RSG

Remuneration Strategies Group

BOARD OF TAXATION

EMPLOYEE SHARE AND OPTION PLANS IN START-UP, R&D AND SPECULATIVE-TYPE COMPANIES

- Determination of Market Value
- Tax Deferral Arrangements

SUBMISSION AND RECOMMENDATIONS

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SUMMARY OF SUBMISSION

ESP Tax Deferral

- The qualifying deferred provisions of Division 13A ITAA 36 were already sub-optimal, inflexible and suited only to stock exchange listed companies with short-term, speculative and sometimes excessive allocations to executive participants of large ASX listed companies.

- The proposed new provisions have merely exacerbated that situation.

- Therefore, it is both appropriate and necessary to develop separate taxation deferral arrangements for employees of start-up, R&D and speculative-type companies receiving shares or rights under employee share plans.

- Other business organisations with large capital investment programs, low immediate cash flow and limited equity trading potential also require similar separate deferral programs.

The Benefits of ESP's

- ESP's have become a vital part of attracting, retaining and motivating labour at all levels of Australian organisations. The benefits of ESP's are as follows:

  - Attracting the right workers for the right jobs.

  - Retaining workers.

  - Developing and Training workers as key assets.

  - Aligning workers' vision with shareholders' vision.

  - Motivating workers to achieve organisational performance objectives.

  - Recognising and Rewarding human capital as a valuable asset.

  - Succession Planning for management and/or worker buyout.

  - Reducing business cash outflows.

  - Maximising business capital investment and creating more jobs in sustainable, high performance enterprises.

  - Creating More Surplus Value and Sharing Surplus that Value with workers.

Treasurer's Announcements

- Further to the Treasurer's 12 May Budget Announcement and the Consultation Paper released on 5 June 2009 by the Assistant Treasurer, on 1 July 2009 Senator Nick Sherry released a further Policy Statement setting out the Government's "final" policy

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on the taxation of employee share plans as of 1 July 2009. The "final" policy is as follows:

(a) raising the adjusted taxable income threshold for the $1,000 tax exemption up to $180,000 per annum;

(b) introducing a new qualifying salary sacrifice share plan, capped at discounts of $5,000 per annum;

(c) introducing a limited deferral of the taxing point for discounts on shares and options, where there is a 'genuine risk of forfeiture' and restrictions on disposal for up to seven (7) years;

(d) amending the basis for employee refund of income tax paid upfront for only certain forfeited equity benefits;

(e) introducing enhanced reporting requirements for the above plans; and

(f) confirming the application of the new proposals from 1 July 2009.

- Unfortunately, these changes will continue to cause some allocations from 1 July 2009 from qualifying deferred employee share and option plans to create upfront or premature tax liabilities for employees, preventing employees from taking up offers and leading to the depletion of employee share plan assets.

- However, on the positive side, unlike the former provisions of Division 13A (ITAA 36), benefits under the three qualifying plans mentioned above (refer points (a), (b) and (c) above) can be provided <u>conjointly</u> in the <u>same</u> tax year.

- The impact on employees, employers and Australian business has been to cease operations of ESP's. This has been to the detriment of the Australian economy, especially for start up, R&D and speculative-type companies.

- The capping of salary sacrifice at $5,000, the requirement to impose design conditions for tax purposes (i.e. "genuine" forfeiture conditions) and the restriction on the refund of tax on forfeited or lost benefits represents excessive Government intrusion into the optimisation of the design of employee equity participation plans.

<u>Optimal Timing for Taxing Deferred Benefits</u>

- Generally speaking, employees can only afford to pay tax on their equity benefits when they sell their equity. Earlier taxation triggers can only act to deter employees from participating in ESP's, force premature disposal of shares and depletion of plan equity. This is especially the case for employees offered equity in start-up, R&D and speculative-type companies, which are often not listed on a recognised stock exchange.

- Unlisted organisations face vastly different issues to those facing stock exchange listed companies. They have no organised external market and usually target an IPO and/or other "Monetisation Event" for employee equity realisation.

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- Taxation and realisation of employee share benefits should only arise upon the occasion of a "Monetisation Event". A Monetisation Event usually occurs by way of a trade sale and/or an "Initial Public Offer" (IPO) on a recognised stock exchange.

- The optimal employee taxation regime for all types of ESP's, but especially for ESP's in start-up, R&D and speculative-type companies, is to:

  - tax employees only when shares are sold;

  - subject the original value of the share to ordinary income tax (i.e. max tax of 46.5%); and

  - subject the growth in the value of the share to CGT (i.e. max tax of 23.25% if held for more than 12 months).

- The Australian tax system tends to penalise employees for share retention, overseas tax systems in comparative economics tend to reward share retention by employees with CGT concessions (i.e. by tax exemption and/or ratal reductions).

Valuation Matters

Currently, there is a lack of coherent Government and Departmental policy formulation in regards to taxation, corporations law, public disclosure and valuation issues.

- Employee share plans are a complex area that straddle a broad range of tax, accounting, corporate legal, human/industrial relations, investment and remuneration issues.

- RSG applauds the Government's proposal to accept general valuation rules for unlisted company shares and rights, without company shares and rights, without being obliged to use an auditor, provided they can justify the market value appropriately. This will remove some major obstacles for unlisted companies providing equity to their employees and other workers.

- The development of accurate, and internationally accepted equity valuation principles, under accounting standard AASB2, has greatly assisted with employee equity valuation issues. It has enabled the development of accurate reasonable equity allocation levels, integrated into the organisations' base remuneration, short term incentive and long term incentive strategies.

- RSG believe the determination of equity taxable values should accord with those equity values expensed in the accounts under AASB2 of the organisation and communicated and disclosed as benefits to their employees.

Government Policy

- While there is some disagreement amongst the Australian various political parties about the taxation treatment of employee share plans, all political parties have expressed firm support for the concept of employee share ownership and its key role in job creation and maintenance. On September 2, 2009, the current Federal Government granted Federal Government Funding of $1.8 million to the Australian

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Employee Ownership Association to empower and assist employees to buy out the companies that they work for (refer **Attachment 1**).

- We believe it is incumbent upon Governments, their Ministers and Departmental advisors to develop appropriate taxation treatments for employee share benefits to enable those policies of supporting employee share plans, of all types, to be achieved and for such plans to proliferate.

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THE STRUCTURE AND OPERATION OF EMPLOYEE SHARE PLANS

How Australian businesses choose a suitable ESP

In this section we will provide an outline of the range of ESP arrangements currently available in Australia and how choose which plan(s) are most suitable for various businesses.

Many companies have a good idea of what kind of ESP they want to use, usually based on specific needs and goals. However, sometimes they might be better served with another kind of plan or a combination of plans. And yet others say they'd like to have an ESP, but they are not sure what it might be.

The challenge is to optimise the portfolio of ESP's

There are a broad range of plans to choose from. Quite often it is appropriate to have more than one plan. For example, there may be a broad based offering of ESP's involving. qualifying 13A Exempt and Deferred Plans, or a Broad Based Loan Participation Plan or Loan Share Plan.

These plans may have little or no downside risk and are designed to maximise employee participation. They are able to be designed to encourage retention i.e. shares vest and only become available after a certain period of service or they may only vest if a certain performance criteria being met or a combination of both.

Share Plan Options could be designed for senior management which more closely align their success to those of the shareholders and can be designed on achievement of a stipulated total shareholder return as well as achievement of other individual key performance indicators.

Where an employer does not have available shares – e.g. a joint venture or a franchise company, then it may be appropriate to provide a combination of Employee Loan Participation Plan i.e. facilitating investments in other than employers shares and/or a Replicator Plan.

Many of Australia's largest companies are subsidiaries of overseas based companies, sometimes listed on different overseas exchanges.

The Loan Participation Plan facilitates through a trust arrangement, the ability to acquire shares on market on those foreign exchanges or from new issues of shares which may have vesting conditions attached, or may be acquired as part of a salary sacrifice/bonus sacrifice equity based remuneration strategies.

Other plans may be designed to encourage senior executives to use salary sacrifice and bonus sacrifice sums to acquire shares in their own company or in an approved list of investments.

There are many combinations to suit the specific purposes of every type of business and any level and type of employee/worker/contractor.

Choosing the Best Plan: A Roadmap

The term ESP covers a broad range of arrangements in a variety of organisations. When considering the optimal plan for an organisation, one should match the purpose of the plan in

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the context of the circumstances of the organisation, and the objectives of implementing an employee share plan.

The plans have been designed for universal application. That is, the intention in the design of the plans is that any employer organisation (that is, incorporated, unincorporated, listed, unlisted, government or private) operating in Australia will be able to utilise a plan and implement an employee share plan for all their employees.

Special consideration has been given to designing plans for those organisations for which implementing employee share plans were believed previously to be too difficult or inappropriate.

For example, for those organisations without available shares (for example, closely held family companies, government corporations, unit trusts, and co-operatives) so-called “replicator” plans and loan participation plans (that is, enabling investment in non-share securities) have been provided.

While certain plans have been designed with specific types of organisations in mind, for example:

- qualifying share plans for ASX listed companies; and
- replicator plans for unlisted or non profit organisations,

A listed ASX company may find that the non-qualifying loan participation plan and replicator plans are suitable for their employees. This is especially relevant, given the recent changes to the accounting standards, which will apply to all Australian companies, which require full disclosure and expensing of employee share benefits. Such changes will have the effect of creating a more neutral, “level playing field” between the different plans.

Prerequisites for ESP’s

In order to create the necessary structure for effective delivery of equity benefits, it is important to recognise the important pre-requisites of an ESP. These are:

- Determination of the type of equity (e.g. shares, options or participation units);
- Valuation of the equity;
- Allocation of the equity; and
- Utilisation of a plan trustee for the implementation, administration and marketing of the employees’ equity.

Employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or unit trust structures, which are appropriate for the circumstances of the particular employer organisation and its employees.

It is important that employees are secure in the knowledge that their participation delivers a fair share in the capital growth and profitability of the company, without jeopardising their fixed pay

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entitlements, nor exposing them or their families to unnecessary downside risk if the value of shares, being the subject of the options, happens to fall.

