

# Greenwoods & Freehills

## Tax Brief

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### **Exposure draft employee share plan legislation: few surprises, not much joy**

The Federal Government released on Friday the much anticipated exposure draft employee share plan tax legislation. *Tax Laws Amendment (2009) Budget Measures (No. 2)* Bill 2009 will delete Division 13A from the *Income Tax Assessment Act 1936* and insert in its place new Division 83A in the *Income Tax Assessment Act 1997*. Subject to some essentially peripheral matters, the draft accords with the Government's most recent announcements:

#### **Deferral**

- Tax deferral will only be generally available for shares and rights that are subject to a real risk of forfeiture.
- Deferral will be available until the later cessation of any sale restrictions that are in place at the time of grant (or earlier termination of employment).
- There will be an exception for salary sacrifice plan benefits capped at \$5,000 per employee per year.
- The salary sacrifice exception will only be available for shares, not rights (that's new).
- The maximum deferral will be seven years.
- Employees will not be able to pay tax up-front in order to access the 50% CGT discount.

#### **Exemption**

- The \$1,000 exemption will continue on existing terms subject to a \$180,000 income cap.
- Employees will not be able to forgo the exemption in order to defer tax on exemption plan benefits. However, the exemption will not deny them access to deferral on another plan.

#### **Withholding & reporting**

- Withholding obligations will apply where employees do not provide their TFN's.

- Employers will have annual reporting obligations, including an obligation to estimate the value of benefits in the year that they are taxable.

### **Start date**

- The new rules will apply to shares and rights acquired on or after 1 July 2009.

### **So what's new?**

There are a number of marginal aspects of the rules that are new, and will be significant if you are at the margin, but of more general significance are some things that the Government is continuing to insist on.

### **Still the same**

First, the Government proposes to continue with the taxation of underwater options, seeming even those that don't vest in some cases, and will also deny a refund in the event that the options expire unexercised.

Second, termination of employment will continue to be a taxing point notwithstanding APRA recommendations for compensation to remain contingent beyond termination in some cases, and numerous practical problems such as taxation of equity on transfer of employees to joint venture companies or across dual listed structures. In addition, exemption plans must continue to prohibit forfeiture of shares on cessation of employment, even where that occurs the day after grant. The Government should be pressed to review these quizzical policy settings.

Third, the Government refuses to accept that tax deferral to promote *ongoing* share ownership is a legitimate and worthwhile employer objective. Rather, the Government continues to see deferral as simply a tax advantage for employees. More than that, in the best of Orwellian revisionist traditions, the Government refuses to acknowledge that taxation of benefits only when they are realised, or realisable, is not 'deferral'. The exposure draft explanatory memorandum (EM) espouses the principle that employee equity is equivalent to other forms of compensation and should be taxed in the same manner; and yet, whereas tax on deferred cash is deferred, tax on deferred equity generally will not be deferred.

### **Real risk of forfeiture**

The 'real risk of forfeiture' concept remains central. There is regrettably little extra detail on what it means, but there is some. The risk must be 'more than a mere possibility' but need not be 'significant or substantial'. A requirement for an increase in share price, however small, seems to be

enough. This will all be fertile ground for dispute in years to come, and no doubt the subject of many initial ruling requests.

Loyalty conditions (requirements to remain employed) will be a real risk. Good leaver exceptions don't change that. That hasn't changed since the last announcement.

Once the possibility of sale arises, even if only fleetingly, tax will be payable.

An example in the EM suggests that a mechanism to prevent options vesting underwater could be regarded as 'contrived', and therefore to be disregarded. The EM gives an example of receiving:

'rights to 1,000 ... shares in 5 years if the market price is above the strike rate agreed upon ... After 5 years, the market value is below the agreed strike rate and the rights are forfeited'.

Tax is paid up-front and the EM says that a refund will be denied because:

'... [the] ... arrangement is contrived to ensure participating taxpayers are not exposed to downside market risk.' (example 1.17)

A very common option format is a 5 year option exercisable after, say, 3 years with an exercise price equal to the market value of the shares at the date of grant of the option. It is not entirely clear, but example 1.17 suggests that options in this format would be taxed at year 3, regardless of the share price, and that the employee would not be eligible for a refund at year 5 even if the options remained underwater for the duration.

But the EM also implies that were these options exercisable at a premium of only 1 cent to the share price at the time of grant, that 'hurdle' would mean that the options are not taxed if the share price never increases.

This seems anomalous and, hopefully, unintentional. We expect these sorts of anomalies to be ironed out in the review of the exposure draft by the Board of Tax.

## **New**

A number of other things are new, but they are at the margin.

- Probably the most important of them, which is potentially concessional for taxpayers, is that they can choose to value rights in accordance with ordinary market value principles, effective immediately. This was previously proposed to commence only after a Board of Tax review of the market value rules.
- A second significant clarification is that the deferral of tax for a capped salary sacrifice plan will be exactly that. It will not be available for after-tax plan benefits. It is difficult to understand why employees should disqualify themselves from this 'concession' simply because they contribute some of their own funds. This restriction means that typical share-save plans offered by many

companies will no longer be tax effective. Again, Government should be pressed on such a quizzical policy setting.

- It will be possible now for an employee to obtain in the same year both the \$1,000 exemption and deferral of tax on benefits under another plan. The old rule that employees must choose between the two has been abandoned. It will also be possible, within limitations, to obtain both the capped salary sacrifice plan deferral and also deferral under another contingent equity plan.
- Two timing rules have been changed. First, employees selling shares within 12 months of being taxed under new Division 83A will not qualify for the 50% CGT discount, notwithstanding that they may have held the shares for up to a total 8 years ie maximum 7 years 'deferral' plus 12 months. However, this change will have limited consequences now, because employees generally will not have paid tax up-front, and therefore growth during the tax 'deferral' period will not be eligible for the discount anyway.
- Second, employees will be taxed on the market value of shares at the time of sale where they are sold within 30 days of a Division 83A tax event eg termination of employment (a sale to an independent party will presumably establish the market value). This will only be significant where, for example, an employee ceases employment on 30 June but sells the shares on 15 July. The old rules would have reset the market value to the sale price, but would not have moved the taxing point from 30 June. The new rules will also move the taxing point to the 15 July tax year.
- There are some new details on trading windows. If the rules of the plan prevent sale of shares other than within approved trading windows, that restriction can operate to further defer the taxing point.
- There are also some other new rules to overcome previous technical deficiencies. First, deemed market value rules generally applicable for CGT purposes will be switched off for employee share plan benefits – to prevent potential double taxation. Second, a new foreign investment fund exemption will apply to employee shares held through foreign entities.

## Going forward

The Board of Tax is holding a consultation meeting tomorrow to consider technical aspects of the exposure draft (and the drafting does include some errors). It will then also consider valuation questions associated with employee shares and rights generally, and whether there should be further dispensations from the new regime for start-up, research and development and speculative type companies.

The new legislation is to be tabled in the current Spring sitting of Parliament.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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