

## Tax Brief

18 June 2010

### **ATO employee share scheme fact sheets – new Division 83A – ‘real’ risk, ‘genuine’ restrictions, market value and employer reporting**

In this tax brief:

- more colour to ‘real’ risk of forfeiture and ‘genuine’ disposal restrictions
  - minimum forfeiture periods
  - insider trading restrictions
- new market value rules
- employer ESS reporting
  - 14 July and 14 August reporting deadlines not extended
  - reporting details outlined

***... employee equity granted  
but not taxed before 1 July  
2009 must be reported ...***

The Australian Taxation Office (ATO) posted employee share scheme (ESS) fact sheets on its website on Wednesday, 16 June 2010. They cover both technical and practical issues. Most critically at present, the fact sheets outline the ATO’s plan for employer reporting to employees (by 14 July) and to the ATO (by 14 August). These deadlines have not been extended (but that is not to say that extensions will not be allowed upon application on a case by case basis). Transitional rules reduce the reporting required this year in some cases eg \$1,000 tax exempt plans (refer below). Employers should also remember that employee equity granted but not taxed before 1 July 2009 must be reported this year if it became taxable by 30 June 2010.

The ATO posted 5 separate fact sheets and this Tax Brief deals with each of them separately.

#### **‘Real’ risk of forfeiture**

[This fact sheet](#) further explains what the ATO sees as a real risk of forfeiture for deferral of tax under new Division 83A. The ATO confirms that ‘real’ must be determined on a plan by plan and employee by employee basis. It invokes a

**... something highly unlikely to occur or which is only a rare eventuality is not what a reasonable person would regard as a real risk.**

**If an employee signals at or before grant an intention to retire within the forfeiture period, the grant is unlikely to be regarded as subject to forfeiture ...**

'reasonable person' test to say that real means more than a mere possibility; that something highly unlikely to occur or which is only a rare eventuality is not what a reasonable person would regard as a real risk. This is a high benchmark compared to case law<sup>1</sup> but accords with statements in the explanatory memorandum to new Division 83A.<sup>2</sup> It can be contrasted to the seemingly more relaxed approach taken by the UK Court.

## Service conditions

The ATO will assess whether or not service conditions have been contrived for tax deferral. A short service condition and a long sale restriction period may indicate contrivance, as might a discretion to vest which is routinely exercised.

The ATO will accept, however, a 12 month service condition for any further period of tax deferral ie subject to the maximum 7 years. It will also accept a 6 month service condition for deferral of up to 3 years. These parameters effectively establish safe harbours.

The ATO has also confirmed its acceptance of good leaver dilutions of service conditions in ordinary circumstances, including discretions to vest equity in retirement cases where the company does not have a minimum retirement age. If an employee signals at or before grant an intention to retire within the forfeiture period, the grant is unlikely to be regarded as subject to forfeiture (note that this employee intention criterion could cause practical difficulty for employer reporting obligations). However, eligibility for retirement does not of itself prevent equity which may vest on retirement being subject to forfeiture. So, for example, an employee over 55 years and eligible to retire, and to retain employee equity upon retirement, can still qualify for tax deferral. This will need to be determined on a case by case basis.

Retirement in this context means permanent departure from the workforce.

## Performance hurdles

The ATO will also assess in each case the likelihood of a company meeting performance hurdles. However, it will ordinarily accept that vesting at a 50th percentile total shareholder return (TSR) comparator is a sufficient hurdle, even where the company regularly achieves a 'high' percentile, ie presumably meaning

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<sup>1</sup> Refer *Sir John Aird's Settlement* [1982] 2 All ER 929 in relation to when a contingency "has reality and substance and when it does not": "A contingency is an event which may or may not happen. If there is no real possibility that it will not happen, so that it is as good as certain that it will, it is a contingency without reality and substance and no contingency at all. But a real possibility is not the same thing as a probability. It may be highly improbable that an event will happen, but there can still be a real possibility that it will. If there is that possibility, however remote it may be, the contingency is one of reality and substance."

<sup>2</sup> Refer paragraph 1.156.

higher than 50%. That is in practice an important acknowledgement because many public company plans commence vesting at the 50<sup>th</sup> percentile.