Also the taxation outcomes of the ESP's chosen should be confirmed by an appropriate Ruling from the Australian Taxation Office.

The broad range of plans include:

- Qualifying Exempt Plans;
- Qualifying Deferred Plan;
- Non-Qualifying Employee Loan Plans; and
- Non-Qualifying Replicator Plans.

These plans can be broken down further into:

- Qualifying Exempt Plan
  - Exempt Share Plan
  - Exempt Option Plan
- Qualifying Deferred Plan
  - Deferred Share Plan
  - Deferred Option Plan
- Non-Qualifying Employee Plans
  - Loan Share Plan
  - Loan Participation Plan
  - Employee Option Plans
  - Geared Employee Share Trust
- Non-Qualifying Replicator Plans
  - Unfunded Replicator Plan
  - Funded Replicator Plan

While not all of these plans will enable employees to become long-term holders of shares in their employer, all of the plans will enable employees to share in the growth and prosperity arising from their work with their employer.

Employee Equity

The employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or share trust structures, which are appropriate for the circumstances of the employer organisation and its employees.

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Until the late 1980s, employee share plans were typified by loan plans and partly paid share plans, supplemented in the executive arena by the provision of executive options.

Since the late 1980s, due to a number of factors including changes to the superannuation requirements restricting the ability of superannuation plans to invest back into shares of the employer, a series of corporate crashes, a recession on the Australian share markets and the adoption of New Pay strategies highlighting the need to more directly integrate employee share plan strategies with employee strategic remuneration, there was a steady move away from loan plans and partly paid plans.

Loan plans and the partly-paid plans (for example, shares issued, called and paid to one cent) were seen as inflexible, separate from the remuneration strategies of the organisation and difficult to impose performance-based vesting conditions upon.

Options were popular at the executive levels, but had little acceptance or relevance at the lower ends of the corporate hierarchy.

Employee Share Option Plans

Increasingly, employees and non-employee contractors are asked by the company offering them a job, to receive a substantial part of their remuneration in the form of share options in the company. These options may have a life of 5 to 10 years and are usually subject to vesting conditions or a non-exercise period extending 2 to 5 years. They may also be subject to other conditions such as performance hurdles or a growth in shareholder value (i.e. by issuing options with a premium exercise price).

Options as a substantial part of professional remuneration packages are becoming increasingly popular, especially for start-up companies in their early growth phases. In industries such as the mining industry, options fulfil an indispensable role as a means of attracting, retaining and motivating key staff.

However, those participating in option allocation programs need to be confident that the options are valued properly, administered correctly and can be exercised into marketable shares or the cash equivalent at some time in the future.

The valuation of options has become more reliable and consistent since 1 January 2005 because of new accounting rules, which have been introduced recently in Australian and most other advanced western economies (refer AASB2 issued by the Australian Accounting Standards Board).

Restricted Shares, Performance Rights and Zepo's

Restricted shares, Performance Rights and Zepo's (zero exercise priced options) provide the employee with the benefits of a whole share, which includes the acquisition price of the share plus any growth of the share that has occurred over the holding and vesting period. We shall refer to these arrangements as full value equity (FVE's).

Exactly the same vesting and performance conditions can be applied to FVE's as applied to classical, growth-only options. FVE's provide a more effective and efficient provision of share benefits, because employees receive the benefit of the whole share. This means that less share capital is required to provide benefits to employees under an FVE plan than a classical, growth-only, option plan. Furthermore, an FVE plan preserves the efficacy of the employer's

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long-term incentive structure as share benefits can be provided effectively in “crab” and “bear” market conditions, under which the shares may be experiencing nil or minimal capital growth.

Recently, some company’s have broken up the long term incentive based FVE into two components. Those components are:

- Are the employee retention component which is delivered by way of FVE; and
- An incentive component that is delivered by classical, growth-only options.

Earmarking Equity for Staff

Companies often earmark or set aside a percentage of the issued share capital in the company to be provided in the form of share options. This percentage may range from 5% to 20%, depending on the size and type of company, its maturity, its business circumstances and the remuneration strategies of the company.

Plans for Unlisted Companies

For unlisted companies, there are four methods for providing both real and notional equity to the employees:

- $1,000 per annum worth of qualifying tax exempt shares or share options;
- a replicator plan which does not utilise shares at all, but communicates formula-based performance rights and is ultimately paid out as ordinary salary and wages;
- a special purpose employee share trust, which allows selected employees to invest in shares or other securities of the employer and ultimately acquire those investments funded by an interest-free, non-recourse, loan facility; and
- a special purpose Employee Option Plan, which allows selected employees to acquire options to shares of the employer, or receive the equivalent in cash.

The five requirements for an employee share plan, utilising unlisted shares are as follows.

- The plan must involve available shares or their substitutes (for example, shares, units, rights, options or other entitlements).
- There must be an acceptable valuation basis for the shares (for example, multiples of earnings before interest and tax or net asset values).
- There must be a reliable warehouse for share, investments to ensure shares are retained within the plan (for example, a share trust, share company or option contracts).
- There must be an effective market for shares (that is, usually an employee share trust funded by the employer and participating employees).
- There cannot be any obstacle to employee participation (for example, no drain on employees' personal cash resources, controlled downside risk exposure, no tax

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upfront and deferred tax until disposal of entitlements).

Plans for Listed Companies

Listed Companies can also provide these plans to their employees but also in addition to the Qualifying Tax Exempt Plans, Listed Companies are able to offer Qualifying Deferred Plans. However, the application of Qualifying Deferred Plans (e.g. as restricted share or option plans) will become limited to delivery of Executive Long-Term Incentives, which readily incorporate "real" risk of forfeiture (now required under the proposed Division 83A ITAA 1997) and which are short term and will encourage more short term risk taking by participants.

Consequently, there will be a trend for listed companies to adopt long term incentive based employee equity strategies outside of the provisions of the proposed Division 83A ITAA 97.

Government support for employee share plans

The Federal Government in February 2004 announced its policy intention to develop a program to encourage equity participation in Australian businesses – with the aim of doubling the current level of employee equity participation from 5.5% to 11% over a 5-year period. As a part of that process, RSG was awarded the tender to design a range of employee share plans which could be used in a wide range of Australian businesses.

The Government believes that it is in the public interest to promote employee share plans to:

- better align the interests of employees and employers;
- to develop national savings;
- to facilitate the development of sunrise enterprises;
- to facilitate employee buyouts and succession planning; and
- to develop internationally competitive, best practice, remuneration strategies for employees of all organisations.

The Federal Government, by way of the Department of Employment and Workplace Relations (DEWR), accepted RSG's recommendation that, in order to achieve its target levels of equity participation, it needed to encourage equity participation in all its forms (that is, real and replicated), for application in all types of Australian employer organisations, for all categories of employees.

All the ESP's outlined in the RSG ESP Framework have been implemented in Case Study organisations nominated by DEWR.

The RSG Road Map and RSG ESP Framework outlined below resulted from this project.

ESP Roadmap

Set out below is the RSG Employee Share Plan Roadmap (see diagram on following page) to assist an organisation with charting the course of best plan selection for the circumstances of the organisation. To chart the roadmap, you simply begin from the top left hand corner and

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chart the flow of the roadmap according to the Yes or No answers to the factual circumstances presented. You should end up with the plan or plans that suit the particular circumstances of the organisation.

The following plan outlines includes successful design features that have been confirmed as a viable, working model capable of implementation in Australia based on international "best practice" and the actual experience of successful employee share plans implemented for Australian companies of all types and sizes.

The taxation consequences of the various plans are in accordance with private binding rulings obtained from the Australian Taxation Office.

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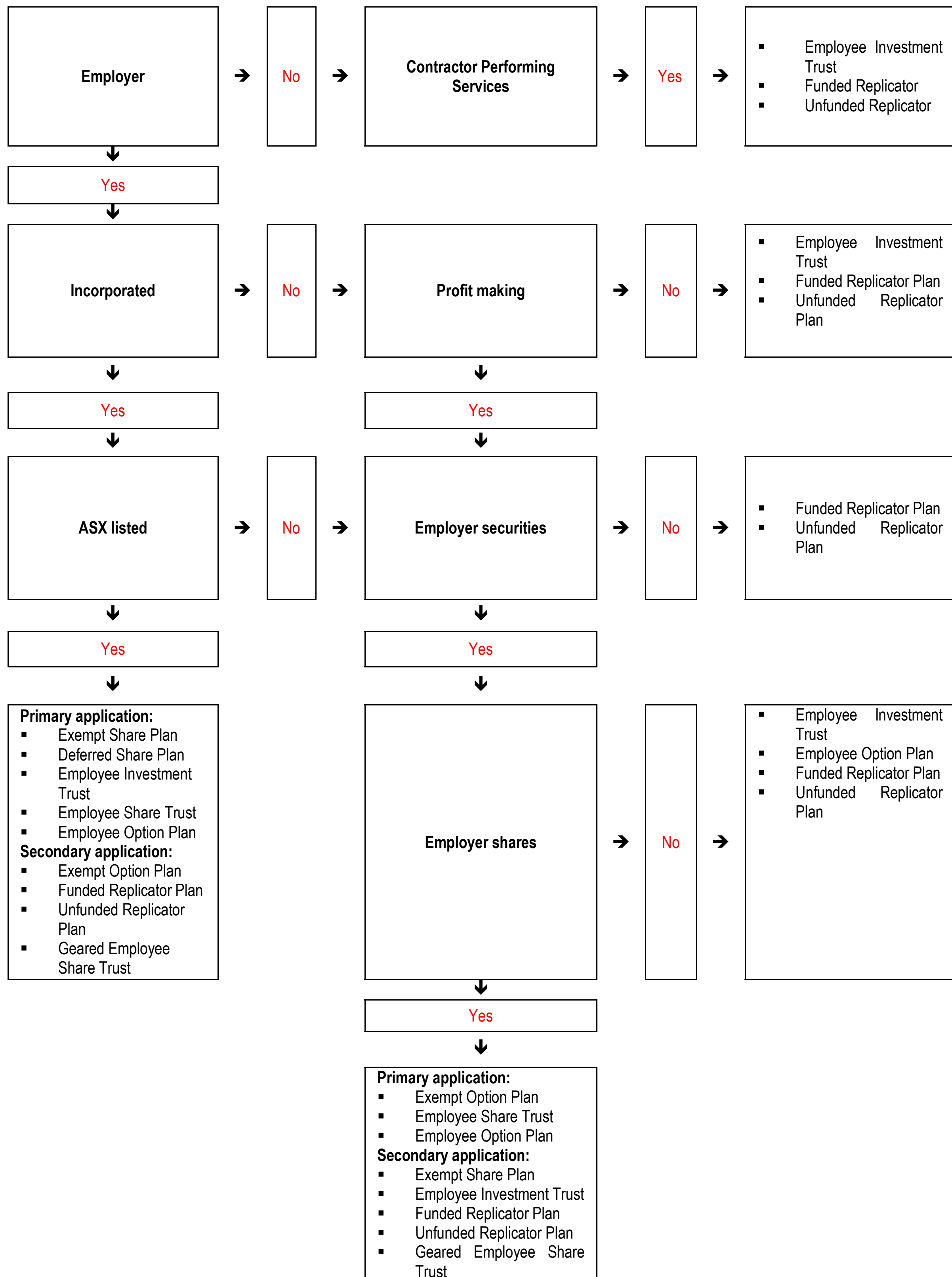
Employee Share Plan Decision Tree - "Roadmap"



