Corporate Tax Essentials

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Employee Share Option Strategy no longer effective

The Tax Office's recently released Employee Share Scheme (ESS) fact sheets may have closed the door on commonly used strategies that rely on satisfying the real risk of forfeiture test to defer the taxing point of ESS interests.

Real risk of forfeiture test

Generally, an employee receiving a discount to the market value of an ESS interest is taxed on that discount in the year in which the interest is acquired.

Where there is a real risk that the benefits of the ESS interest may never be realised due to the interest being forfeited by the taxpayer, the tax may be deferred to a deferred taxing point.

Broadly, an ESS interest is considered to be at real risk of forfeiture if a reasonable person would consider there is more than a mere possibility that the employee holding the interest could forfeit or lose that interest, other than by:

- Disposing of or exercising the interest; or
- Letting the interest lapse.

Option strategy no longer effective

The Tax Office fact sheet highlights an example of a common strategy where ESS options are subject to forfeiture conditions requiring an employee to remain employed for a specific period before the rights vest.

In this situation, if the employee does not exercise the options after they vest (for reasons such as the options may be "out of the money"), the Tax Office considers the options will no longer be at a real risk of forfeiture.

This means the deferred taxing point will occur when the options vest. After the vesting date, the Tax Office believes there is no longer any risk of losing the options because the employee has the choice not to take any action.

The following example is from the Tax Office fact sheet.

Forfeiture after vesting due to choice, no real risk

Aimee works for Skydiving Ltd and is granted rights to acquire shares in Skydiving Ltd under an ESS.

Under the conditions of the scheme, Aimee must remain employed with Skydiving Ltd for two years before the rights can be exercised.

After the two-year period, the rights can be exercised for a period of four years.

However, Aimee's rights will lapse:

- *if she ceases employment before exercising the rights, or*
- *at the end of the four-year period (if the rights are not exercised).*

In this case, we consider that at the time of acquisition the rights are at a real risk of forfeiture.

However, after two years Aimee's rights will no longer be at a real risk of forfeiture.

We consider that any risk of Aimee losing her rights after the two-year period will be due to her choosing not to take action to exercise her rights.
Ref : ATO Fact sheet – Real risk of forfeiture.

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Non-resident employers, PAYG and FBT

The Tax Office has issued Draft Tax Determination TD 2010/D1.

It states non-resident employers who employ Australian resident individuals overseas (the individuals provide their services outside Australia) will not have PAYG or FBT liabilities in Australia unless they (the non-resident employer) have a sufficient connection with Australia or they have registered for PAYG.

Is there a sufficient connection with Australia?

A non-resident employer will have a sufficient connection with Australia if it:

- carries on enterprise or income producing activities in Australia; and
- has a physical business presence in Australia - may include an office, business operation, trading presence and employees in Australia.

In these circumstances, the non–resident employer is obliged to withhold PAYG from salary and wages paid to an Australian resident employee for work performed overseas.

The non-resident employer will also have an Australian FBT liability in respect of fringe benefits provided to the employee.

The Tax Office has stated that a parent company, a subsidiary company or an associated entity of the non resident employer may provide the non resident employer with the requisite physical presence in Australia if the entity in Australia:

- carries on the Australian business of the non-resident employer; or
- is an agent of the non-resident employer.

However, a non-resident employer will not have a physical presence in Australia if it:

- merely has Australian clients without any office or employees located in Australia; or
- only owns real estate or other investments in Australia.

In these circumstances, the non resident employer will not be obliged to withhold PAYG, nor will it have an Australian FBT liability.

Employee's tax consequences

The income tax implications for the Australian resident employees will differ depending on whether the non-resident employer has a physical presence in Australia.

If a non-resident employer has a physical presence in Australia, the employee will be taxed in Australia on their foreign sourced salary and wages, and the employer will withhold PAYG (which the employee can claim as a credit in their income tax return) and pay FBT on any taxable benefits provided.

Importantly, in calculating the FBT liability, the employer will be entitled to FBT concessions for benefits such as living away from home allowances, relocation expenses etc.

Where the non-resident employer does not have a physical presence in Australia, no PAYG will be withheld which means the employee will not have any credits to claim when they lodge their income tax (although the income will be assessed in Australia).

As the non-resident employer will not have paid FBT on the benefits provided to the employee, the Tax Office is of the view that the employee should include the value of all benefits received (which would otherwise have been subject to FBT) in their income tax return and pay income tax on these amounts at their prevailing marginal rate.

Of greater concern in this regard, the Tax Office has also indicated that, in calculating the value of benefits to be included in the employee's income tax return, FBT concessions and exemptions should be ignored which would otherwise reduce the taxable value of fringe benefits.

This means, for instance, that an employee of a non-resident employer who is subject to FBT could receive a living away from home allowance free of income tax and FBT (as the living away from home allowance is generally exempt from FBT).

However, the employee of the non–resident employer who is not subject to FBT would be personally subject to Australian income tax on that same living away from home allowance.

This is an important issue, as poor structuring may result in expatriate Australian employees being significantly out of pocket on overseas assignments.

Ref: Tax determination TD 2010/D1

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Franked dividends payable from loss companies

Dividend traps released

Changes to the Corporations Act could provide companies that have accumulated losses with the opportunity to pay a dividend in excess of any accounting profits that the company may generate.

Prior to these amendments (which apply from 28 June 2010), it was difficult for loss companies to make a distribution to free up franking credits that may have been trapped in the company.

New requirements for paying dividends

The new rules remove the restriction that permitted companies to only pay dividends where they had profits. The amendments introduce a new solvency test which will allow a company to pay dividends if:

- the company's assets exceed its liabilities immediately before the dividend is declared, and the excess is sufficient for payment of a dividend;
- it is fair and reasonable to shareholders; and
- it does not materially prejudice the company's ability to pay its creditors.

A director's duty against insolvent trading still applies.

Income tax changes

A corresponding change allows dividends paid out of amounts other than profits to be treated as dividends paid out of profits for tax purposes. However, this does not address a number of issues from an income tax perspective.

Warning on paying dividends

Are distributions from share capital a dividend?

The definition of "dividend" contained in Section 6(1) of the 1936 Act has not been amended. This means that distributions from share capital accounts (which may occur under the amendments to the Corporations Act) may not be dividends for income tax purposes.

There is an exception where amounts are credited to a share capital account under an arrangement, and the company subsequently makes a distribution from its share capital of that amount. However, this may only occur in rare circumstances.

Are all distributions frankable?

Another issue is whether dividends paid out of amounts other than profits will be frankable. The Explanatory Memorandum to the Corporations Act amendments indicates these distributions will be frankable, subject to the imputation integrity rules. However, a distribution may not be frankable if it is not considered a dividend under section 6(1) or section 960-120 of the 1997 Act.

Furthermore, companies should be aware that a distribution sourced from its share capital account may not be frankable (section 202-45(e) of the 1997 Act).

Ref: Corporations Amendment (Corporate Reporting Reform) Act 2010

Should you require assistance additional information, **contact your PKF tax adviser** or:

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