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## New Employee Share Scheme Bill Introduced

In our August 2009 *Tax Flash*, we highlighted proposed changes to the employee share scheme (ESS) rules contained in the Government's exposure draft legislation. The Government has now introduced legislation reforming the ESS rules. The Bill contains a number of important changes from the exposure draft and the accompanying Explanatory Memorandum provides further guidance and clarification on new concepts, including "real risk of forfeiture" and the transitional rules.

Under the ESS tax reforms, the critical factor in determining the tax treatment of ESS interests is the structure and characteristics of the scheme. This will determine whether employees (including independent contractors and directors) will be taxed upfront or whether tax can be deferred.

Under the new rules, tax deferral will only be accessible where there is a real risk the shares or rights may be forfeited or lost. Consequently, before employers can provide shares or rights under the new ESS rules, they will need to carefully plan the structure of the scheme to ensure desired tax outcomes are achieved. If these changes become law, the new ESS rules will not only apply to shares and rights acquired **on or after 1 July 2009**, but also to certain shares or rights acquired under a scheme before this time, with some transitional relief.

Key aspects of the new ESS tax regime introduced by the Bill include:

### Upfront tax and \$1,000 exemption

Generally, any discount that an employee receives to the market value of shares or rights provided under an ESS is included in the employee's assessable income in the year of acquisition.

A \$1,000 tax exemption is available to taxpayers participating in an ESS who:

- pay tax upfront;
- have taxable income (after adjustments) of \$180,000 or less. Taxable income will be adjusted by adding an employee's reportable fringe benefits, super contributions and total net investment loss for the year; and
- the employee and the scheme meet certain conditions.

The \$1,000 tax exemption provides that employees do not include a discount on ESS interests (i.e. ESS shares or rights) in their assessable income if the value of the combined discounts is \$1,000 or less. If the discounts are greater than \$1,000, they will be assessed on the excess over \$1,000.

The other conditions for the upfront concession are:

- ▶ at the acquisition time the employee must be employed by the company offering the ESS, or a subsidiary;
- ▶ the scheme must be offered to at least 75 per cent of permanent employees who are Australian tax residents with three or more years service (whether continuous or not);
- ▶ the shares or rights provided must not be at real risk of forfeiture (explained below);
- ▶ the ESS interests must relate to ordinary shares;
- ▶ the shares or rights must be required to be held by the employee for at least three years, or until the employee ceases employment, whichever is earlier; and
- ▶ the employee must not receive more than five per cent ownership of the company or control more than five per cent of the voting rights in the company as a result of participating in the scheme.

### Structuring an ESS to defer tax

Under the new rules, the capacity to defer tax depends solely on the structure and characteristics of the scheme and not on any choice made by a participating employee. Therefore, if employers wish to offer their employees deferred taxation on ESS interests, their schemes will need to satisfy the conditions outlined below.

For the deferred tax rules to apply, the following conditions need to be satisfied. The ESS interest:

- ▶ must be subject to a “real risk of forfeiture”;
- ▶ must be acquired at a discount under an ESS;
- ▶ must relate to ordinary shares;
- ▶ must be offered to at least 75 per cent of permanent employees who are Australian tax residents with three or more years service, whether continuously or non-continuously. (This condition does not apply to rights to acquire shares); and
- ▶ must not result in the employee having more than five per cent ownership of the company, or control more than five per cent of the voting rights in the company, as a result of participating in the scheme.

In practice this means all ESS plans need to be reviewed. In many cases ESS plans may need to be rewritten to ensure they obtain the tax outcomes employers and employees want to achieve.

Tax deferral may also be available for shares received at a discount through a salary sacrifice arrangement linked to an ESS, whether a real risk of forfeiture exists or not. However, the total market value of shares acquired is limited to \$5,000 per employee, per employment relationship, per year. (Employees with multiple employment relationships within the one corporate group, can only access the \$5,000 cap once per year).

## Real risk of forfeiture

An ESS interest is at **real risk of forfeiture** if there is a real risk the employee could forfeit, lose, or never receive the interest (or a share acquired on exercise of an ESS right), other than by:

- selling or exercising it;
- intentionally taking no action to realise the ESS interest; or
- the market value of the ESS interest falling to nil.

Examples of a real risk of forfeiture of ESS interests include where an employee will only receive shares if the company, or the employee, meet certain stipulated operational or financial targets, or if the employee remains employed with the company for a specified period.

