GRG Remuneration Insight 68

New Employee Share Scheme Taxing Provisions Released

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INTRODUCTION

On 14 January 2015 Treasury released for public comment drafts of proposed amendments and explanatory materials related to previously announced changes to the employee share scheme (ESS) taxing provisions. Submissions in relation to the proposed changes may be submitted until 6 February 2015. As the amendments are intended to come into effect on 1 July 2015 it may be anticipated that the amendments will be finalised and submitted to Parliament to be passed before the end of June 2015.

The amendments fall into two broad categories being:

- broad changes to the ESS taxing provisions, and
- new concessions restricted to participants in qualifying schemes operated by small startup companies.

Each of these is discussed in the following.

BROAD CHANGES

Maximum Tax Deferral Period

Under the current ESS taxing provisions tax deferral is available until the earlier of:

a) cessation of both any real risk of forfeiture and any dealing restrictions,

b) cessation of employment, and

c) 7 years after the date of grant of the ESS interests.

The 7 year period will be extended to 15 years.

Taxing Point for Rights

The Change

Rights which meet some basic tests will qualify for tax deferral if they are subject to:

a) a real risk of forfeiture (current position), and/or

b) disposal restrictions (new concession).

Noting that the taxing point may not be deferred beyond 15 years after the grant or termination of employment the deferred taxing point will be the earlier of:

1. when neither a real risk of forfeiture nor a disposal restriction applies to the right (i.e. before exercise), and

2. on exercise of the right if there is no real risk of forfeiture and no disposal restriction applicable to the share acquired when the right was exercised, and
3. if a real risk of forfeiture and/or disposal restriction applied to the share acquired by exercise of a right then when neither applies.

Comments

Long Term Incentive Plans

Most long term incentive plans do not allow disposal of rights prior to exercise and do not allow exercise until vesting conditions have been satisfied. For rights which may not be disposed of, the new provisions will allow tax deferral until exercise or later if the shares acquired by exercising the rights are subject to risk of forfeiture (unlikely as vesting conditions will have been satisfied) or the shares are subject to a dealing restriction.

STI Deferral

Deferral of part of short term incentive (STI) awards is a common practice with the deferred amount being delivered in a grant of rights which vest after an additional period of service. That executives have been exposed to possible forfeiture of the rights that have been earned via STI performance has not been well regarded by executives. However it was necessary to defer the taxing point. The proposed new ESS taxing provisions will allow rights to be offered without a real risk of forfeiture provided they are subject to disposal restrictions. Such a change will make STI deferral more acceptable to executives.

Salary and Fee Sacrifice

Salary and fee sacrifice arrangement using rights have virtually disappeared due to the current need for a real risk of forfeiture. Why would any executive or director choose to sacrifice salary or fees for a right that is subject to forfeiture? As indicated above the proposed new ESS taxing provisions will allow rights to be offered without a real risk of forfeiture provided they are subject to disposal restrictions. This change will make salary and fee sacrifice arrangements a viable alternative for executives and non-executive directors.

Options for Resources, Biotechnology etc. Companies

The proposed changes to the taxing of rights will mean that the problems associated with options and which led to many resources, biotechnology and other emerging ASX listed companies choosing not to use them have been addressed. Thus, options may be reconsidered by such companies as a remuneration tool for both executives and non-executive directors as a real risk of forfeiture will no longer be required to defer tax and the taxing point can be deferred until the options are exercised.

New Option Valuation Table in Regulations

Safe harbour schedules for valuing options for ESS taxing purposes are currently in the Regulations. New schedules are to replace the current schedules and will apply to ESS interests acquired from 1 July 2015 onwards. The new schedules will produce generally lower taxable values for options although there are some minor exceptions for options with short lives (<9 months).

Also the Australian Taxation Office will work with industry to develop other safe harbour valuation methodologies that will be added to the Regulations.

Due to the other changes to the taxing point for rights these safe harbour valuation schedules will generally only be relevant for rights with neither dealing restrictions nor real risks of forfeiture.

Tax Refunds for Forfeited ESS Interests

New provisions will be introduced to allow amendment of prior tax returns to exclude previously taxed ESS benefits when the ESS interests were subsequently forfeited. There will be no time limit on such amendments. However, certain conditions will need to be satisfied. These conditions are that:

- the employee had no choice but to forfeit the ESS interest – an exception applies if the choice related to ceasing employment, and
- the conditions of the ESS were not constructed to protect the employee from market risk.

Increase of 5% Ownership Limit to Access ESS Taxing Provisions

If employees own or control more than 5% of issued shares or voting rights they have been precluded from access to the ESS tax deferral and other concession. This limit is to be increased to 10%.

SMALL STARTUP COMPANY ESS TAX CONCESSION

Limited Applicability

Small Startup Companies

This concession only applies to small startup companies which will be defined as companies that:

- are Australian residents,
- are unlisted,
- have been incorporated for less than 10 years, and
- have annual turnover of not more than $50 million per annum.

Offer Conditions

In the case of offers of:

- shares the discount must be less than 15%, and
- for rights/options the exercise price must be not less than the market value of a share at the time of the ESS interest is acquired.

The ESS interest must be held for 3 years or until earlier cessation of employment.

The Concession

Any ESS discount is not assessable income.

Shares are deemed to be acquired at market value (discount is tax exempt), no tax is payable until the shares are sold and the tax is calculated under the capital gains tax provisions (50% tax free concession may apply).

Shares acquired from exercising rights are deemed to be acquired for the amounts paid to acquire the rights and exercise them. No tax is payable until the shares are sold and the tax is calculated under the capital gains tax provisions (50% tax free concession may apply). Any discount is taxed as a capital gain.