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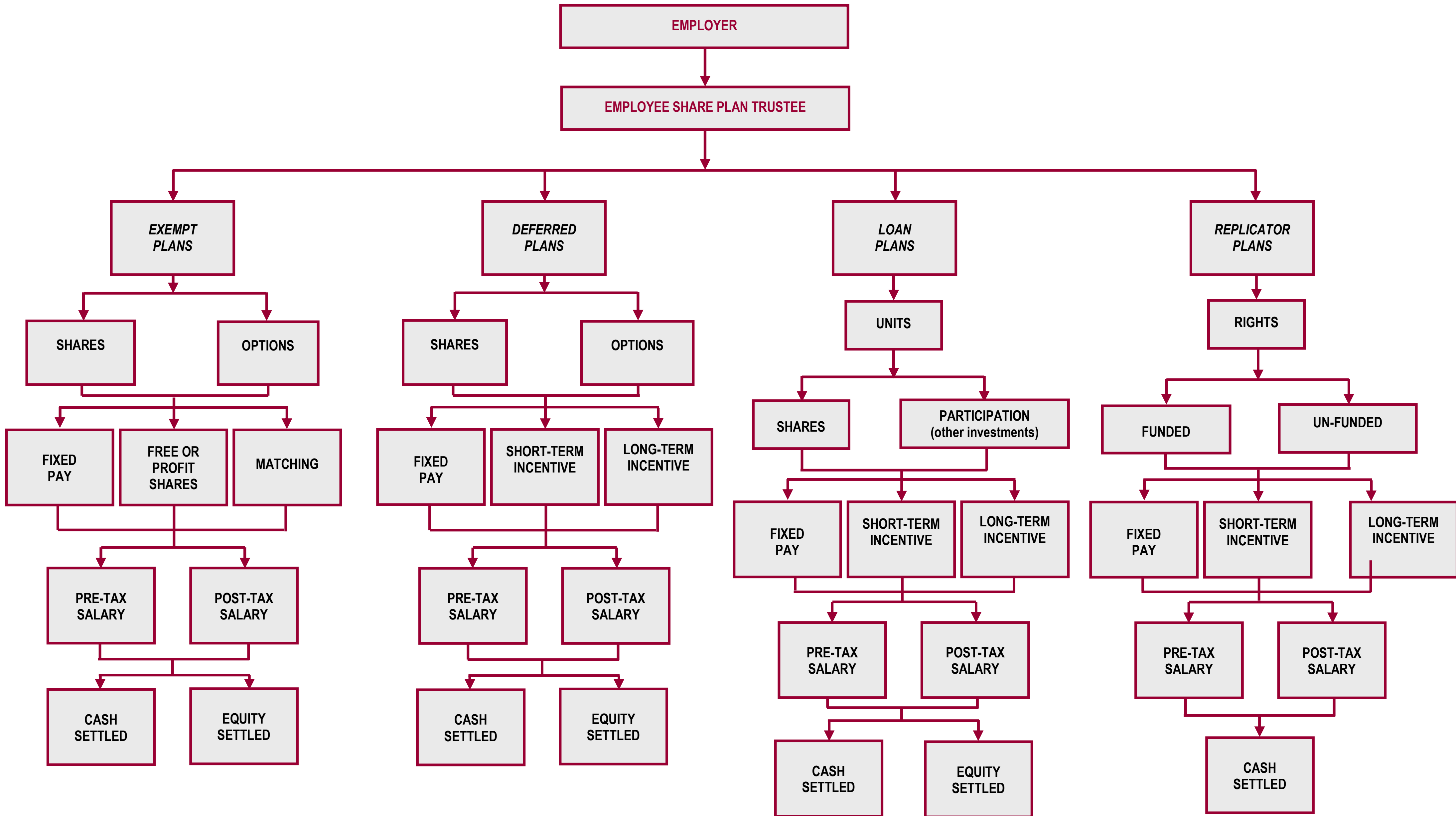
RSG ESP Framework



THE BENEFITS OF EMPLOYEE SHARE PLANS

The Benefits of Employee Share Plans

Employee share plans should be about developing and optimising the value of human capital as business assets of the organisation and personal assets of the employees of the organisation.

The value of human capital is optimised by:

- **Attracting** the right employees for the right jobs.
- **Retaining** employees.
- **Developing and Training** employees as key assets.
- **Aligning** employees' vision with shareholders' vision.
- **Motivating** employees to achieve organisational performance objectives.
- **Recognising and Rewarding** human capital as a valuable asset.
- **Succession Planning** for management and/or employee buyout.
- **Reducing** business cash outflows.
- **Maximising** business capital investment and creating more jobs.
- **Creating More Surplus Value and Sharing Surplus Value** with employees.

This is best achieved by ongoing employee training and development projects and by linking employees to the company by utilising the right kind of employee remuneration strategies and related employee equity programs.

There is a direct link between Employer Equity Programs, Human Capital Management and Companies Financial Performance.

International experience demonstrates that effective Employer Equity Plans assist in the attraction, motivation and retention of employees.

Furthermore, for employees that human capital value should be manifested into actual asset value emanating from effective short and long term equity based incentive programs, providing an enduring and valuable capital base to maintain their human capital investments.

It is RSG's experience, supported by extensive international studies, that the opimal methodology for the design, implementation and administration of effective employee LTI programs for <u>all</u> stakeholders is to base the LTI program on Employer Equity Plans. These programs are most effective where equity holdings are maintained and not dissipated by short term profit taking.

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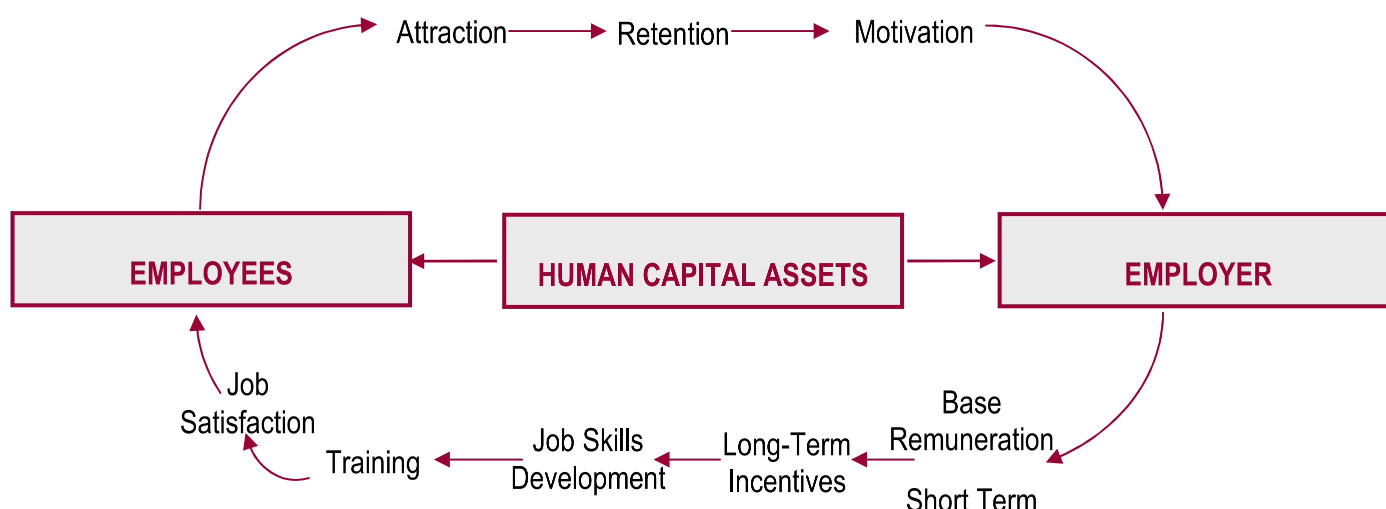
The Human Capital Dynamic



Long Term Incentives (LTI's)

LTI's assist in the retention of employees, which means the business can afford to spend more money on training. Additional training results in better qualified employees and a more productive and profitable business. And because employees are trained to develop job skills they feel more appreciated, more respected and have greater levels of job satisfaction which will ensure that they remain employed longer.

Retention

An Australian Human Resources Institute ("AHRI") survey has found Australian employers are losing an extra $20 billion per year as staff turnover increases dramatically.

- A dramatic increase in staff turnover figures across Australia is putting people management practices under pressure.
- An AHRI HR pulse survey has found most organisations have employee retention problems.
- An overwhelming majority reported an impact on the organisation's effectiveness and the bottom line.
- Most also believe their organisations are not prepared to deal with the labour crisis.

Staff turnover in Australia has increased by more than 5% as the continuing staffing crisis caused by the skills shortage and the ageing population puts people management practices under pressure.

A study last year by Vedior Asia Pacific put the cost of replacing an employee at closer to 150% of salary when recruiting, training, specialist knowledge and productivity are included in the cost.

