
10 Taxation issues

Key points

- The Australian tax system does not specifically target executive remuneration quantum or structure. In other jurisdictions, additional taxes have been imposed on components of executive remuneration, or access to concessions disallowed.
- Using the tax system to constrain particular components of executive remuneration can have perverse consequences, including:
 - consequential increases in other components of executive remuneration. This in turn can impact on the extent that remuneration is linked to performance and may also serve to increase total remuneration
 - the use of tax ‘gross-ups’ which may increase total remuneration and raise costs to the company.
- Equity-based payments are an increasingly significant component of executive remuneration. Taxation of equity-based payments can be complex, as:
 - different amounts may be variously taxed as salary or substitutes for salary, fringe benefits, or capital gains
 - there are several points in time at which tax can apply
 - the value of future, or contingent, equity rights can be very difficult to determine.
- The timing of the taxation of equity-based payments and the value placed on equity can have a significant influence on the total amount of tax paid.
- Currently, income tax on equity-based payments is generally payable at termination of employment, irrespective of whether performance conditions or holding requirements still apply.
 - From an executive’s perspective, this creates a disincentive to deferring equity over the longer term and thus could work counter to approaches that seek to improve managerial alignment with shareholder interests.
 - While there may be some costs to revenue from extending tax deferral beyond termination of employment, the broader economic costs of not changing this policy are judged to be more important. Any adverse implications for tax system integrity and compliance from such a change appear surmountable.

10.1 Introduction

Taxation arrangements have the potential to influence the level and structure of executive remuneration, including the extent of alignment between executive and shareholder interests. Many participants suggested that tax policy does indeed affect remuneration design in Australia. However, to date, Australian tax law has not been used actively to influence remuneration levels and design — unlike some other countries, where employer tax deductions have been limited or additional taxes imposed on components of executive remuneration.

The government has appointed a panel to review Australia’s Future Tax System, chaired by Dr Ken Henry (box 10.1). Taxation arrangements for executive remuneration clearly fall within that review’s scope. However, given the breadth of the review’s terms of reference and its longer-term focus — together with the existence of this inquiry — it is unlikely that executive remuneration will be a significant part of the review.

There have been other such reviews of relevant taxation issues, particularly relating to equity received through employee share schemes (box 10.2).

In this inquiry, the Commission has been asked by the Government to consider the role played by tax treatment of equity-based remuneration in better aligning the interests of boards and executives with shareholders and the wider community.

This chapter examines the extent to which current taxation arrangements influence executive remuneration levels and structure. It includes a consideration of equity-based payments (such as those provided through employee share schemes) including recent modifications, in addition to taxation arrangements for executive

Box 10.1 **Review of Australia’s Future Tax System**

This review encompasses Commonwealth and State taxes (except, notably, the goods and services tax) and interactions with the transfer system. The terms of reference stipulate that the review will comprehensively examine Australia’s tax system and make recommendations to ‘create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia’s economic and social outcomes’ (Treasury 2009a).

To date, the Henry review has released several consultation papers on the architecture of Australia’s tax and transfer system, addressing a range of economic issues relating to the tax system. Taxation arrangements specific to executive remuneration have not been covered. The final report of the review panel with recommendations for reform is to be submitted to the Treasurer in December 2009.

Box 10.2 Recent inquiries covering taxation of employee equity

In addition to the Future Tax System Review (box 10.1), other recent inquiries where stakeholders made submissions regarding taxation arrangements for employee equity include:

- The Australian Prudential Regulation Authority's (APRA) revised governance requirements for APRA-regulated institutions — a consultation paper was released in May 2009, and a second package comprising revised draft versions of governance standards and an associated draft prudential practice guide was released in early September. Final prudential standards and the associated prudential practice guide were released on 30 November 2009 and take effect from 1 April 2010.
- Treasury Consultation into Reform of the Taxation of Employee Share Schemes — Consultation process on a consultation paper and exposure draft bill jointly released by the Treasurer and the Assistant Treasurer on 5 June 2009. The final taxation treatment was announced on 1 July 2009 and an exposure draft was released on 14 August 2009. On 21 October, the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009 was passed by both houses on 2 December 2009.
- Senate Economics Committee Inquiry into the operation of employee share schemes in Australia — this inquiry commenced in June 2009, and the final report was released on 17 August 2009.

remuneration more broadly. Recommendations relating to taxation arrangements are provided in chapter 11.

10.2 Taxation of equity-based payments

Equity-based payments refer to remuneration provided in the form of shares or rights to shares (chapter 7). Given a significant proportion of executive pay is provided in the form of equity, taxation arrangements for this form of income are particularly relevant when examining issues of executive remuneration. Taxation of equity-based payments can be complex:

- there are several points in time at which tax can be applied
- income must be qualified as either employment income or capital income
- the 'value' of the equity can be difficult to determine where the rights provided are subject to vesting requirements or contingencies, particularly for non-traded equities (such as executive stock options).

Current arrangements

The timing of taxation of equity-based payments can have a significant influence on the total amount of tax paid. The general principle applied in Australia is that where a taxpayer acquires a share or right as employment income, the assessable income of the taxpayer includes the difference between the market value of the share or right and the amount paid to acquire it (this value is called the ‘discount’). The actual point at which income tax is payable can vary. Irrespective of the point at which income tax is applied, capital gains tax may be payable on sale of the share or right (while a ‘right’ is not explicitly defined in the legislation it is generally taken to mean an option or performance right) if it has appreciated in value from the time its receipt was first recognised for tax purposes.

Recent changes to tax law for concessional taxation of equity-based payments

Favourable taxation treatment is available for equity-based payments received through ‘approved’ employee share schemes under certain conditions. Legislation was first introduced to support employee share schemes in 1974, with the rationale for concessional treatment being ‘to ensure better alignment between the interest of the firm and the firm’s employees’ (Treasury 2009d, p. E3). These concessions are directed at employee share schemes which encourage investment by employees in their employer and which are broadly available to all permanent employees (House of Representatives 2009).

Until 2009, no restrictions were applied on the extent to which executives could access these concessions, beyond those applicable to other employees. However, changes to these provisions announced in the 2009-10 budget (boxes 10.3 and 10.4) limit access to the upfront tax exemption of \$1000 to taxpayers with an adjusted taxable income of less than \$180 000 (Sherry 2009a). In addition, equity received through employee share plans will be taxed on acquisition unless certain conditions hold, for example:

- equity is at ‘real risk of forfeiture’
- equity is provided through an approved salary sacrifice employee share scheme.

Box 10.3 A final position on taxation of employee share schemes?

The Government announced changes to the taxation of employee share schemes on 12 May 2009. According to the Assistant Treasurer, the changes were intended 'to help ensure everyone pays their fair share of tax by better targeting eligibility for the employee share scheme tax concessions' and were expected to provide an additional \$200 million over the forward estimates (Sherry 2009a, p.1). Furthermore, the explanatory materials for the draft legislation amendments stated that the changes were designed to ensure taxpayers are taxed consistently regardless of the forms of remuneration they receive (House of Representatives 2009).

