GRG Remuneration Review

New Employee Share Scheme Taxing Provisions

Remuneration Review No 20

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INTRODUCTION

Legislation Introduced to Parliament

On 21 October 2009 the new employee share scheme taxing provisions were introduced into Federal Parliament. Given the extended period over which the legislation has been developed it is hoped that there will be no further changes before it is enacted. This article outlines the new ESS taxing provisions and provides some preliminary comments on the future viability of various types of executive and director equity participation plans.

NEW ESS TAXING PROVISIONS

Employee Share Scheme (ESS)

The new Employee Share Scheme taxing (ESS) provisions relate to plans that constitute "employee share schemes". These are defined as plans under which employees (including past or prospective employees) or their associates are provided with beneficial interests in shares or rights to shares in the company or its parent company in relation to the employee's employment. The same provisions also apply to stapled securities provided that the stapled security includes a share in a company.

It should be noted that the definition does not require the shares or rights to be provided at a discount to their market value. However, taxable benefits will only arise when there are discounts.

Options Are Rights

It should also be noted that there is no reference to options. This is because the term "rights" covers options with exercise prices and those with zero exercise prices (often referred to as ZEPOs or performance rights or share rights).

Discount is Assessable Income of Employee

The discount is calculated at the taxing point which may be in the year of acquisition at a deferred taxing point.

The discount is calculated as the excess of the market value of the share or right over the cost base of the share or right.

100% of the discount is taxed at the employee's marginal rate of income tax except for any tax exempt amount of up to $1,000, if certain conditions are satisfied.

The employee is taxable on the ESS benefit received even if the shares or rights are acquired by an associate of the employee.

Capital gains tax (CGT) may apply to any profit or loss realised on sale of the shares or rights calculated using the market value of the shares or rights at the taxing point as the cost base. The time of acquisition for CGT purposes is deemed to be the ESS taxing point, thus the 12 month holding period required to qualify for the 50% CGT discount commences at the deemed acquisition time. Also note that if a right is exercised after the ESS taxing point then the starting point for determining the 12 month holding period for CGT purposes will be set back to the date of exercise.

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.

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Deductibility of Employer Cost of Providing ESS Benefits

A tax deduction is available to employers to the extent of the tax exempt benefit provided to employees ignoring the income test. This means that when up to $1,000 of tax exempt benefit is provided, the employer will be able to claim a tax deduction for the up to $1,000 amount. Whether individual employees will qualify for the tax exemption when their adjusted taxable incomes are taken into account is ignored.

To obtain tax deductions, employers tend to provide ESS benefits via Employee Share Trusts (ESTs). When shares need to be acquired the employer contributes its part of the cost of the shares (full amount in the case of shares and excess of share price over the exercise price in the case of rights/options) to the EST trustee. The amount contributed by the employer will qualify as a tax deduction when the employees acquire beneficial interests in the shares.

The trustee can then acquire the shares via on-market purchase (cash outflow) or subscription to a new issue (cash flow neutral).

Indeterminate Rights

If an employee acquires a right and it later becomes a right to a share then it will be treated as if it had always been a right to a share. This would apply in the following circumstances:

- when the employer must, in its discretion, provide either discounted shares and/or rights or cash and it chooses shares or rights,
- when the right applies to a value of shares rather than a number of shares or to an indeterminate number of shares.

If the taxing point occurs earlier than when the benefit is determined to be an ESS benefit, the relevant employee's earlier tax return is amended to include the benefit and it may attract the shortfall interest charge.

Refund May Be Claimed if ESS Benefit Lost in Certain Circumstances

A refund of the tax paid on ESS benefits may be claimed if:

- The share or rights is forfeited or lost, and
- The forfeiture or loss is not the result of:
    - a choice made by the employee other than a choice made to cease particular employment, or
    - a condition of the ESS that has the direct effect of protecting, (wholly or partly), the individual against a fall in the market value of the share or right.

