

**SUBMISSION TO
THE BOARD OF TAXATION REVIEW INTO ELEMENTS OF THE TAXATION OF
EMPLOYEE SHARE SCHEME ARRANGEMENTS
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Conclusions and recommendations

Conclusions

1. The current method of determining market value of a security is fair and reasonable, except where the security has service or performance restrictions where the taxation value is penal, but simpler valuation alternatives could be considered.
2. The current method of determining the market value of a right is concessional, particularly for companies with relatively high volatility.
3. The timing of the taxing event under the proposed Division 83A (ITAA 97) will adversely affect all holders of unlisted and thinly traded securities because the 30 day period in which to monetise the benefit is unreasonably restrictive and will either create a 'tax trap' for employees or result in forced sale conditions.
4. Changes to the accounting standards, in particular AIFRS – 2, accounting for share based payments, has created major permanent and timing differences between tax and accounting profit, which are complex to interpret, reconcile and understand.
5. Division 83A (ITAA 97) introduces the concept of tax on an accrued rather than a realised basis for ESS benefits. This is completely at odds with most taxing events.
6. Division 83A (ITAA 97) will force earlier realisation of ESS benefits by employees completely at odds with the principals of long term equity participation.

Recommendations

1. We recommend preserving some features of Division 13A (ITAA 36) incorporating a choice of taxation alternatives is recommended to ensure smaller and/or riskier companies can offer equity, avoid unforeseen tax traps and continue to attract the employee/executive talent necessary to be competitive with other small overseas businesses and larger Australian companies.
2. We recommend that the existing valuation tables, as applied under Division 13A (ITAA 36) and as temporarily applied under the proposed Division 83A (ITAA 97) should be left unchanged for all unlisted companies but that new tables based on known historic volatility ranges for listed companies should be created. That is, if the historic volatility of a listed company falls within certain ranges, then different tables would determine the taxation values to apply, assuming tax is paid on grant.
3. We recommend, to allow for the two critical differentiation factors for unlisted and thinly traded listed companies, being illiquidity and market value determination difficulties, that the taxation of benefits arising under ESS transactions be deferred until the monetisation date, where the monetisation date is within 180 days of the cessation date, or the cessation date, if the monetisation date is more than 180 days after the cessation date. This at least allows a reasonable period for a company to arrange for a liquidity event (e.g. a buy-back, external sale etc) or to have a valuation prepared for the purposes of determining the tax value at the cessation date.
4. We recommend that unlisted companies be given a choice of valuation methods consisting of either capitalisation of future earnings, discounted value of cash flows, or an independent valuation.
5. We recommend, to encourage the referenced (start-up, research and development and speculative) companies, that an up-front tax election (as per Division 13A) be allowed on the grant of ESS and allow CGT concession on any gain, but cap the CGT concession to no more than \$250,000 for any one individual, as a life-time benefit, in total and require increased reporting requirements to protect revenue
6. We recommend, to encourage the referenced companies, that a tax free threshold amount be allowed on any gain arising from an ESS benefit for all qualifying employees limited to say \$5,000 for any one individual to encourage broad based equity participation in these companies.

A. Introduction and Background

In a Media Release dated 24 July 2009, the Assistant Treasurer, Senator Nick Sherry, announced the timeframes for the final round of industry consultations on reforms to the taxation of employee share schemes (ESS), including releasing the Terms of Reference for the Board of Taxation review component.

This paper addresses the specific issues set out in the Terms of Reference for the Board of Taxation. At the time of writing this submission, the proposed new ESS enabling legislation contained in a new Division 83A (ITAA 97) and supporting administrative guidelines has not been finalised.

The author of this paper, Mr Ian Crichton, is a Fellow of the Institute of Chartered Accountants, a senior member of the Finance & Treasurers Association, a consulting member of the Australian Employee Ownership Association, a fellow of the Financial Services Institute of Australia and a member of the Australian Institute of Company Directors and has more than 20 years practical consulting experience in the ESS industry advising clients ranging from top 100 listed companies to micro (less than 5 employees) unlisted enterprises, including 'hands on' experience in all aspects of the design, documentation, approval, compliance, communication, implementation and on-going administration of ESS.

The views expressed in this paper are intended to provide guidance to the Board of Taxation as to the need for functional and practical laws in this difficult and interpretive area in order to avoid unnecessary taxation 'traps' for companies and employees and to limit, where practicable, excessive compliance costs.