The changes were highly criticised by a variety of groups and, after a period of community consultation, a revised final 'policy statement' was released on 1 July 2009. The policy statement indicated that new arrangements would apply to all shares and rights acquired on or after 1 July 2009 (Sherry 2009a).

Subsequently, the Assistant Treasurer outlined a three-stage consultation process:

- a two-week public consultation period on a draft Exposure Bill
- a Board of Taxation consultation on:
 - technical issues relating to the Exposure Bill (due one month after its release)
 - the market value of employee share scheme equity and whether employees of start-up, research and development and speculative-type companies should be subject to separate arrangements (due February 2010) (Sherry 2009b).

In August, the Senate Economics References Committee inquiry into taxation arrangements for employee share schemes recommended that the government delay the introduction of changes to tax legislation in order to take note of other reviews in this area, including the Commission's inquiry and the Henry Review, to maintain legislative integrity and coherence (Senate Economics References Committee 2009). However, the Labor Senators' Dissenting Report did not support this recommendation.

On 21 October, the Government introduced legislation based on the policy statement into Parliament. This bill was passed by both houses on 2 December 2009.

This chapter refers to the 'previous' arrangements (taxation treatment prior to 1 July 2009) and the 'new' arrangements (as outlined in the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009).

Under the previous arrangements for taxation of employee share scheme equity, employees who had been issued 'qualifying' equity had the option of choosing the point at which income tax was applied (box 10.4). Figure 10.1 illustrates the taxing points under the previous and new tax laws.

Box 10.4 The changes to taxation of employee share schemes

The arrangements prior to July 2009

Prior to the change, employees who received shares or options under 'qualifying' employee share or option plans were able to elect either to:

- defer when the discount (the difference between the market value of the share or right and the amount paid to acquire it) was assessable as taxable income for up to ten years or
- pay income tax up front and receive a \$1000 tax exemption (appendix C).

'Qualifying' employee share schemes must offer ordinary shares, or rights to ordinary shares, in return for employment services. The employee must not consequently have control of more than 5 per cent of the company or be in a position to cast, or control the casting of, more than 5 per cent of the maximum number of votes that might be cast at a general meeting. Additionally, in the case of 'qualifying' shares, at least 75 per cent of permanent employees must be entitled to acquire shares in an employee share scheme offered by the company at that time or at some time previously.

The new arrangements

Under the Government's 1 July 2009 changes, the discount on all shares or rights received through employee share schemes will generally be assessed in the income year in which the shares or rights are acquired. The tax exemption of up to \$1000 will be restricted to employees with an adjusted taxable income of less than \$180 000. Taxation of equity from employee share schemes will occur at the time of grant, unless one of the following requirements is met:

- equity is received through an approved salary sacrifice employee share scheme
 - approved schemes must offer up to \$5000 worth of equity in an income year with no risk of forfeiture, meet certain requirements (equivalent to the previous 'qualifying' rules, appendix C) and be clearly distinguished as a deferral scheme
- equity is at 'real risk of forfeiture' and meets certain requirements (equivalent to the previous 'qualifying' rules, appendix C)
 - this includes meaningful performance hurdles or a requirement to serve a minimum term of employment.

Under either of these circumstances, tax can be deferred for up to seven years or until the point where the risk of forfeiture is removed and no genuine restrictions preventing disposal exist or where employment is terminated (whichever occurs first).

In addition, the Government will also introduce annual reporting requirements for employers and a withholding tax applicable in circumstances where the employee does not provide a tax file number or an Australian Business Number to the employer.

These measures will take effect (retrospectively) with respect to shares and rights acquired after 1 July 2009.

Figure 10.1 Taxing point of equity from employee share schemes under previous and new tax law

	Grant	3 years	Performance hurdle met (vesting)	2 years	Holding requirements lifted	Exercise options	1 year	Sale of shares (underlying shares)
Share price	\$1		\$2		\$3			\$4
Previous tax law	Non-qualifying performance right ¹	★						★\$3
	Qualifying performance right	★						★\$3
	ELECTION 1					★		★\$1
	ELECTION 2							★\$3
Proposed tax law	Qualifying option	★						★\$3
	ELECTION 1					★		★\$1
	ELECTION 2							★\$3
	Non-qualifying performance right ²	★						★\$3
Qualifying performance right					★		★\$1	
Qualifying option					★		★\$1	

★ Tax paid at marginal income tax rate ★\$x Tax paid at discount CGT rate on any increase in market value of the share since the taxing point, x=capital gain

Notes:

- Election 1 – pay tax upfront on grant
- Election 2 – defer tax

1. A performance right is also known as a 'zero exercise price option'.
2. This is also equivalent to a qualifying performance right with no performance hurdles.

The Government's first announcement regarding taxation of employee share schemes (in the 2009-10 budget) generated significant concerns among stakeholders. These initial concerns were raised in submissions to this inquiry, in addition to other reviews at the time. A key message from participants was that income taxation should not be levied before the point where the employee is able to sell the share or option (and thus finance the tax bill) (Australian Human Resources Institute, sub. 49; Charles Macek, sub. 55; PricewaterhouseCoopers, sub. 85; KPMG, sub. 95).

After a period of consultation, the Government revised the original proposed changes — where income taxation would occur at grant — to the final arrangements where deferral of income tax is allowed in circumstances where equity or rights are provided through an approved salary sacrifice scheme or where a 'real risk of forfeiture' is applied on the equity or rights (box 10.4). Treasury argues that providing for deferral in these situations recognises that:

- employees utilising salary sacrifice employee share schemes under the existing law will continue to be able to access these schemes with minimal disruption, thus encouraging the broad availability of, and participation in, employee share schemes in Australia (House of Representatives 2009, pp. 42–3)
- the employee may never 'have a chance to realise the economic value of the [employee share scheme] interest' and that having remuneration 'at risk' in this way is entirely consistent with the objective of aligning the interests of employees and employers (House of Representatives 2009, p. 17).

Treasury also noted that the limited deferral period of seven years is aimed at ensuring fairness, aligning interests of the employer and employee and preserving the integrity of the tax system by preventing unlimited deferral of tax on significant remuneration (House of Representatives 2009, p. 46).

Under the new arrangements, 'real risk of forfeiture' refers to situations where a share or right is subject to meaningful performance hurdles or a minimum term of employment requirement (appendix C). A restriction that prevents the employee from disposing of a share or right for a specified period of time does not constitute a 'real risk of forfeiture' and thus does not enable deferral of tax by itself.

Under the new arrangements, 'risk of forfeiture' is an entry requirement to defer tax, and once it is satisfied, tax can be deferred until the risk of forfeiture is lifted and genuine restrictions preventing disposal of the share or right no longer apply. In this context, 'genuine restrictions' can include conditions of the employee share scheme that contractually prohibit disposal of shares, an internal company policy with serious and enforced consequences for breaches, or where disposal of the

equity is a criminal offence (for example, where disposal would infringe insider trading laws).

In the case of an option, tax can be deferred until the point that there is no real risk of forfeiture of the right or the underlying share and any genuine restrictions preventing disposal or exercise of the right or disposal of the underlying shares no longer apply. The intention is for tax to be due at the point where the taxpayer can take some action to realise the benefit, irrespective of whether they choose to do so (House of Representatives 2009).

