approve optional safe harbour valuation methodologies which will be binding on the Commissioner. The method for calculating the value of an ESS interest can also be specified by regulation in the *Income Tax Assessment Regulations 1997*.	The ESS rules generally use the ordinary meaning of market value and do not specify which valuation methodology can be used. The method for calculating the value of an ESS interest can also be specified by regulation in the *Income Tax Assessment Regulations 1997*.

Annexure B — Detailed submissions on ATO's standard documents and safe harbour valuation methods

ATO's standard documents

The ATO has developed a set of standard document templates designed to help eligible start-up companies establish and operate an employee share scheme (ESS).

The standard documents that have been developed are:

- ATO Instruction Guide - Employee share schemes: start-up companies (PDF, 398KB) This link will download a file – an instruction guide on how to use the above documents
- a standard Employee Option Plan (DOCX, 313KB) This link will download a file.
- a standard Employee Option Plan Offer Letter (DOCX, 258KB) This link will download a file.
- a standard Employee Share Plan (DOCX, 315KB) This link will download a file.
- a standard Employee Share Plan Offer letter (DOCX, 262KB) This link will download a file.

These standard documents are not designed to meet all the requirements of every company. They are designed to reduce the financial and compliance burden but they do not eliminate the need to engage professional advisors to implement an ESS or issue an ESS interest. Professional advisory costs are said to form a significant portion of ESS implementation costs.[4]

The standard documents are designed to address the start-up concession only. They do not address tax deferred or up-front ESS.

Under the start-up concession, and provided certain conditions are met, any discount on the issue of an options will not be taxed as assessable income on grant, vesting or exercise. Rather, the taxing point will be deferred until the sale of the shares acquired upon exercise of the option and the gain will generally be taxed as a capital gain – that is, as a CGT event. The 50% CGT discount will apply if the sale of the shares occurs at least 12 months after the grant of the Options.

The CGT treatment of employee share schemes, is generally set out in Subdivision 130-D of the ITAA 1997.

The ATO's standard documents and safe harbour valuation methods have been welcomed as positive steps by some.[5] Potentially they could reduce a substantial portion of a company's ESS implementation costs. However, publicly available commentary indicates their use may be limited and there may also be potential to expand their use, as indicated below.

[4] For example, such costs have been estimated to range from $3000 (see, for example, Palmer-Derrien, "A fair bit of s**t: Government opens employee share scheme consultation, to lukewarm reception", Startup News, 10 April 2019 (available from www.smartcompany.com.au) to $30,000 (refer Pitcher Partners, "Employee Share Schemes", a submission to the Treasury consultation Employee Share Scheme (available from www.treasury.gov.au), 8 May 2019, p 2).

[5] see, for example, Employee Ownership Australia's website www.employeeownership.com.au

Expansion of ATO's standard documents

Companies are likely to need to amend the ATO's standard documentation to suit their particular circumstances and as such are likely to incur some additional advisory costs to implement. That is, even where the ATO's standard documents are used, professional advisory costs are likely to be incurred to progress the plan rules to a final form. The Committee may seek evidence of what professional advisory costs are necessary to be incurred in circumstances where the ATO's standard documents are used. Such advice may arise each time rights are granted to employees.

The standard documents do not appear to include some of the more common clauses in ESS arrangements. There may be an opportunity to further reduce implementation costs by including a larger repertoire of common clauses in the ATO's standard documents. For example, rule 2(c) of the standard 'Employee Option Plan' provides discretion to the board that administers the ESS in deciding how options will be treated when an employee ceases employment. It does not provide 'good leaver' and 'bad leaver' provisions that are commonly used in ESS arrangements as default provisions which may be relaxed at the discretion of the board.[6] These good leaver/bad leaver provisions are aimed to promote longer term employee participation in actively building the business and deterring key personnel from leaving before an agreed date, respectively.

In our view, the ATO could further consult with interested parties to explore whether employers' ESS implementation costs could be further reduced where a broader repertoire of standard clauses is made available and additional ATO binding advice is provided. This may include, for example:

- Clauses that are commonly used in ESS arrangements (in circumstances beyond the start-up concession);
- Clauses that assist employers to minimise the costs of complying with taxation and corporations law requirements.
- Additional ATO binding advice on when there is no longer any real risk of forfeiture under an ESS tax deferred scheme.

