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AUSTRALIAN TAX UPDATE

CHANGES TO THE EMPLOYEE SHARE SCHEME TAX REGIME

The Government has released exposure draft legislation in relation to measures designed to soften the tax treatment of employee shares schemes (**"ESS"**). The proposed changes were announced by the Government in October 2014 and the exposure draft legislation is largely in line with the previous announcement.

The proposed amendments include:

- for options (or similar rights) employees are only taxed on any discount under an ESS once the option has been exercised (provided the option itself can't be traded). Previously tax could arise once there was no real risk of forfeiture, even if the option remained unexercised;
- tax deferral can now apply to an ESS for rights where there is no real risk of forfeiture (where certain other requirements are satisfied). Previously a real risk of forfeiture was mandatory;
- for all ESS interests the latest taxing point is extended from seven years to 15;
- start-ups are able to issue ESS interests in certain circumstances without any discount being included in the employees assessable income; and
- significant changes to the valuation tables in the regulations used to value rights in unlisted entities.

Although the proposed amendments are a welcome development, in practice the main sector that will benefit and potentially change their current ESS practices are companies that qualify for the start-up concessions. In most other sectors, the changes may provide further alternatives which can be considered in designing an ESS, but are unlikely to provide a reason to immediately change the current ESS practices.

BACKGROUND

One issue with the current tax rules is that to defer tax on an ESS discount, the offer to an employee needed to include a "real risk of forfeiture". This means that in order not to give an employee an "up-front" tax bill, their equity interests needed to be "at risk" of being forfeited, if certain circumstances arose. The most common condition of forfeiture is where the employee leaves employment pre-vesting and this would mean that they forfeited their interests. As a result, this can make it very hard for employers to incentivise employees where the employee would have the choice between paying tax up-front, or deferring tax, but attributing nominal or nil value to their employee share scheme equity, due to the risk of forfeiture.

Specifically, where an employee remains in their employment, the current deferred taxing point for options is the earliest of:

- disposal restrictions on the options are lifted (ie it can be sold) and there is no real risk of forfeiture;
- cessation of employment;
- seven years; or
- when all of the following things occur:
  - the real risk of forfeiture ceases or is released; and
  - the employee can exercise the option; and
  - if the employee exercises the options and receive the share, there is no risk of forfeiture in relation to the share; and
  - restrictions from selling or transferring the share are lifted.

As a result, there are situations where an employee can be taxed when an option vests, even if the option was "out of the money", and even in circumstances where the option may not be exercised and the employee may never realise any value in the future. The process by which options are valued can create the situation where out of the money options will have a positive market value, generally due to the period that the option can be exercised. This created an unusually unfair outcome as the employee would be faced with a tax bill in relation to an out of the money option (which they would not exercise in any case).

OPTIONS

Since 2009, ESS plans have generally avoided the issuing of options where this unfair scenario could occur due to the risk that employees may be taxed on any discount (as determined by the tax valuation regulations) despite not having exercised the option. This obviously created a mismatch between the time that tax may be payable and the actual realisation of any gain by the employee to fund that tax liability.

The proposed amendments will reverse some of the 2009 changes and restores the position that the discount will be taxed once the options have been exercised and there and no disposal restrictions on the resulting share. This position is broadly consistent with the treatment of ESSs in other countries.

We note that the current amendments do not seek to fully reverse the 2009 changes, for example, pre-2009 if an option was capable of being sold, the deferred taxing point did not arise until the time it was actually sold, whereas under the proposed amendments the deferred taxing point would still arise at the time the option is able to be sold and there is no real risk of forfeiture.

Since 2009, many corporate groups have adopted limited recourse loan style plans to provide employees with funds to purchase shares at market value. These plans generally fall outside the ESS rules as there is no discount provided to the employee.

Although the amendments will make the issuing of options more attractive, a limited recourse loan style plan may still be the most attractive option for many ESSs (see comments below regarding those companies eligible for the start-up concessions).

START-UPS

The main benefactor of the proposed amendments are companies that qualify for the "start-up" concessions. We note that the term start-up is not defined and the rules are not limited to a particular type of business. Where the conditions are met, the discount on an ESS interest issued by these companies is not included in an employee's assessable income. The intention being that start-ups are able to offer employees more attractive remuneration policies to attract more and better talent.

The main qualification requirements are:

- the company must not be listed;
- the company and all group companies must be less than 10 years old;
- the aggregated turnover of the group must not exceed AU$50 million (aggregated turnover includes connected entities which may include and foreign entities connected to the group);
- the discount on the ESS interest must:
  - in the case of a share - be less than 15 percent of the market value;
  - in the case of a right or option - have an exercise price that is greater than or equal to the current market value of an ordinary share (ie issued at market value or out of the money);
- the scheme is available to at least 75 percent of the permanent employees with at least three years' service; and
- the employee must not hold more than 10 percent of the shares in the company (including the shares that could be acquired by exercising options/rights held by that employee).