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AHRI's quarterly HR pulse survey, has recorded a turnover rate of 17.4% for large employers and an average of 18.5% across all organisations. The survey was carried out in conjunction with retention specialists, TalentDrain. Research last year confirmed the rate at 12.6% in large Australian companies (AIM National salary survey 2007).

More than 60% of the people surveyed admitted they had a problem retaining staff and 80% reported an impact, cause by retention issues, or organisational effectiveness and financial performance.

An overwhelming majority of respondents to the HR pulse survey (82%), believed that their organisations were not prepared for the continuing skills shortage.

All Types of Businesses

LTI plans delivered through employee participation plans are no longer the exclusive preserve of senior management of large, publicly listed companies.

It is no secret that the skills shortage is crippling many industries. And so, tools and strategies that attract, and keep key staff are more crucial than ever. Employee Share Plans ("ESP's"), are one such tool. These are arrangements whereby business owners share the surplus value (profitability and capital value) of their enterprise with employees.

Businesses of all sizes and types can develop ESP's which generally aim to encourage employees to invest in the business they work in, and to more closely align employee performance with corporate financial and business objectives.

While ESP's might seem complex or costly to implement, the key message to businesses is that ESP's can be put in place for all types of organisations and all types of employees and/or contract non-employees working in Australia. And given the current skills crisis facing many industries, ESP's could be the answer to acquiring and retaining key employees.

The whole purpose behind employee ownership is that the employees have a share in the business, and it's considered that will give them greater incentive to perform. And as the business grows, they benefit.

Consequently, these plans offer potential benefits to employers such as helping to retain key employees, motivating staff, and improving productivity, efficiency and competitiveness.

Because employee retention improves, so too does the financial efficiency in investing in training and development, to improve the value of the business Human Capital Assets.

Optimum Remuneration

The optimum remuneration strategy has three elements: fixed remuneration (what workers are paid to come to work), short-term variable remuneration (profit share, incentives and bonuses) and long-term incentives (usually a share in the capital value of the organisation – an ESP).

Fixed remuneration or base pay, as it is also known, is commonly defined as the salary or the pay amount given to an employee for performing the daily duties of the defined job.

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Short-term incentives – including annual incentives, bonuses, commissions and the like – reward the individual employee for achieving certain goals over a short period. The measurement period for short-term incentives is most often quarterly, semi-annually, or annually. Short-term incentives can be measured based on the individual's own performance, group or team performance, or the companies overall performance. This depends on the organisation, the incentive plan, and the level of the individual within the organisational hierarchy.

LTI's delivered though ESP's – including shares, restricted shares, share options, phantom shares, share replicators, participating units, and the like – measure organisation-wide performance, typically over several years. The intent of such plans is to provide incentives for employees to improve the overall performance of the organisation by linking the employees' long-term rewards to the organisations long-term results.

ESP Plans

ESP plans reward participants (e.g. employees) for attaining results over a longer measurement period. For this purpose, long-term generally means more than 1 year, and typically is between two and five years.

The form of benefits and delivered from a long-term incentive plan is normally cash or equity. The reason an employer would choose one or the other depend on the goals of the plan, the type of recipients and the availability of cash or equity for delivery of those benefits.

Cash Based ESP's

Cash-based replicator plans allow organisations to target specific performance levels over a long term. Organisations using such plans need to exercise caution to avoid confusion and complication that may result from implementing a long-term cash incentive plan that looks like the organisations short-term incentive plan.

Cash-based plans have their place. They are effective in rewarding employees, teams, groups, departments and other entities for meeting or exceeding performance milestones that span more than 1 year. One of the benefits to the employer of using a cash-based plan is that the plan and its rewards can be very specifically tailored. For example, if the goal of the company is to increase market share for a particular product line from 10% to 33% over the next 39 months, the company can match a long-term incentive plan to that goal (presuming there is a reliable measure of market share for that product). Further, because the payments are made in cash and not equity, there is no need to introduce a second variable (e.g. share price) that complicates and confuses the linkage between the performance and reward. That is, the value of the awards can be pinpointed the day the program is in place because the currency does not change over time.

Cash-based plans are effective when:

- The target recipients are to be rewarded for performance that isn't precisely correlated with share performance.

- The share price is not tracking properly with the company's performance (e.g. the industry is out of favour).

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- Shareholder dilution is a concern.

- Broad-based employee groups are targeted for ESP's and they have shown strong preference for cash rather than shares (Companies sometimes find it favourable to pay with cash rather than to pay with shares when they believe employees will sell any shares as soon as possible to convert them into cash).

- Employee retention is critical.

Equity Based ESP's

Equity-based plans are the most common form of ESP; and share option plans and restricted shares are perhaps the single most common for of ESP in use.

Equity-based plans are effective when:

- The employer wants to create a strong link between the employee's performance and the company's performance.

- There is limited cash available for employee incentives. This is most prevalent among early-stage start-ups that are cash poor and therefore use equity for its high risk/high reward characteristics.

- It is desirable for employees to feel and act like owners.

- Retention is important.

- The employer has substantial growth (i.e. "blue sky") potential.

Equity-based plans can take two forms; entire value, or appreciation only. The primary difference is that one form provides full value of the equity whereas the other measure only the increase in value of the same equity – typically measured from the equity's value on the day of the original grant. Neither form is better than the other, each has its strengths and weaknesses. Plans with awards based on appreciation only are perceived to be stronger when the goal is to reward for future performance – that is, to reward for the increase in value from today. Plans with awards based on entire value provide a broader continuum of payments, allowing awards to be paid if the share value drops below its current level. These plans provide more stability in payments and typically less volatility overall.

Linking Performance

For some time, executive remuneration has been a high profile issue. It seems that every day there is an article splashed across the business pages of the newspaper, expressing concern about the amounts of cash and equity being delivered to executives. A large part of the concern is that executives are seen to be rewarded independent of company performance. The perception is often that executives get rich at the expense of the shareholders.

In this environment, it is extremely important that executives' and employees' remuneration strategies have been closely linked to company performance and shareholder value creation. Choosing effective performance measures in long-term incentive programs will ensure that

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rewards are commensurate with performance, and that shareholders feel they are all being treated fairly.

Australian Experience

In the past, Australia has missed golden opportunities to develop and maintain effective employee ownership policies. Given looming demographic pressures, any future failure to promote commitment and productivity in the workplace will have a serious effect on this nation's prosperity and the distribution of that prosperity. Ordinary Australian workers must have the chance to become significant co-owners of the businesses in which they work.

The Shared Endeavours report into employee share ownership was tabled in the House of Representatives in October 2000. In March 2003, the Federal Government responded, but then only to support limited measures. These included the establishment of an Employee Share Ownership Development Unit within the Department of Employment and Workplace Relations ("DEWR"). Subsequently, at the 2006-07 Budget, the Government extended the tax provisions governing employee share plans to ASX listed stapled securities.

What is Human Capital

Human capital management ("HCM") has been described as "a strategic approach to people management that focuses on the issues that are critical to an organisation's success" (Kingsmill, 2003) and "the possession of knowledge, applied experience, organisational technology, customer relationships and professional skills that provide a company with a competitive edge in the market" (Edvinsson, 1997).

Human capital is a component part of the "intellectual capital" of a company, which is linked to the difference between market value and book value of a company. "Recent estimates suggest that 50 to 90 percent of the value created by a firm comes, not from management of traditional physical assets, but from management of intellectual capital" (ICAEW, 1999).

The term "human capital" represents an asset with a flow of benefits that are greater than the cost of the asset. To most, the term human capital means assets that yield income, so that when using the term human capital, it means the value added by the workforce.

There is no question that it pays to manage people correctly and maximise the human capital assets of the organisation.

Organisations have long focussed resources on other aspects of their companies, including infrastructure, R&D, sales and advertising, just to name a few. These things can increase shareholder value creation in measurable ways. Some – but certainly not all – tried to optimise their human capital to increase returns to shareholders. But even these companies were taking a shot in the dark, because no one could quantify which human capital programs were linked to good outcomes. Some companies failed to maintain and develop their optimal human capital programmes.

It is now incontrovertible LTI's delivered through ESP's form an integral part of Human Capital Management.

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Why Employee Ownership is Popular

Employee participation in share ownership can have significant benefits to both employees and their companies.

Whether the company is privately held or listed, an efficient share plan provides a viable source of low-cost equity.

For unlisted companies this might avoid the necessity and cost of going public to raise funds. It might also provide a process for achieving ownership succession without selling out to a competitor. Share incentives can play an important part in attracting and retaining good staff.

There are a number of reasons for the growing popularity of employee share ownership. The use of employee share ownership plans (or ESOP's) – first envisioned ESOP creator Louis Kelso in the 1950's in the US in order to bring to employees the wages of capital as well as the wages of their labour – was to buy newly issued shares in a company, with the borrowed funds being used to buy new capital. The company, in effect, can finance growth in pre-tax dollars while these same dollars create an employee benefit plan.

Over the years, ESOP legislative developments throughout the world have greatly enhanced the appeal of ESOPs as a business financing vehicle. ESOPs especially can provide a way for owners of private businesses to sell all or part of their interests to their employees. A most common current application for an ESOP is to buy the shares of a departing owner of a private company. About half the ESOP's in private firms in the US are used to buy out an owner; the rest are typically used as a primary employee benefit plan.

ESOPs make it possible for companies to provide an employee benefit simply by contributing tax-deductible funds to a controlled trust and issuing shares and allocating them to employees.

Controlled Employee Share Trusts negate any potential minority shareholder problems.

Another development has been that of employee share option programs. Broadly granted share options give growing companies a way to compensate employees with equity rather than more cash and despite the recent "Budget" uncertainty will continue to be popular particularly for "start up" companies all for employees of private companies.

Other forms of employee ownership – such as employee savings plans and company loan based plans – allow employees to put aside (through salary and bonus sacrifice) part of their pay-packets to buy shares.

An important impact of these developments has been the potential for productivity gains. Studies consistently show that when broad employee ownership is combined with a highly participative management style, companies perform much better than they otherwise would be expected to do. Profits increase and the business grows in value. Neither ownership nor participation accomplishes these significant gains on its own. Companies want employees to "think and act like owners". What better way to do that than to make them owners?