It should be noted that for ‘real risk of forfeiture’ to trigger tax deferral, certain conditions must be fulfilled. These are equivalent to the ‘qualifying’ rules under the previous Division 13A, *Income Tax Assessment Act 1936* (Cwlth). Thus, where equity-based payments are not provided in the form of ordinary equity, or would result in the executive controlling 5 per cent or greater of the company, deferral is not allowed. In addition, for shares, the company must provide equity through employee share schemes in a ‘non-discriminatory’ manner. Thus, there are some cases where executives may face a ‘real risk of forfeiture’ of their equity, but not have access to the tax deferral concession and income tax will be due at grant.

Some key issues

The appropriate taxing point for equity-based payments

In the case of equity-based payments, there are generally four points where taxation may occur: at grant, at vesting (once restrictions on the option or share are removed), at exercise (for options) and at sale (box 10.5). However, it is more

Box 10.5 International taxation treatment of equity-based payments

In most OECD countries, equity-based payments are generally treated as ordinary employment income and taxed at income tax rates with capital gains tax payable on sale of the asset. However, in some jurisdictions — Poland (for all schemes) and Denmark, United Kingdom, Ireland and the United States (for concessionary schemes only) — employee options are taxed as capital gains rather than employment income (OECD 2005).

Concessionary arrangements for employee share schemes in other jurisdictions may provide for equity-based payment income to be taxed at capital gains rates and not as employment income (as is the case in the examples above), permit a deferral of income tax or provide a tax exemption. Removal of ‘risk of forfeiture’ is used as a taxing point in other jurisdictions, including the United States and the United Kingdom. However, it is not always defined in the same way as in Australia.

common in other countries for income tax to be levied on employee share scheme equity at *exercise* with treatment varying for concessional plans (appendix C provides further details about the different approaches taken internationally).

A general principle of income taxation is that it should apply in the year that income is derived. A conceptually neutral income tax system would tax taxpayers on the value they receive, irrespective of the form in which that value is provided (box 10.6). Thus, a taxpayer who received \$100 000 in cash income, and chose to use this to purchase company shares, should be taxed in the same way as an

Box 10.6 Defining income

From an economic perspective, income is a material gain to somebody during a specified period and measured according to objective market standards (Simons 1938). Thus, an economic definition of income does not make a distinction about the source of the income or whether it has actually been realised. Under this definition, gains from labour, capital, gifts and increases in the value of an asset are all treated the same. Thus, for example, the increased value of a family home constitutes economic income, irrespective of whether this gain is realised (Waincymer 1993).

The most commonly-accepted economic measure of income for the base of income tax is attributed to Haig and Simons. Simons defined personal income as:

... the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. (1938, p. 50)

This definition treats individuals with different sources of income uniformly and does not affect decisions about how to allocate resources to the generation of income.

However, in practice, this definition is not always applied in income taxation, for both administrative and political reasons (Waincymer 1993). For example, a range of non-market activities generate 'imputed income' — which relates to the potential income of property or labour used for personal purposes — that under the Haig-Simons definition should be included in the income tax base. An example of this would be various home production activities such as cleaning or maintenance. While imputed rent from owner-occupied housing has been seriously considered for inclusion in the tax base in some countries (and was taxed in Australia between 1915 and 1923), imputed income is taxed in few cases.

The economic definition of income does not distinguish between realised and unrealised increases in wealth. However, measurement of all unrealised income can pose significant administrative problems. It can be difficult to determine whether an economic gain or loss has arisen. And the gain/loss may be difficult to measure prior to realisation. A related difficulty involves situations where the taxpayer has no other funds (besides the asset) from which to pay the tax — for example, farmers or small business owners. As a result, most income tax systems include capital gains in the tax base only when they are realised. This may also serve to encourage the accumulation and transmission of wealth.

employee who received pay in the form of company shares valued at \$100 000. However, several complications arise in the application of this principle to taxation of equity-based payments — particularly where an employee may be granted equity but receipt is dependent on certain conditions.

Deferral of taxation

The point in time at which income tax is paid can significantly influence the total amount of tax paid on equity-based payments. In Australia, an individual can receive a discount on capital gains of 50 per cent for an asset that has been held for 12 months or more. Thus, assuming that the share price increases, where employees pay income tax up-front at grant on equity-based remuneration (which is held for 12 months), they are able to shift a greater proportion of their taxable income to be taxed as capital gains rather than as employment income, relative to employees that pay tax at exercise or vesting. This may have provided an incentive for employees to be paid in equity under the previous arrangements. The impact of income tax at grant or at vesting is illustrated in box 10.7.

Deferral of income taxation is effectively equivalent to the government providing the employee with an interest-free loan for the amount of tax due over the period of deferral. However, deferral of tax accompanies a deferral of receipt of the employee's remuneration which reduces the value of the remuneration provided to the employee relative to receiving the remuneration immediately.

The recent changes to employee share schemes mean that tax deferral on equity-based payments will henceforth stem from share scheme design not the employee's election.

Time limit of deferral

The new arrangements enable deferral of taxation on eligible equity-based payments for a maximum duration of seven years. Under the previous legislation this limit was ten years (box 10.4). Regnan (sub. DD 159) argued that in order to promote better alignment between executives and long-term owners (who invest for well beyond seven years in a company) this limit should be a minimum of ten years.

The time limit chosen for deferral is an arbitrary point and is intended to prevent unlimited deferral of tax on significant remuneration (House of Representatives 2009). While extension of this time limit would enable employers to require executives to retain 'skin in the game' for a longer period (and share in the upsides and downsides experienced by shareholders), it also extends the period over which

employees can defer paying tax. Currently, the Commission understands that performance-linked remuneration generally vests after three to four years. Thus, within this context, the seven-year limit in practice would provide room to increase the period of time over which remuneration vests without taxation being imposed prior to vesting.

Box 10.7 Total tax payable on shares with upfront payment or deferral

The diagram below depicts the two options that were available to employees under the previous arrangements (either pay tax upfront on grant or defer for up to ten years) under two scenarios (a rising share price and a falling share price).

In the first scenario, where an employee pays income tax upfront on the 500 000 shares at the point of grant (where shares are worth \$1 each) the amount of tax due is \$225 000. The employee then pays tax on the discounted capital gain on sale of the shares a year after the shares vest. The total discounted tax payable is \$325 790. The total net benefit to the taxpayer is the value of the shares at year 3 (\$1 000 000) less the amount of tax paid.

Thus less total tax is paid in the first scenario where a taxpayer pays tax upfront than where the taxpayer defers income tax until their shares vest. However, the deferral of tax confers a benefit equivalent to an interest free loan from the government to the taxpayer. The benefit from this loan is assumed to be equivalent to the return that the taxpayer would receive by investing the \$225 000 at the Treasury 10-year bond rate for one year (equivalent to discounted present value of \$12 030). This is then taken into account when calculating the employee’s total net benefit in year 3.

