

## Tax Brief

23 October 2009

### Taxation of employee share and option plans – legislation tabled

#### Tax Laws Amendment (2009 Budget Measures No.2) Bill 2009

The Bill to enact the proposed new regime for the taxation of employee shares and options was tabled in Parliament on Tuesday, 20 October 2009. It largely replicates the August exposure draft but there are some important further changes, and the explanatory memorandum (**EM**) now provides more explanation of the new rules, including further examples of a “real risk of forfeiture”.

But some significant problems with the August exposure draft remain:

- Underwater options, incredibly, are still taxable;
- Cessation of employment is still a taxing point;
- Deferral is still denied for “share-save” or “top-up” style plans;
- FBT still applies to shares and options given to joint venture and other non “subsidiary” employees;
- There remains no default market value rule for listed shares;
- There are still significant gaps between the legislation itself and the EM explanations;
- And still more clarity is required for “real risk of forfeiture” – although it will remain inherently an uncertain concept.

And there are significant new problems:

- Share plan trustees will be taxed on gains on unallocated shares – double taxation; and
- Cash settleable rights, and rights to an indeterminate number of shares, will be subject to a complicated new amended assessment rule.

Passage of the Bill through Parliament, at least in its current form, is also as yet not assured. Indeed, some corrections are yet necessary. Groups wanting to move forward with plans redesigned to accommodate these new rules, and even with employee communications about new offers under existing plans, must still make a judgement call as to what will remain the same, what will change and what is just too uncertain to predict. This problem is becoming acute given that annual post-reporting allocations for many groups are now mid-stream.

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This *Tax Brief* does not (given our previous *Tax Briefs* on the same subject) outline all aspects of the new regime, but seeks to highlight some of the key remaining issues.

## Real risk of forfeiture

The key requirement now for tax deferral in most cases is “real risk of forfeiture”. So what exactly is a “real risk”?

As often happens, the question has already been addressed overseas. In ***IRC v Trustees of Sir John Aird's Settlement***, [1982] 2 All ER 929, Nourse J was asked to look at when a contingency “has reality and substance and when it does not”. He said:

“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.”

So a gift made contingent on “being alive at the death of someone who dies tomorrow, being a Saturday, and who shall be the first (in alphabetical order) of the persons dying on that date to be named in the ‘deaths’ column of *The Times* for the following Monday” was held to be subject to a real contingency because: “*The Times* column for that day confirms what I might otherwise have inferred, namely that the reports of one day’s deaths are usually spread over a number of different subsequent days. Therefore there could well be Mondays when no death on the previous Saturday was reported.” UK capital transfer tax was not payable as a result.

A peculiar case maybe, but the point is we can expect some real(!) action on this in Australia as well because what is a “real risk” is essentially a question of judgement and perspective.

Paragraph 1.156 of the EM says: “The ‘real risk of forfeiture’ test does not require employers to provide schemes in which their employee share scheme benefits are at a significant or substantial risk of being lost. However, ‘real’ is regarded as something more than a mere possibility.” That’s *Aird* to the letter. But the same paragraph goes on to say: “Something is not a real risk if a reasonable person would disregard the risk as highly unlikely to occur or as nothing more than a rare eventuality or possibility.” Alas, ambiguity!; *Aird* rule diluted.

The EM now provides numerous helpful examples, but they include some surprises and contradictions; fertile ground for dispute. Tax rulings will be imperative in many cases:

- a loyalty requirement (ie a requirement to remain employed) is a real risk of forfeiture;

... what is a “real risk” is essentially a question of judgement and perspective ...

*... whether or not performance hurdles constitute a real risk is “a question of fact and circumstance ...*

- a good leaver exception for sickness, invalidity, redundancy or change of ownership, will be tolerated;
- a good leaver exception for retirement may or may not be tolerated;
- three months is not enough – at least not to qualify for deferral over a 5 year sale restriction period, but 12 months is enough;
- a requirement not to join a competitor “will depend on the circumstances of the individual case”, although a requirement to remain employed or leave the industry altogether is probably enough.
- forfeiture for fraud or misconduct is not enough;
- whether or not performance hurdles constitute a real risk is “a question of fact and circumstance” in each case;
  - a requirement for a 10% market share increase where it was steady the previous year is enough;
  - a requirement for a 10% share price increase against previous performance in line with the sector index is enough;
  - a requirement for at least a flat share price against a previous 50% price fall is enough; and
  - a requirement for at least a flat share price against a previous 20% annual price increase is not enough: “a reasonable person would not consider that Nina has a real risk” – an interesting comment from Treasury given 2008 market performance!
- employee controlled risks are not real;
  - a requirement to fund an account for the exercise price of options is not enough; likewise, a requirement to retain employer company shares to qualify for further free shares is not enough – but these plans would normally also include loyalty conditions which would qualify them for deferral.