The broad intention of our recommendations is to provide practical direction for an improved taxation framework in this widespread and important area that will allow Australia companies of all sizes to remain competitive; particularly small entrepreneurial businesses that are often cash constrained, by ensuring that any tax imposed on benefits arising from ESS transactions is collected at the point that the benefit is monetised and within a reasonable time horizon of 180 days from vesting but no more than 7 years from grant.

B. How best to determine the market value of employee share scheme (ESS) securities?

Currently, there is a divergence in the way ESS securities are valued from a taxation perspective, under Division 13A (ITAA 36), and from an accounting perspective under International Financial Reporting Standards (IFRS). This divergence results in unavoidable differences, both timing and permanent, between taxable income and accounting profit.

Table 1 on the following page illustrates the differences between the valuation methods for the most common ESS securities offered in Australia under both the accounting standards (AIFRS -2) and the taxation rules (Division 83A ITAA 97) as proposed. There are other ESS plans including partly paid plans, hybrid plans and 'phantom', 'replicator' or synthetic plans, but these are very much in the minority and are not considered here.

At the outset it is important to understand the divergence of treatment between tax and accounting that has occurred in recent years.

Up until the introduction and adoption of the International Financial Reporting Standards (IFRS), in particular, AIFRS – 2 – Accounting for Share Based Payments, complying companies had no expense charged for the provision of equity benefits to employees. The logic being was that the provision of equity was dilutive to capital and would impact (negatively) on earnings per share (EPS) and therefore was a 'cost' born by shareholders. If a company decided to settle the equity contract by the payment of money, then an expense to the income statement would be incurred, which should also be tax deductible. In essence, there was symmetry between tax and accounting profit.

Prior to the introduction of IFRS, Division 13A (ITAA 36) had introduced the concept of the \$1,000 exempt benefit and specifically allowed companies to claim a tax deduction even though the company would not incur an expense to the income statement. This was earnings per share (EPS) positive and attractive to many companies to offer.

The introduction of AIFRS – 2, however, changed the way in which companies accounted for share based payments. Now, under AIFRS – 2, in addition to shareholders being impacted by the dilutive effect of issues and the consequent effect on EPS, the income statement of issuers is also impaired by the so-called 'fair value' (as determined under the standards) of equity provided and expensed over the relevant service period. That is, shareholders are effectively hit twice by the equity incentives provided! Even worse, where a 'market based' performance condition is imposed on a grant, if the condition is not met for any reason, and therefore the equity benefit does not vest, then the company cannot 'write-back' the accrual. Profit remains impaired for all time, offset by credit to a reserve account.

It is logical that companies with an expense to the accounting profit would look to claim a tax deduction, however, the 'share-based payment' is not tax deductible. Accordingly, many companies may look to settle their share based payments by cash settled

transactions and the like. This will create many timing and permanent differences between tax and accounting profit, because the cash settled amounts (tax deductible, but not charged to the income statement) will rarely be equal to the accounting expense (not tax deductible, but charged to the income statement).

It is in this context that the proposed new Division 83A (ITA 97) and any amendments need to be considered.