Finally, employees are beginning to expect equity, at least in some sectors. In technology firms, for instance, it is the norm to offer 'all employee options' or other equity, because companies that don't, have a hard time attracting good people.

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Offering some form of equity to employees is also a great way to keep wages under control, which is of particular interest in these challenging times.

As a result of all these developments, during the last two decades, the number of companies sharing ownership broadly with employees has continued to grow (though so as much in Australia as in other countries). While precise figures are not available, it is estimated that at least 6% of the Australian workforce is involved in employee ownership in some way.

As more and more companies want to find ways to align employee and corporate interests, employee share ownership is becoming a popular application in countries around the world.

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ANTICIPATED IMPACT

The immediate impact on these changes has been the freezing of most employee share plans at all levels of organisation, especially large listed organisations.

The actual impact has been heavily focussed on ASX listed companies, as this is where the bulk of employee share plan allocations are concentrated.

Other organisations have been less affected as they tend to incorporate loan based plans and replicator plans, which can continue unaffected by these proposed changes.

2009 Budget – Employee Share Plans

The Treasurer's 2009 Budget Announcement contained in Budget Paper No.2 which as of 7.30pm, Tuesday, 12 May 2008, had the effect of:

- Removing the tax deferral option for employee qualifying share discounts; and
- Limiting access to the upfront, $1,000 per annum, tax exemption to employees with adjusted taxable incomes of less than $60,000 per annum.

Consultation Paper 5 June 2009

In a Consultation Paper released on 5 June 2009, the Government amended the earlier proposal to tax employee share discounts upfront, subject to:

(a) raising the adjusted taxable income threshold for the $1,000 tax exemption up to $150,000;

(b) introducing a limited deferral of the taxing point for discounts, where there is a "genuine risk of forfeiture";

(c) limiting the refund of income tax paid upfront for forfeited benefits;

(d) introducing annual reporting requirements; and

(e) deferring the application of the new proposals until 1 July 2009.

Further to the Treasurer's 12 May Budget Announcement and the Consultation Paper released on 5 June 2009, Assistant Treasurer, on 1 July 2009, Senator Nick Sherry released a further Policy Statement setting out the Government's "final" policy on the taxation of employee share plans as of 1 July 2009. The "final" policy is as follows:

(a) raising the adjusted taxable income threshold for the $1,000 tax exemption up to $180,000 per annum;

(b) introducing a new qualifying salary sacrifice share plan, capped at discounts of $5,000 per annum;

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(c) introducing a limited deferral of the taxing point for discounts on shares and options, where there is a "genuine risk of forfeiture" and restrictions on disposal for up to 7 years;

(d) amending the basis for employee refund of income tax paid upfront for certain forfeited benefits;

(e) introducing annual reporting requirements for the above plans; and

(f) confirming the application of the new proposals from 1 July 2009.

Unfortunately, these changes will cause some existing qualifying deferred employee share and option plans to create upfront tax liabilities for employees.

However, on the positive side, it should be noted that, unlike the former provisions of Division 13A (TAA36), the three qualifying plans mentioned above (refer point (a), (b) and (c)) can be provided conjointly in the same tax year.

As from 1 July 2009, these changes will cause some forthcoming qualifying share and option plan allocations to create upfront tax liabilities for employees. Some employee option plan allocations from 1 July 2009 could be taxable to employees upon vesting.

Tax Upfront

One lesson we have learnt from our long standing professional engagement with employee share plan practice, is that generally speaking, if employees are offered shares and need to pay tax upfront, they will simply not be able to afford to take up the shares offered to them.

The Treasurer's announcements may affect certain allocations to Australian employees as from 1 July 2009 under the $1,000 tax exempt share plans, which are issued at a discount. However, the lifting of the annual adjusted taxable income, threshold, from $60,000 to $150,000 and now to $180,000 per annum (i.e. including taxable income reportable fringe benefits, reportable superannuation contributions and total net investment losses), should ameliorate most concerns with the Government's earlier proposal concerning exempt share plans.

On the positive side, under the new provisions applying from 1 July 2009, it is possible for an employee to participate in the qualifying $1,000 tax exempt plan, a qualifying salary sacrifice plan capped at discounts of $5,000 per annum conjointly and the tax deferred plans that meet the new stringent "genuine risk" of forfeiture conditions in the same year of tax. This has been confirmed by relevant Treasury officials in Canberra.

New Reporting Requirements

As mentioned earlier, there will be new ATO reporting requirements for all qualifying employee plans which will apply to all qualifying employee share issues from 1 July 2009 which must be provided to the relevant employees by 14 July and the ATO by 14 August following the end of the relevant financial year (i.e. 2010).

The limitation of the $1,000 per annum tax exemption on share benefits would have had a particularly deleterious effect on companies' general employee share plan arrangements,

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effecting non-discriminatory offers, across the board, to all employees, reflecting its antecedents as the plan that made all Qantas employees shareholders in the then newly privatised enterprise.

The then Federal Labor Government policy, which privatised several former government enterprises, required those organisations to set aside a minimum of five percent (5%) of their issued capital for the benefit of all their employees (e.g. the Australian Industry Development Corporation, Commonwealth Bank of Australia, and Qantas).

Taxation Consequences

Ironically, qualifying ESP's which provide for a deferral for tax, will provide a substantially greater overall tax take, than ESP's which are taxable upfront (refer to our tabulated comparisons at pages 43 and 44).

Limiting Salary Sacrifice

With this in mind, the proposal to limit qualifying share discounts provided on a salary sacrifice basis to a capping of $5,000 per annum is unduly restrictive. It limits both the potential for employees to maximise their stakeholdings in the company, providing more jobs in that company and the capacity for the Government to maximise its taxation take from employee share plans over time.

Reduction of Tax Deferral from 10 to 7 Years

The proposal to limit the deferral period from 10 to 7 years is again restricting the effectiveness of employee share plans and unnecessary.

Studies completed by Vince Fitzgerald of the Allen Consulting Group in 1995 prior to the implementation of Division 13A, demonstrated that employees maintaining their shares in an employee share plan on average for a period of 7.4 years. Therefore, the limitation of the period of deferral for 7 years, or for that matter, 10 years, is unnecessary.

Tax Refunds for Forfeited Benefits

The employee tax refund rules have been extended to cover forfeited shares as well as forfeited rights – which was a flaw in the provisions of section 139 DD of Division 13A, which was restricted to “lost” rights.

However, the proposal to exclude the refund provisions applying to situations which occur as:

(a) a choice of the employee; and

(b) related to the loss of market value of the shares or rights,

is unduly restrictive and will act as an obstacle for employees taking up equity in their employing company.

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Taxation on Termination of Employment

Of course, the proposal to impose tax on all qualifying deferred benefits on the termination of employment is again short sighted and contrary to the prevailing views of many influential bodies, including the current Productivity Commission.

Proposed Solution

We noted with some concern the Assistant Treasurer's proposed "solution", which appears as follows on page 8 of the Policy Statement:

"Where shares or rights vest after an employee ceases employment with a company, it is open for a company to offer a "partial vesting" arrangement to enable their employees to dispose of a proportion of shares or rights to pay tax crystallised on cessation of employment."

This is an effect a prepayment of income tax by the disposal of shares, prior to the share benefits "coming home" to the employees.

Under ordinary income tax principles, there would not crystallise any taxable benefit, until the benefit had come home to the employee.

Furthermore, had the employee paid the tax on the unvested shares at the time of termination of employment, and the shares never vested the employee would not obtain the shares, the shares would revert back to the employee share plan trustee to reallocate the shares to other current and/or future employees of the employer, who would again need to pay income tax on those share benefits.

If the employee could not obtain a refund of tax on the forfeited shares (i.e. because the employee chooses to forfeit due to loss in the market value of the shares), this would create an illogical situation of double (and possibly further multiple) taxation of unvested share benefits.

Alternatively, if the employee could obtain a refund of tax on the forfeited shares (e.g. because the vesting conditions were not achieved) the employee would be receiving up to 46.5% of the value of shares that he or she should have never been entitled to.

Either scenario creates an unsatisfactory and premature payment of tax and is indicative of a lack of systemic coherence and logic in the proposals.

Start Up R&D and Speculative-Type Companies

The use of employee share and options as a vital part of attracting, retaining and motivating key qualified staff is a vital part of conducting these Start Up R&D and Speculative-Type companies.

Many of these Start Up R&D and Speculative-Type companies are cash poor. The capacity to provide shares and option in lieu of scarce cash resources, and provide employee with a share of the organisation tied to a so-called "monetisation event" (i.e. trade sale, takeover or an Initial Public Offer on a recognised stock exchange) is vital to the effective operation of these companies.

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Again, these situations simply reinforce the truisim for the taxation of employee share benefits, that they should be taxable to employees only when the equity is sold, the benefits are realised and employees have the cash resources to pay the tax.

Once again, the studies show that by deferring the tax on employees' shares the Government's tax take will be maximised (refer Saving Through the Firm: Employee Share Plans – Context Role and Implications for Enterprise Performance Saving and Taxation by Dr. Vince Fitzgerald. The Allen Consulting Group [1993] and letter of 6 August 1999.

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ESP's IN OTHER COUNTRIES

Overview

There is currently, a large amount of international research in the area of ESOP's, the majority of which emanates from the US and, more recently, from the European Union ("EU"). The key difference between the US and EU research is that the implementation of ESOP's is relatively widespread in the US in comparison to the EU (and Australia). The widespread acceptance of ESOP's in the US has broadly been explained as a direct result of tax-incentives introduced in the 1970's and 1980's in the US. Many of these incentives continue to have effect today and encourage further acceptance of ESOP's by both employers and employees in the US.

United States of America

A Statistical Profile of Employee Ownership
Updated February 2008

Estimated Number of Plans and Employees; Value of Plan Assets

Type of Plan	Number of Plans (as at early 2008)	Number of Participants (as at early 2008)	Value of Plan Assets (as at early 2008)
ESOP's, stock bonus plans and profit sharing plans primarily invested in employer stock.	7,774	11.2 million	$928 billion +
Section 401 (k) plans primarily invested in employer stock	748	1.5 million	$133 billion
Broad-based stock option plans	3,000	9 million	(several hundred billion, not realistic to estimate)
Stock purchase plans	4,000	11 million	(not realistic to estimate)

Approximately 15% of the workforce have some form of ESP.

