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Guerdon Associates
Equity and Executive Pay

05 March 2009

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

Dear Tax Review Secretariat

Re: Submission to the AFTS Review – Taxation of Employee Equity Plans

Summary

The current taxation of deferred equity (and other) payments at termination discourages the use of these instruments as executives and other key employees approach retirement. The unintended consequence is that there are fewer controls to ensure management and key employees of Australia's enterprises manage risk for sustainable long-term returns over time. That is, on their departure from an enterprise, there is no method to maintain tax neutral pecuniary interests in outcomes from decisions and actions made by them while in employment. Given that a significant contributor to the world's economic problems has been the absence of these controls, Guerdon Associates suggests taxation regulation amendments to time taxation of performance contingent employee benefits to coincide with payment of these benefits, rather than at termination of employment.

About Guerdon Associates

Guerdon Associates is Australia's largest independent consulting firm specialising in board and executive remuneration matters. Our mission is to provide executive and director remuneration, performance measurement, management and governance advice, and employee equity data and solutions that contribute to improved total shareholder returns.

Clients are mainly board remuneration committees of listed and unlisted Australian companies. These include a significant proportion of Australia's largest ASX-listed companies.

Our website is at http://www.guerdonassociates.com.

Purpose of this Submission In Relation to the Review's Terms of Reference

We note that the report *Architecture of Australia's Tax and Transfer System* published by Treasury in August 2008 as the first instalment of the AFTS review, makes no reference to Division 13A of the *Income Tax Assessment Act 1936* (ITAA), which deals with the taxation of employee equity plans.

Our interest in making this submission is to encourage the adoption of a simple, fair and efficient tax regime for the benefits obtained under employee share plans, including executive incentive plans. In particular, our primary concern is the resolution of unintended Australian tax system consequences that result in employee, and specifically, executive, incentive plans that may drive inappropriate behaviours, or result in less than optimal sustainable returns to shareholders.

A taxation structure that promotes the effective use of general employee share plans and equity-based executive incentive plans is fully consistent with the main focus of the Review's Terms of Reference, including promoting efficient resource allocation, minimising complexity and compliance costs and raising revenue with minimum harm to economic efficiency while maintaining equity within the tax system.

Employee, and more specifically, executive, share ownership and incentive plans have the potential to make a significant contribution to increasing sustainable, long-term shareholder returns with acceptable levels of risk.

The tax system needs to be supportive of employee equity plans that encourage behaviours that are optimal in terms of:

- Shareholder interests
- Wealth creation and sustainability
- Risk management for individual companies and economic stability for Australia
- Competitive advantage for individual companies and for Australia as an investment destination

Current Division 13A Regime

Two 'concessions' are currently offered to participants in employee share schemes under Division 13A, as summarised very briefly here:

1. Tax Exemption

'Tax exemption' allows companies to grant up to $1,000 worth of company shares to an employee each year, subject to meeting the specified 'exemption conditions'.

2. Tax Deferral

'Tax deferral' allows income tax on the market value of equity acquired under an employee share plan to be deferred for up to 10 years from the grant date, or until the earlier disposal of the equity, the removal of disposal restrictions or forfeiture conditions, the exercise of rights (unless the shares remain subject to trading restrictions and forfeiture provisions after exercise of the rights), or the cessation of the employment in relation to which the equity was granted.

> Tax deferral applies by default where 'qualifying' shares or rights are used, unless the taxpayer elects to pay tax 'upfront' on the market value of 100% of the equity at grant date. The up-front election is used almost exclusively in relation to options, because the value of options as determined under the tables in Division 13A is much lower than the full market value of shares; also, tax paid up-front in relation to a right to acquire a share that is ultimately not exercised can be the subject of an amended return, but no similar provision applies in relation to shares.

We support the continued availability of the exemption concession for general employee share plans, and accept that the current provisions in relation to this concession are generally reasonable. However, the annual exemption cap of $1,000 is too low, and should be increased to at least $5,000.

The focus of the rest of this submission is on the tax deferral provisions in Division 13A, which are relevant to executive incentive plans. A general observation is that Division 13A is poorly drafted, unnecessarily complex and confusing. This, coupled with the fact that it is the responsibility of the taxpayer to include relevant income in assessable income at the relevant time, raises questions about the extent to which compliance with these provisions is a problem.