Table 1 - ESS valuation differences between tax and accounting

Type of ESS security	How valued for Taxation purposes	How valued for Accounting purposes	Tax deductibility
Exempt Share	The value of shares acquired up to \$1,000 based on the 5-day Volume Weighted Average Market (VWAP) price at the date of grant or acquisition cost.	The value of shares acquired based on the market price if shares acquired on-market or a VWAP if from a new issue.	Yes, whether by a new issue or on-market purchase.
Deferred Share	The value of shares acquired is based on the 5-day Volume Weighted Average Market (VWAP) price on the cessation date or the market value of the security, if sold within 30 days of the cessation date.	The value of shares acquired is the closing market price of shares on the date of acquisition adjusted for time value of money, volatility and dividends expected to be earned over the expected life, and after determining the anticipated impact of any performance or service conditions.	Yes, if shares are acquired by the payment of monies at settlement.
Performance Rights	The value of a performance right is determined in accordance with sections 139FJ to 139FN in Division 13A (ITAA 36)*. Because a performance right is a zero-priced option and therefore represents a 100% discount to the market value of the security the value of performance right will equal the full market value of that security at the taxing point.	The value of rights acquired is determined using a valuation model (Black Scholes/Merton or similar) with inputs into the model including the exercise price, the closing market price of shares on the date of acquisition, expected life, the risk free rate, volatility and dividends expected to be earned over the expected life, and after determining the anticipated impact of any performance or service conditions.	Yes, but only if shares acquired on exercise of the right are settled by the payment of monies. This will be different to the accounting value.
Options	The value of an option is determined in accordance with sections 139FJ to 139FN in Division 13A (ITAA 36)*. The value determined will vary depending on the contract life of the instrument and the relativity of the exercise price to the market price of the security and the taxing point.	The value of options acquired is determined using a valuation model (Black Scholes/Merton or similar) with inputs into the model including the exercise price, the closing market price of shares on the date of acquisition, expected life, the risk free rate, volatility and dividends expected to be earned over the expected life, and after determining the anticipated impact of any performance or service conditions.	Yes, but only if shares acquired on exercise of the right are settled by the payment of monies. This may be different to the accounting value.
Loan Security (Security is provided and 'paid for' by way of a loan to the employee, usually on preferred terms)	Assuming a loan is provided equal to the market value of the security there is no value determined for a loan security ESS for taxation purposes, because full market value is deemed to have been paid. This also establishes a cost base for tax purposes.	The value of a loan security acquired is deemed to be an 'in substance option' and determined using a valuation model (Black Scholes/Merton or similar) with inputs into the model including the exercise price, the closing market price of shares on the date of acquisition, expected life, the risk free rate, volatility and dividends expected to be earned over the expected life, and after determining the anticipated impact of any performance or service conditions.	No, because there is no value for taxation purposes.

* Note: These valuation tables have been adopted in the proposed new Division 83A (ITAA 97), but subject to review.

Table 2 illustrates the preferred method of valuing ESS securities and the tax deductibility recommendations.

Table 2 - Recommended preferred method of valuing ESS securities for taxation purposes

Type of ESS security	Preferred Method of Valuing ESS security	Tax deductibility
Exempt Share	The value of shares acquired up to \$1,000 based on the 5-day Volume Weighted Average Market (VWAP) price.	Yes, whether by a new issue or on-market purchase.
Deferred Share	The value of shares acquired based on the 5-day Volume Weighted Average Market (VWAP) price at the cessation date or the net sale value of the security if sold within 180* days of the cessation date.	Yes, if shares are acquired by the payment of monies.
Performance Rights	The value of a performance right should be determined in accordance with revised tables similar to sections 139FJ to 139FN in Division 13A (ITAA 36), but the tables varied in accordance with our recommendations contained in Section D of this report. The value of shares acquired on exercise of the rights should be based on the 5-day Volume Weighted Average Market (VWAP) price at the exercise date or the net sale value of the security, if sold within 180* days of the cessation date.	The value determined under the revised tables should be tax deductible.
Options	The value of an option should be determined in accordance with revised tables similar to sections 139FJ to 139FN in Division 13A (ITAA 36), but the tables varied in accordance with our recommendations contained in Section D of this report. The value of shares acquired on exercise of the rights should be based on the 5-day Volume Weighted Average Market (VWAP) price at the exercise date or the net sale value of the security, if sold within 180* days of the cessation date.	The value determined under the revised tables should be tax deductible.
Loan Security	The value of a loan security, where the terms are other than 'at arm's length' should be determined as an 'in substance' option in accordance with revised tables similar to sections 139FJ to 139FN in Division 13A (ITAA 36), but the tables varied in accordance with our recommendations contained in Section D of this report. The value of shares acquired on exercise of the rights should be based on the 5-day Volume Weighted Average Market (VWAP) price at the exercise date or the net sale value of the security, if sold within 180* days of the cessation date.	The value determined under the revised tables should be tax deductible.

* 180 days has been selected as a period that is reasonable in all circumstances. 180 days should allow companies sufficient time in which to manage monetisation of the benefit and hence facilitate taxation alignment, without unduly prejudicing ATO revenues.

C. Whether shares and rights under an employee share scheme that are provided by start-up, research and development and speculative-type companies should be subject to separate tax deferral arrangements outside those proposed by the Policy Statement.

The taxing point proposed by the Policy Statement is problematic for any holder of a security that is thinly traded (including most small or tightly held public companies) or not traded (all unlisted companies).