The dramatic growth in plan assets and in participants in these plans over the last few years appears to result from the better performance of ESOP's companies and a huge increase in the number of ESOP's doing acquisitions.

Multiple Plans

Many companies offer multiple plans, and many employees participate in more than one plan. For example, many employees participate in the company's section 401(k) plan and in the companies other stock option and equity compensation plans.

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Europe[1]

The situation in Europe regarding the application of financial participation schemes has developed slightly overall since the publication of the initial PESPER Report. There is more encouragement given to financial participation than fifteen years ago in virtually all member states. However, there is a growing disparity between the acknowledged financial participation countries (such as France and the UK) and those countries with the least developed financial participation policies and institutions. Those countries committed to financial participation have taken active steps to develop financial participation further, but these actions have not been followed by other member states. Part of the problem is that there appears not to exist any exchange of information between member states regularly either on legislation or good practices.

In summary:

- There is an increase in the use of schemes in Europe.
- However, the substance of share ownership in Europe is generally small, which means that there are relatively isolated experiments going on.
- There is a growing awareness at all parts of industry that employee share ownership might be a new employee benefit to be applied.
- A growing number of trade unions develops a pragmatic attitude towards the phenomenon and tried to be involved.
- There is a growing need for sharing information and a growing need for models and exchange of experiences on best practices and on solutions for apparent problems that show up when practising these schemes.
- Moreover, following the research and discussions more insight should be acquired concerning employee choices and employee representatives' views.
- And more insight should be gained on the views of the social partners on this phenomenon.
- Due to bookkeeping scandals and subsequent impact on these types of schemes financial participation are much more critically approached than at century's end and may have lost some broad based support.

Differences Between European Countries

As expected there are large differences between countries. The UK appears to be the country with substantial application of share schemes. France is a country with mandatory profit sharing since 1968. Spain appears to be a country with a tradition of co-operatives. Germany is a country with established capital accumulation plans for employees, and the Netherlands and Finland appear to be countries with a national wage saving system. These country

[1] Changing Patters of Employee Financial Participation in Europe
A survey among listed Firms in six European Member States
Final report by Erik Poutsma (Ed)
Danial Albra, Panu Kalmi, Andrew Pedleton, Stephan Trbucq, Eckhard Vozz

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differences determine the existence of schemes to a large extent. Most broad based employee financial participation appear to be a result of the legislated benefits provided by government policies in certain European countries.

Supportive Legal Context and Government Policy

There is an increase of the use of these schemes in all countries. The development is supported by legislation in certain countries, most notably the UK and France. In these countries employee financial participation has become the norm and to a certain extent part of national sectoral income policy. The main arguments to promote the system are wage flexibility, productivity and wealth redistribution.

Australia in Comparison[2]

In Summary

- In Australia there is conflicting and limited data regarding the implementation of Employee Share Ownership Plans ("ESOP's").

- There is no comprehensive (accurate) survey of the incidences of the various types of ESOP's by business type in Australia.

- The limitations of previous research include a lack of differentiation between:

    - "type" of ESOP and the key factors that are limited take-up;

    - the focus of the ESOP at the company level, and whether the plans are narrow-based plans (offered to top management group only) or broad-based plans (offered to most or all of the employees, generally considered to be greater than 50%); and

    - the size of the entity, and whether barriers to implementation of ESOP's differ by entity type and size.

- Australian incidence of employee share ownership is low compared to a number of other countries, such as USA, UK, France and Japan. However, employee share ownership in Australian is similar to that in Germany. It also appears that employee share ownership is more concentrated among managerial occupations than in some other countries.

Trends and Statistics

The Australian Bureau of Statistics ("ABS") collects data about shares as a benefit of employment; data was collected on this in 1999 and 2004.

As at 2004, 5.9% of the total employees have employee shares as a benefit of employment. This is an increase of 0.4% from 1999 and a total increase of 3.5% from 1989.

[2] Research provided by TNS Social Research, ACT

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Full-time employees constitute 400,600 of the total number of employees. The ABS data indicates an increase of 0.1% to 0.7% from 1999. An estimated 3.4% of the 80,700 total part-time employees also have employee shares, which is an increase of 1.2% from 1999 and a total increase of 2.9% from 1989.

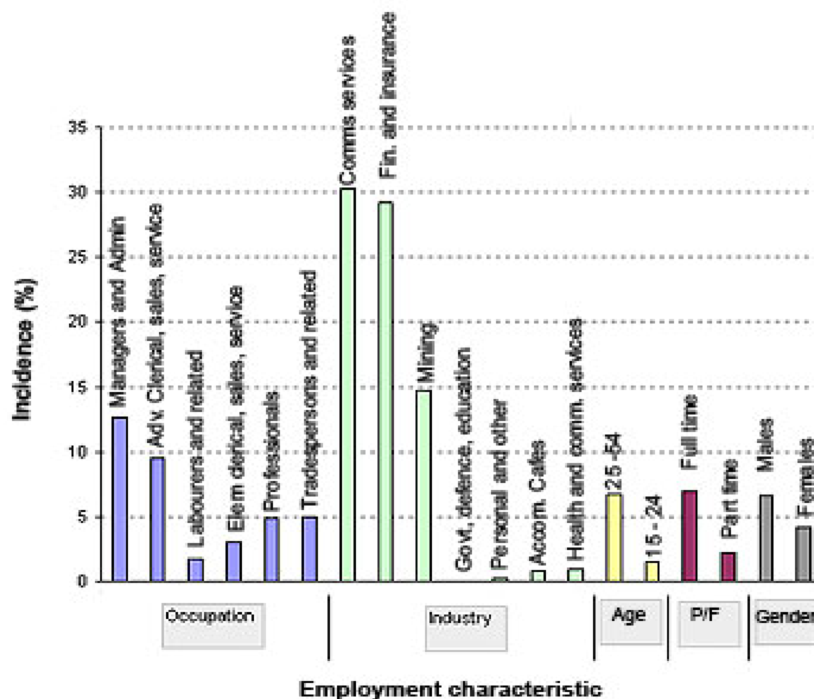
In comparison to other types of employment benefits, the percentage of employees with shares (5.9%) ranked above other benefits such as study leave (4.2%), holiday expenses (3.8%), union dues/professional association (3.0%), medical (2.1%) and child care/education expenses (0.6%).

These statistics indicate that the incidence of employee share ownership is on the increase.

Data from ABS Survey of Employee Benefits and Earnings from 1986-1999 provides the following levels of employee share ownership in main job and occupation:

	1986	1987	1988	1989	1990	1991	1992	1994	1999
Total employees in main job (%)	1.40	2.15	3.25	2.39	2.61	2.76	2.83	3.90	5.54
Managers and administrators (%)	5.76	8.67	9.25	8.25	8.46	8.95	8.13	9.79	12.57
Non managers and administrators (%)	0.95	1.70	2.71	1.96	2.21	2.30	2.42	3.42	5.15

As at 1999, an estimated 5.5% of all employees and 12.6% of managers have employee shares.



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Listed and Unlisted Companies

A very high proportion of Australian listed companies have employee share ownership plans (estimated to be around 90% of listed companies and 56% of subsidiaries of overseas listed companies have at least one employee share ownership plan, noting some of these are executive only plans (*Mercer, 2002)).* A number of reasons are given by the companies surveyed for this high level or employee equity participation, including developing an ownership culture, attraction and retention, and long-term incentives.

A much lower number of unlisted companies have employee share plans (i.e. estimated to be about 0.9% of companies). According to the House of Representatives Inquiry into Employee Share Ownership, the main reasons for employers not putting plans in place are cumbersome administration, cost implications, and, because difficulties with approval and corporate structures not considered to be appropriate (*Shared Endeavours: an Inquiry into Employee Share Ownership in Australia*). [3]

In the USA 90% of both listed and unlisted companies have employee share plans. This is due to the prevalence of geared ESOP's in the USA's unlisted share market place.

ESP's Value

The value of employee share ownership is unknown, but was estimated by the Nelson Committee to be worth between $3 billion and $4 billion in unlisted companies. About $1.5 billion of the total was estimated to be holdings in executive only plans. A significant proportion of the total comes from a small number of very large firms.

[3] Shared Endeavors: An enquiry into Employee Share Ownership in Australia

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LTI COMMUNICATION AND EXPENSING

Expensing

"Worldwide" accounting standards now require employee share and option benefits to be valued and expensed in the profit and loss accounts.

Though there was in some quarters concerns about the requirement to expense equity offerings, it has now been universally accepted and implemented.

Communication

What has not been universally adopted is the communication of the "equity" benefits to employees as part of their Total Employment Cost.

The provision of LTI benefits are a cost of employment the same as Salary and Wages, Superannuation and so on, and employees for the purposes of communication and transparency, let alone retention should be aware of the annual value of their LTI benefits.

Valuation

RSG has developed an employee equity valuation calculator (i.e. the RSG Employee Equity Calculator), in conjunction with a noted academic from a leading university, who specialises in the valuation of options and other equity. The valuation of the employee share options and all forms of employee equity needs to be based on the methods outlined in the AASB 2, which is the Black and Scholes model or a binominal model, with a careful and detailed calculation of the valuation volatility factors.

The RSG Equity Calculator incorporates a 250 step, binominal tree structure, which allows for inclusion of employee vesting conditions, employee turnover rates and early exercise as required by the accounting standards.

It is the determination of the volatility factor that is one of the keys to accurately value share options and other equity. Volatility represents the potential for the option and share benefits to grown in value over the period the employees hold the equity. Accurate determination of the appropriate volatility requires careful analysis of the fluctuations in the company's share prices.

Where a company has little in the way of historical valuation data, it is understood ASIC is has sometimes applied the arbitrary volatility factor of 65%. Most mature companies exhibit a volatility factor of around 20-30%. However, newly established, more speculative mining or hi-tech companies can exhibit unsustainable volatility factors in excess of 100%.