Under the second scenario, the employee who pays income tax upfront pays a higher amount of income tax than the employee that elects to defer. Further, the employee that elects to defer taxation also receives a higher benefit due to the benefit from deferral of taxation for one year. Under both options a capital loss is recorded. The employee that chooses to pay income tax upfront records a larger capital loss (that can be used to off-set capital gains in a subsequent year) than the employee who chooses to defer taxation.

	Grant 500 000 shares ↓	1 year	Shares vest (performance hurdle met) ↓	1 year	Sale of shares ↓	Total tax paid	Total net benefit
<i>Share price</i>	\$1.00		\$1.50		\$2.00		
Pay income tax up-front	\$225 000				\$100 790	\$325 790	\$674 210
	Income tax				CGT		
Defer tax until vesting	<i>Interest free loan</i> = \$225 000		\$319 450		\$50 395	\$369 845	\$642 190
			Income tax		CGT		
<i>Share price</i>	\$1.00		\$0.75		\$0.50		
Pay income tax up-front	\$225 000				\$250 000	\$225 000	\$25 000
	Income tax				capital loss		
Defer tax until vesting	<i>Interest free loan</i> = \$225 000		\$159 725		\$125 000	\$159 725	\$102 310
			Income tax		capital loss		

Notes: Assumes a marginal tax rate of 45%. Values discounted using Treasury 10 year bond rate of 5.65%. As shares are held for one year the CGT discount applies on sale.

Taxation of equity-based payments at termination of employment

Generally, income tax on equity-based payments is payable at termination of employment even where a ‘real risk of forfeiture’ exists (this was also the case under the previous taxation arrangements for equity-based payments). This creates a situation where income tax can be due on an equity-based payment at a point where a ‘real risk of forfeiture’ is still in place.

Inquiry participants observed that this approach provides a disincentive for deferring equity over the longer term (box 10.8). Several participants warned that companies were structuring remuneration packages to vest at termination and consequently creating an incentive for executives to maximise the share price at this point with potentially perverse effects. This may also change an executive’s attitude to risk. In particular, it could serve to encourage more risk-averse behaviour towards the end of an executive’s tenure. Some also argued that the requirement to pay tax at termination of employment could lead to employers increasing other components of remuneration, such as short-term incentives or base pay, in place of long-term deferred equity.

In November 2009, the Australian Prudential Regulation Authority (APRA) released a revised Prudential Practice Guide for remuneration that seeks to align Australian principles with recently-developed international principles on sound remuneration practices, in particular those of the Financial Stability Forum. In response to concerns regarding taxation of equity at termination of employment, APRA noted that ‘it is inevitable that the design of remuneration arrangements will be influenced by taxation legislation. Taxation requirements may interact with APRA’s principles in a manner that requires, for example, that an institution permit the partial vesting of an amount to cover taxation obligations of the employee arising from the deferred component’. APRA expects all such arrangements to be adequately documented in the remuneration policy and to be consistent with the governance standards (APRA 2009c).

In its finalised Prudential Practice Guide released in November, APRA cautions that partial vesting could lead to perverse outcomes such as where an employee ends up receiving a benefit that they are otherwise not entitled to. For example, APRA (2009c) cites the possibility that where partial vesting is allowed, and later (after termination) it arises that the performance hurdles are not met and full vesting does not occur, the institution may be left attempting to recoup the released payment from the ex-employee.

APRA concludes that it would ‘not be prudent practice for deferred payments to vest automatically upon cessation of employment with a regulated institution’. It

argues that it is preferable for deferral and vesting arrangements to remain in place post termination of employment and that cessation of employment as a taxation point for deferred share schemes ‘has the potential to cause conflict between prudent deferral and taxation requirements’ (APRA 2009c, p. 13).

In its Consultation Paper on the Reform of the Taxation of Employee Share Schemes, Treasury noted that APRA would prefer termination of employment not to trigger a complete vesting in shares of the departing employee. Nevertheless, Treasury maintained that termination of employment should remain a taxation point for employee share scheme equity, as otherwise tax integrity issues would arise. For example, employees may move overseas after ceasing employment, creating difficulties for the Australian Tax Office to collect tax (Treasury 2009d). However, several participants submitted that the proposed improvements to reporting requirements and withholding arrangements should address this problem (Ernst and Young 2009; KPMG, sub. DD145; PricewaterhouseCoopers 2009).

Currently, corporate governance principles are being revised internationally, acknowledging the importance of aligning executive remuneration with long-term shareholder value. This has been emphasised by the Financial Stability Forum in its

Box 10.8 Inquiry participants’ views on taxation of equity-based payments at termination of employment

Many participants argued that taxing equity-based payments at termination encourages short-termism and provides a disincentive to put in place arrangements to manage risk for sustainable long-term returns (Guerdon Associates 2009a; Origin Energy, sub. 93). Macquarie noted that this runs counter to remuneration best practice, particularly for financial institutions (sub. DD157). Regnan maintained that reform of any tax disincentives to holding equity through retirement is fundamental to bringing about better aligned executive remuneration practices (sub. 72). The Australian Institute of Company Directors also noted that taxing equity-based payments on termination puts upward pressure on lump-sum payments (sub. 59).

Both Origin Energy (sub. 93), the Australian Bankers’ Association (sub. 70) and PricewaterhouseCoopers (sub. DD138) cautioned that, in some cases, boards are waiving vesting periods to enable executives to sell shares and pay their tax bill. Guerdon Associates noted that it is common practice for boards, when designing packages for executives approaching retirement, to:

- substitute short-term cash incentives for long-term equity
- have any long-term, performance-contingent equity vest on retirement, perhaps with the quantum pro-rated in proportion to the part of the performance period completed
- increase cash salary in lieu of equity-based remuneration (Guerdon Associates 2009a, p. 3).

Principles for Sound Compensation Practices, and subsequently by the G-20 and European Union. To achieve improved alignment, requiring executives to hold equity post-termination is generally considered to be best practice. This view is also held in Australia. For example, the Australian Shareholders' Association (sub. 54) supports executives holding equity for a period of at least two years after departure, and Regnan (sub. 72) supports a policy where all executive remuneration above a pre-determined threshold should take the form of common equity vesting over a period of five to ten years (box 10.9).

In its Prudential Practice Guidelines, APRA noted that 'particular attention needs to be given to the length of the deferral periods of equity-related remuneration components. Ideally, executives will maintain a long-term view, even when approaching the end of their period of employment' (2009c, p. 15). However, levying tax at point of termination would undoubtedly work against this objective, particularly in the period approaching the end of an employment contract.

The extent of this disincentive is likely to vary on a case by case basis depending on a particular employee's preferences to pay tax without liquidating the asset (in general, the decision to borrow, liquidate the asset or use other funds to finance a tax bill will be made on the basis of portfolio choice) and his or her expectations regarding the future share price. Permitting the partial vesting of an amount to cover taxation obligations addresses concerns to a certain extent. However, it is a compromise, risks creating a situation where an employee is granted a portion of their payment without fully meeting performance requirements and does not completely counter the fact that current law provides an incentive for remuneration design contrary to international best practice approaches to corporate governance.