Commercially, it will generally be desirable to include good leaver and bad leaver provisions to ensure the ESS interest is awarded in appropriate circumstances. These will inevitably create a risk of forfeiture which is a critical taxing point for tax deferred schemes. Different views about what constitutes a real risk of forfeiture may exist and uncertainty about the relevant taxing point arises when there is such ambiguity. Additional ATO guidance and practical examples of when there is a real risk of forfeiture may assist. For example:

- Is forfeiture upon a resignation a real risk of forfeiture?
- Is forfeiture determined by good leaver and bad leaver notions?
- Is a risk of forfeiture necessarily asymmetrical – only where the employer can determine circumstances which give rise to a forfeiture?
- Can a period of time be used as a rule of thumb (e.g. a 12-month rule of thumb) in determining the timing of a real risk of forfeiture? If so, when should such a period commence and upon what event – eg. should it start either on the expiry or upon entry into an ESS or after a 'cliff' period (which can be in the first year of an ESS[7]).

[6] See, for example, Hall&Willcox, "Employee options are back! Plus new ATO guidance for start-ups", 16 July 2015 (available from www.hallandwillcox.com.au)

[7] See, for example, Sadauskas, Smart Company "Why Australia keeps getting it wrong on employee share schemes", 10 February 2015 (referring to M. Barrie's views).

Safe harbour valuation methods

Unlisted companies do not have simple means to determine the market value of their shares due to the lack of a liquid secondary market for sale of those shares. Valuations can assist these companies mitigate the risk of ATO challenge regarding the value of the rights issued under ESSs. Valuation costs, however, may operate as a deterrent for implementing an ESS as such costs are likely material.

The ATO's safe harbour valuation methods can assist to reduce such costs as they are provided in a form which binds the Commissioner in any subsequent compliance activity.[8] The safe harbour methodologies are set out below.

Approved Methods for Valuing Unlisted Ordinary Shares

Method 1

(1) For a company that:

(a) has not raised capital of more than $10 million during the period of 12 months immediately before the valuation time; and

(b) at the valuation time, either:

(i) has been incorporated for not more than 7 years; or

(ii) is a small business entity within the meaning of section 328-110 of the *Income Tax Assessment Act 1997;* and

(c) prepares, or will prepare, a financial report (within the meaning of the *Corporations Act 2001),* for the year in which the valuation time occurs, that complies with the accounting standards under the *Corporations Act 2001;*

(d) the method set out in sub-clause (2) is an approved valuation method.

(2) The market value of an ordinary share in the company at a particular valuation time is worked out under the following method statement:

Step 1	Work out the amount of net tangible assets of the company (disregarding any preference shares on issue) at that time.
Step 2	Work out the amount of the return that would be required to be provided under the terms of any preference shares on issue at the valuation time if those shares were to be redeemed, cancelled, bought back or otherwise satisfied at that time (disregarding any contingencies as to the provision of that return and any return that would not rank before ordinary shareholders upon a winding up).
Step 3	Reduce the Step 1 amount by the Step 2 amount.

[8] via Legislative Instrument ESS 2015/1

Step 4	Divide the Step 3 amount by the total number of: (i) ordinary shares; and (ii) any preference shares that may participate together with any ordinary shares in the residual assets of the company upon a winding up; on issue in the company at that time.

Method 2

(3) A method that satisfies the requirements set out in sub-clause (4) is an approved valuation method.

(4) The requirements of this sub-clause are that the valuation of ordinary shares must be:

(a) performed by either:

(i) the chief financial officer of the company; or

(ii) a person having the knowledge, experience and training to perform such valuations; and

(b) in writing and fully documented, taking into account the following on a reasonable basis:

(i) the value of tangible and intangible assets of the company;

(ii) the present value of anticipated future cash flows;

(iii) the market value of similar businesses, including the use of earnings multiples;

(iv) uplifts and discounts for control premiums, lack of marketability and key person risk; and

(b) endorsed in a written resolution by the directors of the company as to the method used and the resultant value.

Method 3

(5) If a company chooses to use a method of valuation that produces a value not less than the amount which would be produced using a method under this approval that the company could otherwise apply, that valuation is taken to have been made under this approval.

As a result, eligible start-up companies that apply these methods (or other methods which produce values less than those produced by the safe harbour valuation methods) do not need to incur the cost in obtaining independent valuations to address the risk of ATO challenge.

Providing safe harbour valuation methods which bind the Commissioner is consistent with the recommendations made in the IGTO Review in 2014 *Review into the ATO's administration of valuation matters*.[9] These recommendations included:

[9] see recommendation 4.1(a)

Recommendation 3.1

The IGT recommends that, in designing tax laws, the Government consider:

a. requiring valuations only where the relevant regulation impact statement demonstrates that it would be of the 'highest net benefit'; and

b. where valuation is required, provide safe harbours or allow the use of existing valuations obtained for other purposes such as accounting standards or as part of natural business systems.