It should be emphasised that the valuation of share-based payments are not limited to employee option plans. For example, many companies have loan share plans (i.e. employees are given an interest free loan by their employer to invest in the company's shares) and they will also need to disclose and expense the value of this equity. Generally speaking, the value of employee loan plans can be determined on a similar basis to employee option plans but without the lost dividend yield cost factor.

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Also, it is not limited to public companies, the requirement to expense LTI benefits applies to most who are offering “equity” benefits in lieu of services performed.

Valuation of Equity

- Currently, the Government proposes that, under the general valuation rules for unlisted shares and rights, taxpayers will no longer be obliged to use an auditor provided they can determine and justify the market value appropriately. This will remove one major obstacle for unlisted companies providing equity to their employees and other workers.

  We agree with this approach as it is fair, flexible and enables organisations, who are usually the best judge of their arms length, market value, the flexibility to determine and justify that value without engaging an auditor.

- We note that the existing rules in Division 13A ITAA 36 (i.e. refer section 139FJ to section 139FN ITAA 36 are to be retained as an “interim measure” in the proposed provisions (refer paragraphs 1.78 to 1.81 of Chapter 1 of the Treasurer’s Explanatory Materials).

- According to our option valuation calculator those tabulated taxation calculation percentages are concessional, where the options involve an exercise price at the market price of the subject share prevailing at the time of issue of the option.

  For example, in the fictional case of Spec Pty Ltd, an option with an exercise price of $1, which is equal to the prevailing market value if the share will have an AASB2 value of 21.71 cents (refer **Attachment 2**). Whereareas, the tabulated value under section 139FM (1) will be 11.6 cents.

  To approximate that value of 11.6 cents, we prepared an option valuation under AASB2 for the fictional case of Spec Pty Ltd, but needed to reduce the volatility factor to the unrealistically low figure of 15.5% (refer **Attachment 3**).

- To combine and unify the taxable value with the accounting expensing AASB2 value and the value of the benefit communicated to the employee, RSG prefer to base the valuation of all its employee equity valuations on the principles expounded under accounting standards AASB2.

  These standards originate from the London based International Accounting Standards Board, headed by Sir David Tweedie. They are internationally accepted as creating an accurate and standardised valuation methodology for all so-called share based payments.

  Therefore we recommend that the employee share plan taxing provisions accept valuations in accordance with AASB2 as an acceptable basis for all employees’ and workers’ shares and rights.

Typical employee share option scenario

(Source: Employee Shares in Volatile Markets by Gary Fitton, Director, Remuneration Strategies Group, Thomson Reuters, Weekly Tax Bulletin, No 8, 27 February 2009).

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Option Valuation

The options proposed to be offered to employees would need to be valued and expensed under the relevant accounting standard, being AASB 2, under a Black Scholes Merton methodology.

Growth-only valuations

Utilising the RSG Equity-based Remuneration calculator, each growth-only or geared option would be valued at 75 cents.

This valuation is based on the following assumptions:

- a share price of $4.00;
- a "strike" or exercise price of $4.00;
- a call life of 5 years;
- a vesting period of 3 years;
- a risk-free interest rate for the company of 3.25%;
- a lost dividend yield of 5.5%;
- a volatility factor of 30%; and
- staff turnover of 5%.

For the gross remuneration cost of $200,000, the employee would receive 266,666 options.

Growth in share value

As the options have been issued with an exercise price at the prevailing market value of the shares, the only basis for providing a benefit under this arrangement is from the growth in the share value, over the period the options are held unexercised by the employee. This is referred to in colloquial, general business parlance, as a “growth-only” benefit.

Zepo

We have also valued zero exercise priced options (Zepos), as an alternative to be considered in contrast to the growth-only options.

The value of the Zepos, utilising the RSG Equity-based Remuneration calculator, will be $3.41 per option.
This valuation utilises the same assumptions as the growth-only options, except, of course, the “strike”' or exercise price will be zero.

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Practical Example

Based on recent cost/benefit analyses of alternatives for various option-based delivery methodologies for employee long-term incentives and employee retention mechanisms, we prepared a comparative summary of the cost/benefit attributes of a range of those alternative equity based, long-term incentive (LTI) delivery facilities.

We will assume these comparisons have been prepared for a Large Mining Company (LMC).

Assumptions

- The employee receives a relatively low fixed remuneration and is “topped up” with substantial share option-based incentives;
- the employee has a marginal income tax rate of 46.5%;
- the amount of the long-term incentive (LTI) is $200,000;
- options are issued for nil consideration;
- exercise price is at the prevailing market price of the share (eg $4);
- vesting period of 3 years;
- share value of $10 at the end of year 3 (refer **Table 1**);
- we have also provided examples or share values of $4, $2 and $1 respectively at the end of year 3 (refer **Tables 2 and 3**);
- LMC AASB2 option value of 75 cents, expensed over the 3-year vesting period;
- LMC AASB2 Zepo option value of $3.41, expensed over the 3-year vesting period; and
- we assume the share is sold as a consequence of option exercise, but this would only need to occur in Examples 1, 2 and 3.

Three examples are set out below.

Option Example 1: Growth-only option with s 139E election

The s 139E election to be taxed upfront will have a taxable value of 11.6% of the $4 market value of the share (refer s 139FK-FM of the ITAA 1936), being 46.4 cents per option.

The employee will pay 21.6 cents per option income tax (i.e. assuming a 46.5% income tax rate), and will establish a CGT cost base of 46.4 cents per option.

When the employee exercises the option and sells the $10 share to pay the $4 exercise price, the employee will:

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- have paid income tax upfront of 21.6 cents on the option acquisition;

- pay CGT of $1.29 (i.e. $10 - $4.46 = $5.54 x .5 x .465 = $1.29); and

- receive net after-tax proceeds of $4.50 (i.e. $10 - $4 = $6 - [$0.216 + $1.29] = $4.50).

The employee will receive 266,666 options (i.e. $200,000 divided by 75 cents).

Upon exercise of the options, the company will receive an amount of $1,066,667 as an accretion to issued capital. It will also have received a tax saving of $60,000 in respect of the tax deductible contributions to the Plan Trustee.

The AASB2 value of 75 cents per option will be debited to the employee's gross remuneration package as a long-term incentive/retention benefit.

The employer will expense the AASB2 value of 75 cents over the 3-year vesting period (i.e. at 25 cents per year).

The employer will receive an income tax deduction under s 8-1 of the ITAA 1997 for contributions to the plan trustee (i.e. equal to the 75 cents AASB2 value of the options) upfront in the year they are incurred (refer ATO Interpretative Decision ATO ID 2002/1074).

We have assumed that the share is sold upon the exercise of the option, because the employee will need to sell the shares to pay the exercise price, in the so-called “cashless exercise” process that has typified most Australian employee option plans over past decades.

This process undermines the potential for the equity of LCM to act as a sustainable incentive, as it acts to dissipate the equity held by employees. It turns the employee share plan into a short-term speculative exercise, rather than an ongoing and long-term investment and goal alignment strategy.

The other concern with this arrangement is that, if the share price remained at $4 or dropped to $2 or $1, the employee would derive no long-term incentive benefit under the plan (see **Tables 2 and 3**).

Another problem with this alternative is encouraging the employees to make the s 139E election and pay the tax upfront on an option they cannot dispose of for 3 years.

In this case, the upfront income tax would amount to $57,536, which, if the options were underwater, the employees could only retrieve (i.e. with interest) from the ATO upon cancellation of the options or at the end of the 5-year option life. Short of mortgaging the family home, most employees (including so-called “fat cat” executives) simply do not have ready access to that amount of money.

Our experience is that, as a rule, the s 139E election does not happen and can detract from the general appeal and effectiveness of the plan for employees. Consequently, employees do not retain their shares, as they need to sell the shares to pay the exercise price and the tax on exercise (see Option Example 2 below).

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Option Example 2: Growth-only option with no s 139E election

As is typical in these arrangements, the employee will not make a s 139E election to be taxed upfront.
Assuming the option to be qualifying rights under the provisions of s 139CD of the ITAA 1936, the employee will exercise at year 3, with the following consequences,

- sell the shares for $10 each and pay the exercise price of $4 each, resulting in an income taxable discount of $6 per share;

- pay income tax of $2.79 (i.e. $10 - $4 = $6 x 46.5 = $2.79); and

- receive net after-tax proceeds of $3.21 (i.e. $6 - $2.79 = $3.21).

The employee will receive 266,666 options (i.e. $200,000 divided by 75 cents).

Upon exercise of the options, the company will receive an amount of $1,066,667 as an accretion to issued capital. It will have received a tax saving of $60,000 in respect of contributions to the Plan Trustee.
The AASB2 value of 75 cents per option will be debited to the employee's gross remuneration package as a long-term incentive/retention benefit.

The employer will expense the AASB2 value of 75 cents over the 3-year vesting period (i.e. at 25 cents per year).

The employer will receive an income tax deduction under s 8-1 of the ITAA 1997 for contributions to the plan trustee (i.e. equal to the 75 cents AASB2 value of the option) upfront in the year they are incurred (refer ATO ID 2002/1074).

While there is no upfront tax for the employee to pay, for the reasons already stated above in the Option Example 1, we believe this alternative to be sub-optimal as the shares must be disposed of to pay the exercise price and the income tax. This dissipates the equity in the employee share plan and, therefore, is an inefficient application of employer shares.

Again, as in Option Example 2 above, the other concern is that, if the share price remained at $4 or dropped to $2 or $1, the employee would derive no long-term incentive benefit under the plan (see **Tables 2 and 3**).

Option Example 3: Zero exercise price option (Zepo)

This example is of a Zero Exercise Price Option (Zepo), provided as a long-term incentive. It can also be structured as, so-called, performance rights or restricted shares.

The AASB2 option value of $3.41 will be expensed in the accounts of LMC over a 3-year vesting period. This is based on a share value of $4, discounted by the cost of options not being capable of paying dividends.