There is no real risk of forfeiture if the risk is contrived (for example, if there are conditions restricting employees from disposing of ESS shares for an extended period and the scheme features a very short employment condition), or if the employee controls the risk.

## New deferred taxing point

Under the new rules, the deferred taxing point is the earliest of:

- ▶ when there is no longer a risk of forfeiture of the ESS interests and any restrictions on the sale or exercise of the ESS interests (and in the case of an ESS right, the underlying share) are lifted;
- ▶ when the employee ceases employment; or
- ▶ seven years after the shares or rights were acquired

The new rules effectively bring forward the taxing point from when the employee sells or exercises their ESS interest (as per the current rules), to the time when the employee can first take action to realise the ESS benefit (whether they choose to or not).

## Transitional rules

Under the new transitional rules, shares or rights acquired before 1 July 2009 will be brought within the new ESS regime, but current deferred taxing rules will be preserved.

However, a new ‘30 day’ rule will apply to the old taxing point for transitional shares or rights. This means the deferred taxing point will be moved to the time the employee disposes of the shares or rights (or in the case of ESS rights, the underlying shares), if the disposal occurs within 30 days after the original deferred taxing point.

The new rules for calculating the amount to include in assessable income (broadly, the discount represents the market value of the ESS interest less its ‘cost base’) will apply to those shares or rights acquired pre 1 July 2009 which have been brought within the new rules.

There is also a tiebreaker rule. This rule provides that if the time of acquisition differs between the new and the current law, the time of acquisition under the current law will be used.

## Electing to be taxed upfront still available

In certain circumstances employees can still elect to be taxed up front in relation to ESS interests with potential to be brought under the new rules. Treasury has confirmed an employee holding qualifying shares or rights at 30 June 2009 (where the cessation time did not occur before 1 July 2009) will still be able to elect to be taxed up front (i.e. in the 2009 income year) by disclosing the discount as assessable income in their 2009 tax return, when lodged.

## Interests provided to associates or acquired via an Employee Share Trust (EST)

Under the current rules, an employee is taxed upfront on ESS interests provided to associates. Under the new rules, in these circumstances and subject to the ESS meeting the deferral conditions, a deferral of the taxing point will still apply.

The new rules treat an employee who acquires an ESS interest through an EST to be absolutely entitled to the share or right from the date of acquisition. The inclusion of this rule has certain (CGT) implications and in the event the recipient employee is subsequently entitled to a refund under the ESS rules, the employee may not actually have legal title for general tax purposes, resulting in the possible need for amendments to prior income tax assessments for the employee and/or the EST.

## Indeterminate rights

An interesting development with the introduction of the Bill is the potential for the taxing point of ESS interests to be brought forward in situations where an employee eventually receives ESS interests after initially only receiving an 'indeterminate right' to future interests. Broadly, this represents a right:

- to an indeterminate number of ESS interests; or
- that may ultimately be realised (usually, subject to the employee meeting certain performance hurdles) in shares, cash (or both), or some other form.

Once it becomes clear the right will be satisfied by the receipt of a definite number of ESS interests, the right will be taxed under the ESS rules as though it were always clearly an ESS interest.

## Tax refunds for forfeited ESS interests

Under the new rules an employee will only be eligible for a refund of tax where:

- ▶ the employee had no choice but to forfeit or lose the ESS interest (except when the choice was to cease employment); and
- ▶ the conditions of the scheme were not constructed to protect the employee from downside market risk.

Therefore, in a situation where an employee decides not to exercise an ESS right and let it lapse because it is out of the money, no refund entitlement exists.

## Integrity measures – reporting and withholding

The main integrity measure introduced by the Bill is the possible requirement for **providers** of ESS interests to report annually to both the ATO and employees, disclosing certain information about the recipient employees and their ESS interests.

The reporting obligations apply in respect of:

- ▶ ESS interests provided after 30 June 2009 and taxed upfront;
- ▶ ESS interests (whether provided after 30 June 2009 or not) on which tax is deferred and the relevant ESS deferred taxing point occurs after 30 June 2009; or
- ▶ indeterminate rights, when it becomes clear after 30 June 2009 that a right provided to an employee in a previous income year is a right to a definite number of ESS interests.

The new rules also impose a withholding tax obligation on employers in situations where an employee (or independent contractor) fails to provide the employer with their tax file number or Australian Business Number. However, employers do not have to withhold tax for shares or rights that have been transitioned under the new ESS rules.

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

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