Recommendation 3.3

The IGT recommends that, where eligibility criteria for tax concessions or benefits require valuation, the Government should consider the use of tapering to avoid disproportionate outcomes that may arise due to minor differences in valuations.

Recommendation 4.1

The IGT recommends that the ATO:

a. continue consultation with stakeholders to develop and implement, where possible, administrative safe harbours that may reduce compliance costs associated with valuation; …

Recommendation 4.5

The IGT recommends that the ATO use legal and valuation expertise, including external expertise, to:

a. assist in areas such as identifying issues, gathering information and instructing valuers; and

b. provide training to staff to build capability for the long term.

Recommendation 4.6

The IGT recommends that the ATO:

a. allow taxpayer access to its instructions to valuers; and

b. only use publically available information or information that can be disclosed to the taxpayer in arriving at its market valuation.

Recommendation 4.7

Where a valuation dispute is primarily due to the professional judgement of valuers engaged by each party, the IGT recommends that the ATO provide guidance to its staff on when they should accept the taxpayer's point estimate. Such guidance may provide a number of methods and when each may be appropriately used. Examples of these methods may include applying a 10 per cent tolerance to point estimates or obtaining an opinion from the ATO's valuer as to the reasonableness of the taxpayer's point estimate.

Recommendation 4.8

The IGT recommends that the ATO:

a. promote the availability of Market Valuation Private Rulings (MVPR);

b. jointly appoint valuers with taxpayers for MVPR purposes and allow the taxpayer greater access to the valuer; and

c. consider bearing some of the valuation costs of MVPR to reflect potential ATO savings.

Recommendation 5.1

The IGT recommends that the ATO:

a. ensure that it facilitates taxpayer requests for expert valuer conferencing on competing valuations to reach a common understanding of inputs and methodologies used by each valuer, the resulting valuation and the reasons for it;

b. make taxpayers aware that they can request expert valuer conferencing as mentioned at (a) above; and

c. in its guidance relating to valuations, update the range of dispute resolution approaches that may be used to include joint instruction of separate valuers, joint appointment of valuers and expert valuer conferencing.

These recommendations were aimed at reducing small businesses' compliance costs and improving certainty of tax treatment where the valuation is critical to determine the tax outcome.

The ATO's safe harbour valuation methods appear relatively easy for start-up companies to use. They also include one method which appears to be aimed at arrangements whereby private investment is secured rights via preference shares (method 2). However, there are indications that companies do not rely on the ATO's safe harbour valuation methods in such circumstances.[10]

The Committee may wish to consider whether the safe-harbour valuation methods should be available for a broader range of ESS interests – not just start-up concession ESS interests.

Under the tax administration laws, taxpayers also have the option of seeking a private ruling on a market value which binds the Commissioner in any subsequent compliance activity.[11] However, from prior reviews we are aware that small business taxpayers are generally reluctant to seek such binding advice due to the costs involved as the ATO either requests a taxpayer-procured valuation report to be provided as part of the ruling application or for the taxpayer to pay the costs of an ATO-appointed valuer.[12] The Committee may wish to consider whether it would be appropriate for the ATO to incur the costs of such private rulings – for small business at least. A relevant consideration in this respect could include whether such an outcome would appropriately incentivise the ATO to proactively provide binding advice on issues that are common to a number of binding ruling applications.

[10] refer Pitcher Partners, "Employee Share Schemes", a submission to the Treasury consultation Employee Share Scheme (available from www.treasury.gov.au), 8 May 2019.

[11] refer section 359-40 of Schedule 1 of the *Taxation Administration Act 1953*

[12] see paragraphs 4.85-4.87 and the ATO's response to recommendation 4.8(c) of IGTO, *Review into the ATO's administration of valuation matters*, 2018 (available from www.igt.gov.au)

In a similar vein, the Committee may consider whether there are other taxation administration issues affecting the ESS taxation regime which would benefit from binding ATO advice and assist businesses to reduce ESS implementation costs.

Concerns with the ease and availability of obtaining binding ATO advice is not unique to valuation or ESS matters and may be an issue which the Committee could request the IGTO to conduct a broader review in future.