Employer Report and PAYG Obligations

Employers are required to:

- report ESS benefits provided to employees, and
- remit to the ATO amounts equal to the PAYG tax applicable to ESS benefits if the employee fails to provide the employer with their tax file number (TFN) or their business ABN.

In most cases employees will provide their TFN's and therefore there will be no need to remit PAYG tax in relation to ESS benefits.

Aspects Where Change Possible

Two aspects of the ESS taxing provisions have been referred to the Board of Taxation for review and they are:

- how best to determine the market value of ESS benefits, and
- whether ESS benefits provided by start-up, R&D or speculative focused companies should have separate tax deferral arrangements, despite not being subject to a real risk of forfeiture.

The Board of Taxation is to submit its report by the end of February 2010.

Plan Types

The following table identifies the four categories into which ESSs may be classified having regard to their taxation consequences.

<table>
<tr><th colspan="2">Tax at Grant</th><th colspan="2">Tax Deferred</th></tr>
<tr><th>No Concession</th><th>Tax Exemption Concession
(on up to $1,000 of discount p. a.)</th><th>Vesting Grants</th><th>Salary Sacrifice Share Plan
(for up to $5,000 p. a.)</th></tr>
<tr><td rowspan="2">Plan does not qualify for tax deferral or tax exemption concessions.</td><td rowspan="2">The following conditions need to be satisfied for the tax exemption concession to apply:
The shares must be ordinary shares and rights must be to ordinary shares.
Both the ESS and any scheme for the provision of financial assistance must be operated on a non-discriminatory basis in relation to at least 75% of permanent employees of the employee’s employer who have completed at least three (3) years of service (whether continuous or non-continuous) and who are Australian residents.
There must be no risk of forfeiture of the:
shares,
rights, or
shares acquired by exercising rights.
Disposal of the shares or rights must be restricted for all participants in the ESS until the earlier of:
three (3) years after acquisition, and
termination of employment.
Access to the tax exemption concession is not available to employees who:
hold a beneficial interest in more than 5% of the shares in the company, or
may cast or control the casting of more than 5% of the maximum number of votes that may be cast at a general meeting of the company.
The tax exemption concession is also not available to employees who are simultaneously employed by a company that has the predominant business of acquiring, selling or holding shares, securities or other investments and another company that is a subsidiary or holding company of that company.</td><td colspan="2">The following conditions need to be satisfied for the tax deferral concession to apply:
The shares must be ordinary shares and rights must be to ordinary shares.
If shares are acquired then at least 75% of permanent employees of the employee’s employer who have completed at least three (3) years of service (whether continuous or non-continuous) and who are Australian residents, must be or have been entitled to acquire:
shares or rights under the ESS, or
company or parent company shares or rights under another ESS.
Access to the tax deferral concession is not available to employees who:
hold a beneficial interest in more than 5% of the shares in the company, or
may cast or control the casting of more than 5% of the maximum number of votes that may be cast at a general meeting of the company.
The tax deferral concession is also not available to employees who are simultaneously employed by a company that has the predominant business of acquiring, selling or holding shares, securities or other investments and another company that is a subsidiary or holding company of that company.</td></tr>
<tr><td>If a share is acquired then it must be subject to a real risk of forfeiture under the terms of the scheme
If a right is acquired then:
it must be subject to a real risk of forfeiture under the terms of the scheme, or
the share acquired by exercising the right must be subject to a real risk of forfeiture under the terms of the scheme.</td><td>This plan needs to be in relation to the shares (not rights) being acquired due to:
the employee agreeing to acquire shares in return for a reduction in salary or wages that would not have happened apart from the agreement, or
as part of a remuneration package, in circumstances where it is reasonable to conclude that the salary or wages would be greater if the shares were not provided as part of the package.
The discount must equal the market value of the shares.
The plan must not allow acquisition of securities to which the tax deferral provisions do not apply.
The rules governing the plan must state that the tax</td></tr>
</table>

Tax at Grant		Tax Deferred	
No Concession	**Tax Exemption Concession (on up to $1,000 of discount p. a.)**	**Vesting Grants**	**Salary Sacrifice Share Plan (for up to $5,000 p. a.)**
	The tax concession is not available if the shares or rights are acquired by a person who is not an employee.		deferral sections of the ESS provisions apply to the plan. • The total market value of securities to which the salary sacrifice provisions apply is limited to $5,000 per annum per employment relationship e.g. if two unrelated employers then can sacrifice two lots of up to $5,000 in one year.