From a theoretical, tax-neutral perspective, income tax on equity-based payments should be applied at grant. However, due to the difficulties in valuing performance-contingent, unlisted rights and the Government's expressed intention to provide concessions for broader employee share ownership, deferral of income taxation is permitted under certain circumstances. Within this context there is little rationale for ceasing tax deferral at termination of employment. It is not clear why two employees should be treated differently where they hold identical, unvested deferred rights and one retires and the other continues working. Thus, while there is a rationale for applying income taxation at grant, vesting or exercise, this is not the case for termination of employment. Further, unlike at grant, vesting or exercise, termination of employment is a point that is open to manipulation.

Box 10.9 Regnan's approach to deferred pay

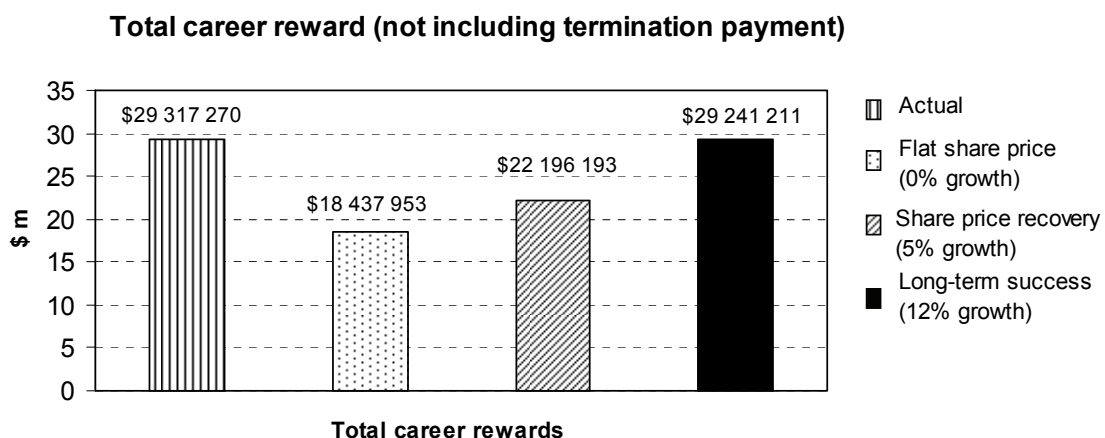
In its submission, Regnan presented a remuneration reform proposal that aims to align executive incentives with long-term sustainable company growth. It stated 'executives make decisions whose effects in many cases outlast their tenure and we believe that alignment of executive rewards to better reflect this reality would strengthen Australia's governance practice' (sub. 72, p. 3).

Key features of the proposal are:

- boards to set a threshold on annual cash remuneration, which may differ by executive (termination payments would be part of this threshold)
- all remuneration above the threshold to be paid in equity, vesting after five years, in five equal annual tranches, regardless of continued employment
- a binding shareholder vote on termination payments above 12 months' base salary.

Regnan argues that its proposal still gives boards the discretion to determine remuneration, including overall quantum, short- and long-term incentives and performance hurdles. In the case of short-term incentives, this would allow 'executives to earn in the short term, but collect in the long term' (sub. 72, attachment, p. 2).

Regnan applied its proposal to some recent CEO departures, focusing on remuneration for the preceding five years and assuming a \$1.2m cash threshold and various future share price movements to calculate 'total career reward'. The following figure was presented for the departing Transurban CEO in 2008 (termination payments were excluded as Regnan assumed shareholders would have rejected the \$5.2m payment made by Transurban).



There are indications that the rule regarding taxation at termination of employment has been overcome in the past. A 2006 class ruling for BHP Billiton by the Australian Taxation Office found that, where rights provided under employee share schemes are provided at 'the discretion' of the employer, the right is not considered to be 'a right to acquire a share' within Division 13A (ATO 2006). Under the BHP

Billiton scheme, the remuneration committee retains discretion to deny award of equity even where performance requirements are met. The Australian Taxation Office ruled that BHP Billiton employees participating in the company's 'Long Term Incentive Plan' were therefore considered to acquire a right for the purposes of Division 13A on the date that BHP Billiton advises employees whether they have satisfied the performance hurdles. Thus, participating employees do not pay income tax on the rights until vesting. This applies to all participants in the scheme including employees who no longer work for BHP Billiton.

Regnan — who strongly argued that boards should be unconstrained in terms of the period over which they align shareholder and executive interests through remuneration arrangements — noted that it and other shareholders will be forced to go to Australian company chairs and say:

We're not happy with what you're doing and regardless of the cessation of employment, we demand that you put in place a remuneration system that has serious risk of forfeiture ... and you're going to have to get a public tax ruling in relation to the remuneration system and you're going to have to do it one by one ... (DD trans., p. 69)

The taxation provisions for employee share schemes are not specifically designed for executives and must apply to all Australian employees. Furthermore, the concessions that enable deferral of tax for equity-based payments are targeted towards schemes that encourage broad employee share ownership. It is questionable whether it is beneficial for all permanent employees to have aligned incentives with their employer post termination, and unlikely that employers would have such arrangements with non-executive employees. Thus, changing this rule is likely to primarily extend concessional treatment to executives and not affect other employees receiving equity more broadly.

Treasury argues that changing the tax law will have costs, particularly related to maintaining the integrity of the tax system and achieving compliance. Further, as deferral of tax beyond grant is equivalent, when compared to the status quo, to the provision of an interest-free loan from the government, the extension of current deferral arrangements will have revenue impacts.

Nevertheless, the requirement that employees must pay income tax on equity at termination of employment creates a disincentive to defer equity beyond retirement for executives and is thus contrary to best practice governance promoted in Australia by the prudential regulator and overseas. Further, it maintains an inconsistency in the Government's approach where taxation on performance-contingent, unlisted rights can be deferred until vesting where the employee continues employment, but not in circumstances where this employment

ceases. In circumstances where deferral is deemed appropriate during employment it is not clear why it is no longer appropriate after termination.

The Commission notes that removing termination of employment as a taxing point would reduce projected savings over the forward estimates from the tax law changes and lead to efficiency costs due to the need to source revenue from elsewhere. However, it is not clear to what extent retaining this taxing point would contribute to projected savings, particularly where organisations seek tax rulings to circumvent this rule. In addition, there are several factors that could minimise the impact on revenue from removing this taxing point:

- removal could be applied only where equity is at risk of forfeiture (and not to salary sacrifice schemes)
- the government's recent changes include measures aimed to improve integrity of employee share schemes (including employer reporting and a withholding tax)
- it is unlikely that in all cases taxpayers will defer tax for the full seven years.

There are also potential efficiency costs in relation to retaining the policy, particularly where accounting for the possible perverse effects of altering an executive's attitude to risk prior to termination. As argued by the Australian Securities Exchange (sub. DD142), 'a taxation policy that drives remuneration design and practices that are inconsistent with corporate governance policy is both inappropriate and counterproductive' (p. 9).

From the executive's perspective, taxation is deferred only to the extent the remuneration benefit is deferred and thus removing termination of employment as a taxing point is unlikely to spur arrangements whereby tax is deferred indefinitely.