In our view, there would be benefit in the ATO consulting with interested stakeholders to explore the options for safe harbours for more mature companies, including those which have obtained private investment, as well as the availability of safe harbour valuation methods to a broader range of small to medium enterprises and ESS interests. It could also be explored whether the safe harbour valuation methods could be used by the companies for FBT purposes.

Other issues

Based on our understanding of publicly available materials and commentary[13], we understand that commercial concerns arising from the Corporations law may be affecting the implementation of the ESS – including after the 2015 changes.

For example, such concerns relate to the compliance costs in preparing prospectuses or disclosure documents, availability of exemptions under the corporations law from preparing such documents (eg ASIC Class Order 14/1001) as well as the caps which restrict remuneration packages designed around equity awards that are aimed at attracting key personnel based on the anticipated uplift in value of shares.

This is made clear in the ATO's standard documents which state:

> *Disclosure and other obligations relating to offers of Options*
>
> *In offering to employees, companies are primarily responsible for ensuring that they comply with any applicable requirements under the Corporations Act. Any offer made under the Employee option plan must comply with disclosure, licensing, advertising and hawking, managed investment scheme registration and other relevant provisions in the Corporations Act. Please refer to the Instructions for the Employee option plan for more information about these provisions of the Corporations Act. Companies should consider obtaining legal advice when establishing their Employee option plan.*
>
> *In addition to using the Offer letter referred to above, unless a disclosure exemption under the Corporations Act applies, an offer under the Employee option plan must also be accompanied by either:*
>
> - *a disclosure document (usually an Offer Information Statement (**OIS**)); or*
> - *an offer document if the Company is able to rely on the relief in ASIC Class Order 14/1001 relating to employee incentive schemes for unlisted bodies **(ASIC CO 14/1001).***
>
> *The Instructions provide limited information about these documents, when a company can rely on the relief in ASIC CO 14/1001 and when a disclosure exemption may apply. It also guides you to where you can find more information about the contents of these documents and other requirements.*

[13] for example, submissions to Treasury's April 2019 consultation on Employee Share Schemes (available from www.treasury.gov.au)

However, note that an OIS must contain, among other things, the company's audited financial report and an offer document must contain the audited financial report where the company has a statutory obligation to, or has, prepared this, or otherwise, a special purpose financial statement.

For more information and guidance, see the following documents which are available at www.asic.gov.au:

- *ASIC Regulatory Guide 49: Employee incentive schemes*
- *ASIC CO 14/1001*
- *ASIC Regulatory Guide 218: Prospectuses: Effective disclosure for retail investors (which also covers OISs)*

The Committee may wish to explore with professional advisory firms in particular what the impact of Corporations Law issues may have on the intended policy objective and the prevalence of ESSs both before and after 1 July 2015.

Annexure C — Complaints and submissions raised with the IGTO

There have been few complaints raised with the IGTO regarding the ATO's administration of the ESS taxation regime and few submissions regarding it. The complaints and submission summarised below show that when such issues have been raised with the IGTO they reflect misunderstanding of the operation of the regime or concern with matters that arise from the regime's interaction with other taxation obligations. Importantly, in the last two years, the IGTO has not received submissions for broader IGTO review the taxation administration of the ESS regime or any related complaints.

Complaints

Since 1 July 2015, four (4) complaints have been lodged with the IGTO regarding the ATO's administration of the ESS taxation regime. All of these complaints were lodged by or on behalf of employees participating in an ESS.

Two (2) complaints were lodged by unrepresented individuals who did not understand that exercising options under an ESS tax deferred arrangement may result in amounts being included as assessable income and a Pay-As-You-Go (PAYG) instalment liability in the following year. These employees became aware of the issue when their income tax assessment was amended by the ATO based on information provided by their employers. These employees sought assistance to understand the basis for the ATO amendments and how the ESS taxation regime worked, following attempts to obtain information from the ATO.

Two (2) other complaints were lodged by employees' tax representatives who believed the ATO had incorrectly calculated their clients' ESS income. In these cases the ATO had relied on the information provided by the employers to prefill the employees' income tax return with ESS income. The representatives sought assistance to persuade the ATO to take into account the employees' difficulties in obtaining supporting documentation from their employers (one was located overseas and the other was in liquidation).

Submissions

Since 1 July 2015, the IGTO has received two (2) submissions from tax professionals regarding issues related to the administration of the ESS taxation regime. These submission were received in early 2017 as part of the IGTO's *Review into Aspects of the Pay-As-You-Go (PAYG) instalments system* which was conducted in early 2017.