Not all of these examples can be reconciled to the Aird explanation of contingency, which is probably the closest thing we have to judicial precedent – the examples assume a more stringent test. Not all of them can be reconciled to each other eg why does a retirement exception to a loyalty condition disqualify it, and yet an exception for leaving the industry does not? The inconsistencies demonstrate that the answer to questions of perspective such as these are “in the eye of the beholder”. And how do the examples line up with what the Productivity Commission, and indeed industry generally, would regard as contingent remuneration? Again, it seems, the examples assume a more stringent test.

## **Sale restrictions – black-out periods**

This is one area that generally has been cleared up. Tax on qualifying shares and options subject to a real risk of forfeiture is deferred until sale

restrictions cease ie subject to ceasing employment and a maximum 7 years.

The EM accepts that securities dealing restrictions are generally sufficient for deferral. A company's internal share trading policy restrictions will be sufficient provided "the penalty for breaking the policy constitutes an effective sanction". There need not be a mechanism to prevent a sale occurring, but if not there must be "serious and enforced consequences for breaching the policy".

- Termination of employment is an effective sanction.
- A law regulating insider trading that would make a sale a criminal offence is an effective sanction.
- A policy that routinely is not applied is not an effective sanction.

Employees will need to be aware however, that even a momentary ability to sell between consecutive black-out periods will end tax deferral.

## Sale restrictions – general

Some more clarity is provided for the sufficiency of sale restrictions generally.

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- Provisions for release of sale restrictions in cases of severe financial hardship do not disqualify the restriction.
- A restriction preventing sale "without the permission of a manager" is not enough because it is "open to manipulation".
- Query the case of other company board discretions to lift discretions?
- Employees may choose their own sale restriction periods eg 3 year, 5 year or 7 year periods.

## Underwater options

The Government has chosen to continue with the taxation of underwater options and the EM seeks to manipulate the refund rule to entrench that position.

Options will be taxable as soon as they are technically exercisable, even though the exercise price might exceed the market value of the shares and remain above it for the life of the options, such that it is never economic to exercise them. The tax payable is not refundable because the employee made a "choice" (indeed a Hobson's choice!) not to exercise them.

Moreover, the terms of many options prevent exercise while they are underwater, but the EM sees those terms as protecting the employee from downside market risk – which also prevents a refund. (NB Either an employee choice or a market risk protection mechanism can prevent a refund.) The EM is wrong in this respect, because it is the ability not to exercise which protects against market risk rather than the restriction on exercise. Nevertheless, in practice the ATO is unlikely to depart from the EM direction. This is a particularly unfortunate aspect of the new regime, (a)

because the inequity it entrenches is clearly bad policy, and (b) because the EM insists on it but not the legislation and accordingly there remains a very real question as to whether or not Government intends such a harsh approach.

A simple example illustrates the inequity. Employees A and B are granted 5 year options exercisable after 3 years at an exercise price equal to the market price of the shares at the time of grant of the options ie \$5.00. The employees must remain employed until year 3 for the options to vest, so there is no doubt that they are subject to a real risk of forfeiture. The options cannot be exercised while the strike price is below the market value of the shares. The share price falls to \$4.50 shortly after grant of the options and remains there for the life of the options. They lapse unexercised as a result.

- Employee A was made redundant at year 4 and consequently was taxed on the market value of his options at that time – a not insubstantial value even though the options were underwater at the time. He is denied a refund because the term of the options preventing exercise while they are underwater is treated as protecting him from downside market risk.
- Employee B remains employed by the company. She's laughing! Because she was always prevented from exercise by the terms of the options (ie while they were underwater) and as a result she is never taxed.

If not for the restriction on exercise while the options were underwater both employees would be taxed in year 3. All of this clearly needs correction and we are yet hopeful that Parliament will see that. Employee A does get a capital loss but that will be a small consolation for many employees, particularly given the market we've just had.

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## **Share-save or top-up plans**

Many companies currently operate "share-save" or "top-up" style plans which allow employees to invest after tax dollars in company shares at a small discount (eg 5%) free of brokerage. Typically a relatively short sale restriction period is applied (eg one year), consistent with the small discount allowed, and the tax deferral available helps to make the plan attractive. Shares acquired under these plans do not include forfeiture conditions because the employees pay for the shares.

Regrettably, and seemingly without any policy driver for it, tax deferral will no longer be available for these plans. They do not qualify for "\$5,000 concession" deferral because employees contribute to the cost of the shares with their own money. But why is that a good reason to deny tax deferral?

Company groups should now consider whether these plans should be moved to a pre-tax (ie salary sacrifice) rather than post-tax contribution arrangement to (re)qualify them for tax deferral, this time using the \$5,000 concession. That may of course bring with it additional administration for the company, and additional complexity for employees. Ironically though,

the additional tax deferral involved may lift participation rates. (And remember that employees will now be able to access both tax exemption - ie for a \$1,000 plan - and tax deferral in the same tax year.)