Valuation of options

An option provides the holder with the right to purchase shares at an agreed 'strike' price within a predetermined period. An executive will only exercise an option where the strike price is below the current market value of the stock (were this not the case, the executive could do better buying the shares on the market). It is the difference between the strike price and the (potential) market price that gives rise to a benefit to the executive (appendix E).

The value of an option is determined by calculating the expected future payoff (which, being contingent on the share price and potentially other variables as well, cannot be known with certainty) discounted to the present. The method used to calculate the market value of an option (if it is not quoted on an approved stock exchange on the day of acquisition) under the *Income Tax Assessment Act 1936* is

based on a hybrid of financial valuation models, including Black-Scholes (Treasury 2009b) (appendix E). The estimated value depends on the market value of the share on that particular day, the exercise price and the expiry date of the option. This valuation does not take into account the impact of performance hurdles.

Hence, the greater the likelihood that the option will not be ‘in the money’ when the employee is able to exercise it, the lower the value ascribed to the option. Consequently, situations can arise where executives are granted options and pay tax up-front on a fraction of the current market price of the relevant shares.

It is not clear whether the valuation rules for options have resulted in companies favouring options over other forms of remuneration. The Commission understands that there has been a reduction in the use of options over the past decade. However, while this can be verified from the period 2002 to 2006, the data for 2007 suggest otherwise (table 10.1). The use of performance rights (which are valued the same as shares granted for free) has steadily increased. One of the reasons that other forms of remuneration would be preferred to options is that the value of the option reflects the risk and uncertainty to the executive of the option’s future value. Thus, while the executive’s tax bill may be reduced, the lower tax value reflects a lower expected total value of remuneration to the executive.

As part of the recent changes to the taxation of employee share schemes, the government has announced that the Board of Taxation will review the valuation rules for options (Sherry 2009b). In the interim, taxpayers can use the existing rules in relation to valuing non-traded rights, or opt to use a valuation methodology that fits their circumstances and has the lowest compliance costs (House of Representatives 2009). In its evidence to the Senate Economics References

Table 10.1 Components of remuneration as a proportion of total remuneration

<i>Component of remuneration</i>	2001	2002	2003	2004	2005	2006	2007
	%	%	%	%	%	%	%
Options	13.3	19.9	10.8	7.7	7.3	6.1	9.2
Performance rights			4.3	4.0	5.6	8.3	8.8
Deferred shares	10.3	8.7	2.5	3.4	6.1	3.7	5.9
Loan funded share schemes			0.8	0.3	0.5	1.6	0.4
Free shares			–	4.4	6.1	–	–

– Nil or rounded to zero.

Source: ACSI (2008b).

Committee on Employee Share Schemes, Treasury (2009b) states that the valuation method used in the existing law for unlisted rights ‘significantly under-values those rights’. Furthermore, that the valuation methodology provides an ‘embedded concession within the law’ and that one issue to be reviewed is whether this concession is appropriate (Treasury 2009b, p. E14). In its submission to the Senate Inquiry, Treasury states that ‘the general principle of market value should apply in determining the market value of a listed and unlisted security in the first instance. However, the new framework will allow the Government to provide for a ‘rule-of-thumb’ in regulations’ (2009d, p. 25).

The Commission considers that provisions to value options for tax purposes should require an estimate of the future expected value discounted to the present. While this may result in the value of an option for taxation purposes being a percentage of the current market price of the underlying share, this is not a distinction in itself: it merely recognises the uncertainty regarding the future market price of the underlying share and thus the real benefit to the executive of holding that option.

The Government has indicated that a refund will be available for tax paid on forfeited equity where the employee had no choice but to forfeit the employee share scheme equity, except where that choice was to cease employment, and where the conditions of the scheme were not constructed to protect the employee from market risk (House of Representatives 2009). Previously, a refund was available on tax payable irrespective of the reason for forfeiture. Several participants considered that the recent changes to the refund rules are inappropriate (Ernst and Young 2009; Guerdon Associates 2009a; KPMG 2009b). Rio Tinto argued that:

... as the taxing time can arise in advance of the employee being able to sell the shares, we submit that the phrase ‘a choice made by the individual’ should be clearly defined in the legislation as not including options which were never in the money during the period when the employee was not prohibited from exercising them. (2009, p. E19)

Given the current approach to option valuation under the tax law, the Government’s position on tax refunds is considered to be appropriate. Provision of a tax refund where the employee does not exercise an option as it is ‘underwater’, would mean that the government was insulating the taxpayer from a market risk that was taken into account in the valuation of the option at the point that tax was paid. Where valuation methods also take into account the uncertainty that the employee may not receive the equity or right due to performance hurdles (as is the case for accounting fair values where performance hurdles are market-related) no refund would be necessary where performance hurdles are not met.

Taxation of options

Several participants have argued that options subject to real risk of forfeiture should be taxed at exercise (Guerdon Associates, sub. DD163; Institute of Chartered Accountants, sub. DD146; Origin, sub. DD129). The Commission notes that under the new legislation the taxation of options can occur at a range of points, depending on the conditions of the scheme (that is, whether there is a risk of forfeiture on the rights or underlying shares and any genuine restriction on disposing the right, exercising the right and disposing of the underlying shares).

Guerdon Associates (sub. DD163) argued that personal income tax should only be levied on income actually realised by the employee. In particular, it is concerned that the government's taxation of options at vesting will 'severely hamper Australia's ability to create sources of new growth' as it will impinge on the ability of start-up companies to attract talented staff by providing options (with no risk of forfeiture) in lieu of salary. While Guerdon acknowledges that the government has asked the Board of Taxation to examine whether employees of start-up, research and development and speculative-type companies should be subject to separate taxation arrangements, it believes a fundamental change to the new arrangements will be required.

The Commission considers that once there is no longer any risk of the granted rights being forfeited or any further genuine restrictions on their disposal the employee has received income (in the form of equity). The decision of whether to realise equity or how to finance any tax bill will be made on the basis of portfolio choice and does not alter the fact that the employee has received a benefit for their labour.

Similarly, where employee share scheme options vest 'underwater', these options still confer an opportunity for benefit to the employee and have value. The value of 'underwater' options will be significantly lower than 'in the money' options — and the amount of tax payable will accordingly be less. Only requiring tax to be paid where the underlying shares increase to a point where the option is 'in the money' and is realised would protect the employee from down-side market risk and thus provide a significant concession.

Salary sacrifice schemes

The new legislation also allows for deferral of taxation where equity is provided through an eligible salary sacrifice scheme, so that employees accessing such arrangements under the existing law can continue to do so with minimal disruption. Equity-based payments made through eligible schemes must be in shares and not rights. However, both shares and rights are able to be offered where they are at risk

of forfeiture (for example in a ‘matching scheme’, see appendix C). As such, the rationale for allowing deferral of taxation beyond grant for shares through salary sacrifice is not related to the fact that there is uncertainty that the employee may actually receive the benefit, but rather it is a concession to encourage the use of these schemes. Deferral of tax under eligible salary sacrifice arrangements is limited to \$5000 per employee per employment relationship in order to provide a relatively more attractive concession for low and middle income earners (House of Representatives 2009).