We have assumed the employee will not make a s 139E election, as the taxable discount for s 139FC purposes will be the full marker value of the share (i.e. $4). Consequently, had the employee elected to pay tax on the acquisition of the options, he or she will be liable for income tax upfront of $1.86 per option and will have a CGT cost base of $4 per option. As the

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employee is being offered 58,651 options (i.e. 200,000 divided by $3.41), he or she would be liable for a total of $125,513 income tax on the acquisition of the options.

Interestingly, Zepo-based option valuation is one of the few occasions that the Div 13A valuation for tax purposes will be greater than the accounting valuation for AASB2 purposes. This is due to the fact that the Div 13A valuation does not factor in the cost of the options not being able to pay dividends. To that extent, the Div 13A valuation actually overstates the value of the zepo-based option or Performance Rights for taxation purposes at acquisition.

The employer will make a tax deductible contribution of $3.41 to the plan trustee to acquire an option as a fresh issue.

The trustee will have acquired the option for its market value of $3.41 and allocate the option to the employee.

The AASB2 option value of $3.41 per option will be debited to employee's gross remuneration package as a long-term incentive/retention benefit.

The employee will acquire the options with the following consequences:

- no dividends are payable until the options are exercised into shares. The trustee will distribute any dividends;

- the employee exercises the option and receives $10 per option as an income taxable benefit;

- the employee will receive net after-tax proceeds from exercise and sale of the shares of $5.35 per option (i.e. $10 - $4.65 = $5.35).

The employer receives a tax deduction for the contribution of $3.41 per option, resulting in a net tax saving of $60,000.

Upon exercise of the options, the company will receive no further amount as accretions to issued capital.
As there is no exercise price to pay, the employee will not need to sell the shares to pay the exercise price, but will need to sell the shares to pay the income tax.

For LMC, this means that the equity in the employee share plan is dissipated and has no incentive and goal alignment attributes over the long term.

Conclusion

Where the shares grow in value to $10, Options 1 and 2 are clearly the optimal equity delivery arrangement (refer **Table 1**). However, where the shares do not grow in value, Option 3 is clearly the optimal equity delivery arrangement (refer **Table 2**). However, these equity delivery arrangements should not be viewed as mutually exclusive.

Depending upon the purpose of each proposed allocation of Share Units, the employer may choose to utilise growth-only options or Zepos under the EST arrangement.

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The benefit of Zepos, or full-value shares, is that they produce a return to the participating employees even in “bear” or “no-growth” market conditions (refer **Table 3**).

The benefit of growth-only options or loan-based shares (i.e. with the exercise price or loan at the market value of the share at the time of issue of the Share Unit) is that it maximises employee returns in “bull” or “high-growth” market conditions. However, they produce no return to the employee in “bear” or “no-growth” market conditions.

Recently, one insightful listed company proposed to break the LTI into its component parts, being:

- the retention component of the LTI; and
- the pure incentive component of the LTI.

It then based the retention component of the LTI as a “full-value” ZEPO and the pure incentive component of the LTI as a “growth-only” classical option plan.

This means that the employees would receive:

- their retention benefit, even if no growth in share value occurred; and
- their incentive component, which would maximise their incentive component in a “bull market” or “high-growth share value growth scenario”,

provided they remained with LMC for their requisite service period - which in this case was a period of 3 years.

This combination of full-value and growth-only equity approaches means that employees are encouraged to remain with the company and perform to maximise the growth and profitability potential of LMC, their employing company.

The common underlying deficiency in these 3 alternative option strategies is that none of them facilitate the retention of shares by the participants after exercise, thereby dissipating the employee equity into a short-term cash realisation exercise.

The Government is proposing to limit the tax deferred model from 1 July 2009.

Ironically, the tax deferred model in Table 2 produces substantially more tax paid (i.e. by $343,999 or 86%), than the tax paid upfront model in Table 1. This tax differential would be even greater if one takes into consideration that very few employees will take up the offer of options if they expect to be taxed upfront.

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Table 1

Table 1			
	OPTION 1 s 139E Election Taxed Upfront	OPTION 2 (Tax Deferral) No s 139E Election	OPTION 3 Zepo
Assumptions			
AASB2 valuation	$0.75	$0.75	$3.41
$ amount LTI	$200,000	$200,000	$200,000
No of units	266,666	266,666	58,651
Exercise price	$4.00	$4.00	$0.00
Market price at sale	$10.00	$10.00	$10.00
Company	$	$	$
Net cash flow	$0	$0	$0
Tax deduction	$60,000	$60,000	$60,000
Receives from exercise	$1,066,667	$1,066,667	$0
Net cash inflow	$1,066,667	$1,066,667	-
P&L AASB2 - Expensing PA over 3yrs	$66,667	$66,667	$66,667
Employee			
Receives $ per share	$4.50	$3.21	$5.35
Pays tax to upfront	$57,536	-	-
Receives from exercise	$1,199,997	$855,998	$313,783
Total Tax Paid	**$399,999**	**$743,998**	**$272,727**

Table 2

Table 2: Comparative Market Prices at Exercise and Sale			
	OPTION 1 s 139E Election	OPTION 2 No s 139E Election	OPTION 3 Zepo
Market price at sale			
$10			
Company net cash inflow	$1,066,667	$1,066,667	$0
Employee receives	$1,199,997	$855,998	$313,783
$4			
Company net cash inflow	$0	$0	$0
Employee receives	$0	$0	$125,513
$2			
Company net cash inflow	$0	$0	$0
Employee receives	$0	$0	$62,757
$1			
Company net cash inflow	$0	$0	$0
Employee receives	$0	$0	$31,378

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Table 3

Table 3: Tabulated Summary							
Example	**Net return to employee**				**Dividends**	**Tax upfront**	**Shares retained in plan**
	$10 share price	**$4 share price**	**$2 share price**	**$1 share price**			
1	$4.50 (Tax $1.50)	0 0	0 0	0 0	No	Yes	No
2	$3.21 (Tax $2.79)	0 0	0 0	0 0	No	No	No
3	$5.35 (Tax $4.65)	$2.14 (Tax $1.86)	$1.07 (Tax $0.93)	$0.535 (Tax $0.465)	Yes, after Option Exercise (5.5% yield)	No	No

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ATTACHMENTS

Attachment 1

MEDIA RELEASE Chris Bowen MP

Federal Member for Prospect Minister for Financial Services,
Superannuation and Corporate Law Minister for Human Services

NEW LOCAL EMPLOYMENT BUYOUT CENTRE TO SUPPORT OVER 600 JOBS

September 11, 2009: Federal Member for Prospect and Financial Services Minister Chris Bowen today congratulated the Australian Employee Ownership Association (AEOA) for securing over $1.8 million in Federal Government funding for a pilot project which will support 603 jobs in the Holroyd, Blacktown and Fairfield regions.

The creation of the Employee Buyout Centre will convert a dozen salvageable businesses with 600 jobs at stake into viable firms. The centre will empower and assist employees to buy out the companies they work for, as an alternative response to deal with company insolvencies, closures and break ups in South Western Sydney.

"This pilot project is one-of-a-kind and well-suited to south-western Sydney with its thriving industries including building, transport, construction and light manufacturing," Mr Bowen said.

"The work of the Employee Buyout Centre will go beyond the health of one company. Employee buyouts will support the jobs of mums and dads in Western Sydney, keep capital in the community and provide employees with a greater sense of workplace participation."

The AEOA successfully applied for funding through the Federal Government's Jobs Fund program which provides a maximum of $2 million funding for one-off capital projects to create jobs, build skills and produce long-term improvements in local communities.

"A range of job seekers and workers will benefit with the project expected to create or retain 603 jobs, 30 traineeships and 30 work experience positions," Mr Bowen said.

The Employee Buyout Centre will be based in Fairfield and will work with local providers and business groups to offer mentoring and support services to businesses and employees throughout the buyout process.

AEOA President, Ian Woods, welcomed the Federal Government's decision to fund the Employee Buyout Centre adding, "This project is a unique example of what can be done to promote and protect jobs in Western Sydney through innovation."

"The AEOA is looking forward to working with local communities and businesses, unions and other stakeholders to drive the project and show what can be done by bringing people together."

About the AEOA

Since its founding in 1986, the Australian Employee Ownership Association [AEOA] has actively promoted employee ownership (or co-ownership) of the businesses where they work. It was formed by 20 companies as a member-focused, non-profit, private sector association to assist members with their employee ownership and participation efforts. Its mandate is to help Australian companies, trade unions and governments attain greater productivity and flexibility in the business sector, and to provide new jobs for Australians through shared ownership and workplace participation.

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Attachment 2

Thursday, 10 September 2009 **Equity-based Remuneration Toolkit**

Company	Spec
Scenario	Spec 1
Date	10/09/2009 12:23:13PM
How Many Shares	1
Financial Period	1/7/2009 - 30/6/2010
Description	
Share Price	$ 1.00
Strike Price	$ 1.00
Call Life	5 years
Vesting Period	3 years
Vesting Price	$ 0.00
Volatility	30.00 % p.a.
Share Prices	
Interval	
Risk-Free Rate	5.00 % p.a.
Lost Dividend Yield	5 % p.a.
Staff Turnover	5 % p.a.
Exercise Multiple	2
Marginal Tax Rate	30 % p.a.
Call Option Value	$ 0.2171
After Tax Cost	$ 0.152
Pre Tax Value	$ 0.3101
Total Call Option Value	
Total After Tax Cost	
Total Pre Tax Value	

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Attachment 3

Friday, 11 September 2009 **Equity-based Remuneration Toolkit**

Company	Spic
Scenario	Spic 1
Date	10/09/2009 12:25:38PM
How Many Shares	1
Financial Period	1/7/2009 - 30/6/2010
Description	
Share Price	$ 1.00
Strike Price	$ 1.00
Call Life	5 years
Vesting Period	3 years
Vesting Price	$ 0.00
Volatility	15.50 % p.a.
Share Prices	
Interval	
Risk-Free Rate	5.00 % p.a.
Lost Dividend Yield	5 % p.a.
Staff Turnover	5 % p.a.
Exercise Multiple	2
Marginal Tax Rate	30 % p.a.
Call Option Value	$ 0.1136
After Tax Cost	$ 0.0795
Pre Tax Value	$ 0.1623
Total Call Option Value	
Total After Tax Cost	
Total Pre Tax Value	

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