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21 October 2009

Review of Employee Share Schemes
The Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

Re: Valuation of Employee Share Options

Dear Chairman,

We welcome the opportunity to make a submission into the Board of Taxation's review into elements of the taxation of employee share schemes. Our comments relate to the determination of the market value of unlisted employee share schemes options in publicly listed companies at the time of vesting of the options. We note that where the options are exercised and the shares sold within 30 days of vesting, the valuation of the options is not relevant as the taxable value in this case is equal to the sale proceeds of the shares.

We note that this issue arises by reason of the proposed change to the taxing point of employee share options from the time of exercise of the option (where the market value of the option can be easily identified) to taxing at the time of vesting (where the market value can be determined by a number of different methodologies and therefore is less certain).

Executive summary

Woolworths is concerned as to the impact that option valuation methodologies, including those used in the current Division 13A of the ITAA 1936, may have on employees who will, under the proposed employee share employee scheme legislation, be required to pay tax at the time of vesting of their options. In particular we are concerned that a taxation liability may arise to an employee in excess of any cash benefit which the employee is able to realise at the taxing point. This is of particular concern for Woolworths as our long term share option incentive plan extends to wide range of employees including those, such as store managers, who the company sees as critical to retain for the growth of our business.

In this regard Woolworths recommends that the difference between the share price and the exercise price associated with the option at the relevant valuation time (typically the vesting time) should be the market value of unlisted options in a publicly listed company. This is a simple, practical solution which will capture the major determinant of the valuation of an option.

Alternatively the Board of Tax should ensure that the regulations regarding the valuation of employee share options are sufficiently robust to allow a valuation which takes into account the specific characteristics of particular employee share options.

Background

The current law which governs the taxation of employee share schemes, Division 13A ITAA 1936, makes use of tables to value options. Paragraph 2.43 of the explanatory memorandum to Taxation Laws Amendment Act (No.2) 1995, which introduced Division 13A, states that:

> *"The Tables contained in new sections 139FJ-FN use an accepted methodology for valuing options, which has been modified to make them easier to use. Further, the variable factors underlying the tables are generally concessional."*

It is understood that the 'accepted methodology' used in the tables in sections 139FJ-FN is based on the Black Scholes model. The Black Scholes model determines the value of an option by considering numerous variables such as the exercise price, current value of the security, the riskless rate of return, time to expiration and the volatility of the share price.

Current determination of the discount factor

The new legislation which the Government has proposed regarding the taxation of employee share schemes requires employees to recognise the value of the option in their assessable income at the time when the option vests (provided the option has a significant risk of forfeiture otherwise the taxing point will be at the time when the option is issued). The amount that is to be recognised, as specified in the regulations, is either the:

- market value of the right; or
- the amount calculated using the tables in the regulations.

There are numerous ways to ascertain the market value of an option. In our view the most practical method of determining the market value of an employee share option at the time of vesting is the difference between the share price at that time and the exercise price of the option. Our concern however is that if the regulations do not recognise this as an acceptable valuation method but instead prescribe an alternative valuation method to determine market value, for example, a method similar to the tables currently used in Division 13A of the ITAA 1936, then this will lead to a less than satisfactory outcome for employees.

To illustrate this point the matrix below shows the impact on the taxable value using the valuation tables as compared with the cash benefit associated with the option (being market value of the shares less the exercise price) held by an employee at the vesting time. The table is based on an employee holding 3,000 options which have a $25 exercise price and a 30 month exercise period after vesting.

Market value of share at vesting	Market value of 3000 shares less exercise price	Market value per Division 13A valuation tables
20.00	-15,000	225
21.00	-12,000	600
22.00	-9,000	1,350
23.00	-9,000	2,550
24.00	-3,000	4,275
25.00	Nil	5,325
26.00	3,000	7,800
27.00	6,000	10,575
28.00	9,000	11,775
29.00	12,000	14,175
30.00	15,000	16,575

The above indicates that the valuation tables may result in options that are:

- out of the money being subject to tax

  For example, if an employee on a salary of $85,000 was issued 3,000 options at $25 and at the vesting day the market value of the shares was $24, the employee would be required to include $4,275 in his/her taxable income and pay tax of $1,688.63 (assuming a marginal tax rate of 39.5%), even though the options are out of the money by $3,000 with no ability to obtain cash by exercising the options.