## **‘Genuine’ disposal restrictions**

***... the ATO also concedes that a contractual prohibition on sale is sufficient if there are ‘serious and enforced consequences’ for breach ...***

Division 83A tax deferral can be extended beyond vesting by ‘genuine’ disposal restrictions (beyond grant in the case of salary sacrifice plans). In [this fact sheet](#) the ATO makes a number of useful practical concessions. The fact sheet acknowledges that employee share trusts and holding locks are acceptable mechanisms for enforcement of sale restrictions.

However, the ATO also concedes that a contractual prohibition on sale is sufficient if there are ‘serious and enforced consequences’ for breach eg termination of employment or demotion (the parameters of what constitute ‘serious’ consequences are not specified). So a mechanism to sanction sales in breach of restrictions can be sufficient; a mechanism to prevent sale is not absolutely necessary.

Moreover, a company discretion to lift trading restrictions in ‘special circumstances’, for example severe financial hardship, does not of itself unacceptably dilute restrictions. (A requirement for an employee to request that restrictions be lifted is not sufficient of itself to constitute a genuine disposal restriction.)

## **Securities trading restrictions**

The ATO also accepts that a company’s securities trading policy need not be written into plan rules or offer documents, or employment contracts, provided that the policy is documented and the employee is required to comply with it – once again at the risk of serious and enforced consequences for breach.

A requirement to request clearance to trade is not of itself a sufficient restriction – the employee must be in possession of inside information or otherwise in a category where clearance would be refused if requested. Clearance to trade request procedures will be acceptable restrictions where employees are required to state in writing that they are not in possession of inside information and the employer (or delegate) is required to be satisfied that the statement is correct. Individual employees must then keep ‘records that provide evidence’ they have inside information for any period they claim to be restricted. ‘Records’ in this context presumably means personal records that in truth provide only secondary evidence that the employee holds the information.

## **Employer reporting**

As something of an employer reporting dispensation, the ATO will accept effectively a quarterly testing regime. Employers may assume, until the end of the financial quarter, that an employee has inside information and is therefore restricted from trading if:

***A requirement to request clearance to trade is not of itself a sufficient restriction ...***

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***... because equity is taxable at the first opportunity to sell, even a momentarily window in an otherwise restricted trading period can trigger taxation.***

- within 10 days of being otherwise able to trade equity, the employee:
  - advises that the employee has inside information; or
  - is refused a request to trade; and
- the employee is required to advise when the employee no longer has inside information.

Employers may then treat (ie report) the employee as unrestricted at the beginning of the next financial quarter unless within 10 days the employee again advises the employer that the employee still has inside information (or is again refused a request to trade).

Finally, the fact sheet cautions that, because equity is taxable at the first opportunity to sell, even a momentarily window in an otherwise restricted trading period can trigger taxation.

## Market value of listed shares

[This fact sheet](#) sets out acceptable methodologies for determining the market value of listed shares and stapled securities now that the Division 13A one week volume weighted average price is no longer compulsory ie new Division 83A allows application of general valuation principles. Average cost, weighted average closing price over a 5 trading day period and closing price are each acceptable in at least some circumstances.

The fact sheet accepts continued use of the Division 13A one week volume weighted average price. It also sets out some alternative methodologies, and circumstances where they can be applied:

***... shares purchased through an employee share plan trustee on-market can be valued at the average cost ...***

- **average cost** – shares purchased through an employee share plan trustee on-market can be valued at the average cost of the shares – this is acceptable where the shares are both purchased and allocated within 5 days, but also ‘still acceptable’ where the shares are purchased ‘continuously over a period (up to 30 days) so as not to distort the market price’;
- **weighted average closing price** – shares may be valued at the 5 trading day weighted average closing price upon:
  - issue to an employee or trustee for employees otherwise than on a public float or other public offer;
  - forfeiture to a trustee and later reallocation; or
  - the occurrence of a deferred taxing point ie where the 30 day rule does not apply;
- **closing price** – at the deferred taxing point ‘where a stock is relatively liquid and does not exhibit significant price volatility’; and

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- **retail offer price** – shares acquired via a public float or otherwise pursuant to a public offer can be valued by employees at the retail offer price, provided in the case of a float they are acquired (or allocated by a trustee) within 5 days of the float ie either side of it.

'Significant' in terms of price volatility is not explained. Presumably volatility in line with the ASX index or a recognised segment of the index would not ordinarily be regarded as significant – but this has not been confirmed by the ATO. On the other hand, volatility resulting from 'abnormal trading' as contemplated by the subdivision 960-H rules may be significant. Similarly, general index movement of a magnitude experienced for example in September/October 2008 might preclude use of the closing price.