Under the proposed new Division 83A (ITAA 97) securities provided under an ESS will be taxed at the earlier of seven years, termination of employment or the date when 'real risk of forfeiture' ends (Cessation Date). Participants have 30 days in which to monetise this 'benefit' or they will be taxed based on the 'value' of the benefit at the cessation date. Participants who do not or cannot monetise this benefit within 30 days will potentially have two incompatible taxing events. The first at the cessation date (income) and the second at the monetisation date (capital).

For thinly traded or untraded securities this sets up the significant potential for a 'tax trap' often out of the control of the participant because, if the monetisation value is less than the cessation date value, then an income gain and a capital loss may arise. In many cases this is totally out of the control of the participant.

To avoid this 'tax trap' being entrenched in the legislation, we strongly recommend that separate tax deferral arrangements apply to all affected companies. A definition of a thinly traded security could be made by reference to the number and value of securities traded in a 30 day period prior to vesting relative to the value of the ESS transaction.

Historically, that is up until 30 June 2009, by far the most commonly offered ESS for the referred companies, were market priced options. Options were preferred by most companies in the reference group for a number of reasons, including:

- Options are relatively simple to document and offer and simple to unwind in the event of non-exercise or forfeiture/lapse;
- Under Division 13A (ITAA 36) participants had the choice of either a) paying tax up-front based on the value determined in accordance with sections 139FJ to 139FN and thereby ensuring that any further tax on any benefits could be deferred until the underlying share was sold, thereby avoiding the potential 'tax trap' referred to above, or b) deferring tax until the option was exercised. This provided sensible flexibility to all participants, if properly applied;
- Options provided a sensible alignment of interest between capital providers and employees because employees paid the same price for their shares as the capital providers and their exit (monetisation) was similarly often linked to a trade sale or Initial Public Offering (IPO);
- Where an IPO was an identified liquidity event the tax paid up-front election ensured that shares acquired at an IPO and subject to escrow conditions under the Prospectus terms would not create a mismatch of taxation obligations that in certain

circumstances could result in employees incurring substantial taxation obligations that could not be subsequently funded due to a fall in share values post an IPO, for example;

- Options provided the greatest up side benefit potential to growth in value for successful companies and therefore were valued highly by employee recipients and thereby reduced the cost of cash paid remuneration;
- Options allowed small 'risky' companies to hire employees/executives attracted by the wealth creation opportunity that may have been otherwise unaffordable due to the cash constraints of the business.

The proposed changes embodied in the new proposed Division 83A (ITAA 97), if not corrected, will either result in less effective remuneration being offered in the referenced companies or higher cash remuneration alternatives being offered which in turn will lead to a diminution in the competitiveness of these smaller/riskier businesses and/or result in many companies offering options, as in the past, unaware of the looming 'tax trap' imbedded in the legislation leading to unforeseen tax liabilities arising or worse still unintentional or intentional avoidance.

These 'problems' imbedded in the proposed legislation are unlikely to be observed for several years after the changes have been adopted.

Recommendation

Preserving the better features of Division 13A (ITAA 36) incorporating a choice of taxation alternatives is recommended to ensure smaller and/or riskier companies can offer equity, avoid unforeseen tax traps and continue to attract the employee/executive talent necessary to be competitive with other small overseas businesses and larger Australian companies.

D. Whether the existing rules for valuing unlisted rights to acquire shares properly reflect market value?

Market value is an extremely complex issue. Market price is fairly easy to determine for a listed security, but is this its true market value? If 1% of a company's securities are traded in a given day, then arguably 'a willing buyer, willing seller' exists. But what about the other 99% of shareholders who are not willing sellers and obviously believe the market value of their holdings is greater than the current price offered. Do trades representing such a small percentage of a company represent its overall market value?

The value of a security under an ESS is even more complex, because often the security requires both service and performance conditions to be satisfied. Add to this the fact that a security, in most unlisted companies, may not have a ready market and the difficulty in ascribing a 'value' is further compounded.

Under the existing Division 13A (ITAA 36) and as proposed under Division 83A (ITAA 97) at least until the Board of Taxation review has been considered the market value of an unlisted security can be determined in one of two ways:

1. As specified in a written report by a qualified person (e.g. a registered company auditor); or
2. As calculated in accordance with a method approved in writing by the Commissioner.

The only problem with the first method is one of cost. It is by far the most effective method, because it is independent and takes into account all the factors of a dynamic environment.

