

July 2010

Employee Share Schemes – Tax Office Fact Sheets

Recently, the Tax Office issued a number of fact sheets to clarify technical and practical Employee Share Scheme (ESS) issues. Most importantly, the ESS rules, which apply from 1 July 2009, impose annual reporting (and certain withholding) obligations on employers. Specifically, employers must give employees an ESS statement by **14 July 2010** detailing information about each employee's ESS interests.

Employer reporting requirements

Employers must provide ESS statements to employees and the Tax Office. For 30 June 2010, the employee statements are required by 14 July 2010 and the Tax Office statements are required by 14 August 2010.

ESS statement to employees

A statement must be provided to employees where:

- ▶ they (or their associates) have acquired an ESS interest under a taxed-upfront ESS at a discount during the financial year
- ▶ a deferred taxing point for an ESS interest acquired under a tax-deferred ESS (or a cessation time for interests acquired before 1 July 2009) has arisen or could have arisen in the financial year.

Employers must report to affected employees the:

- ▶ discount for an ESS acquired under a taxed-upfront scheme (split into amounts eligible for the \$1,000 tax exemption and amounts not eligible for the tax exemption)
- ▶ discount for an ESS acquired under a tax-deferred scheme for a taxing point arising during the year
- ▶ discount for shares and rights acquired before 1 July 2009 if the cessation time occurred during the year
- ▶ total Tax File Number (TFN) withheld from discounts.

The Tax Office suggests this pro-forma statement be used for the 14 July 2010 reports. Approved forms have not yet been finalised.

Employee tax file number/ABN

Taxed up front scheme – eligible for reduction

Discount from taxed up front schemes – eligible for reduction

D \$

Taxed up front scheme – not eligible for reduction

Discount from taxed up front schemes – not eligible for reduction

E \$

Deferral schemes

Discount from deferral schemes

F \$

Discount on ESS interests acquired pre 1 July 2009 and 'cessation time' occurred during the financial year

G \$

TFN amounts withheld from discounts (total includes cents)

C \$

Statements to the Tax Office

The Tax Office statement must be provided on the approved form. It must provide information for each employee and for each ESS the employee participated in. The general information required includes:

- ▶ The plan identifier (details of each plan)
- ▶ Plan date (date taxing point occurs under)
- ▶ TFN amounts withheld from discounts.

Where the ESS is a taxed-upfront scheme, the following information must also be provided:

- ▶ The number of ESS interests acquired which are eligible for reduction in the financial year (the \$1,000 tax exemption)
- ▶ The discount for ESS interests acquired which are eligible for reduction
- ▶ The number of ESS interests acquired during the financial year not eligible for reduction
- ▶ The discount for ESS interests acquired not eligible for reduction.

Where the ESS is a tax-deferred scheme, the following information must also be provided:

- ▶ The number of ESS interests for which a deferred taxing point arose during the financial year
- ▶ The discount on the ESS interests acquired during the financial year
- ▶ The discount on the ESS interests acquired before 1 July 2009 for which a cessation time occurred during the financial year (irrespective of whether the employee has made an election).

Acquiring interests through share trusts

If shares are provided through a trust, and the employee has an interest in a specific number of shares in the trust, the employee is treated as holding a beneficial interest in those shares. In these circumstances, an ESS statement must be given to all employees who acquired shares through the trust and include the information in the Tax Office statement.

Transitional arrangements

As noted above, the reporting requirements also apply to interests acquired under the old ESS rules which applied prior to 1 July 2009. Employers must report on interests acquired before 1 July 2009 where there had been no cessation time before 1 July 2009, and the first cessation time occurred during the financial year.

Reporting amendments

Employers will be required to amend both employee and Tax Office statements for any material changes or omissions within a period of 30 days. This will include circumstances where the taxing point of shares moves due to the operation of the 30 day rule and where indeterminate rights become rights to acquire shares.

Reduced reporting for 2009/10

For 30 June 2010 only, employers may give employees a reduced ESS statement by **14 July 2010** in the following circumstances:

1. Shares or rights were acquired before 1 July 2009 with a deferred taxing point in 2009/10 and the employee qualified for the \$1,000 exemption and the discount was less than or equal to \$1,000
2. Shares or rights were acquired after 30 June 2009 under a tax-deferred scheme with no taxing point in 2009/10
3. Shares or rights were acquired after 30 June 2009 in a taxed-upfront scheme where the employee is eligible for the \$1,000 tax exemption, the discount is less than \$1,000, there is no tax withholding amount and the employee earned \$150,000 or less.

In the first two sets of circumstances employers do not need to report to the Tax Office.

For reference, a reduced ESS statement for the first scenario is reproduced below.

During 2009-10, you had a potential 'deferred taxing point' for shares or rights that you acquired under an employee share scheme before 1 July 2009.

The Australian Taxation Office advises us that you do not need to report this information on your 2010 tax return.

For more information on the taxation treatment of employee share schemes, see page 22 in TaxPack 2010.

In the third scenario, employers may provide employees with a reduced ESS statement (set out in the fact sheet) in place of the full statement. In this case, employers must still provide an ESS annual report with details of shares and discount amounts to the Tax Office.