## **Market value rule for listed shares**

In an endeavour to create more valuation flexibility, principally for unlisted companies, the Government has at least for the present omitted the one week weighted average price rule for listed shares. Although the rule had its wrinkles, it effectively acted as a safe harbour, albeit a compulsory one.

The legislation as currently tabled omits the requirement to use this rule. However, in dispensing with the requirement, the Government has also eliminated the safe harbour, except for the limited purpose of valuing unlisted options which was retained by the previously released draft regulations.

Consequently, whether or not shares (as opposed to options) are acquired at a discount cannot now be known with any certainty. For example, if a \$5.00 share is acquired at the closing market price on the day of acquisition, but at a 20¢ discount to the weighted average market price for the week, or vice-versa, are the shares acquired at a discount or not? Either way the shares might be acquired at, say, a 10¢ discount to the weighted average price for the day of acquisition. Who decides?; the employer company?; the Commissioner?; each employee on an individual basis such that some will return a taxable discount (of varying amounts) and some will instead say that they are only subject to CGT on sale of the shares?; with what will the Commissioner "pre-populate" returns if that measure is introduced?; what is the employer ("provider") required to report, and must the employees also adopt that value? Without a safe harbour, you end up with a mad woman's breakfast!

Yet it would have been a simple matter to retain the safe harbour – hopefully a further version of the regulations will restore the safe harbour. The Board of Tax will no doubt also ultimately have something to say about this. It is due to report to Government in February 2010.

## **Taxing trustees on unallocated shares**

Gains on unallocated shares held in an employee share trust will be taxed to the trustee at the point of allocation, except if they are used to satisfy rights. This is new and it will cause double taxation. It arises from the part removal (in effect) of the former s 130-90 exemption.

Consider the example of a trustee that acquires shares at \$10 each, one month in advance of free share allocations to employees when the share price is \$12. The shares remain in trust subject to forfeiture and the employees are taxed on vesting when the share price is \$15.

- The employees pay tax at vesting on \$15 per share.

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...*

- The trustee pays tax at allocation on \$2 per share. (Although query whether, alternatively, dividend recipients would be liable for that tax as beneficiaries presently entitled to trust income).

Treasury may have been concerned about the situation where employees acquire their shares at the market value at the time of allocation, \$12 in this example. In that case Treasury would want to tax the trustee's \$2 gain, but that gain was not exempted by former s130-90 anyway.

This also needs correcting.

## Cash settleable rights

Rights to shares that are settleable in cash at the option of the employer, and rights to an indeterminate number of shares, are to be treated as rights to shares and taxed under Division 83A. But only if and when ultimately they become settleable only in a known quantity of shares. And then they are treated as always having been rights to shares. Amended assessments will be necessary if, on this assumption, a taxing point has already arisen.

The Government's intention is to ensure that all shares acquired in respect of employment are taxed under Division 83A, which is sensible enough. However, this aspect of the rules (new s 83A-340) will be complicated because, it will require a reconstruction of events to determine when the rights would have been taxed had they always been rights to that known quantity of shares.

*... this aspect of the rules ... will require a reconstruction of events ...*

The EM provides the following example (abridged): An employee is given a right to 50,000 employer shares if the share price increases 30% over 7 years, subject to an employer right to cash him out. He ceases employment at year 4 but he keeps the rights. At year 7 the rights vest and the employer's entitlement to cash them out falls away. The employee is taxable back at cessation of employment in year 4 and must seek an amendment of his year 4 assessment.

There could be many variations, and it is not clear how the rights should be valued: must you disregard the contingencies also for valuation purposes?

A settlement in cash would have remained taxable at year 7, assuming the ATO has not pre-empted that with an FBT analysis of the rights – although another of the EM examples suggests that FBT would not be applicable.

## Miscellaneous other remaining issues

- **Employer reporting:** Employers must report not only post 1 July 2009 equity but also shares and options issued before 1 July 2009 if it was not taxable before 1 July. Employers must therefore ensure that their systems capture this information.
- **Options:** The EM examples still don't provide a clear answer to the simple question: "Is a 5 year option exercisable after 3 years at an exercise price equal to the market price of the shares at the time of grant of the options subject to a real risk of forfeiture?" Often these

options will be subject to a loyalty condition and that will qualify them for deferral, but not always.

- **Salary sacrifice matched share plans:** While the \$5,000 deferral concession will only be available for salary sacrifice share plans, the provision of accompanying rights to matching shares will not disqualify the salary sacrifice shares from deferral.
- **Rights or shares:** The perennial problem of determining whether you have rights or shares has not been resolved. It arises, for example, when there is an initial temporary delay in providing promised share scheme benefits (eg there may be internal procedures for a share issue). The issue was always relevant to whether or not the 75% offering requirement had to be satisfied; it is now also relevant to whether rights are provided pre 1 July 2009 or shares are provided after 1 July.
- **Transitional:** A different but related point to the previous one – the new rules will not apply to rights acquired pre 1 July 2009 even if they do not become rights to shares until post 1 July eg because they are at first rights to an indeterminate number of shares

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