



THOMSON REUTERS

## WEEKLY TAX BULLETIN

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**Employee equity arrangements and limited options - get with the times**

**- by Gary Fitton, Director, Remuneration Strategies Group**

The allocation of company equity has become a common, accepted and, indeed an essential practice for mining companies, especially in their initial start-up phases. Company equity has become an essential means of attracting, retaining and motivating key employees, directors and others closely involved with developing the mining company beyond the initial capital raising and exploration stages to fully operative mining operations. These fully operative mining operations then become capable of exporting vast quantities of minerals to the major markets to the north of Australia.

Company equity schemes, usually involving options with a share value growth focus (ie with a strike or exercise price at or around the prevailing share market price), have the multiple and compatible aims of retaining key staff, integrating the corporate and individual performance focus *and* not imposing an immediate cash outflow from the company. For a capital starved mining company, in its initial exploration stages, sometimes staggering from one capital raising to the next, retention of cash resources for capital investment purposes is of particular importance, prior to the self-sustaining achievement of share market recognition and successful export trading results.

In short, the compression of cash-based fixed remuneration in exchange for the delivery of company equity and the concomitant share in the future success of the company is critical to the inception, conception and survival of Australian mining companies.

#### **Factual background**

The application of the provisions of the former Div 13A of the ITAA 1936 and, from 1 July 2009, the supervening provisions of Div 83A of the ITAA 1997, in situations where the deferral and/or exemption provisions do *not* apply, tax the recipient or an associate upfront on any *discounts* on the value of shares and/or rights to shares (ie options) they acquire in respect of employment and/or services provided to the sponsoring company.

Unfortunately, some directors and corporate officers on the receiving end of substantial option allocations, and the companies issuing the options, may not have been aware of the immediate income tax consequences of accepting offers of such allocations. Not all directors and officers of the company acquiring options under traditional arrangements were able to access the tax deferral provisions of Div 13A. If anything, this situation has deteriorated for employees, directors and officers of the company under the tax deferral provisions of Div 83A.

### **Recent AAT case**

Such was the case in a recent AAT decision - *AAT Case [2010] AATA 420, Re Willis and FCT*, reported at 2010 WTB 26 [1014] - concerning the director and chairman ("the taxpayer") of Mt Gibson Iron Ltd (Mt Gibson). The taxpayer was provided with one million options to acquire shares in Mt Gibson, under the Mt Gibson Iron Limited Directors, Officers, Employees, and Other Permitted Persons Option Plan, for no consideration, with an exercise price of 25 cents per option, to be exercised on or before 31 December 2006 (ie a minimum holding period of 2 years and 7 months).

The consequence of the acceptance of the offer of equity was that the taxpayer was assessed upfront on an amount of \$427,000, being the taxable discount arising from the *acquisition* of the options by an associate of the taxpayer. This equates to a taxable discount of 42.7 cents per option which, on my calculations, is based on a prevailing market share price of 76.47 cents.

### **Issue considered**

The sole issue to be considered in the case was the determination of the date that the options were acquired by the taxpayer, for the purpose of determining the discount taxable to the employee under s 139B of the ITAA 1997. The discount is determined by reference to the market value of the share, being the subject of the option under the provisions of ss 139FJ to 139FN. Those sections are based on a Black Scholes Merton methodology (minus a volatility factor).

### **Contentions**

The taxpayer contended that the date of acquisition was 3 May 2004, the date of the General Meeting in which Shareholder approval was granted to the allocation of the options. The Australian Stock Exchange (ASX) closing price as at 3 May 2004 was 17 cents.

If the options were acquired for taxation purposes by the taxpayer as at 3 May 2004, the taxable value of the options would have been nil.

The Commissioner disagreed with the taxpayer's contention and determined in an amended assessment that the date of acquisition was 8 April 2005.

The date of acquisition for the purposes of Div 13A was highly significant given that the price of Mt Gibson shares (and the taxable discount) had increased significantly over that 11-month period (ie from 17 cents to 77 cents - see below).

### ***Allocation of options***

On 15 April 2005, the taxpayer was provided with an Issuer Sponsored Holding Statement which showed the date of allotment as 8 April 2005. The ASX was advised of the issue of the options and informed that the date of issue was 8 April 2005. The ASX closing share price of Mt Gibson shares on 8 April 2005 was 77 cents.

The registered owner of the options was shown as W Willis and R Willis as the trustees of the Willis Superannuation Fund - which is an "associate" of the taxpayer.

Under s 139D of the ITAA 1936, the taxable discount is deemed to be included in the assessable income of the taxpayer ie *not* the associated superannuation fund.

### ***Section 139G of the ITAA 1936***

Under the then governing provisions of s 139G, "a person acquires a share or a right [eg an option to a share], if...another person creates the right in that person..." and "...the other person [Mt Gibson] provides the share or right".

The critical date to be determined is when in fact that option, as a contractual right to acquire shares of Mt Gibson, was acquired by the taxpayer. Under the elements of common contract law, a contractual right is created when a person being the offerer (ie Mt Gibson) makes an offer of options and the person to whom the offer is made, being the offeree, accepts the offer. The offeree provides the consideration by way of the acceptance of the contingent obligation to meet the exercise price and acquire the shares, if and when the options are exercised.

This is a classic unilateral contractual arrangement, under which the contractual right is created in the recipient taxpayer by the provider (being Mt Gibson).

### ***The AAT decision***

AAT Senior Member Pascoe ruled (at para 9) that,

"While the Act does not define a time of acquisition...the resolution of 3 May 2004 did nothing more than approve in advance the allotment by the Board of 1,000,000 options pursuant to the Option Plan [to the taxpayer or his nominee]."

In this case, the "nominee" was the taxpayer's superannuation fund. However, under s 139D(1), the taxpayer is deemed to have the discount amount included in his or her assessable income - *not* the associate (ie being the superannuation fund).

### ***Comment***

One can only but agree with the logic and correctness of the decision made by Mr Pascoe in this case.

However, one must question the efficacy of the design and delivery of an equity arrangement, which subjects directors, officers, employees and "other permitted persons" to upfront taxation consequences, upon the acquisition of the equity.

As mentioned earlier, the effective provision of equity to mining companies' key labour inputs is vital to the ongoing success of these companies and their role in maintaining a strong export-driven Australian economy.

An optimal employee equity design would not subject the participants to tax upfront and not provide the participants the means with which to pay the tax.

Timing of the taxation event is all important for the participants taking up the equity and the company issuing the equity. Those equity benefits should only be taxed when the equity benefits are realised, which is at the time of the sale of the equity, when participants are in a position to pay the tax on those benefits.

There are employee equity plans which continue to deliver these optimal equity benefits, even in the current Div 83A ITAA 1997 taxation environment.

Mining companies, and all companies for that matter, need to review their current employee equity arrangements, in the light of alternative equity delivery arrangements which are readily available in the market place.

Many longstanding, traditional equity arrangements, especially option-based arrangements, simply do not work anymore. But there are option plan arrangements which do work and continue to work very well.

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