

Tax Brief

3 July 2009

Taxation of employee share and option plans - round three

The Assistant Treasurer announced on Wednesday afternoon further changes to the proposed new regime for the taxation of employee shares and options. This is the third announcement. The first, on budget night, was roundly criticised. The second, on 5 June, which included exposure draft legislation, somewhat ameliorated the initial proposal. With this announcement, the Government has largely reverted to the pre-budget tax arrangements, although with some very important differences.

The main points arising from Wednesday's announcement are as follows.

- Sale restrictions are to be reinstated as a deferral mechanism, but with important limitations – refer below.
- Forfeiture conditions will remain a mechanism for deferral if they represent a “real risk”. This is not a further change but the Government has elaborated on what will constitute real risk – refer below.
- Rights and options will generally remain taxable when they vest, rather than later upon exercise.
- The income cap on the \$1,000 exemption will be lifted from \$150,000 to \$180,000.
- The Government will proceed with the 1 July 2009 start date.

We can expect to see more contingent employee equity as a result of these rules, and more reliance on sale restrictions; for example, grants contingent on remaining employed for an initial 12 month period, followed by sale restrictions for a further period.

In addition, rights and options will even more commonly be exercised, and the shares sold, as soon as they vest, or at least in the tax year that they vest, because employees will be taxed in that year. And no longer will employees be able to choose to pay tax on their equity “up-front” in order to obtain the benefit of the CGT discount i.e. on growth in value prior to the end of conditions and restrictions.

The main thrust of the proposed regime now, compared to the pre-May budget tax arrangements, is as follows:

- First, tax deferral will be significantly curtailed. Subject to one exception, sale restrictions will defer tax only if they are at least initially accompanied by a “gateway” forfeiture condition.

However, the new regime will recognise a “loyalty” condition (i.e. to remain employed for a period) as a forfeiture condition, and “good leaver” provisions will be generally disregarded.

- The exception is that sale restrictions alone will be sufficient to defer tax on shares or rights to shares worth up to \$5,000. Although it is not expressly stated, “\$5,000” presumably means \$5,000 per employee, per year.
- Second, forfeiture conditions will only be recognised if they involve a “real risk” of forfeiture. In this respect, forfeiture for gross misconduct will not be regarded as a real risk, presumably because personal conduct is within an employee’s own control.
- Third, the maximum period for deferral will be reduced from 10 years to 7 years.
- Fourth, rights and options will be taxed when they are either exercisable or saleable, rather than only when they are actually exercised, unless there is also conditions or restrictions on the shares acquired on exercise. In most cases this will mean that rights and options will be taxed on vesting.
- And fifth, employees will no longer be able to choose to pay tax for the year of grant of their equity in order to secure the benefit of the CGT discount. The existing election will be eliminated and the tax treatment of equity will be determined by the structure of the plan rather than by any choice of employees.

Other significant aspects of the proposed regime are now as follows.

- First, the \$1,000 exemption for broadly based plans will be available only to employees with adjusted taxable income up to \$180,000 being the maximum personal income tax rate threshold. The adjustments will require a gross-up for reportable fringe benefits and superannuation contributions, and negative gearing losses. However, in practice the income cap is unlikely to have a significant impact because employees at that level of income have often participated in tax deferral plans that precluded them from making an exemption election in practice.
- Second, employers will be required to report the employee equity they allocate each year i.e. numbers of shares and rights, and the employees (TFNs) to whom they allocate. In addition, for the years when employees are taxed under the plan, employers will be required to estimate the market value of their shares and rights.

Although the Assistant Treasurer advised that this is the Government’s “final position”, there will be further review processes.

- First, the Board of Tax will be asked to determine how best to value shares and rights for employee taxation purposes, presumably to deal with the difficulty in valuing unlisted equity in particular. In addition, the Board will be asked to advise whether additional concessions should be available to start-up, research & development and other “speculative-type” companies.
- Second, the Productivity Commission will be asked to examine “equity-based payments for executives” more broadly, and to co-ordinate that with APRA and the Henry Tax Review.
- Third, further exposure draft legislation will be released for consultation on technical and implementation issues before being tabled in the Spring sittings of Parliament.
- And fourth, although it was not a Government initiative, on 23 June the Senate referred the operation of employee share schemes in Australia to the Standing Committee on Economics for a report by 17 August 2009.

In all likelihood there will be yet further changes, at least at the margins.

The announcement and attached “Policy Paper” are still short on detail and in various respects unclear. For example, the availability of \$5,000 deferral “concession” is not clear, particularly where a number of plans operate concurrently.

Nevertheless, it is possible to make some general statements about how the new regime will affect various common plan styles in future.

- **Share-save plans** (where employees invest after-tax dollars) and **salary sacrifice plans** (where employees invest pre-tax dollars) will remain viable in their current form, but only to the extent of \$5,000 worth of shares per employee, per year.¹ These plans typically do not involve forfeiture conditions.
- **Exemption plans** will remain largely unaffected.
- **Performance based share plans** for more senior employees will remain viable, but with deferral only until vesting unless additional sale restrictions are attached. Restrictions will of course compromise the utility of these plans from the perspective of employees.
- **Performance based rights and option plans** will also remain viable with deferral until vesting, but employees will have an incentive to exercise and sell as soon as possible.
- **Loan plans** will be unaffected.

¹ Although it is not certain that the \$5,000 deferral concession will be available to share save plans, involving after tax contributions, at all.

Employers that want to promote ongoing employee share ownership will be forced now to apply sale restrictions and therefore limit the flexibility of their plans to suit individual employees (assuming it is not feasible to have lengthy contingency periods attached to the remuneration of most employees). Employers may be able to offer employees a choice of sale restriction periods up to 7 years, thereby retaining a degree of flexibility, but that level of detail is not yet clear.

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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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