- neither in or out of the money being subject to tax

  If the market value of the shares was $25.00 at the date of vesting, the employee would be required to include $5,325 in his/her taxable income and pay tax of $2,103.38 (assuming a marginal tax rate of 39.5%) even though the options are neither in or out of the money with no ability to generate cash by exercising the options.

It should be noted that whilst the current Division 13A rules have operated for many years using these valuation tables the tables only applied to valuing options at the time when the options were issued in circumstances where the employee wished to pay tax up front. Therefore the employee was able to exercise a choice as to whether to incur a tax liability on income not yet received.

Under the new employee share scheme legislation the choice to pay tax upfront has been removed and instead the new rules will require all employees to be taxed at the time of vesting. Therefore the employee has no choice as to whether to incur a tax liability on a value which cannot be realised in cash. So whilst the valuation tables may have been seen as acceptable in a situation where an employee had the choice as to whether to pay the tax on income not yet received such valuation techniques do not seem to be appropriate where the employee has no control over his taxation liability or the means by which to meet that liability.

Determinants of an options value

It is commonly accepted that the value of an option is determined by several components, namely:

- The difference between the market value of the share and the exercise price;
- The riskless rate of return and the time to expiration; and
- The stock volatility and the time to expiration.

The proportion of the value that is attributable to the riskless rate of return and stock volatility generally increases the greater the time to expiration.

Most employee share schemes prevent an employee from transferring or selling an option, even if there was market for such options (which is generally not the case). As a consequence holders of employee share schemes options cannot make the same risk diversification decisions as normal option holders and consequently most employee share scheme option holders exercise early to defray the risk of the shares becoming worth less than the exercise price[1].

[1] Daniel Sandler 'The taxation treatment of employee stock options – generous to a fault' p.268 Canadian Tax Journal (2001) Vol.49 No 2

Given that most employee share scheme options are exercised early, for the reasons noted above, most of the value associated with an employee share scheme option will be captured by the difference between the market value of the underlying share and the exercise price at the time of vesting.

It is noted that there are a number of alternative methods of valuing options and that the valuation methods all contain various assumptions in an attempt to capture the value associated with the riskless rate of return and stock volatility. These alternative methods often involve complex calculations and would probably need to be 'adjusted' to take into account the unique circumstances of employee share schemes. Even if the alternative methods were adjusted, it is difficult to envisage a valuation method which will reflect the appropriate market value for every taxpayer given the disparity of circumstances between companies which issue employee share scheme options and the taxpayers who receive them.

It should also be recognised that a discussion about what is an appropriate valuation technique is not about whether an amount of tax will be avoided under one method vis-à-vis another because ultimately the same amount of assessable income will always arise. The issue is more about ensuring that the timing of the liability which arises is commensurate with the employee's ability to pay.

Way forward

In these circumstances, rather than taking a formulaic approach to the valuation of an option at the time when the option vests, Woolworths proposes that the market value of an employee share scheme option in a publicly listed company be determined as the difference between the share price and the exercise price at the vesting time. This is a simple and effective method of determining the taxable value of an employee share option which would result in the greatest single determinant of an option's present value, namely the difference between the current share price and the exercise price of the option, being taxed.

Not only would this provide greater transparency for the employee in understanding how the option has been valued but more importantly leads to an equitable result for the employee who is in a position to immediately realise in cash the equivalent amount of benefit on which he/she is being taxed. In this regard we note that in many instances options are received by valued employees who do not necessarily have the financial resources to meet tax liabilities which arise on notional amounts of income.

As an alternative employees (through their employers) should be able to rely on obtaining other estimates of value which take into account the specific characteristics of the options they hold, such as the volume of options issued, the restrictions on transfer and disposal and the particular volatility of the underlying shares.

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If you have any queries regarding this submission please contact Darren Day on 02 8885 3407.

Yours sincerely

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Woolworths Limited