Key Issue

As a minimum, the timing of the liability for tax on equity plan benefits requires particular consideration. The risk at present is that the encouragement Division 13A gives to ending incentive plans when employment ends will focus CEOs on maximising outcomes just at that point.

Also, the fact that under tax deferral equity plan benefits will be taxed no later than on cessation of employment, has meant that for executives approaching retirement, current common practice is to

- substitute short-term cash incentives for long-term equity
- have any long-term, performance-contingent equity vest on retirement, perhaps with the quantum pro-rated in proportion to the part of the performance period completed
- increase cash salary in lieu of equity-based remuneration

Delaying the liability for tax for several years beyond cessation of employment would mean equity-based long-term incentive plans could provide CEO's, in particular, with an incentive to ensure that the decisions they make in the final stages of their term of office are fully supportive of the on-going sustainable success of their company.

Removing cessation of employment as a trigger for tax liability, at least in relation to equity that remains subject to performance conditions, will facilitate the provision of effective risk-management incentives through equity-based plans as a key part of executive remuneration. This is consistent with current responses to the global financial crisis, which include efforts to ensure that risk is properly taken into account in executive remuneration. The Financial Stability Forum, for example, has advised that:

> *"The financial industry should align compensation models with long-term, firm-wide profitability. Regulators and supervisors should work with market participants to mitigate the risks arising from inappropriate incentive structures."*

Since that time, various regulators around the world have been seeking ways to encourage financial services firms to implement such incentive frameworks. But the concern has not been limited to financial services firms. Adequate incorporation of risk and elimination of "short-termism" in executive incentive frameworks has been debated for years (for example, search terms on these items will reveal numerous articles with links to other commentators on these subjects at Guerdon Associates' web site).

One of the potential solutions has been to require executives to maintain holdings of equity in the company they managed for some time after they have left the company. That is, on retirement they will not be allowed to immediately sell their accumulated equity for cash and will remain, in effect, financially accountable for decisions made on their watch (including the appointment of their successor). At the very least, these executives should still have any performance contingent rewards, payable in company shares, rights or options, maintained.

Current practices are the unintended consequences of taxing all vested and unvested equity on termination of employment. The high taxes that are payable encourage these executives to remonstrate with their boards for these amendments to their compensation. Boards, anxious for a smooth transition to new management, find that it is the easier course to comply.

It would be better for shareholders if management continued to be held accountable for decisions and actions on their watch after they have left employment, with the scale of this accountability winding down over time. Amending Division 13A to maintain the taxation conditions until the regular and usual performance period has run its course and the performance conditions have been tested, for a reasonable period after an executive's employment has been terminated, would be in shareholders' better interests.

Related matters

We note that cash based remuneration is also taxable at termination, even if the receipt of such remuneration were to be deferred and subject to an assessment of performance. We expect that APRA will introduce a "remuneration code of practice" for all APRA regulated companies, requiring a significant proportion of annual incentive compensation to be deferred and contingent on performance sustainability over time. This regulation will be in response to the global credit crisis and the concerted effort by all major global regulatory authorities to put these principles in place (e.g., see the FSA code at http://www.fsa.gov.uk/Pages/Library/

Other_publications/Miscellaneous/2009/cop_remun.shtml). The purpose of these provisions is in effect to allow financial services companies to claw back incentive remuneration as a mechanism to reduce excessive risk taking.

We further expect that the impact of these regulations will extend, over time, beyond the financial services sector to all sectors of the economy that are capital intensive. The extent to which these practices are taken up will need to be balanced with the need to attract and retain highly mobile skills and experience best placed to realise investor returns. Current taxation regulation militates against the take-up of these better risk management practices, to the disadvantage of investors and the wealth creating opportunities for the country as a whole in attracting and retaining global talent.

Conclusion

As consultants dedicated to advising boards on applying optimal executive reward structures for growth in value and the long-term benefit of their shareholders, we believe that the amendments suggested here will, if enacted, be a significant contribution to the better management of risk and return in listed companies.

Guerdon Associates 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 encouraging the management of Australia's corporations to focus on long term, sustainable growth.

Yours sincerely

Peter McAuley
Director

Michael Robinson
Director