Remuneration Review
Interim Update

New Employee Share Scheme Taxing Provisions

(See Remuneration Review No 17 at www.godfreyremuneration.com which will follow the Government's consideration of the submissions concerning the draft legislation)

June 2009

INTRODUCTION

On 5 June 2009 the Federal Government backtracked on its 2009 Budget announcement to completely remove all tax deferral in relation to Employee Share Schemes (ESSs). At that time it also released draft amendments to the ESS taxing provisions. It indicated that it would receive submissions from interested parties up to 12 June 2009. It is understood that approximately 60 submissions, including one from GRG, were received. It is expected that the government will complete its consideration of the submissions by 26 June 2009.

An important point to note in relation to the announcement on 5 June 2009 was that the old ESS taxing provisions would continue to apply to acquisitions prior to 1 July 2009 and therefore the new ESS taxing provisions will apply to acquisitions after 30 June 2009.

At the date of writing this update the Government has not announced if and to what extent the draft ESS taxing provision amendments will be varied.

MAIN CHANGES

Tax Elections Removed

Under the old ESS taxing provisions, recipients of ESS benefits (discounts on shares and rights) could elect to be taxed in the year that shares or rights are acquired, or could defer the taxing point. Such elections will not be available in relation to acquisitions after 30 June 2009.

Whether an ESS benefit is taxed in the year of acquisition or is deferred will depend upon the terms of the grant. A consequence is that it will be possible for tax deferral to apply to one grant and for tax exemption to apply to another grant in the same tax year. This was not possible under the old ESS taxing provisions.

Share Price Risk Between the Time of Taxing and the Time of Selling Shares

Under the old taxing provisions the longer and simple deferral availability ensured that, in practice, the sale of the shares triggered both cessation of the forfeiture risk and the taxing point. However, the new taxing provisions may mean that the taxing point will be triggered first and then executives will need to sell shares to cover their tax liability.

This will be problematic for executives who are unable to sell shares due to company share trading policies and insider trading restrictions. The delay in sale of the shares will expose executives to risk of paying tax on an ESS benefit value that is higher than the value they can realise by selling the shares.

The foregoing has been coupled with a new prohibition on when benefits previously taxed on shares or rights that are subsequently forfeited may not be excluded from assessable income. The prohibition applies when the forfeiture arises from either:

- choice by the executive, or
- conditions of the ESS that have the effect of protecting employees from share price falls.

Thus, when either of these situations apply, the executive will be taxed on the benefit and may not receive a refund of the tax even though he/she receives no benefit from the ESS due to forfeiture of the shares or rights.

GRG Remuneration Reviews are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

GRG Godfrey Remuneration Group Pty Ltd
ABN: 38 096 171 247
56 Berry Street
North Sydney NSW 2060
Phone (02) 8923 5700
Facsimile (02) 8923 5706

www.godfreyremuneration.com

"Real Risk" Condition for Tax Deferral

The main test for tax deferral will be whether there is a "real risk" of forfeiture. If there is no "real risk" of forfeiture then tax deferral will not apply and the ESS benefit will be taxed in the year the shares or rights are acquired.

If there is a "real risk" of forfeiture and other requirements are fulfilled then the taxing point is deferred until the earlier of:

- For shares and rights:
  - Elapse of 7 years (previously 10 years) from the date of acquisition, or
  - Termination of employment, or
- For shares until the "real risk" of forfeiture ceases,
- For rights until the "real risk" of forfeiture of the rights ceases and the person can exercise the rights.

The standard forfeiture provision in most ESSs is that forfeiture will apply of the employee commits fraud, defalcation or gross misconduct in relation to the company.

If this standard provision is accepted by the Australian Taxation Office (ATO) as a "real risk" then tax deferral in relation to shares will be much the same as it was previously except that the maximum period will be reduced from 10 to 7 years. However, in relation to rights it will mean that tax deferral after the rights have been exercised will not be available. This will either significantly reduce the deferral period or deny executives access to dividends declared between the vesting date and the earlier of: sale of the shares or termination of employment or elapse of the 7 year maximum deferral period.

If the standard provision is not accepted by the ATO as a "real risk" of forfeiture, then tax will only be deferred until the end of the vesting period, which is typically 3 years after the grant. This will apply equally to shares and rights.

The following table assumes that the draft amendments to the ESS taxing provisions and the Corporations Act termination benefit provisions will be passed in much the same form as they are currently drafted. The progress of these proposed amendments needs careful monitoring.

Category of ESS	**Standard Forfeiture Provision**	
	Not Seen as "Real Risk"	**Seen as "Real Risk"**
Non-executive Director Fee Sacrifice Share Acquisition Plan	Not viable	Continues to be viable
Salary Sacrifice Share Plans	Not viable	Continues to be viable
Short Term Incentive Deferred Share Plan	Not viable	Continues to be viable
Executive Long Term Incentive Share Plan	Probably needs to be replaced	Probably needs to be replaced but could be continued
Executive Long Term Incentive Rights Plan	Probably needs to be replaced	Probably needs to be replaced but could be continued
General Employee Tax Exempt Share Plan	Possibly viable. Depends upon taxable incomes of the majority of potential participants. Adjusted taxable income must be less than $150,000 to qualify for tax exemption.	

ooooo00000ooooo