Under the new arrangements it is likely that non-executive directors who are encouraged to fee-sacrifice in return for company shares will be required to pay tax upfront on grant of these shares, where the value of shares received is over \$5000. Some participants have argued that this is counter to good governance principles that encourage non-executive directors to hold shares subject to holding requirements but without performance requirements attached (Chartered Secretaries Australia, sub. DD147; Ernst and Young 2009; Institute of Chartered Accountants, sub. DD146) (chapter 6). However, allowing a taxpayer to defer paying income tax beyond the point when shares are granted where there is no risk of forfeiture provides a benefit to the taxpayer equivalent to an interest-free loan from the government for the period of deferral. While there may be good corporate governance rationales for non-executive directors to hold company equity over their directorship term, it is not clear that a concession should be provided to encourage them to do so.

10.3 Treatment of termination payments

Current arrangements

There are several tax concessions that relate to termination payments in Australia. The concessions are capped and can vary according to the reason for termination and the length of service and age of the employee. This chapter will examine taxation issues relating to termination payments. The Government’s changes regarding termination payments are discussed in chapter 7.

Payments made as a consequence of termination of employment, and received within 12 months of termination, are treated as ‘Employment Termination Payments’. These payments are made on retirement, disablement, death, resignation or involuntary termination and can include: payment in lieu of notice, payment for unused rostered days off or unused sick leave, ‘golden handshake’ or gratuity payments, compensation for loss of job, payments for loss of future superannuation payments, payments in respect of a genuine redundancy or paid under an early

retirement scheme that exceed the tax-free limit (ATO 2007; section 82.135, *Income Tax Assessment Act 1997* (Cwlth)) (appendix C).

Employment termination payments are concessionaly taxed up to a cap of \$140 000 (for the 2007-08 year indexed annually), at a rate of:

- 15 per cent for a recipient at their ‘preservation age’
- 30 per cent for a recipient below their ‘preservation age’.

Payments in excess of the cap are taxed at the normal marginal rate.

Unlike in other jurisdictions, such as the United States, there is no explicit tax treatment for executives in relation to termination payments in Australia (box 10.10). While the concession associated with Employment Termination Payments is available to executives, other concessions such as those for genuine redundancy payments and early retirement schemes (appendix C) are unlikely to be applicable.

Some issues

There has been significant community concern regarding large termination payments granted during or following periods of poor company performance, which are commonly perceived as ‘rewards for failure’ (chapters 1 and 7). In response to this, there have been suggestions that Australia could impose additional tax on termination payments that exceed certain thresholds, as is the case in the United States and the Netherlands (David Peetz, sub. 50).

In the United States — where there is a 20 per cent tax on ‘excess golden parachute payments’ (box 10.10) — there is evidence that the restrictions on termination payments have contributed to substantial increases in termination payments through ‘gross-ups’ (box 10.11). That is, an initiative intended to constrain executive remuneration through the use of a tax on the termination component has resulted in pre-tax executive remuneration increasing. This would be an expected outcome where demand for executives is inelastic, such that increases in taxation result in increases in remuneration to leave after-tax income unchanged.

International experience indicates that attempts to constrain executive remuneration through taxation measures can also result in:

- a corresponding or greater increase in a different component of executive remuneration (that is not covered by the tax measure)
- changes in the structure of remuneration, which may affect the extent to which remuneration is linked to performance.

Box 10.10 Taxation of termination payments in other countries

United States: Since the mid 1980s the US Government has imposed an additional 20 per cent tax on 'excess golden parachute payments' — termination payments that are paid out due to changes in control or ownership of the corporation and exceed the employee's base salary by 300 per cent. This rule only applies to disqualified individuals who are remunerated in the top 1 per cent of employees in the corporation.

Netherlands: In January 2009, the Dutch Government introduced law that imposes an additional tax of 30 per cent on the employer on the amount by which the termination payment exceeds annual salary where an employee earns more than €500 000 per year.

Portugal: In mid 2009, the Portuguese Government approved a bill — yet to be voted on — that would levy a 35 per cent tax on bonuses paid to an executive on termination of employment where the bonus is not linked to performance targets agreed prior to termination (Nuncio 2009).

Box 10.11 Tax 'gross-ups' and golden parachute payments in the United States

A tax gross-up involves paying the executive additional amounts to cover taxes due and ensures that the executive receives the intended contractually agreed payment once taxes are taken into account.

It is common for employers in the United States to enter into contracts with executives regarding termination payments on change in control of the company. These provisions are typically structured as either a tax gross-up, a 299 per cent parachute payment (so to avoid the 20 per cent tax) or a mixture of the two (McNeil 2004).

As a tax gross-up payment is considered an additional parachute payment, the amount by which the payment is grossed-up up also increases the total amount of tax payable (McNeil 2004). Further, the company also forgoes a corporate tax deduction on the 'excessive' component of the termination payment.

A RiskMetrics study found that the tax on 'excess golden parachute payments' in the United States contributed to substantially increasing parachute payments due to 'gross-up' payments. The average potential gross-up payments (for companies that disclosed these amounts) was US\$13.9 million. On average they estimated that tax gross-up payments make up 18 per cent of total potential termination payments (RiskMetrics 2008b).

Several participants addressed this issue. For example, PricewaterhouseCoopers noted that 'the use of taxation law to try to limit the quantum of executive pay is fraught with danger and is likely to produce negative unintended consequences' (sub. 85, p. 2). This view was also supported by the Australian Securities Exchange

which noted that the introduction of legislative restrictions and artificial limits on the quantum or the structure of remuneration could be expected to have distorting effects on the market (sub. 64).

In the case of termination payments, an approach that levies an additional tax on executives would not only add complexity, but would likely encourage efforts by executives and their employers to structure remuneration packages to avoid this taxation (and thus encourage substitution to other forms of pay). Such an approach would also raise issues in terms of defining covered ‘executives’.

The Commission considers that given the range of significant adverse consequences that can eventuate through such an approach, the tax system should not be used to penalise or limit executive termination payments. Further, the new laws granting shareholders a vote on termination payments above a much reduced threshold level will operate in this space to improve shareholder say on termination payments.

One other proposal received by the Commission regarding termination payments was to limit executives’ access to the concessionary treatment currently available to all employees (CGI Glass Lewis and Guerdon Associates, sub. 80). This would involve executives being unable to access the concessionary tax rates on termination payments (for the portion of the payment under \$140 000) and the total of their payment being taxed at marginal tax rates.

However, the same difficulties arise. Taxation law that applies additional taxes on executives or renders them ineligible for particular concessions available to all other Australian employees can lead to perverse outcomes regarding both the level and structure of executive remuneration. Further, it is questionable whether the revenue benefit of removing this concession would merit the additional costs and complexity involved.

10.4 Taxation of bonuses

There is currently no special taxation treatment of bonuses in Australia. Where a bonus is provided as a cash payment to an employee, it is taxed as income in the year it is received and subject to marginal tax rates.

