

Tax Brief

10 June 2009

Taxation of employee shares & rights/options - consultation paper

As anticipated, the Government released on Friday afternoon its revised proposal for the taxation of employee shares, options & rights. What was initially to be a 'policy options paper' was ultimately released as a 'consultation paper'. It contains only a single new proposal, including proposed draft legislation. The paper demonstrates a deeper consideration of the issues, and the Government has in part heeded the calls of industry.

However, this proposal will still very significantly restrict the existing rules. Many plans will need to be redesigned to remain viable under the new regime. Deferral of tax on fully vested benefits has been a mainstay of long term employee share ownership in the past. This real tax deferral, beyond vesting, is now set to be scrapped, as initially proposed by the budget announcement. As a result share and option/rights plans can no longer be the widely used 'shareholder alignment' tool they are at present, particularly for middle management. What has for decades been seen by successive Governments as a cause worth supporting is regrettably now seen as a mischief.

The new regime will commence on 1 July 2009.

1. Overview

Deferral Plans

- Up-front taxation as proposed with the budget address has been scrapped (except for non-qualifying plans, as before).
- It will be replaced with tax on vesting – tax 'deferral' will apply for only so long as there is a 'real risk' of forfeiture.
 - Options and rights will be taxed on vesting rather than on later exercise, seemingly even if underwater (it is not clear) – as a result we may see a shift towards 'European style' options which are exercisable only at a specified vesting date.
 - Sale restrictions will no longer defer tax.
 - Forfeiture in the event of termination for gross misconduct, seemingly (it's not clear), will no longer defer tax.

So it will no longer be possible to defer tax on fully vested benefits.

The impetus for employees to sell shares to fund tax payments will

significantly inhibit the effectiveness of deferral plans, including typical salary sacrifice plans, as long term share ownership tools.

- 'Loyalty' conditions (ie requirements to remain employed – for vesting), will continue to defer tax. They will be treated as real risks of forfeiture.
- The new maximum deferral period will be 7 years. It may seldom operate in practice given that it will only apply to 'at risk' remuneration, and 7 years is a long time for remuneration to remain at risk.
- The election to be taxed up-front in order to secure CGT treatment of growth in value has been scrapped.

Exemption Plans

- The \$60,000 income limit has been lifted to a more credible \$150,000.
- Tax elections will no longer be necessary.

Employer Reporting

- Employers will be required to provide annual statements similar to PAYG statements.
- Tax withholding will only be required where employees do not provide TFNs.

Taxable value

- The Board of Tax is to review whether the existing tabular valuation rules should be replaced – the Government suspects they are unduly concessional. The existing tables will continue in the interim.

New start date

- The Government has sensibly deferred the start date. The new regime will apply to acquisitions on or after until 1 July 2009.

Submissions

Submissions are sought by Friday 12 June 2009.

Numerous issues remain uncertain. Hopefully some can be clarified in the explanatory memorandum to be tabled with the new legislation in Parliament. For example:

- exactly what does constitute a real risk of forfeiture?; and
- will 'good leaver' exceptions to loyalty conditions (eg for redundancy or retirement) vitiate deferral?

The loyalty condition basis for deferral, for example, does not appear in the draft legislation but only in the consultation paper. Forfeiture in the event of termination for gross misconduct is not expressly mentioned in either.

Numerous micro design issues remain problematic. Perhaps at least these can be addressed. Some problems likely to be commonly encountered include, for example:

- the new regime would appear to tax vested but underwater options, and the tax payable generally will not be refundable (refunds will be

available for both shares and rights where they are forfeited, but not where they are relinquished for lack of value);

- shares and rights vesting during a non-sale ('black-out') period will be taxed even though they could fall in value before they can be sold; and
- employers will be required to report value estimates for shares, options & rights both at acquisition and at their later taxing point (which could be numerous as a result of terminations).

And numerous pre-existing problems remain. For example:

- the Government continues to insist on taxation at termination of employment, notwithstanding clear prudential reasons against it at least for APRA regulated employers; and
- incorporated joint venture employees remain locked out of employee share and option/rights plan tax benefits (because 50/50 joint ventures are not controlled by either JV partner).

2. The new rules

The new rules make a clearer distinction between exemption plans and deferral plans by doing away with the election for up-front taxation of non-exempt plans.

One consequence will be that employees of companies anticipating high growth, for example many start-up companies, will not have the opportunity to be taxed on the initial low value of employee equity up-front in order to secure the benefit of the 50% CGT discount on the growth, and deferral of that CGT until sale of the shares.

Exemption plans

The rules for exemption plans have not been changed except for the scrapping of the election – the exemption is now automatic – and the new cap on its availability.

The new cap of \$150,000 applies to:

- your taxable income;
- grossed up for:
 - your reportable fringe benefits – those appearing on your PAYG payment summary (group certificate);
 - reportable employer superannuation contributions on your behalf; and
 - your negative gearing losses ('total net investment loss') for the year.

The new cap will not affect many higher paid employees who were already denied the exemption in practice because of their participation in other deferral plans. The section 139E 'tax' election previously allowed access to either exemption or deferral, but not both.

Deferral plans

Deferral will be available for *shares* until the earliest of:

- (a) the time when there is no real risk that you will never be able to control the circumstances in which the shares will be disposed of;
- (b) cessation of employment; and
- (c) 7 years from acquisition.

Deferral will be available for *options* and *rights* until the earliest of:

- (a) the time when there is:
 - (i) no real risk that you will never be able to control the circumstances in which the options or rights will be disposed of; and
 - (ii) no real risk that you will never be able to exercise the options or rights;
- (b) sale of the options or rights;
- (c) cessation of employment; and
- (d) 7 years from acquisition of the options or rights.

In cases where shares, options or rights are taxed but subsequently forfeited, the tax paid will be refunded. However, refunds will not be available if the forfeiture results from a 'choice' made by the employee, seemingly including a choice not to exercise an option.

Given that only vested equity will be taxed, it seems that refunds will be rarely available in practice. If options vest while underwater and are therefore taxed at that time (albeit that the taxable value may be low), but ultimately lapse unexercised, refunds apparently will not be available because the employees involved will have 'chosen' not to exercise them. Conversely, if shares are forfeited upon termination of employment for gross misconduct, perhaps a refund will be available. (Refunds are presently only available in respect of options and rights.)

In any event a refund possibility cannot cure the inherent problem of employees selling shares as soon as tax is payable ie to fund the tax.

Aside from these changes, which are of course fundamental, the proposed new deferral plan rules (so far as they have been release to date) remain the same as at present. For example, deferral is only available in respect of ordinary shares in your employer or a holding company of your employer (or options/rights to acquire them), and only if you do not already hold more than 5% of the company.

Reporting

The Government has resisted the temptation to apply wholesale tax withholding requirements on employers. Withholding will only be required where recipients of shares do not provide tax file numbers ('TFNs'), or

ABNs in the limited cases where they are applicable ie non-employee service providers.

However, a new all encompassing reporting regime will be introduced. It will largely mirror year end PAYG reporting requirements. Employers will be required to provide the Commissioner an annual approved form statement of discounted shares, options and rights either provided to employees or vesting during the year. The statements must contain details of:

- numbers of shares, options & rights;
- amounts paid for them;
- importantly, the employer's estimate of their market values, both at acquisition and vesting or other deferred taxing point eg termination of employment if applicable; and
- employee names and TFN (or ABN) details.

Equivalent personalised statements must also be provided annually to individual employees.

The value estimates are likely to be the most problematic of these details, particularly if the requirement for them is triggered by individual employee terminations throughout the year.

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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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