The ESS interests in a start-up will be subject to the capital gains tax regime. However, the application of the capital gains tax provisions to these interest present some complexity:

- the discount component in relation to shares will not be taxed under the capital gains tax provisions due to the operation of the market value substitution rule at the time of acquisition;
- the market value substitution rules are turned off in relation to the acquisition of an ESS interest in a start-up that is a right, therefore the cost base of the shares ultimately acquired will not include the market value at the time the right is issued and the discount will be "'clawed back" under the capital gains tax provisions. Where an interest is held for more than 12 months, there is the obvious benefit that any claw back may be eligible for the 50 percent CGT discount;
- many start-ups restrict the exercise of rights until a liquidity event occurs (eg a sale or IPO), which will impact upon the availability of the CGT discount for holders of rights and may ultimately result in the full discount still being subject to tax.

The restriction in terms of ownership and discount value are also not helpful. Often start-ups seek to supplement salary by offering executives an ESS Interest as a way to attract and retain talented individuals. These parts of the rules restricts the amount of salary that can be supplemented. In addition, the limitation on the discount will require companies to value the shares of the company to ensure the discount limit is not exceeded (which may increase compliance costs).

For example, if an executive forgoes AU$100,000 in salary for ESS interests, given the 10 percent ownership limit and discount limit, the company must be valued at AU$6.67 million to be able to provide the forgone salary as discounted shares. In addition, the executive would only be able to participate for the first year, then the 10 percent ownership limit will prevent any further ESS interests being concessionally taxed under the start-up rules. Given the AU$50 million turnover threshold, the application of this concession may be severely limited.

Further the requirement that the scheme be broadly available (ie available to 75 percent of permanent employees) will limit a start-ups ability to fully utilise the scheme as described above.

Where the conditions are met, the discount is not included in the employees assessable income. This may be attractive to companies that qualify for the concession and companies that currently meet the conditions may wish to revisit their ESS. In particular if they currently operate a limited recourse loan plan it would appear that the proposed amendments may make an option plan more attractive to employees.

NEW FORM OF PLAN - NO REAL RISK OF FORFEITURE

The amendments also introduce an alternative test to the real risk of forfeiture test that can be met by schemes that provide ESS interest that are right which are restricted from being immediately disposed of by the employee.

In addition the scheme documents are required to state that the plan is subject to subdivision 83A-C.

These amendments may allow companies to introduce new plans such as salary sacrifice plans whereby the employee does not risk forfeiting the shares.

CHANGES TO REFUNDS

Under the current rules, a taxpayer is unable to obtain a refund for tax paid on an ESS interest discount where the ESS interest is forfeited or lost as a result of a choice made by the taxpayer (eg to not exercise the option). As a result, an employee may pay tax on a "gain" that they never actually derive.

The proposed amendments specifically provide that a choice to let a right lapse will result in the ESS rules never having been taken to apply to the ESS interest and therefore any tax paid on the ESS interest will be able to be refunded to the taxpayer.

Given the changes to the deferred taxation point for rights, this situation is less likely to arise in the future and therefore the changes to refunds may have limited application.

VALUATION TABLES

The amendments also include updated valuation table to be included in the regulations that are used to value rights in unlisted entities. These amendments will result in the value of most rights being lower than under the current regulations. As a result, the amount required to be paid by employees, or alternatively the discount included in their assessable income, will be less under the proposed amendments.

TRANSITIONAL RULES

It is proposed that the amendment will apply to ESS interest acquired on or after 1 July 2015. As a result of the 2009 changes, it is now possible that ESS interest currently held by employees can be subject to 3 different sets of rules (ie pre-2009, post-2009 and proposed amendments). Therefore, although the changes are favourable, an additional regime will result in additional compliance costs for companies.

OUTSTANDING ISSUES

It was hoped that the Government may also look to address other outstanding issues, however, these have not been addresses in the exposure draft, including:

- the cessation of employment as an earlier taxing point appears set to remain, keeping Australia out of step with most of the developed world. Where an employee ceases employment but continues to hold their options (perhaps because they are a "good leaver"), then they are required to pay tax while not having yet (and maybe never) realised any value. When participating in an employee share scheme, the Government requires an employee to provide their Tax File Number, or where this does not occur, for their employer to withhold tax. It is not clear why these measures do not properly address any concerns the Government may have in former employees paying their tax in the same way as current employees; and
- for those companies who do not meet the start-up company definition, employees may not be able to readily transfer or sell their shares. This could be the case where private companies restrict the ability of employees to transfer shares outside of a quarantined group of 'related' people and entities, and even for listed companies whose shares are thinly traded. For employees of those companies, they can still be left in the position where they are required to pay tax in circumstances where they may not be able to easily realise any benefit.

Submissions on the exposure draft are due by 6 February 2015. If you have any comments or queries in relation to the new rules, please contact the writers.

MORE INFORMATION

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