The alternative method is arguably less costly, once obtained, but suffers from inflexibility. Usually, the agreed method will be determined based on applying a discount rate to estimated future maintainable earnings.

The value of unlisted rights with a last exercise date of less than 10 years is then determined in accordance with sections 139FJ to 139FN. This is simple and easy to calculate. The value of unlisted rights with a last exercise date of greater than 10 years is the greater of the value determined in accordance with sections 139FJ to 139FN or the value determined by suitably qualified valuer, in a form approved by the Commissioner, in writing.

As will be observed below in the examples, the current method of determining market value for 'full value' securities (shares and performance rights) is both 'fair and reasonable' for most listed companies, albeit disadvantageous for the participant when the impact of vesting conditions is taken into account.

The current method of determining the value of rights for taxation determined in accordance with sections 139FJ to 139FN is, however, imperfect.

In order to assess whether the valuation tables currently applied are a 'fair and reasonable' approximation of market value we have undertaken a thorough analysis of the values of various equity instruments applying a number of variables.

Under the current Division 13A (ITAA 36) tables (and the interim Division 83A (ITAA 97) tables) there are only three variables to consider, as follows:

1. Market value of the security at grant date;
2. Exercise price; and
3. Contract life (months).

Variable 1 is divided by variable 2 to determine the 'calculation %'. The calculation % determines the horizontal point in the tables and variable 3 determines the vertical point. Dissecting the horizontal and vertical points in the table determines the taxation value of the right under the tables.

Under the international financial reporting standards (IFRS) and applying standard valuation methodologies, the value of a right is determined using a valuation model (Black-Scholes/Merton or similar). The inputs to the valuation model will include:

1. Market value of the security at grant date;
2. Exercise price;
3. Expected life (not contract life);
4. Anticipated risk free rate;
5. Stock volatility;
6. Expected dividends; and
7. Adjustments for market based performance conditions, often applying costly valuation models.

A comparison of values determined depending on the variables applied comparing 'accounting' values to the taxation table values is set out below. All these values are the values at grant date, not at the cessation date, where different values apply.

We have looked at four representative examples as the basis of our analysis, being:

1. **Example 1** – A gas exploration company, with high volatility and no dividend;
2. **Example 2** - A large public company with low volatility and high dividend yield;
3. **Example 3** - A middle tier industrial company with medium volatility and modest dividend yield; and
4. **Example 4** - An unlisted IT company with low volatility (because it is unlisted) and no dividend.

The vast majority of all companies will fall somewhere within the ranges set in these examples.

Example 1 - Gas Exploration Company (High volatility/No dividend)

Variables

Share price	\$	1.00
Exercise price (performance right)	\$	-
Exercise price	\$	1.00
Risk free rate		4.50%
Expected life		3 years
Contract life		5 years
Expected stock volatility		80%
Expected dividends		0%

Values (Gross)		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share	\$	1.000	\$ 1.000	\$ -
Performance Right	\$	1.000	\$ 1.001	\$ 0.001
Option	\$	0.116	\$ 0.545	\$ 0.429
Loan security	\$	-	\$ 0.545	\$ 0.545
Values (After service/performance discounts)		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share - Salary Sacrifice	\$	1.000	\$ 1.000	\$ -
Deferred Share - Performance	\$	1.000	\$ 0.600	-\$ 0.400
Performance Right	\$	1.000	\$ 0.601	-\$ 0.399
Option	\$	0.116	\$ 0.327	\$ 0.211
Loan security	\$	-	\$ 0.327	\$ 0.327

In **Example 1**, the gross option value and gross loan security value is materially higher than the tax table values. This is reduced, although still material after the impact of the service/performance condition is applied. The exempt benefit and deferred salary sacrifice benefit are effectively the same values for taxation and accounting purposes, whereas the deferred performance share and performance right tax and accounting values are the same on a gross basis, but materially different when the impact of service/performance conditions is applied.