Early this year, a bill was passed by the US House of Representatives, and is now being considered in the US Senate, which proposes the imposition of a 90 per cent federal income tax on recipients of any retention payment, incentive payment or other bonus paid after 31 December 2008 by a company or an affiliate of a company that received more than US\$5 billion under the Emergency Economic Stabilization Act of 2008.

In December, the UK Chancellor announced plans for a one-off tax on bankers' bonuses as part of the pre-Budget report. The tax will involve a temporary levy (applied from 9 December 2009 to the end of the financial year in April 2010) of 50 per cent on any individual 'discretionary' bonus paid above £25 000 (UK HM Treasury 2009). Thus, bonuses guaranteed by contract are exempt. It is intended that banks, rather than the bankers, pay the levy. Bankers will still pay ordinary income tax on any bonus or salary received.

Some issues

A number of inquiry participants indicated that there was significant community concern with 'windfall remuneration gains' such as bonuses, particularly in times of poor company performance (chapter 7).

However, there was little support for a tax on executive bonuses. CGI Glass Lewis and Guerdon Associates argued that bonuses allow remuneration to be aligned with economic outcomes, so that remuneration can 'increase when results are good and decrease when results are poor' (sub. 80, p. 89). Other participants submitted that short-term incentives, such as bonuses, are essential components of executive remuneration packages and that there is no obvious case why differential tax rules should apply (BHP Billiton, sub. 45).

Further, a penalty tax on bonuses could create increased pressure on boards to raise base pay to compensate executives for reduced bonus pay (Australian Bankers' Association, sub. 70; Australian Shareholders' Association, sub. 54; Woolworths Limited, sub. 91) or to 'gross-up' bonus payments — as occurs in the United States (box 10.11). Any increase in base pay as a result of such a tax would serve to decrease alignment of executive pay with performance, as base pay is paid irrespective of performance (KPMG, sub. 95).

As outlined previously, the use of tax law to constrain one component of executive remuneration is likely to have consequences elsewhere on both the level and structure of remuneration. A tax on executive bonuses would be subject to the same pitfalls as other selective taxation measures, such as the US tax on 'excess golden parachute payments'.

Furthermore, proposals to penalise bonuses overlook the important role of short-term incentives as a component of total remuneration, particularly in turbulent times. There is no reason why this particular component of remuneration should be subject to higher taxes than any other component. The tax system is not the best means to address public concerns regarding windfall bonuses to executives in times of poor company performance.

10.5 Allowable tax deductions for employers

Current arrangements

An Australian employer is entitled to a tax deduction for a cost incurred by the company in gaining or producing income or carrying on a business for the purpose of gaining or producing income (section 8.1, *Income Tax Assessment Act 1997*). Thus, Australian companies are able to claim a deduction for salaries and wages. As the issuance of shares or options will not generally involve any cost to the employer, it is not an eligible deduction in Australia (appendix C). However, where an employer is providing equity to employees under an employee share scheme (which provides eligible employees with access to a \$1000 tax exemption) a deduction of up to \$1000 per employee is allowed (irrespective of whether the employee is eligible for the \$1000 tax exemption due to their income levels).

In 1993, the United States introduced a \$1 million limit on employer tax deductions for non-performance based remuneration of the CEO and the four other highest paid officers in the corporation. This limit was introduced to strengthen the relationship between executive remuneration and firm performance (Balsam and Ryan 2008) and to reduce excessive CEO remuneration by increasing the cost to the company (Rose and Wolfram 2000).

Some issues

Several participants suggested that Australia should introduce caps on tax deductions in a similar fashion to the United States (Australian Council of Trade Unions, DD trans., p. 33; Carol Steiner, sub. 6; Construction, Forestry, Mining and Energy Union, sub. 78).

The Australian Council of Trade Unions argue that such an approach would mean ‘boards can pay their chief executives whatever they like, but that portion over the threshold comes out of after-tax profits for the company. So it increases the connection between the interests of shareholders and the value for money they get from the executive’ (DD trans., p. 33). The Australia Institute also proposed such an approach calling it an ‘acceptability cap’ where pay above the limit is deemed not to be a legitimate business expense and in turn not tax deductible (sub. DD131, p. 24). David Peetz noted that this would ‘return to the community a fraction of the losses associated with excessive growth in executive remuneration’ (sub. 50, p. 14). Carol Steiner proposed that all forms of remuneration be included under the tax deductibility cap, with no exceptions for performance-based remuneration as applies in the United States.

The US cap on tax deductibility is widely held to have increased incentive-based remuneration as a proportion of total executive remuneration. While a variety of forms of remuneration can qualify as performance-based, options automatically qualify where the exercise price is set at or above the market price on the date of grant (appendix C). Thus, one consequence of the rule was a significant increase in the use of options for executive remuneration (Balsam and Ryan 2008). Some argued that this increased the pay-for-performance sensitivity of affected firms (Perry and Zenner 2001). Others contended that, while the cap led firms to increase the proportion of performance-related pay relative to non-performance pay, this substitution was minor (Hall and Liebman 2000).

Further, it is posited that — as options encourage greater risk-taking than cash remuneration — one consequence of the significant increase in options remuneration was increased volatility in the US market (CGI Glass Lewis and Guerdon Associates, sub. 80). Similarly, Mercer noted that this legislation created more problems than it solved, and drove up the leverage of at-risk pay (sub. 41). BHP Billiton argued that this tax rule ‘was arguably a factor in some of the extremely large equity-based incentives that have been criticised by commentators’ (sub. 45, p. 9).

There is also evidence that the tax deductibility cap had the opposite outcome to that intended and actually contributed to significant increases in executive remuneration. Conway (2003) argued that when faced with remuneration in the form of stock options, executives demanded more in options than they would have been paid in money to compensate for the increased risk of holding stock (chapter 4). Further, CGI Glass Lewis and Guerdon Associates contend that the maximum ‘sanctioned’ amount of US\$1 million became a minimum (sub. 80, p. 86). Thus, remuneration of executives who had previously earned below US\$1 million increased to the cap level, while executives with remuneration above the cap received increased levels of equity remuneration, and pay levels across the board dramatically increased.

There are also indications that such an initiative can distort the structure of remuneration, with employers favouring specific design elements purely in order to retain tax deductibility of remuneration — such as structuring packages to appear ‘performance linked’ but which are more akin to base pay (BusinessWeek 2006; Mercer trans., pp. 335–6). However, increased tightening of the rules in terms of what constitutes ‘performance-based’ may have reduced this somewhat.

In the United States, companies are able to access a business tax deduction for some types of equity-based remuneration (appendix C). This is not the case in Australia, where all equity-based payments are non-deductible. As such, any restriction on

company tax deductions in Australia would relate to forms of remuneration that are eligible for a deduction, such as cash. Consequently, a limit on tax deductibility in Australia linked to remuneration above a certain threshold (even if this threshold is on the basis of total remuneration) has the potential to discourage cash remuneration and potentially result in increases in equity-based forms of remuneration.

It seems the US tax deductibility cap is generally recognised as a classic case of policy with detrimental unintended consequences. The Commission considers that the US experience serves to further highlight the risk of prescribing limits on components of executive remuneration.