Weighted average closing prices need not include prices on the day of valuation (as the former Division 13A VWAP required), and 5 trading days can be used in place of the former Division 13A VWAP 'one week' rule.

The fact sheet does not provide any guidance for valuation of unlisted rights over listed securities. A key question in this regard will be the effect of performance hurdles.

## Employer reporting

From 2009-10 new Division 392 of the *Taxation Administration Act 1953* requires employers to provide annual ESS statements to both employees and the ATO. The employee statements are required by 14 July and the ATO statements are required by 14 August each year. [This fact sheet](#) sets out the information that employers will be required to include in these statements.

## Reports to employees

The employee statements will not be quite so extensive as had been contemplated by new Division 392. Employers will not be required to report numbers of securities ie they will only be required to report discount amounts. They need report plan benefits only once:

- on grant in the case of taxed up-front schemes; and
- at the taxing point for tax deferred schemes (Division 392 would allow the ATO to require reporting of tax deferred schemes both on grant and at the deferred taxing point).

Approved forms are seemingly yet to be published, but the fact sheet does include a 'copy' of the required employee statement:

***Weighted average closing prices need not include prices on the day of valuation ...***

***Employers ... need report plan benefits only once ...***

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Employee tax file number/ABN	
<b>Taxed up front scheme – eligible for reduction</b>	
Discount from taxed up front schemes – eligible for reduction	D \$ <input type="text"/>
<b>Taxed up front scheme – not eligible for reduction</b>	
Discount from taxed up front schemes – not eligible for reduction	E \$ <input type="text"/>
<b>Deferral schemes</b>	
Discount from deferral schemes	F \$ <input type="text"/>
<b>Discount on ESS interests acquired pre 1 July 2009 and 'cessation time' occurred during the financial year</b>	G \$ <input type="text"/>
<b>TFN amounts withheld from discounts (total includes cents)</b>	C \$ <input type="text"/>

As the copy illustrates, ESS 'discount' must be reported in 4 categories:

- taxed up-front plans
  - eligible for reduction ie the \$1,000 tax exemption
  - not eligible for reduction
- tax deferred schemes
- post 30 June 2009 grants
  - pre 1 July 2009 grants for which a cessation time occurs during the financial year – assuming that the employee did not make a former s 139E election to be taxed on grant.

This will mirror the item 12 requirements of 2010 individual income tax returns.

## Reports to the ATO

Employer statements to the ATO must include both the numbers of securities and the amount of the discount involved. Again, employers are required to report plan benefits only once ie upon grant in the case of taxed up-front schemes and at the taxing point in the case of tax deferred schemes.

## Amendment requirements

Employers will be required to amend both employee and ATO statements that are incorrect, including as a result of previously unreported sales of securities within 30 days of the taxing point and upon indeterminate rights becoming rights to acquire shares. The amendment requirements will often need to be met on an employee by employee basis and is therefore likely to be disruptive in practice.

*... [Employee statements will] ... mirror the item 12 requirements of 2010 individual income tax returns.*

*Employers will be required to amend both employee and ATO statements ... upon indeterminate rights becoming rights to acquire shares.*

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The fact sheet confirms again that the ATO will accept effectively a quarterly basis of testing insider trading restrictions as outlined at part 2.2 above.

## 'Reduced' 2009/10 reporting

A [separate fact sheet](#) sets out 'reduced' reporting for the 2009/10 year. There will be three categories of reduced reporting:

- pre 1 July 2009 grants eligible for the \$1,000 tax exemption:
  - employers may provide employees a scripted statement (set out in the fact sheet) in place of the a discount particulars otherwise required;
- post 30 June 2009 grants eligible for the \$1,000 tax exemption for employees earning not more than \$150,000:
  - again, employers may provide employees a scripted statement in place of the discount particulars if the sum of the employee's salary and wages, allowances, reportable fringe benefits and reportable employer superannuation contributions is not more than \$150,000;
  - in this case employers must still report the usual grants details (ie numbers of securities and discount amounts) to the ATO;
- post 30 June 2009 grants under tax deferred plans for which there is not a taxing point in the 2009/10 year:
  - again, employers may provide employees a scripted statement in place of the discount particulars.

*... scripted statements will probably require some further employer explanation ...*

The scripted statements will probably require some further employer explanation in practice.

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