Example 2 - Large established Company (Low volatility/High dividend)

Variables

Share price	\$	1.00
Exercise price (performance right)	\$	-
Exercise price (option)	\$	1.00
Risk free rate		4.50%
Expected life		3 years
Contract life		5 years
Expected stock volatility		30%
Expected dividends		6%

Values

		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share	\$	1.000	\$ 1.000	\$ -
Performance Right	\$	1.000	\$ 0.848	-\$ 0.153
Option	\$	0.116	\$ 0.164	\$ 0.048
Loan security	\$	-	\$ 0.164	\$ 0.164

Values (After service/performance discounts)

		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share - Salary Sacrifice	\$	1.000	\$ 1.000	\$ -
Deferred Share - Performance	\$	1.000	\$ 0.600	-\$ 0.400
Performance Right	\$	1.000	\$ 0.509	-\$ 0.492
Option	\$	0.116	\$ 0.098	-\$ 0.018
Loan security	\$	-	\$ 0.098	\$ 0.098

In **Example 2**, the gross option value for accounting purposes is marginally different to the tax table values, whereas the loan security value for accounting purposes is materially higher than the tax value. After the impact of the service/performance condition is applied the tax and accounting value for options, the values, in fact, reverse. As with example 1, the exempt benefit and deferred salary sacrifice benefit are effectively the same values for taxation and accounting purposes, whereas the deferred performance share and both the gross and after performance/service performance right are materially different.

Example 3 - Middle tier Company (Medium volatility/medium dividend)

Variables

Share price	\$	1.00
Exercise price (performance right)	\$	-
Exercise price (option)	\$	1.00
Risk free rate		4.50%
Expected life		3 years
Contract life		5 years
Expected stock volatility		50%
Expected dividends		3%

Values

		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share	\$	1.000	\$ 1.000	\$ -
Performance Right	\$	1.000	\$ 0.914	-\$ 0.086
Option	\$	0.116	\$ 0.320	\$ 0.204
Loan security	\$	-	\$ 0.320	\$ 0.320

Values (After service/performance discounts)

		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share - Salary Sacrifice	\$	1.000	\$ 1.000	\$ -
Deferred Share - Performance	\$	1.000	\$ 0.600	-\$ 0.400
Performance Right	\$	1.000	\$ 0.549	-\$ 0.451
Option	\$	0.116	\$ 0.192	\$ 0.076
Loan security	\$	-	\$ 0.192	\$ 0.192

In **Example 3**, as with example 1, the gross option value and gross loan security value is materially higher than the tax table values. This is reduced, although still material after the impact of the service/performance condition is applied. The exempt benefit and deferred salary sacrifice benefit are effectively the same values for taxation and accounting purposes, whereas the deferred performance share and performance right tax and accounting values are the same on a gross basis, but materially different when the impact of service/performance conditions is applied.

Example 4 - Unlisted IT Company (Low volatility (unlisted)/no dividend)

Variables

Share price	\$	1.00
Exercise price (performance right)	\$	-
Exercise price (option)	\$	1.00
Risk free rate		4.50%
Expected life		3 years
Contract life		5 years
Expected stock volatility		20%
Expected dividends		0%

Values

		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share	\$	1.000	\$ 1.000	\$ -
Performance Right	\$	1.000	\$ 1.001	\$ 0.001
Option	\$	0.116	\$ 0.202	\$ 0.086
Loan security	\$	-	\$ 0.202	\$ 0.202

Values (After service/performance discounts)

		Tax	Accounting	Difference
Exempt share	\$	1.000	\$ 1.000	\$ -
Deferred Share - Salary Sacrifice	\$	1.000	\$ 1.000	\$ -
Deferred Share - Performance	\$	1.000	\$ 0.600	-\$ 0.400
Performance Right	\$	1.000	\$ 0.601	-\$ 0.399
Option	\$	0.116	\$ 0.121	\$ 0.005
Loan security	\$	-	\$ 0.121	\$ 0.121

In **Example 4**, the gross option value and gross loan security value is materially higher than the tax table values. For options, this is reduced, to negligible amount after the impact of the service/performance condition is applied. The exempt benefit and deferred salary sacrifice benefit are effectively the same values for taxation and accounting purposes, whereas the deferred performance share and performance right tax and accounting values are the same on a gross basis, but materially different when the impact of service/performance conditions is applied.

What conclusions can be drawn from these examples?

First, the higher the stock volatility the higher the value of a leveraged benefit (option or loan security) and the lower the value of a performance right, all other things being equal.

Second, the higher the dividend the lower the value of an option or a performance right, all other things being equal.

Third, the longer the expected life, the higher the value of most ESS securities.

Fourth, the higher the risk free rate, the higher the value of all ESS securities.

Fifth, the current taxation tables produce concessional (lower) gross values for all leveraged instruments, but not materially so in most examples when the impact of service/performance 'risk' are allowed for.