Tax at Grant		Tax Deferred	
No Concession	**Tax Exemption Concession**	**Vesting Grants**	**Salary Sacrifice Share Plan (for up to $5,000 p. a.)**
Discount is assessable income in the year the shares or rights are acquired.	Discount is assessable except for the first $1,000 but only for employees with adjusted taxable incomes of no more than $180,000. Adjusted taxable income is the person's taxable income assuming the tax exemption concession will not apply plus reportable fringe benefits, plus reportable superannuation contributions plus the total net investment loss for the year.	Discount is taxed at the earlier of the following taxing points: • If a share then the earlier of when: o there is no real risk of forfeiture of the share, and o restrictions on disposal of the share no longer apply, or o employment ceasing, or o 7 years elapsing after the acquisition. • If a right then the earlier of: o if the right has not been exercised then when: ▪ there is no real risk of forfeiture of the right, and ▪ restrictions on disposal of the right no longer apply, or o employment ceasing, or o 7 years elapsing after acquisition, o otherwise (after right exercised) the earlier of when: ▪ no real risk of forfeiture of the right, and ▪ if there were restrictions on exercising the right then those restrictions have ceased, and ▪ no real risk of forfeiture of shares acquired by exercising rights, and ▪ no disposal restrictions in relation to shares acquired by exercising rights.	Discount is taxed at the earlier of the following taxing points: • cessation of employment, • end of 7 years after acquisition, • when disposal restrictions cease to apply to the shares.
If shares or rights are sold within 30 days of their original taxing point then the taxing point is moved to the date of the sale.			

OVERVIEW OF IMPLICATIONS OF THE NEW ESS TAXING PROVISIONS

The following table presents a range of types of ESS that have been used by Australian companies and comments on their future viability.

PLAN TYPE	COMMENTS
Non-executive Director Option Plan	▪ Those using a high exercise price premium (nil or low taxable value of option) may continue to be viable even without having a "real risk of forfeiture". Will need to monitor the Government's decisions in relation to the recommendations of the Board of Taxation in relation to determining the market value of shares and rights and any additional concessions for start-up, R&D or speculative focused companies. ▪ If the options have a real risk of forfeiture which may be a period of service then they would continue to be viable.
Non-executive Director Fee Sacrifice Share Acquisition Plan	▪ Up to $5,000 of fees may be sacrificed in relation to each NED role provided that the companies are not related. For NEDs who have multiple board roles this may be particularly attractive. ▪ If more than $5,000 is to be involved then there needs to be a real risk of forfeiture. If real risk is combined with up front acquisitions of shares to cover fee sacrifice over several years then this will be viable. ▪ If there is no real risk of forfeiture then this alternative will not be viable for amounts greater than $5,000 as the salary sacrifice segment of a tax deferred plans cannot accept more than $5,000 per year per participant. ▪ $1,000 tax exemption plans would generally not be viable as NEDs' adjusted taxable incomes would often exceed $180,000.
Executive Option Plan	Generally would only be viable if: • high exercise price premium (nil or minimal option taxable value at grant) is used , or • real risk of forfeiture is attached to the options.
Executive Rights Plan	Generally would be viable if real risk of forfeiture is attached to the rights.
Executive Share Plan	Generally would be viable if real risk of forfeiture is attached to the rights.
Share Purchase Loan Plan	Remains viable but boards often will not approve plans involving loans to executives.

Note: The proposed new termination benefit limits for executive and managerial officers combined with the taxing of ESS benefits on termination of employment remains a problem for share, right and option plans, making cash share plans an alternative that should be considered.

Godfrey Remuneration Group (GRG)

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