Real risk of forfeiture explained

In addition to the reporting fact sheets, the Tax Office has also issued technical fact sheets to explain some of the more technical issues revolving around the new ESS rules. The first of these concerns an explanation of the real risk of forfeiture.

Generally, any discount an employee receives to the market value of an ESS interest is included in their assessable income in the year of acquisition.

However, where there is a real risk the benefits of an ESS interest may never be realised because it may be forfeited, the tax will be deferred until a deferred taxing point occurs. The real risk of forfeiture test (along with other conditions being met) is used to determine the deferred taxing point.

Real risk of forfeiture test

The Tax Office states a real risk of forfeiture must be determined on the facts and circumstances of each scheme and each employee.

A real risk of forfeiture of the interests occurs where a reasonable person would consider there was a real risk of forfeiture. *Real* is considered to represent something more than a mere possibility. Where a reasonable person would disregard the risk as highly unlikely or it is only a rare eventuality, the ESS interest would not be at real risk of forfeiture.

No real risk of forfeiture

There will be no real risk of forfeiture where an ESS includes conditions which:

- ▶ Restrict an employee from disposing of an ESS interest for a specified time
- ▶ Allow an employee to request the ESS interest be forfeited
- ▶ Provide for an employee to forfeit an ESS interest if they are dismissed for fraud or gross misconduct.

There is also no real risk of forfeiture where conditions are contrived such as a short minimum employment term is combined with a long disposal restriction period, or circumstances where the scheme operator has an overriding discretion to, and they routinely exercise that discretion, vest ESS interests where performance hurdles are not met.

Performance hurdles

Where ESS interests are subject to forfeiture if a company fails achieve specific performance targets, the Tax Office states it will determine the likelihood of the company meeting its targets in each case.

Where there are performance targets which are not genuine hurdles, the Tax Office says these will not create a real risk of forfeiture. They give the example of a company which requires an increase in sales over the previous year, where the company had experienced a 10% increase in annual sales each year for the past five years as evidence of no real risk of forfeiture.

Employment conditions

The Tax Office accepts a real risk of forfeiture where:

- ▶ An employee's minimum term of employment is six months and there is a maximum deferral of up to three years
- ▶ An employee's minimum term of employment is 12 months (there is no stated maximum deferral period, so presumably the maximum deferral period is seven years).

The Tax Office states an interest will be at real risk of forfeiture where the scheme contains good leaver conditions. These allow employees who fail to complete their minimum term of employment (due to invalidity, bona fide redundancy or death) to retain their ESS interests if they cease employment during the forfeiture period.

However, there will not be a real risk of forfeiture if employees are routinely allowed to retain their ESS interests regardless of the reason for ceasing employment.

Employment conditions and retirement

The Tax Office has confirmed it will accept good leaver conditions that allow employees to retain ESS interests if they retire permanently from the workforce during the forfeiture period. However, if the employee indicates their intention to retire during the forfeiture period, the ESS interest will not be at a real risk of forfeiture.

Genuine disposal restrictions

Under the new ESS rules, tax deferral can be extended by genuine disposal restrictions. A genuine disposal restriction can be a condition which prohibits the disposal of a share for a fixed period of time where:

- ▶ The disposal restriction is enforced by a holding lock or by the shares being held in a trust
- ▶ The disposal would be in breach of the insider trading rules in the Corporations Law 2001
- ▶ There are serious and enforced consequences for breaching the condition.

To be a genuine disposal restriction, the disposal restriction should be in the conditions of the ESS when the employee acquires the interest.

Where the company has an internal share trading policy prohibiting the disposal of ESS interests, this may be a genuine disposal restriction. However, this will only be the case where there are serious and enforced consequences for breaching the policy.

Where disposal restrictions can be lifted in special circumstances or in the case of financial hardship, this may continue to be a genuine disposal restriction.

Where an employee is required to make a request for approval to the board of directors to dispose of ESS interests, this may be a genuine disposal restriction only where requests are not routinely approved.

Options

In the fact sheet, the Tax Office states that an ESS condition with exercisable options will automatically be forfeited if an employee ceases employment with the company prior to the expiry date, does not constitute a real risk of forfeiture.

In these circumstances it appears the Tax Office considers any risk of the employee losing his/her options will be due to the employee choosing not to exercise the options and not because of a real risk of forfeiture outside of the employee's control.

The basis for this position is not clear. However, it is difficult to reconcile this position with legislation. It may be that further review and consideration of this issue will be required.

Market value of listed shares

The fact sheet sets out acceptable valuation methods for determining the market value of listed shares under the new Division 83A.

Under the new rules, taxpayers will no longer be restricted to using just the weighted average actual price method. Instead they will be able to choose a valuation method that fits their circumstances and more cost effective.

The Tax Office accepts continued use of the weighted average actual price method but also sets out alternative methods and the circumstances in which they may be used.

In particular, the Tax Office considers the following methods:

- ▶ Average cost of shares
- ▶ Weighted average closing price
- ▶ Closing price
- ▶ Retail offer price.

You should refer to the fact sheet to consider whether any of these methods may be appropriate in your company's particular circumstances.

Should you require assistance or additional information, please contact your PKF Tax Adviser

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