Sixth, the current taxation tables produce penal (higher) values for all unleveraged (deferred shares and performance rights) instruments when the impact of service/performance risk are allowed for.

Finally, valuations of any sort by their nature are estimates only and subject to great variability depending on the inputs used.

Therefore, applying a 'one size fits all' approach to the valuation process will probably produce a result that is incorrect more often than it is correct.

Recommendation

It is our recommendation that the existing valuation tables, as applied under Division 13A (ITAA 36) and as temporarily applied under the proposed Division 83A (ITAA 97) should be left unchanged for all unlisted companies but that new tables based on known historic volatility ranges for listed companies should be created. That is, if the historic volatility of a listed company falls within certain ranges, then different tables would determine the taxation values to apply, assuming tax is paid on grant.

E. Whether special rules are appropriate or necessary to determine the market value of employee share scheme shares or rights (listed and unlisted)?

There are two critical differences between a share or right in an unlisted company or thinly traded listed company compared to its freely traded listed company equivalent. They are:

1. **Access to liquidity.** Freely traded listed company shares can be monetised within 3 business days under the ASX listing rules. Unlisted shares cannot be monetised easily and in some cases at all, unless there is a liquidity event such as an IPO or trade sale.
2. **Market value.** Because there is no freely traded market in unlisted companies or thinly traded listed companies determining a 'market' price or market 'value' is difficult, time consuming and costly. If only 30 days are allowed to monetise a benefit, as is proposed under Division 83A (ITAA 97) then arguably, the value determined will be a forced sale value rather than a 'willing buyer, willing seller' market value.

Special rules are required to level the playing field for listed and unlisted companies, because the provision of equity to executives and employees in small entrepreneurial companies is much more critical than in established companies because of the cash constraints inherent in many of these smaller companies.

Recommendation

To allow for these two critical differentiation factors for unlisted and thinly traded listed companies to receive 'special' treatment we suggest the taxation of benefits arising under ESS transactions be deferred until the monetisation date, where the monetisation date is within 180 days of the cessation date, or the cessation date, if the monetisation date is more than 180 days after the cessation date. This at least allows a reasonable period for a company to arrange for a liquidity event (e.g. a buy-back, external sale etc) or to have a valuation prepared for the purposes of determining the tax value at the cessation date.

F. Whether there are suitable alternative mechanisms for determining market value?

The market value of a security underpins the value of all types of ESS transactions. For listed companies (freely traded) the current method of determining value is simple and relatively easy to determine. For unlisted companies (and thinly traded listed companies) the valuation of a security is a vexed question.

There are several methods of valuation that could be considered. Arguably, if it is simple, it will cost less to comply but may lack both accuracy and sensitivity to changing circumstances. Arguably, if it is complex, it may be costly to comply but should be more accurate and can be sensitive to changing circumstances.

Table 3, illustrates a selection of alternatives to consider, including an explanation.

Table 4, illustrates the strengths and weaknesses of each alternative, including cost, complexity and accuracy.

Table 3 - A selection of share valuation methodologies to consider

Valuation Method	Description
1 Last 3 years earnings multiplied	The last three years net earnings, excluding non-recurring items are multiplied by a determined multiple.
2 Discounting projected cash flows	An analysis of the net present value of projected cash flows or DCF is a valuation method based on the premise that the value of the business is the net present value (NPV) of its future cash flows. The expected level of future cash flows are discounted by an appropriate discount rate based on the weighted average cost of capital (WACC). The cost of equity capital, being a component of the WACC, is estimated using a Capital Asset Pricing Model (CAPM).
3 Capitalisation of future maintainable earnings	The capitalisation of future maintainable earnings multiplied by an appropriate earnings multiple is similar to (1) above and is a suitable method where a business is reasonably expected to trade profitably into the foreseeable future. Maintainable earnings are the 'assessed' sustainable profits that can be derived by a company's business and excludes any abnormal or "one off" profits or losses.
4 Net Asset backing/Orderly realisation of assets	The amount that would be distributed to shareholders on an orderly realisation of assets on the assumption that a company is liquidated.
5 Independent Valuation	An independent valuer is appointed to report on the value of business having assessed all the relevant factors and using the valuation method most suited in the circumstances and applying qualified independent judgement where necessary.
6 Directors Valuation	Directors apply their own determined inputs to value of business having assessed all the relevant factors and using the valuation method most suited in the circumstances and applying qualified subjective judgement, where necessary.
7 Comparable market transactions	Comparable transactions methodology involves applying multiples extracted from a market transaction price of similar assets and applying the multiple to subject company's assets and earnings.
8 % or multiple of Revenue	Businesses are valued based on a % of revenue. Businesses with a high recurring earnings feature (eg. Accounting firms, real estate firms with a rent roll) are often valued on this basis.