These submissions advocated for the exclusion from PAYG instalment calculations of ESS income that was derived under deferred schemes. As is commonly known, a PAYG instalment is a form of forced saving for an anticipated income tax liability in the coming financial year. In the case of the tax representatives' clients, the inclusion of ESS income in the PAYG instalment calculation resulted in an instalment rate that was significantly greater than their clients' highest marginal income tax rate. As a result, the amount of the calculated PAYG instalment liability far exceeded the ultimate amount of income tax that would have been liable to be paid on the ESS income when their client ultimately lodged their income tax return. To avoid this, the PAYG instalment amounts were needed to be manually varied by their clients each year, resulting in increased compliance and administrative costs.

During that IGTO review, the ATO capped the maximum tax rate that may be applied to ESS income in the PAYG instalment calculation, commencing 1 July 2017. The IGTO indicated that more time would be needed to determine whether this capping of the maximum rate was effective in minimising these concerns.[14] Since that review, we have been monitoring the issue and have not received any complaints on this issue in the 2 years following finalisation of that review.

[14] see IGTO, *Review into Aspects of the PAYG instalments system*, January 2018, pp 45-46

Annexure D — Glossary and defined terms

Abbreviation	Defined term
AAT	Administrative Appeals Tribunal
ADJR Act 1977	*Administrative Decisions (Judicial Review) Act 1977*
APH	Parliament of Australia
APS	Australian Public Service
ATO	Australian Taxation Office
CDDA	Scheme for Compensation for Detriment caused by Defective Administration
CGT	Capital gains tax
Commissioner	Commissioner of Taxation
Complaint	A complaint is defined AS/NZS 10002:2014 Guidelines for complaint management in organizations *Expression of dissatisfaction made to or about an organization, related to its products, services, staff or the handling of a complaint, where a response or resolution is explicitly or implicitly expected or legally required.* *Disputes - Unresolved complaints escalated internally or externally, or both.* *Feedback - Opinions, comments and expressions of interest or concern, made directly or indirectly, explicitly or implicitly to or about the organization, its products, services, staff or its handling of a complaint. Organizations may choose to manage such feedback as a complaint.*
DPN	Director Penalty Notice
entity	an entity is defined in section 960-100 of the *Income Tax Assessment Act 1997* that is: an individual a body corporate a body politic a partnership any other unincorporated association or body of persons a trust a superannuation fund

Abbreviation	Defined term
ESS	Employee Share Scheme
FOI	Freedom of Information
FOI Act 1982	*Freedom of Information Act 1982*
FY	Financial Year
GST	Goods and Services Tax
IGT Act 2003	*Inspector-General of Taxation Act 2003*
IGTO	Inspector-General of Taxation and Taxation Ombudsman. The acronym "IGTO" is used throughout the submission to denote both the "Inspector-General of Taxation", as named in the enabling legislation, and "Inspector-General of Taxation and Taxation Ombudsman" as recently adopted due to recent calls for greater understanding and awareness of our complaints services function.
ITR	Income tax return
JCPAA	Joint Committee of Public Accounts and Audit
OECD	Organisation for Economic Co-operation and Development
PAYG	Pay As You Go
SCTR	House of Representatives Standing Committee on Tax and Revenue
TAA 1953	*Taxation Administration Act 1953*
Tax Official	The term 'tax official' is defined in section 4 of the *IGT Act 2003* to mean: c. an ATO official; or d. a Board member of the Tax Practitioners Board; or e. an APS employee assisting the Tax Practitioners Board as described in section 60-80 of the *Tax Agent Services Act 2009* ; or f. a person engaged on behalf of the Commonwealth by another tax official (other than an ATO official) to provide services related to the administration of taxation laws; or g. a person who: i. is a member of a body established for the sole purpose of assisting the Tax Practitioners Board in the administration of an aspect of taxation laws; and

Abbreviation	Defined term
	ii. receives, or is entitled to receive, remuneration (but not merely allowances) from the Commonwealth in respect of his or her membership of the body. For the purpose of this submission, the term 'tax official' is also used to refer to a 'taxation officer' to whom subdivision 355-B of Schedule 1 to the TAA 1953 applies.
TFN	Tax File Number
TPB	Tax Practitioners Board
Whistleblower complaints	A disclosure will generally qualify for whistleblower protection where it is made by an eligible whistleblower to an eligible recipient. These disclosures are typically defined by statute and the protections available are in part designed to encourage disclosures in a prescribed manner. See for example, the definition of eligible whistlebower in section 14ZZU of the *Taxation Administration Act, 1953*.