Table 4 - Strengths and weaknesses of share valuation methodologies

Valuation Method		Strengths	Weaknesses	Cost	Complexity	Accuracy
1	Last 3 years earnings multiplied	Simple, easy and cost effective.	Inaccurate if last three years do not reflect the future. Losses complicate the result, as does selecting the earnings multiple.	Low	Simple	Inaccurate
2	Discounting projected cash flows	Provides a very accurate value where a business has a finite life, but a terminal value used, and its future cash flows can be readily predicted.	Only worthwhile where future cash flows can be accurately predicted.	High	Very	Reasonably accurate
3	Capitalisation of future maintainable earnings	A fairly reliable estimate of values for profitable companies with well established markets and budgeting processes.	Highly subjective in most cases, not independent and selection of the discount rate is complex.	Medium	Moderate	Reasonably accurate
4	Net Asset backing/Orderly realisation of assets	Relatively simple and easy to determine.	Highly subjective for non asset intensive industries, such as most services businesses and does not attribute 'value' as a going concern.	Low	Simple	Inaccurate
5	Independent Valuation	Independent and can take account of all factors in determining the value.	The cost and time delay inherent in the valuation process may deter some companies.	High	Complex	Highly accurate
6	Directors Valuation	Relatively simple and easy to determine in most circumstances.	Not independent and may lead to conflict of interest.	Medium	Moderate	Moderately accurate
7	Comparable market transactions	Provides a reliable value of the worth of a business as a going concern.	Comparable transactions may not be readily available or sufficiently current to provide a true reflection of value	Medium	Moderate	Moderately accurate
8	% or multiple of Revenue	Easy to value selected businesses.	Valuation method only applies to selected businesses.	Low	Low	Low, except for selected businesses

Recommendation

We recommend that unlisted companies be given a choice of valuation methods consisting of either methods 2, 3, or 5, above.

G. Whether it is appropriate or necessary to provide separate deferral arrangements for employees of start-up, research and development and speculative-type companies receiving shares or rights under employee share schemes?

Our comments in **Section C** deal adequately with this issue.

Recommendation

Preserving the better features of Division 13A (ITAA 36) incorporating a choice of taxation alternatives is recommended to ensure smaller and/or riskier companies can offer equity, avoid unforeseen tax traps and continue to attract the employee/executive talent necessary to be competitive with other small overseas businesses and larger Australian companies.

H. Possible options to provide assistance to start-up, research and development and speculative-type companies?

Possible alternatives to provide assistance to start-up, research and development and speculative-type companies and the reasons, include the following:

Table 5 - Possible options to provide assistance to referenced companies

Alternative	Reasons	Estimated Costs
Only tax an ESS benefit at a monetisation event or 7 years, whichever is sooner, based on the net benefit received, as recommended in Section E.	Lack of liquidity and imperfect valuation methodology exposes ESS participants to unreasonable tax risks under the proposed Division 83A legislation	None. Timing difference only.
Allow an up-front tax election (as per Division 13A) on the grant of ESS and allow CGT concession on any gain, but cap CGT concession to no more than \$250,000 for any one individual, as a life-time benefit, in total and require increased reporting requirements to protect revenue.	To encourage highly skilled executives to work in 'sunrise' industries there must be incentives for them to do so.	Approximately, 5,000 companies might qualify for the benefit, but probably less than 20% of these would be successful, therefore the cost is estimated at 1,000 x \$250,000 x 46.5% x 50% = \$58 million.
Allow a tax free threshold amount on any gain arising from an ESS benefit for a 'sunrise' industry employee limited to say \$5,000 for any one individual to encourage broad based equity participation in these companies.	Equity participation in smaller listed and unlisted companies is much less than in large mature public companies. Additional concessions are required to 'level' the playing field.	5,000 companies x 10 employees x \$5,000 x 20%(successful companies) x 30% (tax rate) = \$15 million.